AFME Chairman’s Foreword

The financial crisis of 2008 led global leaders and regulators to focus more than ever before on the need to manage systemic risk in the financial system. The fact that the system was carrying levels of risk that threatened its survival and could not be managed without government assistance came as a shock to many. The realisation led to state interventions on an unprecedented scale. While few would still argue against the decisions to invest substantial public funds in supporting the system through the crisis, it is clear that neither our politicians nor those they represent will accept a reoccurrence. Lessons have been learned from the crisis. Now it is time to look forward, to ensure that taxpayers need never again be called upon to bail out failed financial institutions on that scale.

This leads us to consider how to manage and regulate systemic risk, by which we mean the situation in which levels of risk being carried within the financial system and the inter-connectedness of the institutions themselves mean that the failure of one firm could endanger not only other firms but also the functioning of the entire system. As an organisation that brings together the majority of the pan-European banks, AFME believes this is essential for the protection of the wider economies that the financial system supports. Banks must be free to provide the essential services that their customers require; the challenge is to do so in a way that does not introduce excessive risk.

It is not desirable (or possible) to remove risk from the financial system completely. Even in the most tightly regulated environment firms will – and must be allowed to – fail. The optimal way forward is to develop sensible reforms that reduce systemic risk and the need for government intervention when failures occur. Such reforms would encompass: sound governance and risk management practices in financial firms; robust capital and liquidity regimes that reduce the risk of failure; effective supervision designed to identify risks early and avert institutional and systemic risk; market practices that prevent risks from building up unseen; and appropriate resolution regimes that reduce the impact of any failures.

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The scope of our report

In this document we set out ideas about how such a governance and regulatory regime might operate. We examine the criteria that help identify whether an individual firm or group of firms pose systemic risk and consider whether they should be regulated in a fundamentally different way. We consider the balance between “static” regulation, such as capital requirements, capital surcharges and levies, and “dynamic” regulation, such as supervision. In this context, we set out the good practices that we believe would represent an enhanced form of supervision that reduces the need for capital-based controls. We address the challenge of providing market participants with an appropriate level of certainty and transparency while ensuring that markets can serve their purpose and remain open to innovation. We also consider the factors that constitute good risk management and corporate governance in firms.

Whilst observing that failures will occur in a functioning economy, we put forward ideas for minimising the damage they cause, through effective resolution mechanisms, and detail some of the steps that can be taken, on a contingent basis, to provide the best chance for subsequent recovery. Our recent discussion paper on bail-in and contingent capital set out much of our thinking on this topic and is included as an annex to this report. These ideas have attracted interest from legislators and we believe, though not without debate, have the potential to meet many of their objectives in a way that does not require the levels of capital provision that have been put forward as the basis of other possible strategies for reducing risk in the financial system. We hope that both the industry and legislators will work together on developing them further.

We should acknowledge that the regulatory authorities have already initiated a great deal of reform, at both national and European level. Indeed, the overall structure of the European regulatory system is undergoing radical change. Some of the most significant initiatives in each field are listed at the end of each chapter, together with references to other useful sources of information or analysis.

Although the objective of reforming the regulatory framework enjoys our broad support, we have not set out to provide detailed analysis or comment upon every regulatory proposal currently under consideration. In some instances, future regulation is being developed on an incremental basis with snippets of information made available as the authorities reach decisions. This piecemeal approach makes it more difficult for the industry to respond and would render any detailed discussion in this report quickly out of date. We have instead endeavoured to focus on broad regulatory themes and to advance a considered industry view on the form an effective regulatory framework might take.

Since our focus is on the reduction both of systemic risk and the need for government interventions, we do not deal with current proposals to tax the financial sector. Some governments are currently intending to use the funds raised by these taxes to meet other spending commitments. Whether windfall taxes are economically desirable at this juncture is a separate issue, but they would not help reduce systemic risk, nor would the proceeds be available to support the financial sector.

Other proposals that would dedicate the proceeds to fund future interventions might reduce the chance that a government will need to resort to the taxpayer, but not the likelihood that an intervention would be necessary. Indeed, the existence of such a fund could create the climate of moral hazard that we are seeking to eliminate.

In short, tax is a blunt policy tool with the potential to create more problems than it solves. A better way to manage systemic risk is through precise prudential regulation combined with credible and integrated resolution regimes to manage failure.

Remuneration is also not discussed in significant detail. This is not because remuneration has no role to play in the reduction of systemic risk. Indeed the opposite is true. AFME members have acknowledged that remuneration incentives were not properly aligned with risk management and have worked toward new remuneration structures that complement the control and risk management functions. The G-20 has endorsed the Financial Stability
Board (FSB) Principles and related Implementation Standards, which strike an optimal balance between flexibility, to allow a competitive labour market to operate, and prescription, setting parameters that link remuneration to long-term performance. AFME members have already implemented – and frequently exceeded – the core provisions. In our view, little policy formulation remains to be done. Indeed, much harm could result from uneven global implementation of the FSB Principles and we urge regulators to turn instead to detailed implementation by prudential regulators in close dialogue with individual firms.

How the report was produced
As the only body representing the interests of both European banks and global banks with operations in Europe, AFME has been uniquely able to draw upon the considerable expertise found within its member firms to address systemic risk in a way that embraces and benefits from the diversity of business models, cultures and experiences in its membership.

At the instigation of the AFME Board, which is made up of senior figures from the major firms operating in Europe, a series of working groups was formed, bringing together high-level experts from member firms and other professional advisers where required. These groups were augmented by many members of standing AFME committees, as well as AFME’s own experts, to identify and consider the various elements that can introduce systemic risk.

We also consulted other industry bodies, regulators and experts, as the work evolved. Thus, we feel that this paper may represent the most wide-ranging and cohesive assessment yet from the financial sector itself of how to minimise systemic risk in the European, and perhaps global, financial system. I would like to thank all those who contributed to this work for their commitment and expertise.

Obstacles to revitalising the financial sector
Mitigating systemic risk is, of course, not the only challenge facing the industry and legislators as they try to further economic recovery. Some sectors of the wholesale markets - securitisation, for example - continue to struggle and need constructive regulatory initiatives to revive them. There are improvements to be made to market infrastructures to bring about the right levels of transparency and operational efficiency. Even based on the most conservative current projections, it is clear that large capital injections will be needed to meet impending regulatory requirements and that relationships with the Asian capital markets will become even more important in the absence of significant new capital flows from the Western economies.

However, these problems are not insurmountable and with an effective overarching governance and regulatory regime in place the outcome will be a more stable and resilient financial system that will benefit us all. This is the goal of politicians and regulators worldwide and one that is shared by AFME and its members. We see our role as supporting the relevant authorities – whether central banks, legislators or regulators – in developing a sustainable financial system, by offering our members’ insights to augment their own analysis and expertise.

I stress that in this document we do not claim to have identified the solution to every problem. On some topics there are several options that could be considered and I anticipate constructive discussion between the industry, legislators, regulators and other interested parties. AFME will be holding a conference in Brussels later in the year to provide a forum for this dialogue. I hope that our contribution will play a useful role in the ongoing debate about the future of our industry and look forward to discussing these issues with all stakeholders in the coming months.

Gaël de Boissard
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