1 Executive summary

1.1 AFME referred to regulatory approaches and tools in its response – through its affiliate organisation the GFMA – to the Basel consultations of last December. In this paper AFME sets out good practices for the “enhanced supervision” of financial institutions. The objective of this approach is to mitigate systemic risk by improving the regulators’ ability to identify threats at an early stage and address them before wider intervention is necessary.

1.2 Whilst an important principle that needs to be preserved is that firms govern and take responsibility for themselves, it is accepted that supervisory activity over firms’ behaviour and resources has to improve and become more effective. To some extent enhanced supervision represents the formalisation and consolidation of supervisory practices that have evolved over time and have been given impetus by the recent crisis.

1.3 AFME believes that an approach focusing on enhanced supervision should better secure the objective of maintaining financial stability than imposing standard surcharges on firms deemed to pose a systemic risk by reason, for example, of their size. Enhanced supervision, rather than surcharges applied across a given class of firms, better ensures that the right amount of capital is held in the right places in the financial system as a whole. The blanket application of capital, over and over the contemplated Basel 3 standards (that are to be applied generally across all banks) merely provides false comfort – because it is insensitive to changes in risk brought about by market developments – and systemic risk may be better addressed through enhanced supervision building on the current Pillar 2 regime.
1.4 In this document, we expand upon what constitutes an enhanced supervisory approach. In summary it must:

- be capable of making the link between the activities and risks of the individual firm and the risks to the wider financial system;
- be grounded in a deep understanding of supervised firms’ business models, and the risks inherent therein;
- be sufficiently flexible and risk-based, to ensure that capital and supervisory resources are targeted appropriately;
- be sufficiently responsive, continuous and consistently applied so that emerging risks are identified and tackled at an early stage;
- ensure that supervisors have the appropriate powers and resources; and
- include appropriate safeguards on supervisory action.

1.5 We also suggest that enhanced supervision is best judged by reference to five targeted outcomes:

- supervisory expectations are transparent and benchmarked to reflect a firm’s peers and the markets in which it operates;
- assessment of governance and culture forms an integral part of the risk profile of any firm;
- clear linkage is demonstrated between qualitative and quantitative approaches to supervision;
- timely and targeted supervisory interventions avoid a “one size fits all” approach; and
- market confidence increases as a consequence of enhanced supervisory oversight.

1.6 For enhanced supervision to be successful it must be underpinned by a culture of challenge and cooperation on both sides of the regulatory fences: firms must be willing to work with their supervisors at both the solo and consolidated level in a transparent and open fashion; supervisors must be ready to challenge and proactively influence outcomes.
2 Introduction

2.1 The need for better and more effective oversight and supervision is being addressed by the G-20 – the Toronto Communiqué highlighted that new and stronger rules need to be complemented with more effective supervision and oversight. The G20 has asked the Financial Stability Board (FSB), in consultation with the International Monetary Fund (IMF), to develop recommendations to strengthen oversight and supervision, specifically relating to: (i) the mandate, capacity and resourcing of supervisors and (ii) specific powers, including early intervention, which should be applied proactively to identify and address risks.

2.2 The objective of addressing systemic risks in order to minimize the likelihood of serious threats to the system is best achieved through supervisors enhancing their supervisory relationships with firms such that risks are clearly understood and emerging risks identified. Working with firms on identification, understanding and management of risk should be the main supervisory tool through which systemic risk is managed.

2.3 This enhanced supervision must be grounded in a deep understanding of supervised firms’ business models, and the risks inherent therein; it must be flexible and risk-based, to ensure that supervisory resource and action is targeted appropriately; it must be sufficiently responsive, continuous and consistently applied so that emerging risks are identified and tackled at an early stage; and it must be capable of integrating micro- and macro-prudential supervision, to make the link between the activities and risks of the individual firm and the risks to the wider financial system.

2.4 The recent crisis has already brought about considerable changes to supervisory practice, including more intensive supervision in many countries, especially of firms with greater systemic importance. There has also been a significant and targeted increase in the level of capital and liquid funds held by firms, coupled with better risk management and contingency planning (including work on the introduction of formal recovery and resolution plans).

2.5 In expectation of an upcoming Basel consultation on SIFI AFME has been exploring the case for imposing capital surcharges on firms considered to pose a systemic risk. The argument against surcharges is that they are less able to be adapted to emerging risks and do not help to ensure that the right amount of capital is held in the right places in the financial system. Moreover, before any further quantitative measures are imposed due consideration needs to be given to the changes being introduced via Basel 3 reforms and the calibration of the package.

2.6 We believe that the combination of better risk management and contingency planning in firms and enhanced supervision as we explain would mitigate the risk of future crises much more effectively and proactively than the blanket application of capital above revised Basel standards.
3 Targeted outcomes

3.1 The effectiveness of enhanced supervision will be measured by reference to five targeted outcomes:

*Supervisory expectations are transparent and benchmarked to reflect a firm’s peers and the markets in which it operates.*

3.2 In addition to having a solid understanding of individual firms’ business models and risk profiles, supervisors must be able to benchmark and compare the structure, operations and performance of firms across the industry. Outliers may indicate a need for closer scrutiny. To make appropriate comparisons, supervisors should consider:

- overall business models including sales and distribution arrangements; operating environments and financial structures;
- operating performance, including the use of market intelligence, matched to regulatory returns to identify emerging risks;
- business and risk management practices and the manner in which firms assess the new or specific risks being taken on; and
- the overall governance structure and its effective operation.

*Assessment of governance and culture forms an integral part of establishing the risk profile of any firm*

3.3 Sound governance is a cornerstone of regulation and enhanced supervision should be based on an understanding of the culture and behaviours of firms as a consequence of senior management actions and the role of boards and committees with oversight responsibilities. The quality of governance and the culture which it engenders should be reflected in all of a firm’s activities, from dealing with individual customers to strategic decisions on risk allocation.

*Clear linkage is demonstrated between qualitative and quantitative approaches to supervision*

3.4 If regulators are aiming to cover a broader spectrum of elements relating to any individual firm, they will need to adopt a wider range of approaches that combines quantitative and qualitative tools and does not place undue reliance on either. For example, the recent crisis has highlighted the dangers of focusing on quantitative data rather than qualitative factors (or indeed, the dangers of inadequate quantitative reporting combined with gaps in qualitative analysis of factors) such as whether a firm’s executive management teams and board are made up by individuals that can challenge business decisions, or whether the firm is operating within its stated business goals and strategy, and whether that strategy is sustainable.

3.5 This will require a more continuous dialogue between the firm and its supervisors, with less reliance on ‘big bang’ reviews occurring say once every two years (although, depending on a firm’s business these also have their role). The internal processes within the regulator should be transparent and flexible enough to accommodate that breadth of dialogue.
Timely and targeted supervisory interventions avoid a ‘one size fits all’ approach

3.6 A broader analytical framework and dialogue should identify areas of concern at an earlier stage and allow for the development of a tiered approach to intervention (if that is necessary). For example, indications of a firm starting to stray outside its agreed risk parameters would lead to a different intervention than would be the case where there had been dramatic impairments and sharply reduced capital ratios. One might be a precursor to the other and could be a situation where early intervention might avoid far reaching and costly measures at a later date.

Market confidence increases as a consequence of enhanced supervisory oversight.

3.7 Collectively, these outcomes should result in confidence in the prudential soundness of the firm. In turn, it should promote mutual trust, prevent arbitrary regulatory actions and counter the assumption that should be surcharges applied across a given class of firms, above the revised general Basel standards, is the only (or even a superior) supervisory response to a risk emerging within a firm.

4 Enhanced supervision: good practices

Culture of cooperation and challenge

4.1 Underpinning enhanced supervision is a culture of challenge and cooperation. Firms must be willing to work with their supervisors at both the solo and consolidated level in a transparent and open fashion. Firms need also to welcome a more rigorous assessment of their business model, their business strategy and senior management.

4.2 On the supervisory side, there must be a cultural disposition for challenge and for proactively influencing outcomes, rather than merely reacting to events. However, this challenge must stop short of the supervisor acting as a shadow director. [Also see Section 4g on Safeguards on Supervision].

Key features

4.3 Whilst an important principle that needs to be preserved is that firms govern and take responsibility for themselves, the extent of targeted supervisory activity over firms’ behaviour and resources has to improve. We are proposing a holistic approach to supervision and it must:

• Integrate macro and micro supervision, engaging firms in a dialogue on their own risks as well as their views on risks in the market;
• Build on existing qualitative and quantitative tools and practices and allow for flexibility so that supervision evolves in response to emerging trends and risks;
• Identify how the style of supervision may need to change to ensure that it is sufficiently responsive;
• Promote consistency in supervision across and within jurisdictions by encouraging collaboration among supervisory authorities to eliminate duplication or gaps in supervisory coverage;
• Recognise the implications in terms of supervisory resources and mandate; and
• Ensure that safeguards are in place to avoid inefficiencies associated with poorly targeted supervisory requests, over-familiarity of supervisors with the firms they oversee leading to inadequate challenge and disproportionate supervisory actions.

a  Integrated Macro and Micro Supervision

4.4 During the recent financial crisis, there was insufficient focus on the overall risks which had built up in the financial sector. Instead, supervision was aimed at individual institutions without due regard to the state of the underlying economies together with the connections between financial institutions and with other elements of the financial system. It is essential to have a macro-supervisory framework which (a) will identify exuberance in financial markets (for example, the creation of asset price bubbles) and (b) has mechanisms to enable the supervisor to dampen that exuberance where it will create a risk to financial stability. That may mean the introduction of industry-wide measures to curtail the supply of credit, for example, through higher capital ratios, or measures focused on credit provided to particular sectors of the economy that take into account the business models of individual firms.

4.5 A properly functioning macro-prudential framework would:

• Enable supervisors both to raise - and, indeed, also lower - the aggregate amount of capital within the financial system to reflect the overall levels of risk, with that broad industry guidance being translated into recommendations for individual firms, implemented by the day-to-day supervisory team.
• Engage firms in a dialogue with their supervisors on their own risks as well as their view on risks in the market.

b  Building on the continued evolution of supervisory practices

4.6 To some extent, enhanced supervision represents the formalisation and consolidation of good supervisory practices that have evolved over time and been given impetus by the recent crisis.

4.7 In the context of the Basel II framework/CRD these practices reflect what is known as Pillar 2 (in its broadest sense). Pillar 2 concerns the dialogue between the supervisor and the firm on the firm’s risks (including risks, such as reputational risk or strategic risk, that are not easily quantifiable and where a more qualitative approach is needed), and the amount of capital the firm needs to support its economic activities on a forward looking basis. It requires that both firms and supervisors assess a firm’s capital needs taking into account (i) the firm’s ability to identify, control and monitor its risks and (ii) its capital plan, given its business strategy.

4.8 Pillar 2 has always required that supervisors and firms continue to develop the tools and processes used to engage in this dialogue. However, since the crisis, many supervisors have markedly changed their broad approach to this dialogue and to supervision. Supervisors that had previously adopted a narrow approach or had sought a ‘light touch regime’ have boosted their resources to allow them to be more proactive.
4.9 As a consequence, there is greater scrutiny and challenge of firms’ business models, aimed at understanding the key drivers of risk and the sustainability of businesses. This enhanced approach to supervision is also backed up by greater willingness to use corrective action.

4.10 In the Pillar 2 context this has translated into an increased use of more robust stress tests, an increased focus on risks such as funding and liquidity risks (which previously had a lower profile), greater scrutiny of corporate and risk governance, and greater attention paid to colleges of supervisors (now specifically mandated by CRD2 for example). Pillar 2 always provided supervisors with scope to apply a form of capital surcharge to individual firms. We expect to see supervisors setting firm specific capital ratios based on an assessment of all risks, including those which are not easily quantifiable.

4.11 The elements that make up enhanced supervision should not be rigidly defined. Enhanced supervision should be characterised by guiding principles and based on a methodology that supports a structured approach to supervision but allows for some flexibility in order to capture the different circumstances of different firms. It should be used as a tool to: (i) build up a robust relationship between supervisors and institutions; and (ii) support supervisory action at a sufficiently early stage to avoid, for example, capital falling below minimum requirements.

4.12 AFME supports the continued development in supervisory practices, with Pillar 2 continuing to be the building block for the further evolution of supervisory processes and tools. The on-going dialogue between the firm and its supervisor should be structured and encompass both a qualitative and quantitative discussion of a firm’s risks and risk management processes, based on the firm’s own assessment and the supervisors’ analysis and challenge of this assessment.

c Style of supervision: consistency in practice

4.13 To a large extent, supervisors assess similar sets of risks using tools that are largely common to all. Variations in the different outcomes for firms arguably arise over the different styles of supervision - driven by both the ‘supervisory philosophy’ of the supervisor (e.g. ‘top down’ or ‘bottom up’ approach, level of intrusiveness and culture) and the supervisor’s internal framework for assessing risks (e.g. resource allocation, programme of work and depth of the analysis which inform decisions). Each style of supervision has its benefits and costs, but while there is no one ‘ideal model’, a particular question is the degree to which supervisors undertake their work at a firm’s premises.

4.14 Generally supervisors will undertake a combination of offsite and onsite reviews although the balance varies. At one end of the spectrum, historically the Spanish regulator, for example, maintains a permanent onsite presence (in common with the Fed/OCC) for its larger firms; while, at the other end of the spectrum some supervisors carry out mostly desk-based reviews and ‘outsource’ onsite work to third parties such as audit firms.

4.15 Most supervisors will not be based continuously onsite, but will put in place a programme of visits (in the form of inspections /audits /reviews /meetings) over a specific period of time. For example, the UK FSA uses its existing supervisory knowledge of larger firms gained through its ‘close and continuous’ programme, supplemented by additional specific information requests, to determine the scope of its periodic onsite ARROW
risk assessment work. This in turn will inform the ‘Risk Mitigation Programme’ which is likely to include a number of more detailed visits on particular themes ranging from a few days to weeks onsite. In other jurisdictions, such as France, supervisory programmes take the form a series of diarised onsite inspections that may last weeks or months, depending on the nature of the inspection. In Germany, detailed audits are performed onsite over extended periods of time. Many home regulators will also carry out visits to operations outside the home state. In doing so, coordination with the host regulator is essential to avoid duplication and an undue burden on the firm.

4.16 Offsite reviews involve analysis of regulatory returns, management information and additional information (such as policies and procedures) and/or numerical data provided by the firm. Often a desk-based review is used to determine the extent of follow-up and to prepare for onsite work, and can be used to inform a longer-term programme to be carried out over a set period of time. Onsite work can comprise testing of systems and procedures, interviews, etc., as well as more detailed review of files and records.

4.17 Theoretically, a third party review can be equally effective as one undertaken by the firm’s supervisor and holds the promise, for the supervisor, of being a less resource-intensive approach. Its drawbacks, however, are notable. It lacks the benefits associated with a continuing dialogue between a firm and its supervisor. Furthermore, the ability of the supervisor to put findings in context can be compromised.

4.18 Both offsite and onsite reviews are resource-intensive for the supervisors and the firm. However, they can be mutually beneficial if the purpose of the review is clearly understood in advance and information requests are focused and targeted. It is also important to recognise that an approach driven first and foremost by documentation can lead to long delays in decisions. In all cases the timeliness of the feedback and communication of required actions is very important to ensure their effectiveness.

4.19 Finally, it would be overly simplistic to compare the supervisory resources allocated to comparable groups in terms of the number of staff as this would suggest that a direct relationship exists between that and the effectiveness of the supervision. There must be an appropriate blend of technical expertise in relevant risk management disciplines, understanding of the firm’s business model and the markets it operates in and an ability to understand its risk profile. This is a particular challenge where the group has significant operations in jurisdictions where the markets are inherently more complex than its home market. Supervisors should be open in sharing both technical expertise and their knowledge of local markets.

4.20 Enhanced supervision implies a style of supervision that may increasingly feature a propensity for more onsite visits; or, at the very least, improved and ongoing, rather than episodic, dialogue between firms and supervisors. While this approach presents costs, if properly managed it can yield benefits for the firm and its supervisor when supported by the timely analysis of firms’ management information and reports.
d  **Style of supervision: consistency across jurisdictions**

4.21 More recently, governments have paid more attention to regulatory structures. For example, US and UK moves towards a “twin peaks” structure, under which prudential regulation and consumer protection are separated, are partly designed to facilitate greater focus on prudential matters. In the EU, the upgrading of the Lamfalussy Level 3 supervisory committees into authorities, with greater oversight and rule making powers from early 2011, offers the opportunity for a more streamlined and coordinated approach.

4.22 Nevertheless, as indicated under section 4a above, Pillar 2 is at the heart of enhanced supervision no matter the structure. Pillar 2 should not seek to categorise institutions according to systemic importance but it should provide the tools that help to ensure that additional capital is allocated where it is needed (for example, where concentration risk is greater).

4.23 The effective implementation of Pillar 2, in the context of cross border firms, needs to be complemented by the development of guidelines for strengthening cooperation between home and host supervisors. We recognise and support efforts by regulators to promote a framework for supervisory colleges that will help to ensure consistent understanding of a firm’s risk profile across international borders.⁹

4.24 Effective collaboration between supervisors relies on the minimisation of duplication but can cover issues areas such as risk assessment, stress testing and model validation.

4.25 In sum, enhanced supervision should help to ensure that variations in the application of Pillar 2 across jurisdictions are reduced.

e  **Management of the supervisory relationship**

4.26 Enhanced supervision requires the oversight and engagement of senior supervisors and firms’ senior management and must be supported by an established governance process.

4.27 The firm’s governance should identify the main point of contact for the local regulator, lead regulator or college. In addition to addressing how the firm should interact with regulators and supervisory colleges, it should also include processes for managing and communicating information relating to supervisory visits and reviews.

4.28 Regulatory governance should identify key supervisory staff responsible for supervising the firm and include a programme of planned reviews/inspections. The supervisor should also provide feedback to the firm from senior supervisory staff and the firm’s college of supervisors.

f  **Supervisory requirements**

4.29 Enhanced supervision requires that supervisors be provided with a mandate to act and have the skills and resources to undertake this form of supervision.

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⁹ We note that in the Basel Committee’s July 2009 paper **Enhancements to the Basel 2 Framework**, it is stated that “Colleges should not be seen as a substitute for effective national supervision nor undermine the legal and prudential responsibilities of respective supervisors. Colleges are not intended to be decision-making bodies but should provide a framework to enhance effective supervision of international banking groups on a consolidated and solo basis, and could inform decision-making in that regard.”
Supervisory mandate

4.30 Supervisors must be able to intervene, so consideration must be given to the powers that they need and how they should be allocated across supervisory teams and senior supervisory staff.

Supervisory resources

4.31 An effective dialogue with firms requires experienced senior and middle level supervisory staff. Supervisors must:

i. have specialists teams with detailed technical knowledge of risk management practices and processes;
ii. be familiar with high risk strategies;
iii. have an understanding of innovative products and their real risks and benefits; and
iv. have the confidence to challenge conventional wisdom and the ability to engage in contrarian thinking.

4.32 Supervisory teams possessing this mix of skills and aptitudes are difficult to build and retain, but this challenge must be met if the objective of maintaining financial stability is to be achieved.

4.33 One way to train supervisory staff, is via secondments (supervisors to banks) although retention can be an issue. Another way, is for regulators to employ – as some already do - established industry figures who want to undertake a public service role passing on their knowledge and insights. These figures could be used as advisors and/or be integrated, to varying degrees, in supervisory teams where they can more effectively challenge senior industry figures than less experienced supervisory staff might feel confident doing.

g Safeguards on Supervision

4.34 Enhanced supervision should also include safeguards to avoid diminishing returns associated with poorly targeted supervisory requests, unjustified supervisory action or, equally problematic, supervisory inaction.

Managing diminishing returns

4.35 The enhanced supervision approach has to consider the diminishing returns afforded to supervisors and increasing costs for firms providing real time and granular data to supervisors if the purpose is not well [directed]. Obtaining data for its own sake (without the tools to interrogate or analyse it properly) can lead to poor decision-making, cause inefficiencies and be distracting both on a micro and macro-level. Also, unless supervisors are cognisant of the differences between firms, moving away from firms’ own estimates to the increased reliance on supervisory calculations / models / stress tests will not yield the benefits envisaged.

Supervisors getting too close to the firms they regulate (i.e. ‘going native’)

4.36 The risk of the supervisor/firm relationship becoming to close has always existed. Arguably, with enhanced supervision there is an increased probability that the supervisor may be unable to dissociate its view of risks being undertaken by the firm from that of the firm’s management. This could, in turn, lead to a lack of rigorous challenge and inadequate or inappropriate supervisory responses.
Factors which might influence the nature of the relationship include cultural or political issues as well as low turnover in the make-up of the supervision team and firms’ management.

The terms of engagement between firms and supervisors must address the problem of supervisors becoming too close to the firms they supervise. While this suggests putting in place limits on the time individual supervisors are assigned to any individual firm (something which is in place in some countries), this should be balanced with the need to maintain continuity within the supervision team by staggering turnover. This will help to ensure that a supervisor’s knowledge and understanding of the firm is not superficial.

Unjustified supervisory actions

Where supervisory actions appear unjustified, this is likely to manifest itself as an uneven playing field for the firm (or firms) in question. There are in place in certain jurisdictions appeals processes which can be used to challenge decisions. However, even if successful this is likely to be a lengthy and possibly expensive legal process. Therefore it is worth considering whether preventative measures can be put in place to minimise the likelihood of this situation arising in the first place. This could include some form of peer review of decisions made; although we recognise that this is not without political difficulties depending on the make-up and remit of the peer group. This would also require the other regulators in the peer group to have access to the detailed information provided to the home regulator so that the grounds for the latter’s decision could be assessed.

Joint decision-making through colleges and other arrangements may go some way to addressing this risk, although this is more likely to be helpful in the context of decisions relating to solo entities within the same cross-border group, rather than [group] assessments across the financial services sector. Increasingly detailed disclosure by regulators about their decision-making criteria (and potentially ‘anonymised’ statistical information) may go some way towards creating consistency, in the same way that increased transparency by firms is intended to drive good practice.

Supervisory inaction

In some instances supervisors may be outliers in their willingness to take action, which again may lead to an uneven playing field. In addition to being detrimental to firms, in the medium to long run, this undermines market confidence in the local regulator and the firms it supervises.

Inaction associated with the inability of a supervisor to identify that a decision is required is difficult to tackle if the risks being run by the firm are not visible to other regulators who could intervene. Increased transparency and disclosure about the risk profile of a firm could either prompt action directly or indirectly as a consequence of a market reaction. This coupled with timely dialogue between authorities on emerging or evolving risks could lower the likelihood of risks being missed altogether.