SECURING FINANCIAL STABILITY - the next steps

A recent AFME event “Securing Financial Stability – the next steps”, held in Brussels on 30 November, delivered the latest insight on the future of financial regulation at a global and European level.

Hot on the heels of recent G20 meetings on financial reform, the event included a keynote address from Olli Rehn, European Commissioner for Economic and Financial Affairs, as well in-depth panel debates on a variety of topics such as Financial Resources, Corporate Governance, Resolution and Tax.

Panelists, including senior banking figures, regulators and representatives from the European Commission, wrestled with key issues facing the wholesale banking sector and shared candid views to move the debate on.

The market expects

Although the stress tests, conducted last July, provided useful information, Olli Rehn, European Commissioner for Economic and Financial Affairs noted that, by nature of being applied by national regulators, the tests provided inconsistencies in the results.

He added that the European Union is planning a new round of more rigorous stress tests, to be conducted through the European Banking Authority – the new architecture and powers “will improve the quality of the bank stress tests this time around.”

On Basel, Commissioner Rehn noted that the Basel rules need to be implemented coherently and uniformly and suggested that financial markets have expectations that the banks maintain capital ratios above the minimum standards prescribed by regulators. “What the markets now demand from banks are capital ratios above regulatory limits”.

The Systemic Risk Board will begin its work in January to identify and assess risks and warnings, which will then be addressed to EU or individual member states – “the importance of the Systemic Risk Board should not be underestimated”.

Developing ‘Sifis’

The panel debate on Financial Resources opened with reference to the delicate balance between the need for reform alongside a more robust capital liquidity regime and the need to allow the provision of credit to the ‘real economy’.

There was general acceptance that the recovery is not where it needs to be. The European Commission highlighted that it is genuinely concerned about impact of restrictive regulation on the ‘real economy’ and called for the industry to help by providing data to help understand the impact of Basel.

The European Commission also stressed its interest in examining ‘Systemically Important Financial Institutions’ (‘Sifis’), outlining that it needs to better understand the role of risk and seek ways to enhance the role of the Chief Risk Officer. Key to this is to improve the risk information provided to senior management in firms, as well as regulators.
The industry welcomed Basel reforms but suggested that the studies on liquidity requirements were lacking. The introduction of liquidity standards needs further exploration – “much of the area is technical and differences in business models have not been taken into account”.

The area of ‘Sifis’ is complex as these firms are diversified, suggesting they should hold less capital, although their complexity suggests the need for more capital. However, capital adequacy regulation is not a ‘silver bullet’ and it is likely that policymakers will see the need to use a range of options. The panel agreed that there was a requirement to incentivise risk management rather than risk taking.

The Commission noted that the sector is in a genuine transition period with regard to regulation and that ‘one size does not fit all’. Changes will be made wherever they are needed so that “universal banks are not treated like Sparkasse”.

The Q&A session introduced questions around defining ‘Sifis’ and whether or not to produce a published list, which highlighted a difference of opinion among panelists. The Commission view is that there is no benefit of a published list, though one panelist added that there is a risk the list would have to be disclosed in the future. Other panelists view “secret lists as a false comfort” and note that the challenge would be to translate such a list at a national level, requiring in-depth legal discussion.

**Risk in the boardroom**

Corporate governance, the topic of the next debate, was a key priority for Commissioner Barnier when he took office and the panel included industry experts on supervision.

April 2011 is likely to see a consultation paper on corporate governance for listed companies and, potentially, non-listed companies, which will examine the composition of the board, its risk management mechanisms, the role of non-executives and remuneration.

The discussion turned to evaluating the composition and culture of the board, in particular, how it is organised and evaluated.

It is universally agreed that senior management needs to be more involved and the debate has progressed to the idea that setting risk appetite is the responsibility of the board. For the 25 leading global banks, 50% of boards approved risk management in 2007. In 2009, this figure jumped to 90%.

Ambiguity still exists around risk appetite and a need to undertake stress testing.

In addition, the role of non-executive director (NED) is crucial: he or she has to have the capacity to ask the ‘simple’ questions. However, it is important to enable NEDs to be sufficiently well informed to ask the right questions. The panel identified that in order for the NED to understand the basic literacy/numeracy of their firm, they need to undergo a thorough induction process.
This involves the NED engaging with company management and getting beyond the boardroom and forecasts. There will be times “with a seriously embedded culture, when it is hard to mount sufficient constructive challenge in the boardroom”.

Constructive challenge should be mounted in an informal rather than cavalier fashion. “If feedback is indiscriminate then we could end up with people playing to the gallery”.

A significant challenge remains relating to the NED’s time commitment. In the context of David Walker’s recommendation that 30-36 days per year should be spent by the NED in the firm, panelists highlighted that this level of time commitment is too high and simply not practical.

Questions were raised about NED remuneration (“non-execs should be paid in cash for their advice” with “no element of incentive”) and whether the chair of a bank should be a banker (“not necessarily”, “depends on the rest of the board composition”).

Concerns were raised about forthcoming European Commission corporate governance legislation, which could present itself either as a stand-alone consultation paper or within another piece of legislation, such as MiFID. “Central directives which impose unlimited personal liability will produce an odd bunch of candidates”.

The discussion also covered the usefulness of NEDs developing an external perspective, although it concluded that using informal routes may be preferable so that any ‘pushback’ does not come across as confrontational. To this end, firms should examine how they can establish an independent form of advice that is internal.

**Resolve to avoid taxpayer recourse**

The Resolution debate served as a follow-up from AFME’s White Paper on resolution published in August 2010, which examined how a failing financial institution can be managed through a crisis and recapitalised without requiring capital support from governments and taxpayers.

Debate focused on two specific resolution mechanisms highlighted in the report, bail-in and contingent capital (‘cocos’), with explanations provided at the start of the discussion.

A ‘coco’ is essentially a debt security. The trigger could be capital based, so if capital falls below, say, 5%, the ‘coco’ is triggered either automatically or by discretion, with regulators making the decision. Discussion remains around when the mechanism should be triggered in times of stress or in times of bankruptcy.

In particular, the issues of where the trigger lies, who holds it and what happens to conversion or write-down all need to be resolved.
Bail-in (as outlined in a Financial Stability Board paper endorsed by G20) can be used as a primary tool debt for equity swap – in a crisis, if the bank equity is under threat, more equity can be created to allow the bank to continue. This process may result in losses, but not as much as not using a bail-in, which is essentially a recapitalisation structure.

The main benefit is the reduction in systemic contagion which enables the industry to tackle cross border resolution. The concept also puts ‘moral hazard’ back on the table, so it is important to ensure the mechanism is designed correctly, to allow market signals to have a voice - the market needs to play a role.

The Commission outlined its three key three principles: firstly, prevention; banks need to prepare and stronger powers are needed for regulators, so when a bank is going to fail, the regulator has the necessary powers. Secondly, enhanced powers for regulators and supervisors are needed to allow specific action, such as changing the management. Thirdly, with regard to resolution, when the bank is failing, the regulator can step in.

Questions remain such as how will the resolution mechanism apply to all creditors. In addition, the panel discussed the feasibility of allowing a ‘coco’ mechanism to step in first, followed by a bail-in, with the caveat that the whole process should be kept as simple as possible in order for it to work.

Fixed income investors will look at the instruments and make a decision. When a bank fails, it fails before the trigger falls on the equity to debt levels. For a bond investor, who has to manage credit risk – default risk – if there is an embedded option in the instrument, where the bank is a going concern, it is unworkable as the principle is put at risk.

Defining the point of failure at a point than can be understood is crucial. Bail-in of capital is investable for fixed income investors but ‘cocos’ do not meet the basic requirement of fixed income. A fixed income investor also needs to know the duration of the instrument.

For the fixed income investor, the trigger has to be at the last moment and there are other measures that can be taken prior to ‘last minute’, such as restrictions to bonuses and dividend payments. The investor is not worried at regulators having discretion, although the question will be raised as to whether it costs more.

In addition, there is a real need for more standardised disclosure to be able to make comparisons.

Others noted that the trigger needs to be pulled at a high level – the early stage will avoid disaster at the last minute and there was general agreement that ‘cocos’ and bail in could complement each other well. Their purposes would need to be distinguished – ‘cocos’ as a recovery tool, with bail-in as a resolution tool.
Taxing Times

In light of the myriad of tax initiatives being proposed at a national, European and global level, a keen panel debate on Tax ensued around the European Commission’s plans for a resolution fund and the ensuing additional tax on the banking sector.

Industry representatives complained of a lack of clarity as to the purposes behind individual member state taxes, as well as the EC-wide resolution fund tax, and questioned whether they are designed to change behavior. There was clear concern whether the continuing layering of taxes on the sector was sustainable in light of the potential negative impact on the ‘real economy’.

The Commission’s view is that the taxes, including the resolution fund tax, is created to raise money for the future and also to modify behavior. For example, the resolution fund tax will be a risk-based contribution.

One area agreed on by all of the panelists is that with regard to taxes, more global co-ordination is required to create consistency across jurisdictions. This point was specifically acknowledged by the Commission – “we do not think that the Financial Activities Tax is appropriate unless it is globally coordinated”.
APPENDIX I

FINANCIAL RESOURCES PANEL

Moderator: Mark Austen, COO AFME;
Robert Charnley, Head of Regulatory Reporting and New Products, Goldman Sachs;
Martina Kaub, Head of Process Management Global Credit, Unicredit;
Clifford Smout, Head of Deloitte Centre for Regulatory Strategy;
Hywel Dawes, National Expert Banking Regulation, European Commission;
Jean Paul Servais, CBFA (Belgian Banking and Finance Commission)

SUPERVISION / CORPORATE GOVERNANCE PANEL

Moderator: Simon Lewis, CEO AFME;
Catherine Lawton, Director and Senior Advisor, Nestor Advisors
Nickolas Reinhardt, Chair of International Financial and Regulatory Affairs and Senior Policy Advisor, Fleishman-Hillard;
Sir Adam Ridley, Deputy Chairman, Association of Lloyd’s Members, Non-Executive Director, Morgan Stanley Bank International;
Clifford Smout, Head of Centre for Regulatory Strategy Deloitte

RESOLUTION PANEL

Moderator: Jonathan Rosenthal, European Finance and Business correspondent, Economist;
Sabino Fornies Martinez, European Commission;
Thomas Bischof, Managing Director, Legislative & Regulatory Initiatives, UBS;
Roger Doig, Credit Analyst, Fixed Income Research, Schroders;
Wilson Ervin, Senior Advisor to the CEO, Credit Suisse;
Sandra Lawson, Senior Global Economist, Global Markets Institute, Goldman Sachs;
Gilbey Strub, Managing Director, AFME

TAX PANEL

Moderator: Richard Middleton, Managing Director, AFME
Peter Grasmann Head of Unit Economic Analysis of Financial Markets and Financial Stability DBECFIN European Commission;
Elemar Terták, Director, Financial Institutions, DG Internal Market & Services, European Commission;
Geoff Pennells, Regional Tax Director, Europe, Middle East & Africa, Citi
Philip Martin, Managing Director, Co-Head of Global Taxation, Nomura
APPENDIX II

Companion to AFME Resolution Panel: A Glossary of Terms

Commentators in the current debate on bank resolution are using a variety of disparate terms with overlapping, synonymous or even contradictory meanings. For purposes of facilitating a clear discussion among the AFME Resolution Panel, we have provided this glossary of terms.

Background: During the recent crisis, many banks encountered severe difficulty. In some cases, this led to failure with severe systemic consequences; in other cases it led to expensive taxpayer bailouts. These “too big to fail” outcomes are widely seen to be unacceptable. The objective of new recovery and resolution tools is to help supervisors resolve a future financial crisis without recourse to taxpayer funds and without a threat to financial stability. These tools must also be implementable by regulators and workable in financial markets.

Various options under consideration include:

- **Resolution powers** refers to the authorities’ power to seize a troubled bank and liquidate, recapitalize, sell, take into temporary ownership, or establish a “bridge” bank. See e.g. UK Banking Act 2009, German Bank Restructuring Act (2010), draft Dutch Bank Restructuring Act, Dodd-Frank.
- **Orderly Liquidation Authority (OLA)** established by Dodd-Frank, to permit supervisor to seize troubled firm and liquidate it outside of normal bankruptcy. OLA is synonymous with “resolution” in some (but not all) discussions.
- **Bridge bank** is used to separate troubled parts of the bank (bad bank) from healthier parts that can be sold, and allow some critical activities to continue for a time.
- **Resolution funds** which can used to recapitalize or re-liquify a troubled bank and prevent failure.
- **Functional separation** aims to protect critical bank functions by segregating them from risky activities (e.g. investment vs commercial banking ("Glass-Steagall")), or prohibitions on some risk activities ("Volker rule").
- **Narrow banking** is an extreme version with strict limitations on risk assets.
- **Curbs on bank size** is a potential reform focused primarily on the size of individual banks.
- **Recapitalization** strategies include bridge, contingent capital and 'bail-in,' defined below.

‘Contingent capital’ ("co-co's") describes capital market instruments that are debt in most circumstances, but which can be used to absorb losses and recapitalize a firm in case of distress, once a trigger is breached.

- Recapitalization can occur either in the form of conversion to equity or write-down of principal (sometimes with a subsequent write-up feature in case of recovery).
- **RDS** is a specific type of co-co regime that combines an early trigger with a highly dilutive conversion feature. It is designed to create strong incentives for management to raise capital early in a crisis.

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1 This is a subject undergoing rapid evolution, and terminology is not used consistently in all discussions.
The ‘**trigger**’ to convert a co-co can be a breach of regulatory capital standards (e.g. “tier 1 capital below X%”), a market-based test, or determined by regulatory discretion.

- A **high** or **early** or **going concern** **trigger** operates when a firm is weakened but is not near the point of insolvency. A **low** or **late** or **gone concern** **trigger** operates when a firm has minimal capital or is determined to be ‘non-viable’.
- **Non-viability** is a specific type of late trigger proposed in a recent Basel release. It takes effect when the firm could not stand on its own due to severe capital or liquidity problems.

‘**Bail-in**’ is used generally to describe strategies that recapitalize a troubled bank via **debt-equity swaps**.

- Specific versions (e.g. AFME, IIF, Credit Suisse) use “Bail-in” to describe a **package** that includes: asset write-downs, recapitalization via debt-equity swaps, management change and liquidity support. The package is designed to mimic a high-speed, going-concern recapitalization (Chapter 11 in US verbiage).
- **Debt-equity swaps** are frequently used in going-concern recapitalizations; investors exchange their debt obligations for equity interests in the recapitalized firm.

**Statutory** regimes refer to reform regimes that are created by law or regulation, and which can apply to all instruments in a jurisdiction (e.g. UK Banking Act, German Bank Restructuring Act, Dodd-Frank).

**Contractual** regimes operate through provisions inserted into the terms of the instrument, and therefore only apply to new instruments.

**Going concern** means that the troubled bank is returned to health, and continues operations in some form; **gone concern** means that the bank will not continue as a viable standalone entity, and will be wound up.

**Recovery and resolution plans (“Living Wills”).** Planning required of all large firms to ensure they have “disaster recovery” plans to revive themselves, as well as plans for orderly liquidation.

- **Recovery** refers to going concern actions by management to revitalize a firm using corporate finance tools (divestures, capital raising, etc.) Contingent capital is generally considered a recovery tool.
- **Resolution** refers to actions normally taken by supervisors and associated with “gone concern” or winding up.
- **Bail-in** is a “going concern” process that is normally directed by a supervisor, and therefore has some attributes of both resolution and recovery. Some put bail-in into a 3rd category to avoid confusion.