
Special Committee on Banking Union

20/02/2013

Achieving high quality and effective supervision for systemically important firms

Executive summary

- The recent financial crisis had a number of interacting causes, among which were poor risk culture, governance, and management in many firms and weak or not sufficiently effective supervision in a number of cases.
- Significant work has been done since the crisis to investigate failings in firms' risk-related behaviours as well as weaknesses in supervision. Important lessons have been identified and recommendations for improvement made.
- The establishment of a Single Supervisory Mechanisms (SSM) led by the ECB, combined with the responsibilities of the EBA for coordinating high quality and consistent supervision across the EU, is a pivotal moment. It is an opportunity to embed a key set of lessons from the crisis and move decisively to the implementation of high quality, effective supervision across Europe.
- The industry believes that high quality supervision should have a certain nature, certain basic components and be effected in the framework of a supervisory relationship where firms are expected to fulfil their responsibilities on an ongoing basis.
- The objectives of supervision should be clearly articulated. In the framework of a clear distinction and articulation of micro- and macro-prudential supervision, ultimately these should be related to the preservation of financial stability including the need that supervised firms can fail without causing systemic shock, and that the risks to which a firm's activities give rise do not negatively affect tax payers. The powers to implement these objectives must take into account the overall objective of achieving robust and sustainable growth in Europe.
- Supervision should be intensive, challenging, and outcomes focused. There should be a focus on outcomes and reliance on sound judgement.
- Presence, engagement, discussion, analysis and sound judgement are necessary for supervisors to thoroughly understand the activities, business models, risk profile, risk appetite and risk management of highly complex and interconnected financial firms. These are necessary to effectively question, challenge and, where necessary, call for stronger measures to be taken. However, intensive supervision must not become shadow management of the firm.
- Independence and a clear mandate are fundamental elements of a properly designed supervisory system. Supervisors must have adequate resources, both from a qualitative and a quantitative perspective, which should be reviewed and adapted regularly. Knowledge of the specific legal and national frameworks is crucial. The establishment of the Single Supervisory Mechanism should result in synergies of costs, and certainly not duplication. This will allow for higher quality outcomes to be achieved while avoiding increases in the overall costs of supervision in the SSM zone.

- Supervisors should develop a deep understanding of individual firms' business models and the industry as a whole. Clearly, a 'one size fits all' approach is not appropriate and a risk-based, differentiated approach is the one that can deliver consistently effective supervisory outcomes.
- Firms should engage fully and without reservation in the supervisory relationship, on the basis of a culture which regards supervision as a benefit to the firm and a win-win situation over the long-term.
- Culture and the values and approach of the board and senior management are amongst the most important aspects of a well-run firm. Supervision should pay very close attention to these aspects. Failings in this regard were key aspects in the development of crisis conditions. There should be close engagement with senior level management of firms.
- Supervision is a relational activity. It should lever that relationship to the maximum. But where the relationship is shown to be weak strong measures should be expected. Firms have the responsibility to engage fully and without reservations in the supervisory relationship.
- Supervisors must have access to all relevant data and analysis including risk and audit reports. The industry must support them with this, in a spirit of full cooperation. Homogenous information flow from all the banks within the SSM must be ensured. The approach should be based on clear communication, transparency and mutual understanding, supported by explanatory meetings and onsite inspection. Data requests have to be both useful for the authority and feasible for the supervised entity, notably regarding production costs.
- High quality cooperation and coordination between supervisors remains essential to the effective oversight of cross-border firms while preserving maximum value for the economy.
- It is important that the financial system is seen as robust at all points of the cycle and that supervision does not become more relaxed during the upswing. Key to achieving this is cultural change. By developing a strongly positive culture within firms towards supervision and the supervisory relationship it is possible to embed stability for the long term.
- We have listed below a number of general as well as specific suggestions and recommendations for European supervision which we hope will help policy-makers to effectively shape and define the structure and modus operandi of a new high-quality supervisory framework.

Suggestions and Recommendations

In the analysis below we identify a range of recommendations and suggestions that we believe will be helpful in achieving successful supervision across Europe in the coming period. We also identify a number of recommendations for firms to adopt in their approach to supervision.

Suggestions for European supervision

General

- The establishment of the SSM, and the new central role of the ECB in supervision, provides an opportunity to implement lessons learned from the crisis in the area of supervision.
- The role of the EBA in promoting a consistent approach and general methodology for supervision in the EU as a whole, and the development of a Single Supervisory Handbook, is also central.
- Supervision needs to be intensive and challenging. The ECB and other supervisors should focus on developing from the start an approach which centralises a focus on outcomes, reliance on judgement, and the quality of staff and resources.
- The establishment of the SSM provides an opportunity to define the purposes of prudential regulation. In the framework of a clear distinction and articulation of micro- and macro-prudential supervision, ultimately these should be related to financial stability and the need to ensure (a) that supervised firms can fail without causing systemic shock; and (b) that the risks to which a firm's activities give rise are not passed onto the taxpayer. The powers to implement these objectives must take into account the overall objective of achieving robust and sustainable growth in Europe.

Organisational

- The ECB needs to be well resourced with a strong complement of high quality staff based in Frankfurt. It will be important to know how the ECB will define its required numbers and tools, and what proportion of the estimated 5000 to 10000 professionals specifically working on supervision in Eurozone Member States as a whole will be moved to the ECB central supervision. A significant number will be required.
- The organisational arrangements between the ECB and national authorities within the SSM, and the college arrangements between the SSM and other supervisors, must provide the vehicle for the highly effective, efficient and well-organised deployment of high quality staff in the supervision of financial firms operating in Europe.
- Highly functioning IT systems, which need to be well-integrated, are also very important.

Approach

- The focus of prudential supervision must be the risks to which a firm gives rise. Supervision should be focused on the firm's risk profile, risk appetite, risk culture, risk governance and risk management.
- Effective supervision is founded in a relational approach. For firms also this is the most demanding approach. It requires continuing strong demands on firms, but on the basis of predictability, dialogue, transparency, and explanation. The earning of trust, and the constant possibility of its loss, should form an important component of supervision.

- In respect of proposed general methods or requirements consultation must form a key aspect of the development process.
- All supervisory authorities should have a significant focus on senior management. The ECB should prioritise ensuring that they have sufficient ECB staff of significant seniority and standing to be able to credibly engage with, challenge, and where necessary, make demands of top management in firms.
- The ECB and other European supervisors should ensure that the supervision of systemically important firms involves a constant and continuous presence in the daily life of the firm. (For clarification: constant and continuous presence can be achieved in different ways and does not necessarily require the permanent embedding of particular supervisory staff within the firm.)
- Stress testing is an essential risk management technique. Supervision should focus on the quality of the testing and the way in which the results are utilised by the firm. Such risk management stress testing should be distinguished from system-wide stress tests designed to assess vulnerabilities within the system and secure the maintenance of confidence. A priority should be attached to developing high quality standards for stress-testing by firms and its supervision. The role of auditors' in contributing to effective supervision should be given consideration.
- Horizontal reviews based on priority themes to be examined across the sector should form an essential part of supervision at all stages with outcomes well communicated.

Data

- Data gathering is a core feature of effective supervision. It should be "smart": well-tailored to the objectives to be achieved, avoiding data for data's sake, and well explained and understood by both sides. Data gathering should never outreach the capabilities of supervisors to analyse it effectively and in a timely manner.
- A group and its subsidiaries should only face one request for particular data. Within the SSM this should be based on the data only being needed by one recipient, the SSM. More widely, supervisors should coordinate amongst themselves to meet data needs through a single request across Europe.

Cooperation between supervisors

- High quality cooperation and coordination between supervisors – whether within the SSM, across Europe, or internationally - is essential to achieving effective regulation of systemically important firms. Achieving this is of the highest priority. The current supervisory fragmentation engenders important methodological differences and extra costs.
- As for colleges, it could be useful to fix some criteria and rules, also regarding voting arrangements taking into account that the home supervisor is key for choosing the members of the operational core college.

Transition

- Existing supervisory decisions and guidance must be carried forward into the new arrangements until replaced by new ones, which should not be retrospective. An appropriate, efficient and reliable internal supervisor appeals process should be in place. Furthermore, at European level, it would seem sensible that financial institutions should have the right to appeal to the European Court of Justice.

Recommendations for firms

- The industry must adopt an approach to supervision that recognises industry responsibility to ensuring that supervision is effective over the long term.
- Firms should develop and maintain as a matter of priority a culture of regarding supervision as a benefit and a win-win situation, not a burden.
- Firms should develop and robustly maintain an approach of proactive cooperation with supervisors. Firms' senior management should ensure that this is achieved.
- To the extent that a firm's approach to supervision falls short of the nature and quality which is necessary, the mode of supervision should be altered accordingly. In this case it would be expected that intensity give way to intrusiveness; dialogue to direction.
- Boards and senior management should play a pro-active role in establishing, determining, and maintaining the firm's culture, including its approach to supervision. They should inculcate a supportive approach towards supervision, which avoids oppositional or confrontational elements.
- Supervision should be seen by firms as a lasting relationship designed to produce positive rewards over the long run. Discussion should be frank, fair and accepting of well-reasoned judgements.
- An approach based on open communication between firms and supervisors, for example between the ECB and firms within the SSM, is paramount to ensure a successful relationship. For the process to work effectively supervisors need confidence that they are well-sighted on the developing risk profile of the firm and, in turn, firms need to be confident that such communication will form the basis of effective dialogue and discussion.
- Firms should respond positively and openly to supervisors' requests for information, data, risk and audit reports, which could help a better understanding of risks or improve current practices. Transparency is key.
- Within firms there should be appointed at an appropriately senior level within the group an individual responsible for managing the supervisory relationship who should be the central point of contact for supervisors.

Introduction

Background

- The recent financial crisis had a number of interacting causes. These included macroeconomic imbalances; failed understandings of systemic risk; weaknesses and failures in many firms' governance and practices; ineffective regulation, and poor communication.
- Weak or not sufficiently effective supervision also played an important part in many cases. As the FSB reiterated in its November 2012 progress report on the effective supervision of SIFIs¹, in the aftermath of the financial crisis the need for more intense and effective supervision is a priority.
- The proposed establishment of a new Single Supervisory Mechanisms (SSM) for a large number of countries within the European Union, in the framework of the Banking Union project, represents an important opportunity to embed an approach to supervision that will provide

¹ *Increasing the intensity and effectiveness of SIFI supervision*, FSB, 1 November 2012

enduring stability while ensuring that financial firms and markets provide strong support to the sustainable growth of the European economy.

- The EU Single Market for financial services, of which Banking Union will represent an important part, needs a consistent approach to high quality supervision which promotes financial stability, ensures competitiveness, sustains the economy and realises the full benefits of cross-border banking.
- For this reason AFME supports the Commission proposal sets out in its Communication of 12 September that the European Banking Authority (EBA) should have responsibility for a Single Supervisory Handbook.

Suggestion for European Supervision:

The establishment of the SSM, and the new central role of the ECB in supervision, provides an opportunity to implement lessons learned from the crisis in the area of supervision.

The role of the EBA in promoting a consistent approach and general methodology for supervision in the EU as a whole, and the development of a Single Supervisory Handbook, is also central.

An industry perspective

- A good deal of work has been done by the official sector on improving the effectiveness of supervision since 2008. Important work has resulted in documents such as the FSB reports on *Intensity and Effectiveness of SIFI Supervision*², and the Basel Committee's recently revised *Core Principles for Effective Supervision*³. In addition, work has been carried out on the subject by the financial industry. See for example AFME's report *Prevention and Cure*⁴ and the IIF's *achieving effective supervision: an industry perspective*⁵.
- The industry strongly supports the work done by the official sector in this area. We believe that most of the assessments and recommendations made are appropriate and correct and should be implemented. It is the purpose of this note to set out an industry perspective on a number of key aspects of supervision that should be embedded at an early stage in order to lay the foundations for success over the years to come.

1. The approach to supervision

Outcomes-focused; Judgement-based

- We believe that risk is an essential component of economic success and its management is the core task of financial markets and firms. Risk is heterogeneous, dynamic and elusive. Its measurement and management can be helped by rules and models; but these remain reliant on strong analysis and effective, high-quality judgement.
- It is for this reason that supervision, which is about understanding and responding to the risk profile of individual firms and the financial sector as a whole, should have a strong focus on achieving the right outcomes based on effective judgement by high-quality and experienced supervisors.

² FSB, November 2010 and November 2011.

³ BCBS, September 2012.

⁴ *Prevention and cure: ensuring financial stability after the crisis*, AFME, September 2010

⁵ *Achieving effective supervision: an industry perspective*, IIF, July 2011

- Rules and generalised requirements have the benefit of certainty. However, such rules are static and, because of their general application, must either provide room for supervisory judgement or seek an impossible and self-defeating degree of detailed specificity.
- A focus on process or technical compliance, while an appropriate and necessary part of the mix, should not replace the overall aim of attaining the desired outcomes. An undue focus on compliance or process tends to lead to a box-checking approach and allows for the build-up of unrecognised and ultimately unmanageable levels of risk in the system.

Intensiveness

- Key to achieving consistent levels of high quality supervision is the need for an intensive approach. Running a financial firm or carrying out market activities are complex, demanding, intensive activities. The only way for supervision to effectively oversee and challenge them is for it to be equally intensive and sophisticated.
- By an intensive approach to supervision we mean that supervisors adopt an approach based on the allocation of significant resources to understanding thoroughly and in appropriately material detail a) a firm's activities and business model; b) the risks to which this gives rise or may give rise (risk profile); c) how the firm proposes to respond to those risks (risk appetite); and d) how it does so in practice including responding to new and changing risks (governance and risk management).
- Supervision should be challenge-focused. Supervisors should challenge firms continually, including at the highest level. And supervision should be action-oriented; supervisors should be ready to act on their analysis and the judgements. At the same time, it is the responsibility of a firm's board and management to decide on, and run, the firms' business, to identify the risks, determine a risk appetite and manage those risks effectively.

Suggestion for European supervision: Supervision needs to be intensive and challenging. The ECB and other supervisors should focus on developing from the start an approach which centralises a focus on outcomes, reliance on judgement, and the quality of staff and resources.

Objectives

- The objectives of European supervision are ultimately related to the financial stability purpose within the EU economy. This means that supervision has as a central objective to avoid the build-up of risks in individual firms and in the supervised sector as a whole which could lead to a material disruption in the financing of the wider economy and loss of value for investors. The maintenance of confidence in the financial structures should be a key part of supervisory objectives.
- The powers to implement these objectives must be designed to achieve them in the context of robust, sustainable economic growth.
- The relationship between macroprudential authorities and microprudential supervision is highly important. Microprudential supervisors should have the resources, technical abilities, structural makeup and focus to ensure an ongoing understanding of systemic and structural risk within the sector and its linkage to the wider economy.
- A key objective of supervision should be to ensure that, in conjunction with the resolution framework and resolution authorities. The risks to the system and the economy associated with the failure of a supervised firm are minimised.

- An effectively functioning economy requires effective pricing of risk. It is the role of microprudential supervisors to ensure that supervised firms do not externalise the cost of risks that they create. The risks to others – be it depositors or the system as a whole – become problematic when the firms in question disregard them or do not give them appropriate attention.
- Overall, the supervisor is in a position to understand better than any other actor the connection between the risks of the firm’s activities and the risks to the system.

Suggestion for European supervision: *The establishment of the SSM provides an opportunity to define the purposes of prudential regulation. These should be related to financial stability and the need to ensure (a) that supervised firms can fail without causing systemic shock; and (b) that the risks to which a firm’s activities give rise are not passed onto the taxpayer. The powers to implement these objectives must be designed to achieve them in the context of robust, sustainable economic growth.*

2. The components of effective supervision

Independence based upon a clear mandate

- We firmly support the view of the FSB and the BCBS that for a supervisory framework to be effective and coherent, it is of outmost importance that supervisors are equipped with a clear mandate, powers and responsibilities. In the framework of the SSM, all relevant actors - the ECB, national competent authorities and firms - should enjoy a high degree of clarity from the outset, including from an organisational perspective.
- We also agree that a high degree of independence is a fundamental feature of effective supervisory framework. Accountability is equally important. Both can be achieved without compromising each other. This means that accountability should not include ex ante approval for supervisory actions, but should be based on regular reporting and appearance, as well as after-the-fact explanation.

Strongly resourced

- If supervision is to fulfil the objectives outlined above it needs to be well-resourced both financially and in terms of human resources and available operational tools, including IT. AFME supports the BIS view that supervisors should be adequately resourced in a manner that does not undermine their independence⁶.
- This is particularly relevant for the SSM, which will of course draw on the human resources and expertise of the national competent authorities of participating Member States. It is essential that the ECB is sufficiently strongly resourced to allow it to effectively supervise systemically important firms in a manner which avoids multiple layers of supervision.
- It is essential that supervisors have staff of sufficient standing, ability and expertise, supported by high quality risk and business assessment, to challenge effectively decision-making within firms at all levels, including in particular the most senior.
- AFME supports the FSB view that supervisory resources should be continually assessed⁷ and adapted to the planned tasks.

⁶ *Principles for the supervision of financial conglomerates*, BIS, September 2012

⁷ *Increasing the intensity and effectiveness of SIFI supervision*, FSB, November 2012

Suggestion for European supervision: *The ECB needs to be well resourced with a strong complement of high quality staff based in Frankfurt. It will be important to know how the ECB will define its required numbers and tools, and what proportion of the estimated 5000 to 10000 professionals specifically working on supervision in Eurozone Member States as a whole will be moved to the ECB central supervision. A significant number will be required.*

The organisational arrangements between the ECB and national authorities within the SSM, and the college arrangements between the SSM and other supervisors, must provide the vehicle for the highly effective, efficient and well-organised deployment of high quality staff in the supervision of financial firms operating in Europe.

Highly functioning IT systems, which need to be well-integrated, are also very important.

A risk-based and differentiated approach

- Supervisors should properly know and understand firms' individual business models, strategies, processes and resources and the evolving risk profile to which these give rise. They should put this information into a wider system perspective to be able to take appropriate firm-specific and systemic decisions.
- Supervisors supervise different firms in terms of size, business model, activities and internal structures. On the basis of the same supervisory practices, techniques and objectives applicable to all firms, the supervisory approach should be sufficiently tailor-made and firm-specific to allow timely and targeted intervention which avoids a 'one size fits all' approach.
- It is essential that the supervisor understands well the likely impacts of supervisory actions or policy changes.
- In terms of techniques, supervisors should be sufficiently flexible to adapt their techniques and methods to ever-changing technical developments in the industry. The industry should assist supervisors in doing so.
- The need for developing, deciding, and implementing a clearly articulated risk appetite throughout firms' organisation is key. While progress has been made this remains an important challenge for firms over the coming period. We believe that there will be important benefits to be achieved from supervisors placing a significant focus on this aspect.
- High quality supervision avoids being over-prescriptive or unduly rule-oriented. The imposition of higher prudential requirements and more stringent standards is an important tool but should not be mistaken with more effective supervision, as they do not ensure *per se* better governance and risk-management.
- Consideration should be given to how to associate a differentiated approach with the implementation of Pillar 2 requirements under the Supervisory Review Process.

Suggestion for European supervision: *The focus of prudential supervision must be the risks to which a firm gives rise. Supervision should be focused on the firm's risk profile, risk appetite, risk culture, risk governance and risk management.*

A strong, well-functioning supervisory relationship

- To be effective over the long-run, the approach to supervision must be a relational one. This means that demands are most effectively and efficiently met in a context where both parties understand and leverage the value of their long-term and continuous interactions.

- An effective supervisory relationship makes significant demands on firms. These are discussed in more detail in Section [4] below. To the extent that firms fall short in meeting such requirements then we would expect the basic mode of the supervisory relationship to be marked by greater intrusion, doubt, and pressure for change.
- Mutual understanding is essential. Firms need to fully understand supervisors' requests. This applies to data requests, interventions, and lines of enquiry.
- There should be transparency as regards the regulators' work plan in respect of the firm. This ensures better anticipation of the regulators' likely needs and better resourcing and decision making within firms. As an example, it would be very helpful if the deadlines for firms to reply to legal and operational requests from supervisors were formally fixed.
- It is essential that supervisors are enabled and willing to provide timely, consistent and reliable firm specific-guidance on issues. This ensures that the regulatory requirements can be applied in a meaningful and effective way with minimal risk of regulatory arbitrage and assurance on both sides of a level playing field. In this light, the industry emphasises the need to better define under what circumstances ex-ante and ex-post authorisations are needed.
- At the same time the industry acknowledges that supervisors cannot be expected to act as day-to-day consultants to firms which have to take their own responsibilities and judgement calls. The industry is fully ready to play a constructive role in this regard.
- Supervisory reactivity is essential to properly deal with the day-to-day life and activities of global firms. At the same time, we would consider important to have supervisory decisions that are as stable as possible over time and are supported by appropriate justifications and well-articulated. Decisions regarding supervised entities having transversal impacts on the others should be made public.
- It is essential that the supervisory team has the appropriate mix of language skills to ensure appropriate communication at all levels within the supervised firm.
- Consideration should be given to setting out the approach to be adopted and the expectations prevailing in some documentary form for each firm – for example some form of supervisory charter. This would represent the basis of the supervisory dialogue and represent a useful tool to enhance and maintain the quality of the relationship.

Suggestion for European supervision: *Effective supervision is founded in a relational approach. For firms also this is the most demanding approach. It requires continuing strong demands on firms, but on the basis of predictability, dialogue, transparency, and explanation. The earning of trust, and the constant possibility of its loss, should form an important component of supervision.*

Senior level engagement

- The role of a firms' senior management in determining the firms' culture, and its' approach to the governance and management of risk cannot be overstated. A key lesson from the crisis is that in many cases there were weaknesses in the senior governance and leadership of financial firms including at board and top management level.
- In line with FSB recommendations and BIS principles, AFME considers it important that supervision should include as an important component the continuing engagement with firms at the highest level including at Board and senior management level and including the firm's risk committee. There should be willingness and ability to engage on the basis of robust challenge and frank and frequent dialogue.

Suggestion for European supervision: All supervisory authorities should have a significant focus on senior management. The ECB should prioritise ensuring that they have sufficient ECB staff of significant seniority and standing to be able to credibly engage with, challenge, and where necessary, make demands of top management in firms.

Presence

- The industry sees the establishment of frequent and direct contacts between supervisors and supervised firms as an essential component of intensive supervision. This allows supervisors to obtain continuous, updated and deep knowledge of all relevant issues.
- While an appropriate degree of presence within the firm, in one way or another, is vital, it is equally important that supervision remains strongly embedded in the values, perspective and organisation of the supervisor. Supervisors' rotation represents an important element in this respect. Continuity should characterise supervisory relationships rather than unexpected and abrupt developments and seems best suited to ensure an appropriate degree of supervisory intensity and cooperation.

Suggestion for European supervision: The ECB and other European supervisors should ensure that in respect of firms of systemic importance the supervision of such firms involves a constant and continuous presence in the daily life of the firm. (For clarification: constant and continuous presence can be achieved in different ways and does not necessarily require the permanent embedding of particular supervisory staff within the firm.)

High quality data gathering and analysis

- In order to develop a thorough understanding of a firm's strategy and business model, supervisors should be permitted to access all data and analysis they consider necessary to gauge the risk appetite, understand the risk controls and evaluate the risk governance and management of a firm.
- Firms should thus be ready and willing to provide precise and granular data, including that collected internally for risk management purposes. Data should be collected in the most cost-efficient way for both authorities and firms and should be explained and discussed if needed.
- The approach to data gathering and analysis adopted should form an integrated part of the supervisor's outcomes-focused, risk-based approach. Gathering data must never be confused with understanding it; and analysis must not become purely routine. Attention should be devoted by supervisors to constantly improve the analysis of data, products and models, in the framework of appropriate processing capacity.

Suggestion for European supervision: Data gathering is a core feature of effective supervision. It should be "smart": well-tailored to the objectives to be achieved, avoiding data for data's sake, and well explained and understood by both sides. Data gathering should never outreach the capabilities of supervisors to analyse it effectively and in a timely manner.

A group and its subsidiaries should only face one request for particular data. Within the SSM this should be based on the data only being needed by one recipient, the SSM. More widely, supervisors should coordinate amongst themselves to meet data needs through a single request.

Stress testing (firm-specific and systemic)

The industry believes that stress tests represent a powerful tool to improve risk-management and thus financial stability. They need to be comprehensive and sufficiently tailored to the risks and complexities of firms. It is very important to distinguish between stress testing as a risk management

technique and subject to supervisory discussion and assessment and stress testing as a means of assessing financial stability in the system as whole – such as those carried out by the EBA.

- The former should form an integrated component of the overall governance and risk management within a firm. The essential benefit is that the firm uses stress testing to most accurately understand its evolving risk profile and that they are regarded as sufficiently meaningful to found appropriate remedial action where necessary. A priority should be attached to developing high quality standards for stress-testing by firms and its supervision.
- Subject to a degree of common guidance, such stress testing will be most effective if it is firm-specific, nuanced, multivariate, dynamic and evolving. This can be put in jeopardy if it becomes regarded primarily as a technique of supervisory control resulting, for example, in automatic capital add-ons.
- As regards public, systemic risk stress-testing, it is important that, to the extent that it is regarded as desirable to continue with it, the EBA remains responsible for leading the exercise within the EU.

Suggestion for European supervision: *Stress testing is an essential risk management technique and should be a focus of supervision. The focus should be the quality of the testing and the way in which the results are utilised by the firm. Such risk management stress testing should be distinguished from system-wide stress tests designed to assess vulnerabilities within the system and secure the maintenance of confidence. A priority should be attached to developing high quality standards for stress-testing by firms and its supervision.*

Audit reporting

- As is currently the case in a number of jurisdictions, AFME considers that audit reports are helpful to supervisors in providing relevant information on potential problems and on areas of potential risk. We believe that appropriately designed responsibilities for auditors, whose team should be well distinguished from supervisory teams from the national competent authority to ensure its independency, can be a useful supplement to supervisory effectiveness.

Suggestion for European supervision: *The role of auditors' in contributing to effective supervision should be given consideration.*

Horizontal approach

- An important aspect of supervision is the ability to see developments and risks as they affect supervised firms taken as a sector together. National competent authorities in a number of countries already perform horizontal analyses with the aim to properly assess cyclical trends and systemic risks, on the basis of information and data gathered from various relevant sources, including other relevant authorities at national level.
- Horizontal reviews, comparisons across firms and benchmarking represent very important techniques in this regard. The FSB, for example, has underlined the importance of horizontal reviews⁸, which are relevant both domestically and internationally. Reviews provide supervisors with insights and a better understanding of firms while the industry can benefit from them in terms of guidance and comparison.

Suggestion for European supervision: *Horizontal reviews based on priority themes to be examined across the sector should form an essential part of supervision at all stages with outcomes well communicated.*

⁸ *Increasing the intensity and effectiveness of SIFI supervision*, FSB, November 2012

Cooperation between supervisors

- The BIS rightly recommends that supervisors should make arrangements for appropriate, timely and effective information-sharing, co-operation and co-ordination between themselves⁹. This should ensure optimisation of supervisory interactions, minimisation of duplication and maximisation of confidence in the supervisory system. Enhanced convergence should be sought at every opportunity.
- Supervision should reflect the interconnectedness of financial markets and the systemic banks' cross-border nature. It thus needs to be global, with enhanced cooperation and coordination among both national and supranational authorities.
- Efforts should be intensified to increase the effectiveness of supervisory colleges. This should include improved dialogue and information exchanges. In this framework, colleges' conclusions should be provided to all supervisors of the supervised entity (if not classified), with the aim to integrate local supervisors not members of the colleges within the envisaged actions. The industry can greatly contribute to improving the functioning of colleges by working closely with supervisors.
- As for home/host relationships, the BCBS rightly stresses that supervisors of cross-border banks should share information and cooperate for the effective supervision of the group and group entities.
- Colleges should be organised and run in such a way as to avoid extra administrative costs, multiplicative information exchanges and the proliferation of different practice sin supervisory relationships.

Suggestion for European supervision: *High quality cooperation and coordination between supervisors – whether across Europe, or internationally - is essential to ensuring effective regulation of systemically important firms. Achieving this is of the highest priority.*

As for colleges, it could be useful to set some criteria and rules, also regarding voting arrangements taking into account that the home supervisor is key for choosing the member of the operational core college.

Safeguards

- Supervisory structures should include appropriate and balanced safeguards for supervisory inaction, poorly targeted, inadequate and disproportionate actions. This would ensure that the supervisory system is appropriately framed from a legal and operational perspective, thus granting supervised firms the possibility to effectively challenge actions that they consider inappropriate, inadequate or excessive.
- The legal security of the supervised entity must be ensured and formalized - what has been approved by the national supervisor should be considered as valid in the future. This is particularly important in the SSM transition and implies that the method to initiate major changes must be formalised and the settlement timetable must be operational. Moreover, in the framework of the SSM launch, a grandfathering period for national supervisory decisions could be fixed.

⁹ *Principles for the supervision of financial conglomerates*, BIS, September 2012, p. 13

Suggestion for European supervision: Existing supervisory decisions and guidance must be carried forward into the new arrangements until replaced by new ones, which should not be retrospective. An appropriate, efficient and reliable internal supervisor appeal process should be in place. Furthermore, at European level, it would seem sensible that financial institutions should have the right to appeal to the European Court of Justice.

Consultation

- Supervision works most effectively when based on a well-considered approach and on principles and guidelines that are of a very high quality. To ensure that there is strong understanding within the supervised community as how they will be supervised and confidence that the approach is of high quality, it seems essential that supervisors incorporate high levels of effective consultation into their supervisory development process.

Suggestion for European supervision: In respect of proposed general methods or requirements consultation must form a key aspect of the development process.

3. Supervisory relationship and industry responsibilities

- Successful supervision depends upon a strong and effective supervisory relationship, which the industry believes should work as a two-way street. There is, post crisis, an important onus on firms to adopt an approach to supervision that recognises the importance of their role in making supervision effective.
- To the extent that the approach to supervision adopted by supervised firms falls short of the nature and quality which is necessary, the mode of supervision should be altered accordingly. In this case it would be expected that intensity give way to intrusiveness; dialogue to direction.
- Firms should develop and maintain as a matter of priority an approach of regarding supervision as a benefit and a win-win situation, not a burden. A well-functioning supervisory relationship provides firms not only with support for their internal risk governance and management, but also with a perspective on systemic risk and sectoral comparisons.
- The industry has much to gain in engaging fully and without reservations with supervisors to ensure the maintenance of a stable business environment. This should encourage firms to constantly improve their internal models and processes, to the ultimate benefit of their shareholders and creditors, as enhanced supervision increases market confidence and investors' trust that a firm is prudentially robust, thus allowing it to raise funding on a cost-efficient basis.
- Firms should proactively engage in an open and frank dialogue with supervisors, including for the development of techniques and tools of mutual benefit. Moreover, a culture of cooperation within firms must be established and consistently scrutinized over time, with the firms' senior level expected to set the right example.

Governance and culture

- Culture and behaviour of firms are key elements that should be fully understood and assessed by supervisors to properly understand and evaluate management's actions and the oversight role of Boards and internal committees in firms. Firms should approach supervision as a lasting

relationship designed to produce positive rewards over the long run. Discussion should be frank, fair and accepting of well-reasoned judgements.

- The values and approach adopted by the board and senior management maybe the most important aspect of ensuring a high quality engagement by firms in the supervisory relationship. Boards should play a pro-active role in establishing and determining a firm's culture, risk strategy and risk appetite and should make sure that their guidance is being followed by monitoring compliance and continuously judging the effectiveness of governance structures within firms. They should inculcate a strongly positive approach towards supervision, which avoids oppositional or confrontational elements.
- On the supervisor's side, it might be appropriate for them to develop a code of conduct/manual which would help creating a culture within the authority which goes beyond the formal rules and procedures to be followed, on the basis of a soft, non-prescriptive approach, defining methodologies and variables that the supervisor will follow and look at in the framework of its decisions.

Open communication

- An approach based on open communication between firms and supervisors, for example between the ECB and firms within the SSM, is paramount to ensure a successful relationship. For the process to work effectively supervisors need confidence that they are well-sighted on the developing risk profile of the firm and, in turn, firms need to be confident that such communication will form the basis of effective dialogue and discussion.
- Amongst the material that should be made available to supervisors should be risk reports, internal audit reports, internal stress testing etc.
- Firms should appoint an appropriately senior individual responsible within the group for managing the supervisory relationship who should be the central point of contact for supervisors. The identification of key contact points which act as pro-active facilitators and interlocutors constitutes an important practical element for an enhanced cooperation and openness between supervisors and firms. As regards consolidated entities, one team within the firm should be responsible for the supervisory relationship for the whole group.
- Informal contacts between supervisors and supervised can also be important to foster a good supervisory relationship - for a global firm this might involve a relatively large number of day-to-day connections with supervisors. As an example, the way a supervisory decision is communicated after an audit or for a formal approval of the supervisor could be a MoU with an appropriate timetable.
- As for risk assessment, its optimal timing could be once a year when results are published, in view of an assessment of the work of the previous year and the planning of the work for the following year. This could take the form of a meeting at the highest level prepared by working session throughout the year coinciding with publication of intermediate results. Overall, the approach must ensure consistency with respect to the method, periodicity with respect to the timing, and allow for the sufficient flexibility in order to respond to unexpected circumstances.

'Through the cycle' results

- A key challenge both for supervisors and for the industry is to restore confidence in supervision, ensuring its effective application throughout the credit cycle. One of the fears that has been left behind by the crisis is that supervision while strengthened in the period immediately after the

crisis will become weakened once again as the cycle progresses, asset prices increase, and memories fade.

- A key part of achieving this is to put appropriate emphasis on cultural change. Embedding beliefs and behaviour in both supervisors and firms' culture is one of the most important ways of bringing about lasting change which will prove durable to significant alterations in the surrounding environment.
- By developing a strongly positive culture within firms towards supervision and the supervisory relationship, it is possible to go beyond changes to the superstructure that will be vulnerable to the cyclical pressure discussed above, to foundational modifications designed to resist those pressures.