afme/ Finance for Europe

27th February 2013

Mr. Mario Draghi
President
European Central Bank

Dear President Draghi,

The Association for Financial Markets in Europe (AFME) strongly supports the establishment of a banking union in Europe[1]. This major advance in financial market integration will permit the better functioning of the European financial system to support the economy.

AFME represents a broad range of participants in European wholesale financial markets. Our membership includes a large number of banks engaged in cross-border business in the EU Single Market, having headquarters in the Eurozone, in the EU more broadly or in third countries.

In the new Single Supervisory Mechanism (SSM) framework the ECB will effectively become the home or host supervisor for AFME's member firms as well as having a central role in macroprudential policy. AFME and its membership wish to see the development in Europe of supervision of the highest possible quality organised in such a way that financial stability is secured, financial market integration enhanced, and the European economy optimally served by financial institutions.

We are writing to you now as the implementation phase of the SSM begins in earnest, to provide for your consideration an industry contribution on a number of key aspects of SSM implementation.

We are pleased to provide for your attention a submission, *Achieving high quality and effective supervision for systemically important firms*. This document has been developed by AFME and its Members with a view to contributing an industry perspective on this important issue at this key moment in the evolution of European financial supervision.

We plan to share this letter and the submission with a range of interested parties as a contribution to discussions.

In the coming weeks we will provide a further report, based on extensive interviews with firms, focusing on cross-border supervision and providing industry suggestions on optimising cross-border supervision both within Europe and internationally as the SSM is implemented.

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[1] On 18 October AFME issued an Initial Position Paper setting out an industry perspective on key issues in banking union (http://www.afme.eu/Banking-Union/). On 12 December we wrote to Finance Ministers and MEPs on the matter (http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=7820).

Association for Financial Markets in Europe

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Key aspects of SSM implementation

Significant progress has been achieved in the legislative process to establish the Single Supervisory Mechanism. This is very much to be welcomed. We look forward to final agreement being quickly reached between Council and the European Parliament.

It is important that the manner of implementation of the agreed text is in line with the overall best interpretation of the legislation and in keeping with its spirit. AFME is of the view that the new framework should create a supervisory level-playing field and decisively improve the quality and management of supervision of cross-border groups.

While the agreement so far achieved represents enormous potential progress, there remains the risk that this progress could be undermined if the legislation is implemented in a manner which gives rise to gaps, duplications, or misaligned incentives in the new framework of European supervision.

In this respect the role of the Governing Council in adopting the organisational framework to implement the SSM, as well as its general responsibility for its effective and consistent functioning, will be crucial.

Supervisory arrangements for firms of significant relevance

In respect of firms which are of significant relevance, the regulation indicates that the ECB shall have exclusive competence in respect of the microprudential tasks set out in Article 4. Without prejudice to the ECB's responsibility and accountability in this regard, national competent authorities are to be responsible for assisting the ECB with the preparation and implementation of any acts relating to these tasks and shall follow the instructions given by the ECB in this regard.

AFME welcomes the clarity provided by these provisions as to the exclusive competence and primary role of the ECB in this regard. As we stated in our earlier position paper, it is essential that there should be clarity as to who is responsible for what, that the ECB should provide a sufficiently strong core to ensure a deeply integrated and unified system, and that there should be no question of simply adding additional layers of supervision.

There will always be a need for a close knowledge of the local environments in which a financial institution operates. In the shorter term there will be important transitional needs to maintain continuity of knowledge and availability of sufficient resource. Therefore we welcome the identification of a continued role for national authorities.

However, as swift as possible an alignment of goals and incentives will be important. To avoid duplications and uncertainty as regards roles and responsibilities, there should be established a road map setting out the phasing of the transition of supervisory tasks to the ECB and its staff.

In the initial phase, an approach could be envisaged involving supervisory teams comprised of staff from the range of authorities within whose jurisdictions a firm is active. We believe that it is important, and in line with the legislative text, that such a cross-jurisdictional team should be clearly led by ECB personnel. Over time one could imagine such teams consisting for the most part, or wholly, of ECB-accountable staff with national authorities playing an important role in the provision of information and risk-assessment in respect of the local market environment etc.

The establishment of the Single Supervisory Mechanism should result in synergies of costs. This will allow for higher quality outcomes to be achieved while avoiding increases in the overall costs of supervision in the SSM zone.

Macroprudential powers: a need for clear rules and coordination

Macroprudential responsibilities and powers will constitute a key aspect of the banking union framework and the wider economic governance of the Eurozone. Hence the importance of developing a framework for macro-prudential regulation that enjoys an appropriate degree of clarity in relation to i) basic policy objectives; ii) roles and responsibilities; iii) specific policy instruments; and iv) methods of coordination.

It is a likely result of negotiations that macroprudential oversight will be shared between the national and the European level. Such an outcome can be considered appropriate given the current state of economic integration within the Eurozone and more widely. Economic circumstances continue to have significantly national, as well as European, components. This means that it remains, for the moment, justifiable to have national as well as European competences for seeking to mitigate potential excesses in the credit cycle.

However there are also significant risks to such a dual-responsibility approach. In particular, there is the risk that macroprudential powers become diverted at the national level towards the protection of perceived national interests other than the avoidance of undue intensifications of the credit cycle.

It is essential therefore that there should be quickly developed a clear and robust articulation of the objectives of macroprudential powers. It should be required that the exercise of such powers be firmly related to the achievement of those objectives. There should be no question of such powers being used in order to secure perceived national interests or to protect the interests of stakeholders in financial institutions.

There is a need for coordination of macroprudential policies and actions which takes a holistic view of the Eurozone or wider economy and not purely a Member State by Member State perspective. It will be important to give consideration to the arrangements for achieving this under the new framework.

Macroprudential policy tools regularly take the form of micro-prudential instruments that are used for systemic purposes, and effective mechanisms of coordination between macro and micro prudential supervisors will therefore be needed together with safeguards to mitigate potential conflicts of interest.

Systemic risk: the key role of the ECB

It is important that systemic risk arising from the activities of banks and financial groups, whatever their size or complexity, is clearly recognised as the responsibility of the ECB. We are pleased to note that under the agreed ECOFIN text, the ECB is to be given ultimate authority to intervene to exercise directly microprudential supervisory powers in respect of smaller firms not falling within the definition of "significantly relevant". Ensuring the consistent application of high supervisory standards, the condition established by the legislation, will need to be most urgently pursued where a smaller bank, or number of smaller banks, are perceived to be at risk of failure with potential systemic effects.

In order to carry out its responsibilities in this regard, it is essential that, in addition to receiving timely and accurate reports and assessments from national authorities, the ECB have real time, unmediated access to all relevant data in respect of firms supervised under the SSM. It must never be the case that the ECB's ability to intervene is undermined by the unavailability to it of information available elsewhere in supervisory system.

Single Supervisory Handbook: maintaining and strengthening the Single Market

The creation of a Single Supervisory Mechanism should have the effect of deepening financial integration for the European Union as a whole. One important way in which this can be achieved is by taking the opportunity to advance rapidly towards a consistent approach to supervision for the whole EU. It is for this reason that AFME strongly supports the development of a Single Supervisory Handbook by the EBA, to sit alongside the Single Rulebook.

Such a Single Supervisory Handbook, developed on the basis of agreement between the ECB and the other prudential supervisors, would set out the general approach to, and key aspects of prudential supervision within the European Union. It would provide the high level articulation of the more detailed approaches to be set out in the supervisory manuals which we consider desirable to be adopted by the ECB and other supervisors. In this respect it will also be important that the ECB should develop an internal code setting out a single approach to supervision to ensure consistency during the transition period from a decentralized organization towards a centralized one.

Implementation timetable and process: ensuring dialogue with the industry

While it is essential that momentum be maintained in order to realise the historic opportunity presented by the banking union proposals, it is also vital that a very high quality approach is achieved if it is to be avoided that financial fragility is stored up for the future. While recognising the scale and complexity of the challenge, we believe that the overall timetable set out in the ECOFIN text represents an appropriate balance between speed and quality. It is important that this balance is well maintained over the coming period in order to maintain market confidence.

In this regard we consider that the close involvement of the industry will be essential to success. We welcome the requirement in the ECOFIN text that the ECB carry out open public consultations. Beyond this however, it is important that the perspective of the industry as supervised entities, as well as that of consumers of financial services, should be well articulated and understood by the ECB by means of ongoing dialogue. In this regard AFME and its Members stand ready to contribute and assist in any way that might be useful.

AFME's proposals for achieving high quality and effective supervision

AFME and its members have a particular interest in and focus on the achievement of a high quality, effective and consistent approach to supervision throughout the Single Market. We have developed a submission, *Achieving high quality and effective supervision for systemically important firms,* that is submitted for your attention alongside this letter.

We believe that the establishment of a Single Supervisory Mechanisms (SSM) led by the ECB, combined with the significant responsibilities of the EBA for coordinating high quality and consistent supervision across the EU is an opportunity to embed a key set of lessons from the crisis and move decisively to the implementation of more consistent, high quality and effective supervision across Europe.

AFME and its members have thus developed an analysis of key elements that characterise an approach to supervision that delivers the highest quality outcomes. This contribution draws on our Member firms' concrete experience, including with regard to aspects such as the objectives to be achieved; the approach to be adopted; the importance of the supervisory relationship; and firms' culture and approach to supervision. These issues are developed in detail in our submission.

Single resolution mechanism: an independent authority and an ex-post fund

AFME considers that a protracted separation of the jurisdictional scope of supervisory and resolution arrangements could give rise to significant inconsistencies and systemic weaknesses. It is thus important that a single resolution mechanism, complementing the SSM, is put in place as quickly as possible, but without this hindering progress on implementation of the SSM.

While we believe that a single resolution mechanism is an essential complement to the SSM, we do not believe that this requires the establishment of an *ex ante* resolution fund. This is consistent with the views and arguments that we have put forward in the context of the current legislative negotiations on the Bank Recovery and Resolution Directive (BRRD) proposal.

Mis-pricing of risk and moral hazard were at the centre of the crisis. AFME and its Members have firmly supported, and worked intensively to contribute to the development of proposals to ensure that shareholders and creditors bear losses in the event of bank failures. We are firmly supportive of bail-in as an important mechanism for allowing this to be achieved.

We believe that this work will be undermined if the perception emerges that significant funds are readily to hand to bail out banks that get into difficulties in the future. We believe that the establishment of an *ex ante* resolution fund would be likely to give rise to such perceptions. We do believe that there is likely to be the need for the provision of liquidity for certain banks in resolution. While the immediate provision should be by relevant authorities, there should be an ultimate industry responsibility for any residual shortfall not recovered from the failed bank after the resolution process; this should be by way of *ex post* and not *ex ante* mechanisms.

We would very much welcome the opportunity to discuss all or some of the above issues with you, or your relevant colleagues, further if that should be considered useful.

Yours sincerely,

Simon Lewis
Chief Executive Officer
AFME

cc.
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