6

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Sent: Thursday 18 October 2012 13:41
To: SUTTON Michelle (CAB-BARROSO)
Subject: BANKING UNION: AFME POSITION PAPER
Attachments: 121018_BU Paper_Final.pdf

Dear Michelle

I am pleased to send to you our initial position paper on proposals for a banking union, including a single supervisory mechanism.

AFME supports proposals to establish a banking union in Europe. This advance in market integration should enhance the European financial system in its key role of supporting the economy. It is an important step in resolving the Eurozone crisis, supporting the euro, and developing a coherent architecture for Economic and Monetary Union.

We agree with the overall approach proposed by the Commission and the need for rapid progress. We identify a number of important challenges to be addressed to ensure successful design and implementation of the new arrangements. Our note focuses in particular on the practical implementation of banking union and the single supervisory mechanism (SSM) from the perspective of supervised market participants.

We would be happy to discuss any aspect of these issues with you further.

Kind regards

Simon

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18 October 2012

Initial Position Paper on Banking Union Issues

The Association for Financial Markets in Europe (AFME) represents participants in Europe's wholesale financial markets. Our Members are the leading European and global banks and other significant capital market players. Proposals for a banking union in Europe represent far-reaching changes for financial markets and for the European economy. This note represents an initial contribution to the discussions. It adopts an approach focused on the practical implementation of banking union and the Single Supervisory Mechanism (SSM) from the perspective of the supervised community. We stand ready to assist public authorities in any way possible in this important endeavour.

General Approach

AFME strongly supports proposals to establish a banking union in Europe. This major advance in market integration will permit the better functioning of the European financial system to support the economy. It is an essential step in resolving the Eurozone crisis, supporting the euro, and developing a coherent architecture for Economic and Monetary Union.

The overall approach proposed by the Commission is sensible and coherent in view of the constraints, in particular the need to achieve rapid progress to help resolve the Eurozone crisis. However, there are a number of important challenges to be addressed to ensure that:

- the design and implementation of the new framework while timely, is also coherent and effective;
- there are clear and robust arrangements, avoiding gaps and weaknesses, during the period of transition; and
- the establishment of a banking union strengthens the Single Market across the EU as a whole.

Timetable

As proposed by the Commission, we believe that it is important for the Single Supervisory Mechanism (SSM) to be finalised and implemented quickly. Failure to do so risks reigniting the Eurozone crisis at an even deeper level than hitherto. We think it is necessary that clear agreement be reached on all major aspects of this proposal by the end of 2012. Such agreement should be recognised as the turning point of fundamental change to a unified system.

Separation of the jurisdictional scope of supervisory and resolution arrangements, while understandable in the circumstances, is troubling. It could give rise to significant misalignments and systemic weaknesses if allowed to continue for anything but a minimal period of time. We believe that it is important that a single resolution mechanism, complementing the SSM, be put in place as quickly as possible, but without this hindering progress on the SSM.

The need for rapid progress in establishing the SSM poses other significant challenges. High quality financial supervision and regulation are at the heart of a well-functioning economy. It is necessary to ensure both that the foundation for these are well designed and laid over the coming period, and that there is in place a clear roadmap for completing the further necessary changes with strong momentum as quickly as possible thereafter. Temporary misalignments which may result from the need to press quickly forward should be eliminated as quickly as possible while not delaying the required progress.

Concerning the phased implementation of the SSM, in general we support the approach proposed by the Commission though any initial phase before July 2013, should, in the event it is relevant, logically apply only to banks which have received or requested assistance from the ESM.

Achieving high quality and effective supervision

Amongst the many lessons learned from the financial crisis are those relating to the weaknesses and failures of management, governance and culture that arose in many financial firms. There were also failures of regulation and supervision. The establishment of the SSM provides a unique opportunity to implement some of those lessons, in particular as they relate to ensuring high-quality, and effective supervision.

These lessons, however, relate to supervision outside, just as much as inside, the banking union area. Moreover enhancement of the Single Market and realisation of the benefits of cross-border banking in Europe requires that there is a consistent approach to high quality supervision across the EU. For these reasons, AFME supports the Commission's proposal that the European Banking Authority (EBA) should develop a single supervisory handbook to support an agreed approach and consistent supervisory practices across the EU.

In our report *Prevention and Cure,*[1] AFME considered the question of how to make supervision more effective. Complementary to the BCBS *Core Principles for Effective Banking Supervision*, we identified a number of features that we believe to be key to high quality, effective supervision. While not seeking to be determinative, we have sought, through this work, to contribute an industry perspective to one of the most important post-crisis questions. We plan to revisit this work over the coming period to update it in light of developments. We look forward to submitting this and to engaging with the EBA and other authorities in further discussion of this centrally important topic.

Amongst the key features to be incorporated are the following:

- Supervision needs to be well-resourced; based on a clear, reliable mandate with appropriate accountability; it should be intensive and challenging in approach;

- It should be firmly focused on outcomes and be judgement- and challenge-based. It should be grounded in a deep and rigorous understanding of supervised firms' business models, risk profile, and assets quality. It should be adaptive to new risks;

- Supervision should be founded in an understanding of the current risks of the system and their linkages with individual firms' risk profile;

- There should be a clear linkage demonstrated between qualitative and quantitative approaches to supervision;

- There should be a clear focus on assessment of the governance and culture of any firm. Firms, in particular through tone from the top, must inculcate a positive and supportive approach towards

[1] *Prevention and Cure: Securing Financial Stability After the Crisis*, September 2010. Other important recent material includes: BIS, *Revised Core Principles for Effective Banking Supervision*; FSB, *Intensity and Effectiveness of SIFI Supervision*, October 2011; IIF, *Achieving Effective Supervision, An Industry Perspective*, July 2011.

supervision. There should be a high quality supervisory relationship, based on openness and dialogue.

Effective supervisory arrangements

Scope

We support the proposal to include within the scope of the SSM all credit institutions in the countries participating in the SSM. As has been seen, systemic risk can arise in any segment of the banking system. Moreover, this approach will help ensure a level playing field and a consistent supervisory approach.

Basing the SSM on the existing capabilities of the national supervisory authorities is a sound practical approach which allows for pragmatic adaptation to the challenges. It provides the means both to manage well the wide scope of application and to move quickly to implementation of the new arrangements.

Given constraints on the sectoral scope of ECB supervisory authority, we would seek more clarity on how consolidated supervision will operate within the SSM.

Objectives

Effective supervision requires that the supervisory body has the appropriate objectives and authority within which to carry out its responsibilities. We note that national supervisory authorities each act on the basis of a number of expressly articulated objectives such as safeguarding financial stability, ensuring the soundness of financial institutions, and protecting depositors.

It is notable however that the primary objective of the ECB, within the ESCB, is to maintain price stability[2] and that any objectives that it may have in relation to financial stability or prudential supervision derive from this primary objective.

Given the importance of moving forward quickly, it is appropriate, as the Commission proposes, to adopt a task-allocation approach based on Article 127(6) of the Treaty for European Union (TFEU). We believe that in general the list of tasks is well-drawn. And it is important that this set of tasks does not become less coherent or complete during the negotiation process. We believe, however, that there are significant longer-term concerns about adopting a purely task-allocation approach without providing the SSM with a clear set of governing objectives in this area. Without such a mandate, we fear that the longer-term result might be an absence of the fully integrated and coherent approach which is centrally important to effective supervision. This could be compounded by the risk of tension or conflict between the objectives of national supervisory authorities. We think that this is something which, while not for immediate action, needs to remain firmly on the agenda to be addressed.

It will be important to effectively address the relationship between monetary and supervisory functions within the ECB. The practical separation of activities, staff and resources should be addressed, so as to avoid undue interactions and spillover between functions.

Macroprudential supervision

There needs to be further work on how macro-prudential oversight in Europe will be carried out and implemented under the new framework with the aim of ensuring a sustainable supply of credit to the economy to support growth and avoiding asset bubbles in the context of differing credit cycles across the Union. The European Systemic Risk Board (ESRB) should retain its responsibilities in respect of the EU 27. Clarity is needed however on the relationship between the ESRB housed within the ECB,

[2] Art. 127(1) TFEU

the ECB entrusted with prudential supervision within the SSM, and macro-prudential oversight within banking union countries. We note that in some cases, the national supervisory authority for micro-prudential (i.e. firm level) supervision may also have responsibility for at least some aspects of macro-prudential policy.

Structures, roles, accountability

As stated, we believe the overall design of the SSM to be a sensible one. However, moving to a model based on the integration of the roles of the ECB and national supervisory authorities poses many challenges. It is important that weaknesses or divergences between responsibility and ability to act do not arise either during the transitional phase or thereafter.

It needs to be clear who is responsible for what and how respective responsibilities will be carried out. The relationship and the division of activities between the ECB (and its staff) and the national authorities (and their staff) needs to be quickly and clearly defined. The ECB will need to, and should, rely on the expertise and local understanding of national authorities. However it will also need to put in place swiftly the resources, structures, and arrangements necessary to ensure that the centre has sufficient weight and authority and that the system is a truly integrated and unified one. It must be avoided, for example, to simply add a further layer of supervision. The creation of permanent core groupings of supervisors for significant firms should be considered. There will also need to be an effective working relationship with other relevant authorities.

As much EU legislation in the area of financial services has taken the form of directives, requiring implementation by national law, it will be important to achieve practical clarity on the question of what law is being enforced by what level in the SSM and how tensions and conflicts will be resolved. There is a clear need for national regulation to give way to a complete single European rulebook as quickly as possible.

The SSM needs to be appropriately accountable to political authorities. However it is essential that it remains strongly independent in judgement and action. 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.

There need to be in place decision-making arrangements which allow for speed and certainty of action by the supervisory authorities and does not involve a need for broad consensus-building. At this point what these arrangements are proposed to be has not been made clear. Enhanced clarity on the relationship between the Governing Council and the Supervisory Board is also needed.

Resources, supervisory relations, legal safeguards.

It is appropriate as proposed that, in respect of its supervisory activities, the ECB be financed by fees levied on its supervised credit institutions. An appropriate balance between ECB and national fees should be set and it is to be expected that increased costs at the centre will be largely offset by decreases at the national level. In particular, of course, it is to be expected that costs will be offset by staff transfers.

There is a need for articulation of the mode and management of the relationship between SSM and supervised firms. For example, it should be expected that decisions will be supported by reasons and explanations; and that they should be taken in the context of a continuing dialogue between supervisor and firm. Appropriate levels of confidentiality must also be ensured.

The framework for the exercise of powers and authority under the new arrangements needs to be clearly established. It is currently unclear, for example, what arrangements will be available to firms wishing to appeal a penalty imposed on a firm or individual under the new structures. This is a key aspect of a reliable and effective supervisory framework. It is further complicated by the continuing national law basis of supervisory action and uncertainty over legal challenge to the ECB within that.

Dealing with failed institutions – Resolution / Deposit Guarantee

Under the Commission's proposals, resolution (including deposit guarantee arrangements) would at least for the initial phase, continue to fall within the arrangements established in each jurisdiction. There are, accordingly, risks of misalignment associated with the transition period between the SSM and the implementation of a single resolution mechanism, complementing the SSM, to be implemented at a later stage.

To the extent that the current DGS and RRD proposals are adopted before year end this will provide greater consistency. Nonetheless, also under these arrangements, the resolution framework will remain essentially national. We believe accordingly, that it is important that proposals be brought forward quickly to complement the SSM with a single resolution mechanism.

One matter that will need to be clarified in the RRD proposals is the interaction, if any, between the powers conferred on the ECB under SSM and the resolution triggers in the RRD framework. It will also be important to address the operation of the RRD cooperation mandate having regard to the new structural arrangements.

Ensuring that the development of banking union enhances the Single Market

It is important that the Single Market is enhanced and not undermined as a result of banking union. The role of the European Banking Authority (EBA) is essential in this respect. AFME supports the Commission's objectives in this regard to avoid fragmentation of the Single Market "which remains one of the greatest achievements of European integration".

To this end, advancement of the Single Rulebook for banking in the EU is a priority objective. It is right that the EBA's role in this respect be reinforced. We agree that the single market and the banking union are mutually reinforcing processes. However, there is also the risk of tensions arising between the two aspects. To this end we very much support the Commission's goal to seek decision modalities within the EBA that ensure the interest of maintaining and strengthening the internal market for financial services. It is very important that the modalities that are reached are fair and balanced and seek to achieve an appropriate reflection of different viewpoints.

As discussed above, the development of a Single Supervisory Handbook will be another important aspect in enhancing the Single Market in financial services. This Handbook should seek to ensure consistency of supervisory outcomes by providing a common framework for high quality and effective supervision as discussed above based on best supervisory practices.

The dialogue and relationship between EBA, ECB and other authorities will be one of the key features of the new arrangements and we would welcome more clarity on the relationship between EBA and ECB. Consideration should be given to ensuring that there is appropriate equivalence of relationship and authority in the EBA's relations with the different supervisory authorities. A level playing field is essential in this regard. Accordingly, clarity is requested that in respect of its supervisory function the ECB is subject to the same requirements as national authorities.

Cross-border banking

Over recent years the challenges for cross-border banking have grown considerably, with significant fragmentation of financial markets along national lines. The establishment of the SSM and banking union will be an appropriate opportunity to implement a consistent, high-quality approach to the operation of supervisory colleges. Firms' experiences in this respect vary considerably. Now is the moment to identify and implement best practices on a general basis. Consideration should also be given to the functioning of international colleges under the new arrangements. AFME will consider these issues further over the coming weeks and looks forward to further dialogue on this aspect.

Participation of non-Eurozone countries

AFME believes that the SSM and the banking union should be open to all EU countries. While participation is necessary for Eurozone countries, we do not consider that adoption of the Euro is necessary for participation.

It is important therefore that all EU Members States should be able to, and should not be disincentivised from, joining the banking union. Accordingly, an "open architecture" approach should be adopted. Non-Eurozone Member States should be able to join on equivalent terms to Eurozone countries with an appropriate balance of rights and responsibilities, including in respect of their decisional involvement.

Interaction with other legislation (existing and proposed)

Concerning legislative proposals currently under consideration, - in particular proposals for the Capital Requirements Regulation and Directive, the Recovery and Resolution Directive, and the Directive on Deposit Guarantee Schemes - we agree with the Commission's analysis that these are consistent with, and indeed provide an enhanced basis for, banking union. Accordingly the current codecision process on those proposals should be brought to finalisation as quickly as possible. Clearly, these proposals are framed, and should be finalised, with a Single Market focus.