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Comments on the Basel Committee on Banking Supervision's consultative document on *Globally systemically important banks: Assessment methodology and the additional loss absorbency requirement*

Dear Sir, Madam,

Many thanks for the opportunity to respond to the consultative document on Globally systemically important banks: Assessment methodology and the additional loss absorbency requirement.

I. General remarks

1. The Association of German Banks supports the initiatives undertaken by international regulators to sustainably improve the resilience of the financial system in order to prevent future crises or reduce their impact. These initiatives entail introducing an orderly resolution regime and appropriate crisis management mechanism for financial institutions which may pose a threat to system stability, and generally reducing systemic risk in the financial sector. Against this backdrop, the objective of the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision, which is to be operationalised by the present consultative document, is in principle understandable.

2. As the Basel Committee rightly points out, the revision of the Basel framework (Basel 2.5 and Basel III) and, in this respect, particularly the tighter capital and liquidity requirements as well as tougher trading book and counterparty risk rules ushered in reforms that ensure more stability within the financial system. It is also a fact, however, that the new regulations are directed mainly at big banks' business models. On the assumption that large international

banks are perceived as potentially systemically important, regulations have thus been put in place to explicitly ensure that they are made more resistant to crises and have more and better-quality capital at their disposal to absorb losses.

3. It is difficult to understand how the Basel Committee comes to the conclusion that the Basel III regulations, which have not yet entered into force and on whose application no experience has yet been gathered, are insufficient to address the risks of globally systemically important banks. The argument that G-SIBs cause negative externalities ignores the fact that, besides these negative effects, positive external effects also play a role in the global financial system, which are of great benefit to the real economy.

4. The private banks have so far always argued against any one-sided focus on large international banks in the treatment of systemic risk and continue to maintain this position. In particular, we believe that lists of systemically important banks and the prudential measures, i.e. tighter capital requirements, applying to these are the wrong approach, as they fail to address the actual causes of systemic risk. Instead, an appropriate crisis prevention and intervention mechanism such as that already implemented in, for example, Germany under the Restructuring Act should be established. The FSB's work on creating a resolution framework also goes in the right direction.

5. At the same time, we understand that the political will to regulate SIFIs more tightly exists and that the G20 resolution needs to be implemented accordingly. However, particularly because of the comprehensive reform of Basel III and the unclear impact on the financial sector and the real economy, it is highly important that the G20's demands are translated into action properly. In our view, this means initially setting low additional requirements which – if justified – can subsequently be tightened. In this way, the imminent risk of overstraining the financial sector could be avoided.

6. The consultative document pursues two objectives: increasing banks' going concern loss absorbency and creating incentives to reduce their level of systemic importance. However, it is questionable whether it is actually possible for large internationally operating banks to significantly reduce their systemic importance based on the score produced by the proposed assessment methodology without fundamentally altering their business model and business structure, while at the same time avoiding any negative implications for the real economy. We believe that the measures proposed for G-SIBs by the Basel Committee hamper future economic growth by generally punishing and thus limiting any increase in size.

II. Specific remarks

Assessment methodology

7. We believe that, because more complex methodologies are difficult to adapt to the market as a whole due to the lack of satisfactory data quality, a simple and transparent methodology is appropriate.

8. A positive aspect in our view is that – provided data is gathered consistently – a uniform methodology will be applied to all banks, creating a level playing field. In particular, the bar for national supervisors seeking to overrule the score would be high. This is undoubtedly to be welcomed.

9. We also support the Basel Committee's intention to further improve the quality of the data available. In our view, uniform definition and use of the underlying indicators is essential. Divergent accounting standards (e.g. US GAAP, IFRS) in particular produce signify-cant differences that may significantly influence the score.

10. Due to the fact that many indicators are closely correlated with it, size is the dominant criterion in the assessment methodology as a whole. We believe that size is thus strongly overweighted, which is a conceptual flaw in our view. After all, it is evident that any distress of very large international banks will cause shock waves that may destabilise the financial system. An intrinsic feature of big banks is that they are heavily interconnected, inter-nationally active, have a large volume of assets under management and provide global payment and clearing services. It should be made clear that these are, however, mainly requirements dictated by the market (real economy) to which the banks respond.

11. The proposed methodology is therefore able in particular to identify large SIBs. However, it is questionable whether such a methodology is actually needed in the first place for this purpose since, as mentioned above, a large systemically important bank can also be identified by means of a simple expert assessment. The weakness of the methodology lies in the fact that particularly smaller banks and groups of banks whose failure may well pose a threat to financial market stability are not taken into account.

12. The sample incorporates only the data from currently 73 banks chosen on the basis of size and supervisory judgement applied by home supervisors. This effectively means making a pre-selection which is strongly dominated by bank size and which at the same time creates

the danger of other potentially systemically important banks being ignored from the outset. *In our view, the range of potential SIBs is therefore inadequately defined.*

13. Each systemic importance score is produced by setting a bank's individual characteristics in relation to the sum total of the characteristics of all banks included in the sample. This creates three conceptual problems in our view:

(a) The result is merely a score in the form of a ranking within the sample, meaning that a bank's actual importance in the global financial market (see previous point) is not fully reflected.

(b) Changes in economic performance (expressed in terms of GDP) always also affect banks' balance sheets. Assuming that the economy grows during a given period in only one country, the banks domiciled there would obtain a higher score for this alone (and thus be punished) if the increase in the balance sheet total merely reflects the economic growth.

(c) If all the banks in the sample reduce their systemic importance to the same extent, the score will remain unchanged even though the systemic risk in the financial sector has declined. Despite implementation of the objectives desired by regulators, this would have no positive consequences for banks.

Indicators

14. It should, in our view, be ensured that measurement of bank size using the leverage ratio definition is based on uniform accounting standards in order to avoid distortions of competition.

15. Defining the wholesale funding ratio as "total liabilities less retail funding" is, we believe, too broad an approach, since liabilities incurred not to financial institutions but too, for example, industrial enterprises remain covered. Particularly with capital market issues, it is virtually impossible to ascertain which securities are held by financial institutions. Furthermore, provisions would also fall under the definition of wholesale funding. We propose that a clear-cut positive definition be made.

In addition, it needs to be remarked that the the differentiation between short and long term funding ist not taken into account by this indicator. Thus, ignoring that the interconnectedness is strongly determined by the stability of liabilities.

16. It is difficult for us to imagine that the indicators for determining complexity would actually be meaningful. Setting the value of Level 3 assets reported by a bank in relation to the sum total of the amounts reported by all banks in the sample does not, in our view, say anything about the complexity of a bank. For example, it is conceivable that a bank could report a Level 3 asset of € 100, whilst all other banks do not possess any. In this case, the bank would achieve the highest score in this category, even though the volume would be of no significance either in the bank or the banking sector. For this reason, it would perhaps be more appropriate to apply the ratio of Level 3 assets to Level 1 + 2 assets.

The paper presents no recognition of the movement of OTC Derivatives to Central Counterparties (CCP). The new rules have been specifically designed to reduce systemic risk. For this, OTC Derivatives should be deducted when computing the complexity indicator.

17. The substitutability of institution plays an important rule in the assessment system. However, there is no difference in the market dominance of business fields with different degrees of riskiness, the relevant factor is the mere market share. When it comes to highly collateralized activities like payment and clearings systems, capital does not protect this kind of activity. For this it does not make sense to take such business fields as much into account as business field with a capital backed risk profile.

Bucketing approach

18. The consultative document does not explain how the cut-off score is fixed, however. Instead, it creates the impression that the lowest threshold and thus the subsequent thresholds for the individual buckets have been set arbitrarily. To enhance transparency, the thresholds should be fixed on the basis of objective and understandable criteria.

Supervisory judgement

19. Under the proposed procedure, G-SIBs are to be identified using as uniform criteria as possible in order to generally avoid any distortions of competition. We expressly support this approach. In particular, we believe it makes sense to set the bar for judgemental adjustment of the scores high by establishing a clearly defined process in the course of which the approval of both the FSB and the Basel Committee is required. We also welcome it that

adjustment by a host supervisor is subject to much stricter requirements and that this must be well-justified and well-documented, since the framework should never be misused to enforce countries' competitive interests.

20. Scoring will not produce satisfactory results in every case, so that subsequent adjustment by national supervisors in rare cases makes sense. The Basel Committee explicitly states that the quality of the resolution regime should not play any role in this respect, however. We would point out in this connection that the FSB aims precisely to create incentives to implement good, practicable rules at national level in order to ensure resolution of systemically important banks. In terms of the impact on the global financial system, it consequently makes a difference whether a jurisdiction has a comprehensive, sophisticated resolution regime. To strengthen incentives internationally, the quality of the resolution regime in the home country should in fact play a role in the scores.

21. Some countries have supplemented a restructuring regime by already introducing a bank levy designed to provide funds for restructuring distressed systemically important banks and thus to help prevent a systemic crisis. We realise that capital surcharges are intended to have a going-concern impact, so that considering capital surcharges and bank levies as equivalent in this respect would be wrong. Nevertheless, a bank levy fulfils a second purpose that is also to be pursued with capital surcharges: creating incentives to reduce systemic importance/eliminating any competitive advantages. Both instruments therefore go in the same direction. For this reason, we recommend that such a bank levy should be taken into account either when computing scores or when calculating capital surcharges.

Periodic review and refinement

22. As explained above, economic developments are reflected in the underlying indicators, so that adjustment of the thresholds every three to five years could produce undesirable results.

23. We request clarification to the effect that the denominator will be updated simultaneously (annually) with banks' scores.

24. Adjusting the composition of the sample less frequently could, in our view, harbour the danger that developments at banks not included in the sample may not be captured in a timely manner, possibly triggering disruption as a result.

Magnitude of additional loss absorbency and its impact

25. As mentioned earlier, the revised Basel capital framework presents banks with major challenges. In particular, it is uncertain whether the required capital can be generated fully in the market, nor is there any experience of the extent to which the new requirements impact the real economy. In our view, the additional capital requirements of 1% - 2.5% (3.5%) that are to be introduced alongside the capital-conservation and countercyclical buffers are much too high. In a first step, a more cautious approach should be adopted, with the lowest threshold being reduced to 0.5% and the capital surcharge in bucket 4 to 2%.

26. Completely inappropriate in our view is the encouragement given to national supervisors in paragraph 74 to impose a higher additional loss absorbency requirement if they so wish. This will inevitably lead to an unlevel playing field and is at odds with an objective procedure. It is also unclear how it fits in with the process defined in paragraphs 65 – 67 of the consultative document, according to which overruling is only allowed in justified exceptional cases. We are opposed to the idea of giving national supervisors any free rein.

Instruments to meet the additional loss absorbency requirement

27. The limitation to Common Equity Tier 1 is, in our view, too narrow an interpretation of the G20 demands. G-SIBs *are accordingly to have higher loss absorbency, going beyond the* minimum requirements set in Basel III. The FSB progress reports issued so far have always been based on the understanding that higher loss absorbency cannot be achieved solely by more capital but should instead be achieved by a mix of different instruments (capital surcharges, contingent capital ⇒ CoCos, bail-in instruments etc.) geared to national specifities.

28. While it is correct that little experience has been gathered to date with CoCos, the example of Switzerland shows that their successful placement in the market is possible. To ensure a level playing field, the use of CoCos for the additional capital buffer should be allowed.

29. The demand for Common Equity Tier 1 generated by implementation of Basel III would be drastically increased by a capital buffer for systemically important banks that would have to be held solely in Common Equity Tier 1. Issuing CoCos would, on the other hand, considerably broaden the capital and investor base and thus help, overall, to ease the situation not only for G-SIBs. In general, Basle III will lead to an increase of capital for all financial institutions. An additional demand by G-SIBs due to their definition of G-SIB will raise

the cost of scare capital resources for all institutions. We are therefore expressly in favour of allowing the capital buffer for SIBs to be made up at least partly of CoCos, with the actual capital mix being left to the discretion of banks.

30. We believe that the pros and cons of Common Equity Tier 1 and CoCos for achieving higher G-SIB loss absorbency are evenly balanced and therefore cannot understand the Basel Committee's decision in favour of Common Equity Tier 1. The disadvantages outlined in paragraph 87 are, on closer examination, a question of appropriate contractual arrangement of the instruments and precise requirements set by regulators to ensure uniform application.

(a) Trigger failure: We fail to understand this argument. After all, the terms and conditions of the issue set out quite clearly from when conversion takes place. A trigger in the form of a regulatory ratio actually has the advantage that it is objectively determinable and conversion into equity is possible without any problems.

(b) Cost effectiveness: Investors will calculate ex ante how probable conversion is. Irrespective of this, investors in Common Equity Tier 1 expect a higher return because such capital is usually subject to sharper fluctuations in value. The return would be fixed in advance in the case of CoCos as well.
Rollover risk is, in our view, a question of appropriate management and does not differ in this respect from other hybrid capital instruments which have a predefined maturity.

(c) Complexity: Convertible capital instruments are not in principle new capital market products. Merely the tie-in to regulatory triggers could be seen as an innovation. However, such an instrument should be easy to understand for professional investors, so that the charge of complexity is unjustified in our view.

(d) Death spiral/Adverse signalling: Our understanding is that the risks referred to apply to both CoCos and Common Equity Tier 1.

(e) Negative shareholder incentives: Here, too, we assume that the management reactions outlined could apply also if there were a reduced Tier 1 ratio.
We therefore see no difference between the instruments. We doubt, however, that owners will defer losses to let CoCo holders share in them.

Interaction with other elements of the Basel III framework

31. We believe that application of the tighter requirements solely at group level is appropriate. After all, all the indicators for assessing systemic importance are determined at group level. In our view, the actual degree of systemic importance can scarcely be assessed at solo level.

32. Enforcing the additional capital requirements also at solo level may lead to a group of banks holding much more capital overall than is actually called for. This would result in unfair disadvantages. It is, for example, conceivable that a group of banks may conduct mainly retail business and comply with the Basel III minimum capital requirements in one country, whilst setting aside more capital in another country because it focuses there on more volatile investment banking. Overall, it would comply with the minimum capital requirements at group level. If supervisors in country 1 were to demand compliance with the additional capital requirements for G-SIBs, the group would, as a whole, set aside "too much" capital.

33. An obiligation for disclosure is mentioned in the paper as a possiblility, but not lined out. We want to warn forcing institutions to lay down in detail elements of the computations or the underlying scores. We fear that this might be potentially misleading and may have unintended consequences.

Yours sincerely,

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