The voice of banking
& financial services

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Dear Sirs

Global systemically important banks: Assessment methodology and the additional loss absorbency requirement

The British Bankers' Association ("BBA") is the leading association for UK banking and financial services for the UK banking and financial services sector, speaking for over 230 banking members from 60 countries on the full range of the UK and international banking issues. I am pleased to say that all the major banking players in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.

The BBA is pleased to respond to the consultation on global systemically important banks: assessment methodology and the additional loss absorbency requirement paper.

General comments

We support the objective of the paper and the need to both reduce the probability of a failure by a G-SIB, and reduce the extent or impact of any such failure. We are keen to support and work with the Basel Committee in order to be constructive and to ensure the final measures are both suitable and proportionate.

The introduction of G-SIB specific measures needs to be carefully balanced against the higher capital and other measures being introduced through Basel III and the other post crisis initiatives (the most significant of which being those related to higher capital charges). These measures all safeguard and reduce systemic risk, and in order to avoid double counting, it is essential that any additional requirements do not replicate what is already in place.

Based on this assumption we support the acknowledgement that the proposed G-SIB extension to the capital conservation buffer is part of a 'menu of approaches' to address the externalities posed by G-SIBS. Furthermore, loss absorbency at group level needs to be re-evaluated so it does not result in additional requirements at different levels, leading to potential double charging and regulatory uncertainty.

All banks contribute to systemic risk, but it must be acknowledged that each firm has its own idiosyncrasies and a universal approach to all banks is inappropriate. It is important to examine firms at a specific level, an assessment based upon performing a firm specific risk

adjusted assessment. We suggest further analysis is needed to better understand the dynamics and ensure any contribution is considered, fair and proportionate.

The current proposals should be viewed as a stepping stone towards a more risk adjusted basis, with a commitment sought to engage with industry to develop this approach. We suggest that the individual and cumulative impact of the other measures that have already being brought in and introduced by the Basel III changes are considered in their entirety in regards to reducing systemic risk.

Methodology

Categories and scoring

The five suggested categories are reasonable, while any more could become too complex and unmanageable. However, there is a need to make sure the system is not open to gaming and to becoming unmanageable. The indicators also need to be more risk sensitive, and not simply related to size, as they are now.

The score assigned to each bank is calculated in accordance with each bank's weight relevant to the other banks regulated by the requirements. However, we would appreciate clarification that the framework's intention it to be based on absolute measures of systemic importance rather than simply relative to other banks. This is important in order to provide sufficient incentive for banks to reduce their size, interconnectedness and risk.

Incentives to reduce systemic risk

There needs to be scope for all G-SIB banks to collectively reduce their additional loss absorbency requirement, and to move down the buckets scale collectively over time. The parameters need to provide clear incentives for the reduction of systemic risk, and the defined possibility to move down buckets as well as upwards.

It needs to be acknowledged that collective action would reduce both individual and collective risk. A potential issue here is if rankings are based on parameters that are based mostly on size, all firms could educe their size and therefore systemic risk, but proportionately they may not change, and therefore would retain their position in the respective buckets despite the reduction or risk. This reduces the incentives to reduce systemic risk and must be avoided.

The proposal needs positive incentives which capture steps taken to improve recoverability and resolvability. For instance, a bank undertaking structural reforms to lower LGD significantly, whether of its own volition or imposed be separate regulatory intervention (for example, the Independent Commission on Banking in the UK). Recognition of the unique issues posed by institutions that are globally systemically important and the objective and rationale of loss absorbency specific to G-SIBs, thereby reducing the probability of failure and the consequential effects of disruption that would follow. Although we appreciate there need to be general principles, the "one size fits all" approach must be avoided as much as possible.

The 'probability of failure' is determined by many factors, some of which are directly within a firm's control, others of which are at a macro-economic level and cannot be independently controlled by the firm (for example the economic and political environment within which firms operate). To this extent Recovery Plans will increasingly become a key safeguard which can reduce the likelihood of default and Resolution plans will mitigate the effects that follow in

the rare event that a G-SIFI bank default occurs, both reducing risk to the functioning of the financial system and thus systemic risk.

There needs to be clear, measurable and achievable incentives for banks to reduce their systemic risk. Banks that take positive steps to mitigate their contribution to the perceived systemic risks need to be acknowledged. One option to achieve this would be to outline some guidelines for how a firm might achieve “credit” against their systemic importance. This would be predefined and measured against a set criteria, for example, being able to demonstrate a robust Recovery and Resolution Plan. This could lead to a bank potentially moving down a bucket, and provide assurance that banks taking proactive measures to reduce their systemic risk would be rewarded.

Review

Greater clarification is needed on the annual review process which determines which banks are G-SIBS and into what bucket they have been allocated. There needs to be more detail on the process through which the review will be conducted, and how the results will be implemented. For example, it needs to be addressed whether firms will receive specific feedback and guidance, and whether there will there be the possibility to move down the buckets based on the results of the review.

The review of the actual methodology itself should be more frequent than every 3-5 years as currently proposed. The suitability of the indicators used and their application are likely to vary over time scales shorter than every 3-5 years, and review should be more frequent in order to ensure their relevance and effectiveness.

There is concern that the metrics will be continually recalibrated to ensure banks always stay within the same bucket regardless of what they do to reduce their systemic risk. There needs to be clear guidelines on the basis of any future calibrations, and a clear incentive for banks to reduce their systemic risk accordingly.

Cumulative assessment impact

It is critical that there will be a cumulative impact assessment including a clear understanding of the potential economic impact. Although the MAG has been tasked to do this, we should not solely rely on this to highlight any potential consequences.

Transparency

In the interests of transparency the 28 banks should be revealed. The paper indicates the number will evolve over time as banks change their behaviour in response to the G-SIB framework. In order for the process to be credible firms will need to know exactly where are placed in the framework, and it naturally follows without this it they will not be able to manage their business in a way conducive to reducing systemic risk. There also needs to be a high level of transparency around the methodologies used, data and any decisions based on this information.

It is also important to maintain clarity and transparency around entry and exit criteria for G-SIB status, as well as which banks are regarded as G-SIBS, and which bucket they currently reside in.

Interaction with capital buffers and Pillar 2

It is vital to maintain international consistency throughout the implementation process. This is particularly relevant to the Pillar 2 approach; the use of supervisory judgements under Pillar 2 needs to be regulated by precise, workable and consistent international rules. Greater clarity is needed on how this will be achieved and regulated.

We suggest that further consideration is given to the need for a specific GSIB extension to the capital buffer. Supervisors have specific tools at their disposal under the Pillar 2 framework to apply additional capital add-ons where the risks a firm is running are deemed not to have been adequately captured under Pillar I, or are not considered to be sufficiently managed or mitigated. In many cases this may already include an assessment of systemic risk and should form the basis for a more balanced approach taking into account measures already included in Pillar 1 (as part of Basel 3), the quality of Recovery and Resolutions Plans, a capital buffer based of stress test results, local SIFI and supervisory measures already in place.

We believe it would also be prudent for regulators have flexibility to adjust the G-SIB buffer in a stress scenario, to avoid restricting banks from undertaking recovery actions and further constraining economic growth. This would support an increased chance of recovery during a stress event, in a similar way to the countercyclical buffer. A requirement for this to operate effectively would be for banks to have appropriate recovery and resolution plans in place, and steps would need to be taken to promote global consistency.

The BBA also feels that the effect of entering the buffer is too severe, with the initial restriction on capital set at the same 40% level as the capital conservation buffer. This will require G-SIBs to set a management buffer substantially above the combined buffer, adding further to the cumulative impacts of other measures. Instead, we suggest the G-SIB buffer be set as a separate range above the capital conservation buffer. This could then act as a true stress buffer if no restrictions on distributions were applied upon first entering the buffer but rather such an event acted to trigger the implementation of recovery activity which the G-SIB would have previously agreed with the regulator. A more substantial breach of the buffer could then attract restrictions but we suggest setting these at 20% to act as a first stage before the 40% restriction applies at the 7% CET1 capital conservation buffer boundary.

We support the need to make the global financial system more stable through better regulation, including enhanced capital standards and agrees that identifying and understanding the unique risks that G-SIBs pose to the financial system, is an important element of this, but any standards brought in need to be implemented in a globally consistent way.

Contingent capital

In relation to the “cons” of going-concern contingent capital relative to common equity, we would point out the that the presence of a maturity and mandatory coupon date prior to conversion would not necessarily undermine loss absorbency as these factors would have already affected capital treatment as CoCos can feature in Tier 2. The fundamental basis of CoCos is that they turn into equity in a situation where the bank would need it, and in this scenario it could be argued on conversion the factors would not be an issue.

We would suggest further consideration is given to allowing temporary rather than permanent write downs. This would offer more room for manoeuvre, and would have the added advantage of attracting a wider base of investors.

We strongly believe contingent capital should be retained as an option by which banks could satisfy the G-SIB loss absorbency requirement if at all possible. Taking into account the significantly increased capital requirements being placed on G-SIBs, the cost to the economy of requiring the G-SIB buffer to be made up exclusively of CET1 would be significant. It is vital that contingent capital is retained as an option by the Basel Committee. At this stage it would be prudent to apply as much flexibility should be applied to the choice of instruments as possible.

Phase in arrangements

There need to be provisions to ensure the indicators remain relevant and proportionate to any future changes in market and economic conditions. It will be important that industry feedback will be considered both in the run up to 1 Jan 2016 and throughout the implementation period to 1 Jan 2019. Jurisdictions that have few or no banks in the 28 must also be prepared for having any future entrants into the G-SIB category, and be prepared to both regulate these firms and understand any economic consequences of this.

Due to the relatively long time frame before implementation, it is important to have a sufficient observation period and to monitor global economic activity with a view to modifying any requirements if it is prudent to do so.

Conclusion

The BBA supports the objectives of this paper. However, the points outlined above must be addressed, and provisions to put in place to meet the issues, in order to ensure the success of the proposal.

Yours sincerely,

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