European Banking Federation

EBF ref.: D1446A-2011
Brussels, 26 August, 2011

Set up in 1960, the European Banking Federation is the voice of the European banking sector (European Union & European Free Trade Association countries). The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions.
The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.

Subject : Final EBF response to the BCBS consultation on the assessment methodology and the additional loss absorbency of Global Systemically Important Banks (G-SIBs)

The EBF welcomes the opportunity to share with the Basel Committee (BCBS) the views of the European banking sector on the proposal for an assessment methodology and the additional loss absorbency requirement for global systemically important banks (G-SIBs).

It is understood that international policy makers have worked out a two-pronged solution to the systemic risk posed by banks: One of the initiatives is intended to reduce the probability of default of G-SIBs by increasing their going-concern loss absorbency while the other one is geared to reduce the impact of failure by means of recovery and resolution frameworks. It is also acknowledged how difficult it is to develop a new methodology to approximate the degree of systemic risk of banks, due to data availability constraints and lack of precedent in the regulatory arena.

The effort made by the BCBS to widen the set of indicators of systemic risk is recognised and welcomed by the European banking industry. The EBF comes forward in this paper with a number of suggestions with a view to the presentation of a more elaborated proposal at the forthcoming G20 Summit in November 2011. The proposed framework should be adjusted in the future by incorporating additional intelligence so as to ensure that it portrays to a greater extent the genuine sources of systemic risk.

Contact Person: Gonzalo Gasós, g.gasos@ebf-fbe.eu
Related documents: BCBS Consultative Document http://www.bis.org/publ/bcbs201.pdf.

a.i.s.b.l
10, rue Montoyer B-1000 Brussels
+32 (0)2 508 37 11 Phone
+32 (0)2 511 23 28 Fax
www.ebf-fbe.eu

Key points

- The incentives to resolvability should be taken on board in the proposed model.
- The framework should be extended to non-banking financial institutions.
- The assessment methodology should be sensitive to the total systemic risk of the whole sample and not only the relative position within the sample.
- The model should include risk-sensitive measures to complement and improve accounting figures.
- The benefits of diversification should be factored in for the sake of preserving the right incentives.
- Contingent capital should be eligible as a G-SIBs buffer instrument.
- The G-SIB buffer should be established as a distinct range above the capital conservation buffer to avoid the “cliff effect” of the restriction on distributions.
- The activities financed by an affiliate in the country and currency where it is domiciled should be considered local activities and not cross border.
- The nature of the EU single market should mean that intra-EU transactions are not treated as cross-jurisdictional activity.
- Any additional loss absorbency should only be required at the consolidated group level.
- The cumulative impact (on top of Basel III and national rules) remains a major concern, especially in the context of the still fragile economic recovery.
- Additional capital cannot be the only answer. Improved risk management practices and governance are central to systemic risk prevention.

General observations

1. The BCBS approach of arranging G-SIBs in tiers according to their systemic importance is seen as a step in the right direction, though the underlying indicators need to be adequately complemented with the assessment of qualitative aspects such as corporate governance, business models and risk management practices.

2. The BCBS should reconsider the structure of incentives implied in the indicators-based approach. As the proposal stands now, indicators become more important than risk management practices. The reduction of the probability of default (PD) by mere capital surcharges based on indicators is somewhat blunt. An effective framework to reduce the PD of SIBs should rather focus on the incentives to improved risk management practices. Unequivocally, the risk culture, soundness of the credit-granting process, credit administration and the risk controls in place ultimately determine the probability of default to a larger extent than any set of accounting figures.

3. It is the opinion of the EBF that such a high level of additional capital for G-SIBs, with little progress on measures for other institutions which contribute to systemic risk, is too far-reaching and could hamper development of a more robust solution (including the evaluation of risk management).

4. Flexibility should be sought as regards the instruments to meet the additional loss absorbency requirement. In principle, the debate on the instruments to meet additional loss absorbency should be pursued and contingent capital should be admitted as an alternative to common equity tier 1 for G-SIBs. Background experience is too limited to allow for sound market references so far, but it should be enriched during the next 5 years until the expected timeline for implementation of this proposal in 2016.

5. The EBF believes that the criteria for membership of the initial sample of (currently 73) banks should be much more transparent, given that this is such an important part of the methodology. It should also be clarified that membership of the initial sample is based on absolute measures (so that the population could rise or fall) rather than on relative measures (to keep the population constant).

6. As a matter of principle, the EU must be seen as a single market, especially in terms of interconnectedness across borders inside the EU. This should be considered, particularly, in the factor of cross-jurisdictional activity. The EU is committed to do further progress on this front, as can be taken from the Crisis Management framework for the financial sector it wishes to implement in a near future.

7. The European banking community believes that the determination of capital surcharges can only be made at the consolidated group level. Groups as a whole can be systemic but not individual institutions. Allowing host supervisors to apply the requirement at the individual legal entity would complicate implementation and lead to inconsistencies at the international level.

8. The application of consolidated and local requirements without a proper coordination led by the home supervisor could result in an unjustified double surcharge that penalizes the structure of global banks organized as subsidiaries.

9. The assessment methodology overlooks the fact that large cross-border institutions contribute strongly to financial stability through liquidity creation, market making and "buyer-of-last-resort" activities, as has been witnessed during the crisis. Identified indicators will create incentives to reduce these activities. However, the authorities provide no indication on how these vital functions are going to be covered going forward. Consequently, the framework may actually weaken financial stability unless the capital surcharges are kept low while the remaining problems are carefully studied and solved.

10. The EBF remains concerned that the cumulative effects of G-SIBs requirements and other upcoming regulations from Basel III to new market rules pose a risk to the recovery of the global economy and exacerbate the market uncertainties as regards the future asset prices and economic growth thus weakening financial stability.

11. The process needs to be far more transparent. The 28 banks should be made public, and it should be clear why banks are given G-SIB status. This is necessary to ensure the credibility of the regulations and that they are held to suitable scrutiny. Transparency is particularly important in regards to methodologies, data and any decisions made based on this information.

12. The level playing field between all financial institutions should be kept at all levels: globally, regionally and nationally. The EBF is concerned about how this proposal will compare to the US regulation. Indeed, section 165 of Dodd-Frank Act requires the Federal Reserve to adopt rules subjecting US bank holding companies with more than $50 billion in total consolidated assets to « more stringent » capital requirements. The criteria for capital surcharges are not the same as those put forward by the BCBS. Therefore, it is important to ensure that there will be full harmonization between different countries, within countries and between different financial institutions (banks, insurance companies, market infrastructures, and so on) to avoid competitive distortions.

Assessment methodology for systemic importance of G-SIBs

13. As acknowledged in the consultative document, models for measuring systemic importance of banks are at a very early stage of development. Nonetheless, researchers across the world are progressing fast and their contribution should be taken on board in the final framework for systemic risk prevention. The proposed indicators-based approach will be put in place in 5 years time. In this lapse of time, new methodologies will have rendered this model obsolete. Therefore, there is need to acknowledge that the current proposal is a first step that will be refined on an ongoing basis; consequently, the level of associated regulatory pressure (i.e. additional loss absorbency) should be kept lower meanwhile.

14. A case in point is the dynamic factor framework proposed in a recent working paper published by the European Central Bank (ECB)[1]. This empirical study builds an early warning indicator for financial distress based on the dynamics observed in more than 800 European and US financial firms and many more non-financial firms. The EBF suggests that international policy makers do not boil systemic risk prevention down to the current indicators-based system and commit themselves to improve the proposed framework taking on board current and upcoming research.

15. The EBF thinks it advisable to develop additional modelling techniques that could be complementary to the one at hand. The EBF considers that, in what regards systemic risk, it is difficult to argue that one approach, even if it considers different dimensions of systemic risk[2], will be sufficient. The benefits of having complementary approaches when handling systemic risk have been acknowledged in International Monetary Fund (2009)[3], where a series of complementary approaches are used to study different angles of the recent financial crisis. The Deutsche Bundesbank ascertains a similar message[4]: "Measuring systemic risk requires a broad spectrum of approaches in order to adequately capture the manifold aspects of risk". Therefore, the BCBS should take the necessary time to develop complementary approaches, possibly relying on concrete studies/models that build on network theory or real-time market data, among others.

16. Strands of research to analyze systemic risk stemming from the financial sector, like the abovementioned, should not be neglected. It would be a lost opportunity if harsh requirements are now agreed based on a set of simple indicators. Instead, further research should be encouraged and taken on board for the sake of systemic risk prevention.

17. The pre-selection of 73 entities appears to be strongly dominated by bank size. Other systemically important institutions, as experienced in the crisis of 2007, would be out of the sample, rendering the framework incomplete. The proposed methodology is very able to identify large SIBs. The weakness of the methodology lies in the fact that smaller banks and groups of banks whose failure may well pose a threat to financial market stability are not taken into account. The indicators framework is also useful as an input but it should not

[1] Systemic risk diagnostics: Coincident indicators and early warning signals – Bernd Schwaab, Siem Jan Koopman and André Lucas, April 2011 – ECB WPS 1327.

[2] The five dimensions included in the systemic impact score are size, interconnectedness, substitutability, global activity and complexity.

[3] IMF (April 2009) Global Financial Stability Report, Chapter 2: Assessing the systemic implications of financial linkages.

[4] Deutsche Bundesbank, Monthly Report March 2011, page 51.

determine the additional capital requirements to such a large extent. The EBF proposes to soften the additional capital requirements associated with the scores.

18. By and large, all indicators seem to be highly correlated with size. For the sake of understanding, stakeholders would like to know how much of the total score is implicitly explained by the size of an institution itself. If it turns out that the impact of size is overrepresented in the total score, one option could be, if considered appropriate, to reduce the relative weight of size.

19. The incentives to good (improved) risk management practices are missing in the proposal. Accounting data like the one proposed will fall short of capturing the risk management dimension of systemic risk. Provided that it is assessed under sound and consistent standards, risk management quality should be factored in the proposed scoring system replacing partially the weight assigned to quantitative factors.

20. The following issues should be considered in the definition of the proposed indicators:

    a. Cross-jurisdictional activity:

        i. The definition of cross-jurisdictional activity makes no distinction between local currency assets funded with local currency liabilities versus local currency assets funded with non-local currency liabilities. The proposed methodology would penalise local assets in foreign jurisdictions that are funded by local liabilities as compared to those that are funded by liabilities in the bank's home country, even though matching the funding with local liabilities is far less risky and more readily resolvable. Thus, the methodology would incentivise cross border funding of foreign operations, a practice that is objectively riskier. The framework should not reward riskier behaviour.

        ii. Interconnectedness across borders inside the EU should not be seen as contributing to systemic importance. The EU has defined European System of Financial Supervision (ESFS) including both micro and macro-prudential authorities and it has proceeded far in developing its cross-border crisis management framework. Consequently, the cross-jurisdictional activity should be revised to take into account the local nature of EU banks as EU is functioning more and more as a single jurisdiction with increased harmonization of financial market legislation.

    b. Size:

        i. Basing the *size* indicator on the leverage ratio total exposure measure replicates and aggravates the negative repercussions this has for trade

business: taking trade facilities at face value instead of applying a credit conversion factor impacts on cross border trade, the financing of which is concentrated much with the banks in the SIB sample.

c. Interconnectedness:

    i. The approach deducts retail funding from wholesale liabilities but this would capture more than just wholesale funding. As the accounting definition of total liabilities is not harmonised and includes many other things apart from funding (e.g. valuation adjustments, pension liabilities, etc) the ratio could be misleading. It could be better to define the ratio as the sum of wholesale funding items rather than by differences or at least identify the main adjustments that could distort the indicator and drop them for the definition, whichever is easier.

    ii. Intra-financial system assets and liabilities: It is not clear why repos are the only instruments not limited to transactions with financial institutions.

d. Complexity:

    i. In the computation of OTC derivatives the notional value is too crude a measure and netting should be allowed.

    ii. Some of the proposed indicators do not take account of new regulatory measures being implemented (i.e. Basel 3 and derivatives regulation). For example, the measure of OTC derivatives and Level 3 assets will in future overlap, as most OTC derivatives will in future be cleared, and the remaining part may well be less liquid and based on marked to market models.

    iii. There is also an indicator of securities in the trading book with a view on its potential for marked to market losses: this possible effect is already captured and dampened by the new credit value adjustment charge.

21. Periodic review: The proposal foresees individual G-SIB systemic importance scores to be updated annually based on changes in the bank's indicator amounts. Moreover, the cut-off score and the threshold scores for the surcharge buckets will be initially fixed for three to five years and then reviewed. The EBF suggests BCBS to undertake a more frequent periodic review of the methodology and the bucketing approach (the sample of banks) to ensure suitability and effectiveness. Moreover, the process should include an evaluation of the need to widen or reduce the sample depending on the evolution of the global level of systemic risk.

22. The quality of the resolution regime in the home country, as well as the resolvability of individual institutions, does play a role in systemic risk prevention, thus it should be taken into account as a mitigating factor in the scores system. The EBF suggests the BCBS to include the effects of resolution regimes as an incentive in the proposed model, thus introducing the right incentives for the institutions to increase their resolvability.

The magnitude of additional loss absorbency and its impact

23. The mechanics of the proposed model should be reviewed owing to the fact that the scores are assigned to banks, in every factor, according to their weights relative to the rest of the banks in the sample, irrespective of the overall degree of systemic risk involved. To illustrate this point a hypothetical, albeit unlikely, example, is if all the banks in the sample halved their size, interconnectedness, substitutability, cross-jurisdictional activity and complexity, the additional loss absorbency requirement would remain untouched.

24. The system should allow for the whole sample to move downwards in the buckets scale if the absolute amount of systemic risk goes down over time.

25. Starting off by setting a scaled down additional loss absorbency scheme appears a more cautious approach. The proposed capital surcharges are so high that no room is left for improvements in systemic risk prevention.

26. Setting such an ambitious level of additional capital for G-SIBs at this stage, yet with little progress in the examination of the role that other banks and non-banking financial institutions play in the outbreak of systemic risk, appears a too far-reaching commitment and one that could condition now the future definition of a more robust solution.

27. The underlying rationale of the proposed framework is that the PD of SIBs should be lower given the greater economic impact of their failure. However, the indicators-based approach does not incorporate any measure of PD. Therefore, all SIBs would have higher capital requirements imposed without any bearing to their level of PD, thus penalising SIBs with an already low PD. This situation entails a misleading incentive for SIBs to take on higher risks. Thus, the optimal solution would be that the additional loss absorbent capital was a function of the expected impact of failure of a G-SIB[5]. Hence, the financial institutions envisaged would have an incentive to either decrease their loss given default, their probability of default or both, in order to not carry higher levels of loss absorbency capital.

[5] This would be in line with the rationale underlying the estimated impact approach, presented in annex 2 of the consultative document (one of the calibration approaches used to determine the maximum magnitude of the loss absorbency requirements).

However, today there is no international consensus among regulators on a methodology of computing PDs and LGDs of banks. Therefore, it does not seem to be feasible to implement this approach for the time being. As pointed out above, the EBF suggests further research and analysis on an internationally comparable method aiming at incorporating these risk-based factors.

28. Another proposal of the EBF is to incorporate the benefits of diversification. There should remain an incentive to diversify as a source of systemic risk prevention but the current framework may lead in the opposite direction.

29. Overlapping regulation such as Basel III poses a risk to the recovery of the global economy and exacerbates the market uncertainties as regards the future asset prices and economic growth thus weakening financial stability.

30. There is a risk of overkill in the use of the MAG study to justify that the impact of the proposed capital surcharges on economic growth will be next to nothing. It should be recalled that the additional loss absorbency of G-SIBs come after multiple rises in the capital requirements as a result of the Basel III package. It should also be recalled that the result of the MAG study represents just the median of a distribution with a wide range of results, some of which indicate severe economic impacts. Moreover, looking at the current economic situation and prospects, caution should be put before further tightening the capital requirements of the banking system.

31. Not only the overall impact but the effects of the proposed model on specific business areas should be carefully assessed. For instance, the inclusion of undrawn committed lines in the factor of *lending to financial institutions* as a measure of interconnectedness (as proposed in paragraph 30 of the consultative document) could spell a distinct disincentive to international trade finance.

32. The BCBS proposal explicitly allows local supervisors to impose local SIB capital add-ons for subsidiaries of G-SIBs. This de facto means a disadvantage for the decentralised subsidiary model until the announced future review with particular attention to branches takes place, even though it is widely acknowledged that such a model mitigates systemic risk. In this regard, it is important to have in place an adequate process of surcharge application for banks that may be classified as both global SIB and its subsidiaries as local SIBs, in order to avoid double-counting of surcharges. The colleges of supervisors, with the leadership of the home supervisors, can play an important role in this regard.

Instruments to meet the additional loss absorbency requirement

33. The EBF is of the opinion that rule makers should offer flexibility so as to admit contingent capital as an eligible instrument to meet the additional loss absorbency requirement. Despite

the little experience, there is opportunity for a market development in the coming years up to the implementation date of these rules. Such market forces would determine the relative amounts of equity and contingent capital – but, regardless of that, should conditions deteriorate sufficiently the entire amount would comprise of equity.

34. Increased use of regular/standardised disclosures from banks would reduce the risk of trigger failure (paragraph 87 (a) of the consultation).

35. The argument that the presence of a maturity date and mandatory coupon dates prior to conversion may undermine loss absorbency (paragraph 87 (b)) is overstated because those factors would already affect capital treatment as contingent capital can feature in Tier 2. Moreover, the point of contingent capital is that they can convert to equity and so if the bank entered into difficulties it is likely they would convert and the factors would become irrelevant.

36. The death spiral (paragraph 87 (d) could be contained to some extent by the use of capital based triggers and pre-determined conversion price, Market based triggers, on the other hand could increase this risk – see next point.

37. The EBF supports capital based triggers on the grounds that contingent capital are capital instruments. It opposes market based triggers (Appendix 3 of the consultation refers) which could be affected by market manipulation leading to conversions and death spirals and are not favoured by investors as they are more difficult to price. Market discipline acting as a control on bank risk taking seems unrealistic, given that the markets will find it difficult to assess this.

38. Given the volume of proposals that are currently under development - alongside the additional loss absorbency requirements for SIFIs - and their common effect of increased capital requirements on banks, due consideration should be given to the cumulative impact of the combined proposals. We therefore request the Basel Committee to re-assess its position regarding the required type of capital instruments. In our view, more flexible debt instruments, that would attract a more diverse investor base, should be given ample consideration.

Interaction with other elements of the Basel III framework

39. The rationale behind each of the three types of buffer (capital conservation buffer, counter-cyclical buffer and additional loss absorbency buffer) looks more defendable when analysed on a stand-alone basis. But the key point is the amount of the lump sum of buffers, not the good underlying intentions. And the cumulative size of the capital requirement (which could reach the level of 9.5% plus countercyclical buffer), in the view of the EBF, is going far beyond manageable limits.

40. The EBF is concerned that the scale of the combination of buffers will effectively become a hard limit, given that there is an immediate 40% restriction of distributions as soon as a bank enters it. This increases the risks of wider economic effects and unintended consequences, especially because G-SIBs will need to maintain substantial internal buffers over and above the mandated requirements. If they do not maintain this “safety net” then the consequences of entering the buffer will be too severe.

41. Therefore the EBF proposes the G-SIB buffer to be established as a distinct range above the capital conservation buffer – i.e. in a range from 7% to 9.5%. This would then be used to mitigate the “cliff effects” of the immediate 40% restriction on distributions upon entering the buffer. The EBF envisages the G-SIB buffer then being split in two halves. Following the example, an upper range of 8.25% to 9.5% would have no formal restrictions on distributions but act as an early warning. A lower range of 7% to 8.25% would usually generate a 20% restriction on distributions. Such a gradual approach would smooth market reactions resulting from the restrictions envisaged.

42. The empty bucket would generate additional loss absorbency of a further 1% if utilised. The EBF would deem it sufficiently significant if it is set at 0.5% as the bandings in the rest of the G-SIB buffer.

43. A pillar 2 approach should only be used under clear and harmonised international rules. As a matter of fact, pillar 2 is only applicable in jurisdictions where Basel II has been implemented. Clear and precise guidelines on how this will work in practice will be essential in order to ensuring a level playing field.

44. There should not be multiple additional capital surcharges. There is risk of overlapping in the purposes of the different capital add-ons (pillar 2, countercyclical buffer and loss absorbency buffer).

45. More clarity would be appreciated as to how international consistency will be achieved, especially given the uneven landscape of underlying regulatory frameworks underneath, and not least the prevailing differences in accounting standards.

Phase-in arrangements

46. While the proposal of the BCBS to phase-in the implementation looks quite reasonable, there are grounds for thinking that the market will automatically anticipate the increased capital requirements thus rendering ineffective the proposed phase-in period. It seems more cautious to start off by setting a milder range of capital surcharges and review the terms when more (actual) data is gathered from the markets.

47. The EBF proposes reducing the size of the additional buffers under the commitment of working out a more elaborated framework that will take on board the full scope of banks and non-banking financial institutions and the steps forward in the field of systemic risk prevention.

--- 000 ---