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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
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Dear Sir/Madam,

Re: ***IBFed Comments on the Basel Committee's Consultative Document: Global systemically important banks: Assessment methodology and the additional loss absorbency requirement***

The IBFed appreciates the opportunity to comment on the Basel Committee's consultative document entitled *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*. It wishes to offer the following comments:

General

1. The industry urges the broadening of the scope of the SIFI work to non-bank financial institutions, and strongly recommends the BCBS to align timing and phasing in of measures for SIBs and for non-bank SIFIs so as to avoid unintended consequences such as the disproportionate flow of business to non-bank financial institutions which could increase their individual or joint contribution to systemic risk and the ensuing short term to medium term potential for such non-bank financial institutions to threaten financial stability. We support the objective of the paper and the need to reduce the probability and the impact of any failure of G-SIBs. We want to support and work with the BCBS in order to be constructive and to ensure the measures are suitable and proportionate.

2. However, the IBFed does not support the imposition of a surcharge, at least not at such high levels. It is not clear that another increase in required capital will provide any benefit, particularly before the effect of the new Basel III framework, including buffers, is fully known. In addition there have been numerous changes to prudential standards throughout the world in the wake of the financial crisis and it is important to understand

both the effect and interplay of these new requirements and their potential to affect the pace of financial recovery and future economic growth, in advance of adding an additional requirement.

3. SIFI surcharges at all levels should be subjected to recurring impact studies focusing on the growth of the real economy and loss of efficiencies and innovation. The impact study needs to take account of cumulative effects of other regulatory reforms already agreed or in preparation to reinforce the resilience and the macro- and micro-prudential supervision, including the concurrent work on bank resolution for SIFIs in combination with Basel III, as well as the additional loss absorbency requirement for G-SIBs.

4. If surcharges are introduced, these should be based on a reasonable framework. Any surcharge should be moderate in size and the level playing field between all financial institutions should be kept in mind. It will be important to introduce a sufficient observation period, and to monitor global economic activity with a view to modifying any requirements if it appears prudent to do so. Further to phasing-in, the IBFed 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-banks and the steps forward in the field of systemic risk prevention.

5. The IBFed is concerned that the current proposals result in an immediate 40% restriction on distributions as soon as the buffer is entered. This could impede recovery action by G-SIBs and regulators during stress situations. Moreover, the proposals effectively set the minimum capital standard as high as 9.5% for the largest G-SIBs (in practice more with internal buffers and possibly the countercyclical buffer) and so the IBFed proposes that instead the G-SIB buffer is established as a distinct range above the capital conservation buffer. Upon triggering the buffer initially, there would be no restrictions on distributions but this would act as a trigger for management and regulators to undertake remedial actions. Further down the buffer, restrictions could be applied at, say, 20% as an interim step to the 40% restriction which applies upon entering the capital conservation buffer.

6. The BCBS explicitly recommends 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 can mitigate 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 can play an important role in this regard. The focus should be to ensure that inappropriate and unnecessary options for the host supervisors will not be introduced. Any degree of discretion in such field would increase the degree of uncertainty in the financial markets, incentivise ring-fencing practices and distort the level playing field.

7. More concretely, given possible overlaps between global SIB and local SIB/SIFI regulation, the industry requests that the College of Supervisors is deployed to decide on the adequate process and surcharge application for banks that may be classified as both global SIB and its subsidiaries as local SIB. The industry further urges the BCBS to ensure, through the Basel Standard Implementation Group (SIG) mechanism, that local SIFI regulation is aligned – to the extent possible given local specificities – with global SIB regulation and to monitor its implementation. Preferably, deviations by local authorities from the global SIB methodology should be made public to enhance transparency for external stakeholders.

8. There is a need for international consistency in the implementation, especially given that each bank's score is derived from their part of an aggregate industry metric. Inconsistent implementation has the capacity to exacerbate the current inconsistency in risk weighted asset calculations globally. The need for international consistency is also 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.

9. The chosen SIB methodology deals with the potentially negative repercussions of certain business lines deemed complex, possible spill over effects and the complexity of cross border operations but ignores the dampening effects of geographic diversification in local or regional crisis events. Risk spreading both on the assets and liabilities side should not be disincentivised. In the view of the banks, deliberately choosing to tap into a widely diverse and far spread investor base decreases rather than increases systemic risk.

10. The inclusion of supervisory judgement within a Pillar 2 dialogue requires that more detail on the qualitative aspects of systemic risk should be provided such as governance policies, organisational and business model, and quality of management. In our view, the currently proposed ancillary indicators do not fully capture these aspects, and to some extent, duplicate the main indicators on the quantitative side. In particular the methodology further needs to take into consideration incentives for better risk management and lowering the risk of default of SIFIs (financial institutions, not just banks). Good management practices should lead to a lower score and a lower capital surcharge. In order to strengthen incentives internationally for good, practicable rules at national level to ensure resolution of systemically important banks, the quality of the resolution regime in the home country should also be taken into account. Again, it is important that there are harmonised clear, objective and transparent criteria to guide supervisory judgement on these qualitative aspects to ensure a consistent application and a level playing field across borders.

11. The BCBS explicitly recommends (footnote 16) local supervisors to impose higher surcharges in case there is no credible recovery and resolution plan (RRP). The reverse should also be possible within a Pillar 2 dialogue: a credible RRP should *be used to set off and reduce* the capital surcharge as it is a clear mitigating factor impacting directly on the complexity and substitutability areas, thus reducing the negative externalities caused by a failure of a G-SIB. In cases where there is a good quality RRP in place, this should be acknowledged in some form of credit/benefit to the particular bank. Harmonised international guidance as to how institutions could achieve a reduction of the buffer size would be necessary to ensure a uniform global implementation.

12. The IBFed sees it as essential that the proposed framework for the G-SIB assessment methodology and the additional loss absorbency requirements will be re-assessed at a later point in time (i.e. earlier than the timeframe indicated in the current document) when the methodology is more developed and once many of the analytical challenges have been addressed.

13. In the interests of transparency the names of 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. We would appreciate clarification that the measures are based on absolute parameters (so that the population could rise or fall) and not relative to only other SIFIs (to keep the population constant). It might also be beneficial to indicate what will need to be achieved in order to no longer be included in the 28 and also to move between buckets.

Methodology

14. Financial institutions are concerned with the issue of transparency in the proposal. As it is described in paragraph 72 of the consultation, there needs to be a high level of transparency in terms of data and the methodology used which affects banks and its supervision. This would allow SIBs to adapt their business model in order to mitigate their systemic importance and avoid the burden of additional loss absorbing capital. In this context it is important that the BCBS acknowledge the positive externalities and stabilising role of cross border banks and their respective business models.

15. The BCBS proposed methodology should be improved duly taking into account the riskiness of the different business models adopted by the banks under scrutiny. The crisis clearly demonstrated that some business models are riskier than others. Such risk factor could be easily observed for instance through indicator variables such as the loan-to-deposits ratio or on a harmonized risk-weighted asset measure. The indicators in the measurement approach are generally not sufficiently risk sensitive nor risk adjusted.

16. A Uniform definition and use of the underlying indicators is essential. Divergent accounting standards (e.g. US GAAP, IFRS) in particular produce significant differences that may significantly influence the score.

17. The wholesale funding variable used for interconnectedness requires further refining. The “wholesale funding ratio” is defined as the total liabilities less retail funding divided by total liabilities. 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. Perhaps the BCBS could better define the ratio as the sum of wholesale funding items (eventually listing the relevant items and defining the ratio more accurately) rather than by differences or at least identify the main adjustments that could distort the indicator and drop them from the definition, whichever is easier. In addition, if retained, the measure should be amended such that it reflects the increased systemic risk from an over-reliance on short-term or less ´sticky´ funding sources. It should therefore be adjusted to focus on the tenor of the funding.

18. The different indicators are measured for each individual bank score/amount against the aggregate score/amount summed across all of the 73 banks in the sample. The pre-selection of 73 banks seems to be static. It is as yet unclear how the BCBS will ensure that the model stays current with market developments. For example, 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. The methodology for determining the initial population of 73 should also be made more transparent as the total size of the population is such a key factor in the scores generated under the present methodology.

19. Sufficient incentive needs to be supplied in order for banks to reduce their size and systemic risk. This could be achieved by providing a genuine, achievable and transparent scope for all G-SIB banks to collectively reduce their additional loss absorbency requirement, and move down the buckets scale collectively or individually over time. In order to ensure appropriate incentives it will be essential to make the model future proof while also providing an appropriate and transparent process for the review of the benchmarks. Thus, there needs to be more detail on the process through which the review will be conducted, and how the results will be implemented.

20. The Proposal provides that individual G-SIB systemic importance scores will be updated annually based on changes in the bank indicator amounts, and that the cut-off score and the threshold scores for the surcharge buckets will be initially fixed for three to five years

and then reviewed. Given that the calibrations were based on current estimates and judgments regarding the probability of default and the costs of such default, a reduction in these key variables in the aggregate should result in the need for a reduced capital surcharge in general.

21. 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.

22. Some of the proposed indicators do not take account of new regulatory measures in the process of 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. 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 (CVA) charge.

23. The definition of cross-jurisdictional activity is flawed as it 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. In that sense, the methodology would incentivise cross border funding of foreign operations, a practice that is objectively riskier. The framework should not reward riskier behaviour.

24. The proposed G-SIB methodology incorporates 'OTC derivatives notional value' as an indicator of 'complexity'. OTC derivatives notional value is further defined as the 'sum of foreign exchange, interest rate, equity, commodities, CDS and unallocated derivatives. Gross notional is not an accurate measure of risk (it is a measure of size, but this is being included in the 'Complexity' not 'Size' category). This approach fails to consider the important differences which exist within the derivative markets. For example, the primary risk in FX transactions is settlement risk, a concern largely addressed via the development and use of a 'well-functioning international settlement process, namely Continuous Link Settlement (CLS). In order to ensure consistency in the treatment of FX transactions within the G-SIB framework, we recommend that transactions executed via CLS should be excluded from the definition of 'OTC derivatives notional value'. Similarly, OTC derivatives that are centrally cleared should be excluded from the measure.

Instruments to meet the additional loss absorbency requirement

25. On the instruments to meet the additional loss absorbency requirements, the IBFed believes that such surcharge could be met by a broad range of capital instruments including contingent convertible (CoCos) bonds, which are loss absorbent on a going concern basis. They represent an effective incentive to shareholder discipline and have a lower cost compared to Common Equity Tier 1 instruments. The tentative decision to restrict the composition to Common Equity will have adverse macroeconomic consequences, therefore, appears not entirely justified and certainly will create difficulties in raising capital in the markets and, as a result, reduce the G-SIBs ability to sustain financial intermediation to the real economy with real macroeconomic implications. In an adverse global scenario a run on equity may well increase systemic risk.

26. In this respect, the IBFed supports capital based triggers on the grounds that CoCos are capital instruments. It opposes market based triggers 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.

27. 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.

Yours faithfully,

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Mrs Barbara Frohn
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IBFed Prudential Supervision Working Group