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August 26, 2011

Mr. Stefan Ingves
Chairman
Basel Committee on Banking Supervision
Centralbahnplatz 2
Basel
Switzerland

Re: IIF Views on the Basel Committee's Consultative Document on Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement

Dear Chairman Ingves:

The IIF appreciates the opportunity to comment on the Basel Committee's consultative document on *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*. In developing our comments, we believe it is important to reiterate the industry's support for the need to make the global financial system more stable. One important element of this is understanding the unique risks that global systemically important banks (G-SIBs) could potentially pose to the financial system. However, given the complexity of this issue and the large number of aspects of the proposal that remain to be fully developed and addressed, we would request that further analysis and consultation be made before the proposals are finalized. As noted in our detailed comments below, it is our belief that the proposal still needs to be further developed in order to address a number of unclear provisions as well as technically inconsistent elements.

Furthermore, we wish to emphasize that the IIF has consistently drawn attention to the shortcomings of an approach which relies on designating groups of firms (whether banks or non-bank financial institutions, global or local) as potentially systemic and applying additional loss absorbency requirements to these. This approach will increase the moral hazard and market distorting effects arising out of such firms being seen as 'special' and potentially too big to fail.

There is nothing in the consultative document which addresses these problems. Indeed we note the acknowledgment in the paper (para 81) that banks that are likely to be designated as G-SIBs are already likely to secure funding advantages arising from expectations of public sector support. We do not believe that the application of additional loss absorbency requirements will either offset the additional risk resulting from this moral hazard or act as an effective means of offsetting the market distortions.

While we do not support the approach that the Basel Committee is outlining in its proposals including seeking to measure the systemic impact of firms, the following are our comments on the consultative document.

I. <u>Main comments:</u>

In coming up with a methodology that seeks to measure the systemic importance of firms, the Basel Committee should design it in such a way that it is sufficiently clear, adequately reflective of systemic importance by using metrics that are risk-based and risk sensitive, consistently applied across jurisdictions, and provides clear incentives for reducing systemic risk. In addition, this methodology should be framed in the context of the wide range of capital and other regulatory measures introduced post-crisis. As we will point out below, the proposed methodology fails in all respects.

The methodology for identifying G-SIBs and for determining their capital treatment is not sufficiently clear. These points are developed further below. To begin with, the criteria for choosing the group of 73 institutions are not spelled out – a major omission given the importance of this for the identification and treatment of the identified group of G-SIBs. Neither is there clarity about the mechanism or timing for adjusting the scores of the group of identified G-SIBs. These are critical issues for the banks concerned and a lack of operational clarity about these matters will seriously hinder capital planning for the institutions concerned.

This lack of clarity is compounded by the design of the methodology which leaves a lot of uncertainty as to how banks' actions can actually affect their scores and the amount of surcharges that would be applied to them. This leads to a lot of adverse implications, and **does not provide a clear set of incentives for banks to reduce their systemic importance**. This issue can be addressed if the methodology is redesigned such that banks' actions directly affect their scores/surcharges, through the use of absolute rather than relative measures of systemic importance.

While the industry supports the decision to avoid undue complexity in the chosen approach, a balance must be made between having a simple approach and having adequately risk-based approach. Having a simple approach should not result in **overly simplistic indicators that in no way capture systemic risk**, which is the case with the proposal as outlined. This relates as well to the choice of indicator weights, where no rationale was given at all as to why these should be equal. This especially poses a concern since most of the indicators are deemed correlated as discussed further below. At a minimum, the BCBS should clearly spell out the rationale and technical justification as to why all indicators are weighted the same.

We also wish to emphasize the importance of applying this approach consistently across jurisdictions to ensure a level playing field. The current **lack of sufficient reliability or completeness of the necessary data to construct the indicator-based measurement**, as acknowledged by the consultative document, is therefore a critical issue. To correct this and to achieve international consistency, a common international framework for reporting the data that feeds into the GSIB calculation should be in place before implementing the

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proposal. The Basel Committee should play an active role in the development of this international reporting framework, as well as in ensuring consistency in application.

As with any potentially penal capital treatment of firms or activities, there is **considerable scope for unintended consequences**. The underlying assumption of the paper seems to be that the proposed capital treatment will result in 'systemic' activities shifting from G-SIBs to other, less systemic institutions. It is not at all obvious however that this will be the outcome. Taken together with the other measures applied to banks (i.e. Basel III), the effect may, instead, be to drive some activities outside of the regulated banking sector. There would be no certainty that this would reduce systemic risk, while it would make the activities less visible. The incentives created could equally likely result in changes in business models and product mixes whose effects on systemic risk are hard to know in advance.

How these proposals will play out in practice will depend largely on how the various pieces of new regulations (both finalized and those being or still to be proposed) will interact. Hence, the seeming **lack of thought given to the effect of other regulatory measures in the design of the G-SIB proposals** poses some concern. The introduction of the G-SIB surcharge needs to be seen within the overall context of higher capital and other changes introduced by Basel III and other post-crisis initiatives. These new measures are intended to result in substantial increases in the amount of capital and liquid assets that banks hold, and improved market mechanisms and transparency. That is, these new measures already safeguard against and reduce systemic risk. The sufficiency of these new measures should be evaluated carefully and taken into account in the design of any additional measures for G-SIBs. It is essential that any additional measures for G-SIBs do not replicate what is already in place.

The relationship and interaction among the designated G-SIBs, the local SIBs, other SIFIs, as well as the non-systemically important financial institutions will also play an important role in shaping the consequences of these proposals. To provide a clearer picture, it is important that the FSB and Basel Committee give more guidance as to their plans for the rules on other SIFIs and local SIBs.

We also believe that the proposal provides **disincentives to geographic diversification**. While some of the benefits of diversification may have been shown by the crisis to have been overstated, we believe that diversification of firms by geography is an effective means of spreading risk, provided that these risks are properly managed. In fact, there is some evidence that increase in cross-border banking activities, especially those directed at jurisdictions with less connected banking systems, actually result in reduced probability of a banking crisis.[1] By placing additional capital requirements on cross-border activities, the proposed requirements not only create disincentives to geographic diversification, they also disregard the potential benefits of cross-border activities, especially in certain emerging market jurisdictions.

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[1] See for example: *The bright and the dark side of cross-border banking linkages*, IMF Working Paper 11/186, August 2011.

The assumption appears to be that systemic risk can be decreased by encouraging such firms to reduce international diversification, differentiation and ultimately growth. More fundamentally, the risk of unintended consequences in creating incentives to manage toward efficient resolvability, or even failure, should not be underestimated.

Furthermore, placing additional capital requirements on cross-border activities could exacerbate the impact of the "size" indicator on trade finance. This point is discussed further in the detailed comments. Considering the important role that trade finance plays in facilitating economic growth and recovery, this is a critical issue particularly at these times of great uncertainties in the global economy.

The consultation process being followed also leaves much to be desired. First, the consultation period is quite short for a proposed measure that would have significant implications on the banking system. Second, we also find it questionable that the proposals for a G-SIB capital surcharge have been issued ahead of the finalization of the economic impact analysis. One would assume that the results of the impact analysis would be an important factor in calibrating the additional capital requirement. Third, it is also unclear what the follow-up activities are, except for the setting of the cut-off score by no later than January 1, 2014. Given the many flaws identified, we suggest that the Basel Committee gives more thought on reworking the proposal and putting it out for further consultation.

Finally, we believe that it is **not advisable to contemplate the use of additional loss absorbency requirements until the economic impact of this, together with the wide array of existing measures, are better understood**. We welcome the Basel Committee's efforts to assess the impact of the G-SIBs recommendations, although as we have pointed out, this should have been done before any proposal of a capital surcharge was released. Undertaking the necessary assessment of the effectiveness and economic effects of new regulation is an exceptionally complex and oftentimes contentious task. For example, the IIF's initial estimates released last year differ markedly from the official estimates. A follow-up report is in the process of being finalized and it continues to show significant impacts. We therefore suggest that more consultation and dialogue with the industry be done after the release of the Basel Committee impact assessment in September.

II. <u>Detailed comments:</u>

1. Comments on the measurement approach

a) <u>Data issues</u>

The consultative document acknowledges that the data used to construct the indicator-based measurement approach may not be currently sufficiently reliable or complete. The Basel Committee has committed to fully address any outstanding data quality issues before the implementation date (para 71). We support the Basel Committee's efforts to address the data quality issues identified.

Apart from data quality, it is also important to address data consistency issues. It is important to ensure that a common international framework for reporting the data that feeds into the GSIB calculation would be in place before implementing the proposal. In

doing so, the nature of the impact of the differences and changes in accounting standards on the measurement of indicators should be identified and taken into account.

Ensuring data quality and consistency is essential to achieve level playing field. In this regard, the Basel Committee should play an active role not only in developing the international reporting framework but also in ensuring consistency in application. The data used for G-SIB calculation should also be subject to external audit.

b) Determining the sample

The consultative document gives little information as to how the sample of 73 banks was determined, except that they were chosen on the basis of size and supervisory judgment (para 53). This underscores the inordinate focus on size in the determination of systemic importance. The indicators used to determine this sample and/or the role of supervisory judgment will have been critical in determining the sample of institutions. This has important implications since the proposed approach measures systemic importance on the basis of relative ranking of the banks in the sample. A different sample composition could well result in a different set of G-SIBs. This is a methodological flaw that can be corrected if the Basel Committee uses an absolute rather than a relative measure of systemic importance. But in any case, the Basel Committee should be fully objective and transparent in the selection of the sample banks and in the selection of G-SIBs itself for the industry to be able to make a meaningful assessment of these critically important matters.

c) Calculating G-SIB scores: Need for Absolute Rather than Relative Measures

In determining the G-SIB score and the surcharge of a bank, much more clarity is required in particular about the frequency of updating the denominator used to determine the score, i.e. the aggregate amount for all banks in the sample. While most firms have understood the consultative document as indicating that the denominator will be updated simultaneously with the numerator (i.e. individual bank amount), this remains ambiguous and should be clearly spelled out.

If indeed the denominator will be updated simultaneously with the numerator, this could potentially result in a scenario where banks might not get any incentive for reducing their systemic importance. As currently formulated, the methodology implies that if all banks in the sample were to reduce their activities proportionately, then all scores (and surcharges) would remain the same (at least, in between periods when the banks included in the sample are updated). This would clearly be an undesirable outcome that should be avoided.

Moreover, the fact that systemic importance is treated as a relative concept leaves a lot of uncertainty as to how banks' actions can actually affect their scores and the amount of surcharges that would be applied to them. Reducing activities that are deemed systemic will not automatically result in lower score/surcharge for a given institution if the rate of reduction is smaller than the average for the sample. This is especially a concern for a bank that is near the boundary between bucket 4 and bucket 5 (the empty bucket). Even if the bank tries to reduce its activities, if it falls short of the average, it could end up in bucket 5 and penalized with a significant 1% additional capital surcharge. The proposals therefore do

not provide a clear set of incentives to undertake an orderly process of reducing systemic importance.

The uncertainty as to how banks' actions can affect their level of surcharge will unduly complicate capital planning and business management. Capital planning in particular typically takes place over a multi-year horizon and will be greatly complicated by the approach envisaged. This will be exacerbated by the uncertainty that will result from the periodic review and calibration of the methodology, cut-off and threshold scores.

These issues can be addressed if the methodology is redesigned such that banks' actions directly affect their scores/surcharges, through the use of absolute rather than relative measures of systemic importance. This way, a reduction by a G-SIB of its activities that are deemed systemic will automatically result in a corresponding reduction in its systemic importance and surcharge. This will also ensure that if the systemic importance of the whole sample declines, the overall amount of capital surcharge will also decline. This will provide clear incentives for banks to reduce their systemic risk.

d) Bucketing approach

The proposed approach maps the scores above the cut-off score to buckets, which in turn have corresponding capital surcharges. This bucketing approach unnecessarily introduces undesirable cliff effects. The cliff effects would especially be a problem for banks that are on the margins. These banks could end up flip-flopping from a higher bucket in one year to a lower one the next (or vice versa). This exacerbates the uncertainty resulting from a relative ranking approach. The Basel Committee should therefore consider mapping the scores to a continuous surcharge function rather than to a discrete one. This will result in smoother changes in the systemic surcharge.

2. Comments on the specific indicators

While the Institute understands the desire to avoid an overly-complex methodology, we believe that such goal should not result in overly simplistic indicators that fail to capture systemic risk, which is the case with the proposal as outlined. Our comments below outline our criticism of the indicators selected and their applicability.

Our criticism relates as well to the choice of indicator weights, where no rationale was given at all as to why these should be equal. We find this a fundamental weakness of the proposal and one that has significant implications for the specific outcome of systemic determination. This also underscores our concern about the strong levels of correlation that seem to exist among the indicators chosen. The Institute would encourage the Basel Committee to clearly spell out the rationale and technical justification as to why all indicators are weighted the same. This should be based on clear technical grounds that support such fundamental decision to apply the same weight to all indicators.

More specifically, our comments on individual indicators are as follows:

a) Cross-jurisdictional activity

The more cross-jurisdictional claims and liabilities a bank has, the higher will be its score and, hence, its G-SIB capital surcharge (paras 18-26). This approach may be seen to disincentivize less risky business models. Take the example of two bank holding companies with foreign offices in several jurisdictions. The foreign offices of the first bank holding company fund their local currency assets entirely with local currency liabilities, while the foreign offices of the second fund their local currency assets entirely with home country liabilities. Experience suggests that the first structure is generally less intrinsically risky than the second. However, under the proposal, the first will have a higher score and therefore attract a higher surcharge.

One alternative to address the issue identified above is to use net assets or liabilities by jurisdiction. Another alternative might be to use a measure that captures the risk of cross-jurisdictional activities. The treatment of cross-jurisdictional activity, in common with the other indicators, is striking for the absence of any risk-based factors. In this regard, it should be noted that a bank with exposures to jurisdictions with negatively correlated economic cycles would pose less systemic risk.

b) Size

The proposed approach will result de facto in size being counted multiple times as a determinant of systemic importance. For example, a large bank with a large share of cross-jurisdictional assets will be penalized twice for being large – once through the size indicator and another through the cross-jurisdictional indicator. This is also true for most of the indicators because the underlying assumption is that the larger a bank's market share in particular activities, the more systemically important it is. However, large market share is also usually a function of the size of the bank. Hence, by penalizing large market share in different activities, the framework basically penalizes size several times. Given that these correlations between size and the other indicators are ignored, it could be argued that the size indicator is superfluous or its weight could be reduced.

The preoccupation with size and the potential double counting of this are serious methodological flaws. More fundamentally however, the assumption that large size is a function solely of the cost advantages of being seen as systemic is also problematic. A large size is not only associated with cost advantages from too-big-to-fail considerations, which the proposal sets out to penalize, but it also results in economies of scale that follow from technological advantages such as diversification.[2] Even the latter benefits, which may accrue to large banks and which confer considerable advantages to customers, are also penalized.

This emphasis on size would also inadvertently penalize flights to quality and certain regulator-supported actions in times of market stress. For example, large and diversified banks have typically proven to be a significant part of the solution to past banking crises in that they have continued to provide intermediation when others have withdrawn. In other cases, large banks acquire failing institutions or parts thereof, sometimes with the explicit

[2] See for example: *Who said large banks don't experience scale economies? Evidence from a risk-return-driven cost function*, Federal Reserve Bank of Philadelphia Working Paper No. 11-27, July 2011.

support of the regulators, in order to avoid market disruption. Under the proposals, these activities will be penalized with rising scores/surcharges. Rendering it impossible for firms to behave in this way during periods of crisis is a major step which regulators should reflect on further.

Aside from the concerns already expressed about over-penalizing size, basing the size indicator on the leverage ratio total exposure measure replicates and aggravates the negative repercussions that Basel III has for contingent and other business lines, particularly trade finance. Including the face value of trade finance transactions instead of using CCF will adversely affect cross-border trade, given the significant share of the banks in the SIB sample in these transactions.

c) Intra-financial system assets and liabilities

Here too the absence of any attempt to incorporate risk-based factors in the methodology is striking. The focus is simply on the size of intra-financial system assets and liabilities and not on their riskiness. For example, the measures do not take into account collateral or netting arrangements in place.

Asset/liability measures are explicitly described as those involving other financial institutions only with the exception of repos. It is not clear why that exception arises, especially as other securities financing transactions (securities lending/borrowing) are explicitly described as those involving financial institutions only.

d) Wholesale funding ratio

The wholesale funding ratio is included as an indicator of interconnectedness (para 33). However, including this ratio, which is basically a liquidity indicator, seems inappropriate since this is already taken into account in the liquidity rules of Basel III. In addition, this also overlaps with intra-financial system liabilities, which is proposed to be another indicator of interconnectedness.

If the ratio is to be included, it should be defined as a sum of "short-term" wholesale funding items rather than as a difference between total liabilities and retail funding. Using the latter may be misleading and will just result in inconsistencies across banks and jurisdictions. The accounting definition of total liabilities is not harmonized and includes many other things apart from funding (e.g. valuation adjustments, pension liabilities, etc.). In addition, referring only to wholesale without taking into account the term of funding would mean that a 5-year funding facility would be penalized simply for being sourced from a wholesale provider. This contradicts the discussion in the consultative document itself, which basically says that systemic risk is derived from the term of a bank's funding, not its source, i.e. the concern relates to short-term liquid liabilities (para 33).

Moreover, using the current proposed definition of wholesale funding would include mid corporate deposits, which are not truly wholesale. It would also include deposits from wholesale clients with specific operational relationships, such as those relating to clearing, custody or cash management. It should be noted that these operationally-linked deposits are given a lower run-off rate under the liquidity rules of Basel III, thus recognizing their stable

nature. The same treatment should also be used for purposes of this particular G-SIB indicator, to make it more reflective of the underlying risk.

The use of average ratio as the denominator for the wholesale funding indicator is also somewhat odd. This would mean that banks with wholesale funding ratios that are above the sample average would have wholesale funding scores greater than 1. If the ratios are symmetrically distributed around the average value, then approximately half of the 73 banks will have a score greater than 1. This will not only have an implication on the maximum score, but it will also mean that the total score would be quite sensitive to the wholesale funding indicator. This gives undue weight on the wholesale funding indicator, something which we think is not even contemplated by the Basel Committee.

e) Substitutability indicators

Substitutability indicators mostly show only that a bank has a large share in particular market activities (paras 35-42), but do not accurately reflect either the contribution of the activity to systemic risk or the difficulty of finding substitutes for the provision of such activities that could pose a threat to financial stability. The treatment of underwriting and custody is particularly problematic in this regard.

No evidence is offered to show: a) that in the event of one or more substantial custodians failing, it would not be possible to substitute other providers (or perhaps a bridge institution spun off from the failing firm) quite quickly; or b) that even if it did prove difficult to find a substitute for it, the resulting absence of custody capacity would in fact be a source of systemic risk. The fact that a temporary loss of capacity would cause disruption or even economic damage does not equate to this being a source of systemic risk.

Finally, it is very unclear why penalizing underwriting – an activity which contributes to the disintermediation of credit risk to capital markets – should be seen as reducing systemic risk. Underwriting is by definition deal-specific and if one or two deals in the market should fail because of a lead underwriter's failure, it seems highly likely that other firms (including possibly new entrants) would respond very quickly if the market offered opportunities to do underwritten deals. Again, whatever losses or economic damage to issuers or others would result from a temporary diminishment of underwriting capacity would not create a serious source of systemic risk.

If the issue is that an underwriter may be (temporarily) saddled with undistributed securities if an underwriting fails because of a sudden shift of market conditions, that might possibly be a microprudential issue for the specific institution (though with good risk management that in itself would hardly be likely to threaten a firm's existence). It also seems highly unlikely that the aggregate of failed deals in the market could rise to a *systemic* issue. If this is the concern behind the proposed underwriting measure, it would be better addressed through supervision and risk management (as of course it already is) and it is not an appropriate metric for mitigating systemic risk.

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f) <u>OTC derivatives and Level 3 assets</u>

With the push to have central clearing for OTC derivatives, some of the remaining non-centrally cleared OTC derivatives (the focus of this indicator) may be less liquid and hence harder to value. In this case, the complexity indicators on OTC derivatives and Level 3 assets may converge to some extent in the future.

OTC derivatives are proposed to be included on a gross notional amount basis. This does not take into account that much of OTC derivatives activities are conducted under netting agreements. Using gross notional amount is just an indication of size, not risk. As with other indicators, the Basel Committee should consider using more risk sensitive measure of derivatives exposure.

g) <u>Trading book value and Available for Sale value</u>

These two measures focus simply on the size of the trading book and AFS portfolios without taking into account the underlying risk and liquidity. Hence, a large and relatively less risky and more liquid portfolio would be penalized more than a smaller portfolio that is significantly more risky and less liquid. Under the proposal, a bank would also be penalized for increasing its holdings of liquid assets as a means of decreasing its liquidity risk. This is quite inconsistent with the goals of the Basel III liquidity rules, and, to the extent that liquidity risk also leads to systemic risk, even with the goals of the G-SIBs proposal itself.

There is also a potential overlap between the two measures. Trading book has both a regulatory and accounting definition, while AFS is purely an accounting category. The regulatory definition of trading book potentially could cover some securities in an AFS portfolio that are managed like trading assets. This could result in double counting the value of securities that fall in both categories.

Also, the Trading Book Group of the Basel Committee is still reviewing the regulatory definition of trading book and there are still expected changes in the accounting standards. If the two concepts above refer only to the accounting classification, divergence between the IFRS and US GAAP accounting standards as currently proposed would also make the indicators not comparable across jurisdictions.

3. Supervisory judgment

Supervisory judgment is meant to override the results of the indicator-based measure only in "egregious cases" subject to international peer review (paras 13, 56-67). It is not clear, however, what these "egregious cases" are, and little information is given on the process to be followed in coming up with this judgment. The concern is that any use of supervisory judgment may just undermine the Basel Committee's intended approach. This concern stems partly from the fact that it is not sufficiently clear how the identified ancillary indicators will be used to support supervisory judgment. In general, the IIF supports the use of an objective approach, where measures of systemic risk should be based on the consistent and transparent use of common indicators.

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a) Recoverability and Resolvability

It is uncontestable that recoverability and resolvability are key issues in determining the systemic impact of failure. Credit should be given to banks operating in jurisdictions that have in place laws that establish clear recovery and resolution frameworks and require banks to have sound and adequate recovery and resolution plans. It is important however that there are clear, objective and transparent criteria for making the necessary assessments, both of jurisdictions' and firms' arrangements. Once these criteria are in place, recoverability and resolvability should be included in assessing systemic importance. The FSB and/or the BCBS need to establish such criteria as a matter of urgency. In this regard, we welcome the FSB's inclusion of resolvability assessments in its consultative document on *Effective Resolution of Systemically Important Financial Institutions*. However, we reiterate that it is important that these assessments should use objective criteria and clear procedures. The industry is keen to work with the official sector in doing this.

As they stand, the proposals treat the issue of recoverability and resolvability in an asymmetric manner. While the consultative document mentions that "national supervisors could impose higher capital surcharges beyond the additional loss absorbency requirements for G-SIBs that do not have an effective and credible recovery and resolution plan" (footnote 16), it does not give credit to firms that implement sound recovery and resolution plans. It should be noted that even this negative bias is still prone to subjective judgment in the absence of clear, objective and transparent criteria for resolvability.

Finally, if a group of jurisdictions has in place a common recovery and resolution regime, which on the basis of the objective and transparent methodology described above, can be demonstrated to facilitate cross border resolution, it should be considered whether cross jurisdictional activity among these jurisdictions would still be a factor in determining systemic importance.

4. Periodic review and refinement

As mentioned above, the consultative document is unclear as to the frequency of setting the denominator of the indicators, i.e. the aggregate amount across all banks in the sample for each of the indicators. This has important implications, hence, should be clarified.

The consultative document notes that "the Basel Committee proposes to disclose the values of the thresholds of buckets and the denominators used to normalize the indicator values" to the banks, regulators, and market participants (para 72). The underlying assumption here (i.e. for the above information to be useful to market participants) is for banks to also disclose the values of the numerator for all indicators. However, this would lead to the disclosure of potentially sensitive information. The Basel Committee should strike a balance between transparency and the potentially destabilizing effects of disclosing sensitive information.

One way to achieve this balance would be to simply disclose to the market participants the surcharge applicable to each bank, which is ultimately the information, that they are really interested in. It should be noted though that disclosing even just this information would lead us back to our fundamental problem with the proposals, i.e. it reinforces the

negative externalities associated with institutions that are perceived as too systemically important to be allowed to fail.

5. Economic impact

As mentioned in our main comments, we welcome the Basel Committee's efforts to assess the impact of its G-SIB recommendations. We suggest that more consultation and dialogue with the industry be done after the release of this assessment in September, given the uncertainty in the estimates as correctly pointed out in the consultative document, i.e. there are a number of reasons that these estimates could be too small or too large.

The IIF's initial estimates[3] released last year, for example, do not support the preliminary findings of the Basel Committee's assessment. Our initial estimates indicated that the economic impact of the global regulatory reform would be significant, even with the phasing-in arrangements. A follow-up report is in the process of being finalized and, notwithstanding a number of changes in the methodology used and the regulatory environment, it continues to show significant impacts.

6. High-trigger contingent capital

We encourage the Basel Committee to continue to review the appropriateness of using high trigger contingent capital (i.e. CoCos and write-down instruments) to meet the additional loss absorbency requirement. However, the current analysis of the pros and cons of contingent capital focuses solely on CoCos (paras 83-87). A proper analysis should also be done on write-down instruments.

We believe that it would be possible to achieve the same outcome as using CET1 through properly structured high trigger contingent capital. While we understand the Basel Committee's reluctance to use such a "largely untested" type of instrument to meet the additional loss absorbency requirement, we believe that contingent capital deserves further careful consideration. We therefore welcome and appreciate the intention of the Basel Committee to review this issue further. We suggest that this review include comparing the cost to the economy of using CET1 as against contingent capital to cover the additional loss absorbency requirement. This cost analysis could form part of the economic impact analysis being done by the Basel Committee.

7. Interaction with other elements of the Basel III framework

a) Group treatment

The proposed requirement is to be applied to the consolidated group, but it does not rule out the option for the host regulator to apply the requirement at the individual legal entity or consolidated level within their jurisdiction (para 90). This proposed option by the host regulator could potentially result in undesirable layering of GSIB surcharge within the consolidated group. The Basel Committee should clarify whether this is the intended

[3] IIF *Interim Report on the Cumulative Impact on the Global Economy of Proposed Changes in the Banking Regulatory Framework*, June 2010.

scenario. In addition, it could also potentially overlap with rules for local SIBs. It is important therefore that the Basel Committee clarify their plans for local SIBs and how this will interact with the G-SIBs rules. In this regard, it is also 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.

b) <u>Interaction with the capital conservation buffer</u>

The additional loss absorbency requirement is proposed to be implemented through an extension of the capital conservation buffer, maintaining the division of the buffer into four bands of equal size. If a G-SIB breaches the additional loss absorbency requirement, it will be subject to the limitations on dividend payout defined by the conservation buffer bands (paras 91-92). The rules on capital conservation buffer restrict the distribution of 40% of the earnings as soon as a bank falls slightly short of the buffer. The same treatment would apply if a G-SIB falls slightly short of the additional loss absorbency requirement. We think that this is unduly harsh, would just result in cliff-effects specifically on G-SIBs that are just marginally below the requirement, and could seriously undermine management recovery action during stress events. We suggest that the Basel Committee consider recalibrating the payout restrictions, or consider a distinct treatment for the G-SIBs capital surcharge.

8. Phase-in arrangements

We suggest that the phase-in period be used as an observation period, with scope to adjust the measures based on observed impacts.

III. <u>Conclusion:</u>

As we have stated in various occasions, we have fundamental concerns about designating groups of firms as potentially systemic and applying additional loss absorbency requirements to these. However, given that the Basel Committee has chosen to go down this route, we suggest that the methodology should be sufficiently clear, adequately reflective of systemic importance by using metrics that are risk-based, and consistently applied across jurisdictions. The methodology should provide clear incentives for reducing systemic importance by removing uncertainties as to how banks' actions can affect their scores/surcharges. This can be done by using absolute rather than relative measures of systemic importance. In addition, the Basel Committee should be circumspect about the unintended consequences that would likely arise, and should adjust the proposal with the view of eliminating these.

Given the number of fundamental flaws identified in the proposal, we suggest that further consultation be done as soon as a revised proposal is worked out. The revision should take into account the final results of the economic impact analysis being done by the Basel Committee, which should also be a subject of further dialogue with the industry.

Once again, we appreciate the opportunity to comment on the draft consultative document on G-SIBs. We look forward to a continued dialogue with the Basel Committee on this area, particularly on its potential economic impact.

Should you have any questions on the issues raised in this letter, please contact the undersigned (aportilla@iif.com; +1 202 857 3645) or Jermy Prenio (jprenio@iif.com; +1 202 682 7455).

Sincerely,