

BIS – BCBS

COMMENTS

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

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Members of the Desjardins chair in sustainable management and the research group in applied finance welcome the opportunity provided by the BCBS to present our comments on the consultative document: « Global systematically important banks: Assessment methodology and additional loss absorbency requirement». Our comments are structured into four sections. An introduction to the comments is first presented. Second, general comments are formulated. Third, more specific comments are formulated. Fourth, a brief conclusion to the focus of the comments is presented.

1. Introduction

We agree with the views expressed by Mr. Jean-Claude Trichet (25 June 2011) and Mr. Nout Wellink (25 June 2011) in support of the proposed measures to increase the going-concern loss absorbency of G-SIBs. Mr. Stefan Ingves (19 July 2011) also noted that: «The rationale for the policy measures proposed today is to deal with the cross-border negative externalities created by global systematically important banks which current regulatory policies do not fully address».

2. General comments

On page 1, paragraph 1, we regret that the proposed assessment methodology and its accompanying additional loss absorbency requirement will only apply initially to G-SIBs and not to all SIFIs. This fact could open the way to more intense regulatory arbitrage and lead to a more uneven playing field to the advantage of some categories of G-SIFIs as opposed to G-SIBs.

On page 3, par. 12, we endorse the selected assessment methodology for systemic importance of G-SIBs which applies an indicator-based measurement approach as opposed to the development and adoption of a satisfactory model-based approach.

On page 4, footnote 6, the reader is referred to par. 53 for explanations on how the sample of 73 potential G-SIBs was selected. On page 10, par. 54, it is explained how the BC decided that the number of G-SIBs would initially be set at 28. At this point in the text, why not disclose the names of both the 73 potential G-SIBs or at least those of the 28 designated G-SIBs. For instance, this information could have been disclosed just after page 22 in Annex 1.

On page 11, par. 57, we agree with the proposed list of standardised ancillary indicators which can be used to support the supervisory judgment overlay. Similarly, we agree with the BC's view that the assessment methodology provides a framework for periodically reviewing the G-SIB status of a given institution.

On page 15, the magnitude of additional loss absorbency and its impact are discussed in par. 73 and 74. At this point, why not remind the reader about the total amount of common equity tier 1 (CET1) capital. That is, the Basel III requirements plus those indicated on page 15, par. 73, in Table 3. The Basel III capital adequacy and capital conservation buffer of 7% in CET1 per rwa apply to both non-G-SIBs and G-SIBs. Adding the next requirement, see BCBS (2010) on the countercyclical capital buffer, would keep the combined CET1 requirement at 7% in a period of recession, but it could also increase it up to a maximum of 9.5% of CET1

during a period of prolonged and strong economic growth for both non-G-SIBs and G-SIBs. In addition, designated G-SIBs depending on the bucket into which they are placed would be required to hold (if in a period of strong economic growth) either 10.5% of CET1 (bucket 1), 11% (bucket 2), 11.5% (bucket 3), 12% (bucket 4), or eventually up to 13% (bucket 5 (empty for now)).

On page 15, par. 75, we prefer not to comment at this point on the macroeconomic impact of requiring additional loss absorbency for G-SIBs since the work of the MAG is not completed and the final report is expected to be published as soon as September 2011. Moreover, on page 16, par.79, it is said that MAG's September final report will include updated results, information on the range of possible impacts and an analysis of the benefits of higher capital requirements for G-SIBs. In our section on specific comments, some of these possible microeconomic impacts for G-SIBs are examined. The specific comment section will also express our views on the BC's CET1 discussion on page 16, par. 81.

On page 19, par. 88, we extend our support to the BC conclusion that G-SIBs be required to meet their additional loss absorbency requirements with CET1 only.

On page 21, par. 16, we concur with the BC that the banking sector can meet the higher capital standards through reasonable capital conservation measures like reasonable earnings retention, merit-pay, common share repurchase programs and capital raising while supporting sustainable lending to the economy.

On page 21, par. 97, it is added that the additional loss absorbency requirement will be phased-in in parallel with the capital conservation and countercyclical buffers, ie between 1 January 2016 (or sooner) and year 2018 (or sooner), becoming fully effective on January 2019 (or sooner).

3. Specific comments

On page 1, par. 3, it is written « In maximising their private benefits, individual financial institutions may...». Here, the word optimising would seem more appropriate in keeping with suggested best practices in bank risk management governance.

On page 4, par.15, please refer as soon as possible in the text to the presence of Table 1 Indicator-based measurement approach located on page 5. Equally on page 4, par.17, in order to facilitate the use of Table 1 Indicator-based measurement approach, why not carry out in Annex 1 of page 22 a complete computation. For example, for a bucket 3 G-SIB with a 2% additional loss absorbency.

On page 14, par. 68, in light of the Pillar III importance given to transparency allowing market discipline and reinforcing global financial stability, would it be possible to explain why the BC did not disclose at this point the composition of its sample of 73 banks, and its designated sub-sample of 28 G-SIBs.

On page 16, par.79, the text mentions that MAG's September final report will include updated results informing on the range of possible impacts, and an analysis of the benefits of higher capital requirements for G-SIBS. In addition, on page 24, it is said that the expected impact approach does not incorporate any economic costs associated with higher capital requirements for G-SIBs. Further on in the first paragraph of page 25, it is stated that. The magnitude of

additional loss absorbency for a too-big-to-fail bank would be the increase in the amount of equity in a bank’s capital structure (and a reduction in the amount of debt of the same amount) such that its funding costs would equate to what they would have been if the subsidy was absent.

By using the Du Pont financial analysis model, it is possible to carry out a preliminary analysis, and to obtain directional estimates of the potential financial advantages and disadvantages for a bank of being designated a G-SIB. All else kept equal, a G-SIB should be able to generate over time a higher (or at least equal) Asset Yield ratio than a non-G-SIB. The Asset Yield ratio is obtained by dividing a bank’s total income (both interest income + all forms of other income) by its total assets. Similarly, a G-SIB should be able to generate over time a higher (or at least equal) Profit Margin ratio than a non-G-SIB. The Profit Margin ratio is obtained by dividing a bank’s net income after-tax available to common shareholders by its total income. This is because a G-SIB would have a lower proportion of liabilities (deposits and debts), a lower proportional level of interest expenses possibly accompanied by the so-called G-SIB cost of funding subsidy. As a result, a G-SIB could probably be able to generate over time a higher (or at least equal) Return on Assets ratio :

(1) Return on Assets	=	Asset Yield	x	Profit Margin
Net income after taxes / Total assets		Total income/ Total Assets		Net income after taxes/ Total income

We also believe that being designated as a G-SIB would entail lowering a bank’s financial leverage ratio in order to respect its higher CET1 capital requirement. Here, the financial leverage ratio is obtained by dividing a bank’s total assets by its common shareholders equity. Over time, a bank’s return on its common shareholders equity (ROE) could be increased by a higher level of its return on assets (ROA), but could be decreased by a lower level of financial leverage (Lf) :

(2) Return on Equity	=	Return on Assets	x	Financial Leverage
Net income after taxes/ Common share. equity		Net income after taxes/ Total assets		Total assets/ Common share. equity

The short-run economic impact of being designated as a G-SIB as measured above by its ROE could therefore be favourable or unfavourable. In the longer run, the economic impact on a G-SIB could be measured in terms of its estimated weighted average after-tax cost of capital, its risk-adjusted return to shareholders, and its ratio of market value of equity to book value of equity (MVE/BVE). Moreover, comparisons of these same metrics between G-SIBs and non-G-SIBs would need to be carried out over time.

4. Conclusion

We believe that adopting and implementing the BC’s proposals on the assessment methodology and its inherent additional loss absorbency requirement for G-SIBs will generate net benefits in the form of lowering the level of systemic risk and increasing stability within the global financial system. In our general comments, we discussed the importance of requiring additional loss absorbency not only from G-SIBs but from all G-SIFIs. We endorsed the use of the selected assessment methodology based on an indicator-based

measurement approach. We also agreed to the proposed list of standardised ancillary indicators which can be used to support the supervisory judgment overlay. We noted that computing the magnitude of additional loss absorbency should be more fully explained in Annex 1 (p. 22). In our specific comments, we pointed out to the importance of optimising financial institutions' private benefits as opposed to maximising them. We also asked why the BC did not disclose the banks considered in its sample of 73 banks, and the banks in its designated G-SIBs sub-sample of 28 banks. Using the Du Pont financial analysis model, we argued that G-SIBs could well gain some operational benefits by being able to earn a higher return on assets (ROA) over time. However, because of higher CET1 requirements, G-SIBs' use of financial leverage (Lf) would probably be lower. Since a G-SIB's return on equity (ROE) is a direct function of its ROA time (x) its Lf, the resulting ROE figure remains undetermined. Similarly, more empirical work needs to be eventually done on G-SIBs weighted average after-tax cost of capital, and the ensuing market value of equity. Finally, we would like to point out that two new related Basel III requirements have not been discussed either in the BC's consultative document and in our own comments. In a recent speech, Mr. Jaime Caruana (7 July 2011) explained the remaining challenges in the regulatory reform. The first point concerns the proposed regulatory leverage ratio. Should G-SIBs also be required to respect a lower regulatory leverage ratio than non-G-SIBs? The second point concerns the two Basel III liquidity adequacy requirements; that is the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). Should G-SIBs also be required to respect both higher short-term (LCR) and longer-term (NSFR) than non-G-SIBs?

References

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