July 30, 2011

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Dear Sir/Madam,

**Re: Comments on the Basel Committee's consultative document:**
**Global systemically important banks: Assessment methodology and the additional loss absorbency requirement - July 2011**

Thank you for the opportunity to comment on the Basel Committee's consultative document. As an auditor having more than five years experience in financial, internal controls and compliance aspects of banking, and previous contributor on IFRS.org for comments on ED IFRS and IAASB for comments on ED ISA, I would like to comment on the Assessment Methodology for systemic importance of G-SIBs namely the use of an Indicator-based measurement approach, a bucketing approach, the role of supervisory judgement and its periodic review and refinement. The comments expressed are solely my personal views.

I note that the consultative document is a first important step and further tests will be performed to assess the model and it will be modified for further improvement. As a first step the initiative should be encouraged. Below is a summary of the key concerns with regards to this Basel Committee's document, especially the assessment methodology.

Best Regards,

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**Basel III Framework and Global systemically important banks: Assessment methodology and the additional loss absorbency requirement**

As a preamble, it has to be recognized that the Basel III Framework, which covers both microprudential and macroprudential elements, sets out higher and better-quality capital, better risk coverage, the introduction of a leverage ratio as a backstop to the risk-based requirement, measures to promote the buildup of capital that can be drawn down in periods of stress, and the introduction of two global liquidity standards. As regards the latter standards - one standard, the Liquidity Coverage Ratio, addresses the sufficiency of a stock of high quality liquid assets to meet short-term liquidity needs under a specified acute stress scenario. The second complementary standard, the Net Stable Funding Ratio, addresses longer term structural liquidity mismatches.

This guideline forms part of the global framework to increase the resilience of the global banking system as the new Basel framework has been endorsed by the G20 Leaders at the Seoul Summit along with the Financial Stability Board's (FSB) policy framework for reducing the moral hazard of systemically important financial institutions (SIFIs)

Currently under BASEL II, there is no capital conservation buffer. The purpose of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. While banks are allowed to draw on the buffer during such periods of stress, the closer their regulatory capital ratios approach the minimum requirement, the greater the constraints on earnings distributions.

Under BASEL III, Banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirements to 7%.

Capital Conservation Buffer of 2.5 percent, on top of Tier 1 capital, will be met with common equity, after the application of deductions.

Capital Conservation Buffer before 2016 = 0%, 1st January 2016 = 0.625%, 1st January 2017 = 1.25%, 1st January 2018 = 1.875%, 1st January 2019 = 2.5%

Under BASEL II, there is no Countercyclical Capital Buffer.

Under BASEL III, a countercyclical buffer within a range of 0% – 2.5% of common equity or other fully loss absorbing capital will be implemented according to national circumstances. Banks that have a capital ratio that is less than 2.5%, will face restrictions on payouts of dividends, share buybacks and bonuses. The buffer will be phased in from January 2016 and will be fully effective in January 2019.

Countercyclical Capital Buffer before 2016 = 0%, 1st January 2016 = 0.625%, 1st January 2017 = 1.25%, 1st January 2018 = 1.875%, 1st January 2019 = 2.5%

Finally, under BASEL II there is no Capital for Systemically Important Banks. Under BASEL III, systemically important banks should have loss absorbing capacity beyond the current standards. This guideline forms part of the Basel Committee and the FSB integrated approach to systemically important financial institutions.

It should be recognized that after the financial crisis that started in 2007, the Basel Committee on Banking Supervision (the Basel Committee) has adopted a series of reforms to improve the resilience of banks and banking systems. This includes raising the required quality and quantity of capital in the banking system, improving risk coverage, introducing a leverage ratio to serve as a back- stop to the risk-based regime, introducing capital conservation and countercyclical buffers as well as a global standard for liquidity risk. The capital adequacy measures are applied to all internationally active banks to ensure that each bank maintains an appropriate level of capital relative to its own exposures.

It is important to note, however, that current regulatory policies do not fully address the negative externalities posed by G-SIBs and that they are not adequate to protect the system from the wider spillover risks of G-SIBs.

It has been proven that transnational banks are not explicitly or implicitly solid enough and they are no longer being allowed to fail due to their size, interconnectedness, complexity, lack of substitutability or global scope are well recognised. Maximising self-interest and implicit guarantees derived from the perceived expectation of government support may amplify risk-taking, reduce market discipline and create competitive distortions, and further increase the probability of distress in the future.

Global repercussions have effects in many countries and potentially on the world economy at large, it is not uniquely a problem for national authorities, therefore requiring a global minimum agreement.

The solution, however, is complex and there may not be a magic single response to the problems posed by G-SIBs. The proposed series of measures for global systemically important banks are new steps to deal with the cross-border negative external costs created by those banks which current regulatory policies do not fully address. The proposed measures will enhance the going-concern loss absorbency of global systemically important banks and in an uncertain world help to reduce the probability of their failure. Every measure taken in this direction should be supported and I really hope they will contribute to a safer and sounder banking and financial system

As noted above, I would now like to comment specifically on the Assessment methodology for systemic importance of G-SIBs namely the use of an Indicator-based measurement approach, a bucketing approach, the role of supervisory judgement and its periodic review and refinement.

**Assessment methodology for systemic importance of G-SIBs**

In response to the FSB Recommendations, the Basel Committee has developed an assessment methodology for systemic importance of G-SIBs. The proposed methodology is based on an indicator-based measurement approach.

This will ensure consistency through the quantitative indicator-based approach supplemented with qualitative information in exceptional, egregious cases which will be subject to international peer review to ensure consistency in its application.

## A. Indicator-based measurement approach

As a start, the proposed methodology gives an equal weight of 20% to each of the five categories of systemic importance, which are: size, cross-jurisdictional activity, interconnectedness, substitutability and complexity.

The committee should be opened to add any further category which may crop up.

### 1. Cross-jurisdictional activity

The two indicators in this category measure the importance of the bank's activities outside its home (headquarter) jurisdiction relative to overall activity of other banks in the sample. The idea is that the international impact from a bank's distress or failure should vary in line with its share of cross-jurisdictional assets and liabilities. The greater the global reach of a bank, the more difficult it is to coordinate its resolution and the more widespread the spillover effects from its failure.

Other factors that can be considered are the amount of cash/bank balances with other banks and what other banks have with the G-SIBs. The Nostro/Vostro balances as well as inter profitability on charges and fees need also to be considered. Other aspects linked with the above is the volume of transactions, either as final beneficiary or orderer or as intermediary.

2. Size

It is true that a bank's distress or failure is more likely to damage the global economy or financial markets if its activities comprise a large share of global activity. The larger the bank the more difficult it is for its activities to be quickly replaced by other banks and therefore a greater chance that its distress or failure would cause disruption to the financial markets in which it operates. The distress or failure of a large bank is also more likely to damage confidence in the financial system as a whole. Size is therefore a key measure of systemic importance.

Other measure of size should include number of stakeholders which will be impacted if the bank crashes e.g. creditors, shareholders, employees and of course customers.

3. Interconnectedness

Financial distress at one institution can materially raise the likelihood of distress at other institutions given the network of contractual obligations in which these firms operate. A bank's systemic impact is likely to be positively related to its interconnectedness vis-à-vis other financial institutions.

Interconnectedness will also depends on the amount of cash/bank balances with other banks and what other banks have with the G-SIBs. The Nostro/Vostro balances as well as

inter profitability on charges and fees need also to be considered. Other aspects linked with the above is the volume of transactions, either as final beneficiary or orderer or as intermediary.

## 4. Substitutability

It is true that the systemic impact of a bank's distress or failure is expected to be negatively related to its degree of substitutability as both a market participant and client service provider.

Criteria such as assets under custody, values of underwritten transactions in debt and equity markets, payments cleared and settled through payment systems may need to be revised as and when the system gets implemented.

## 5. Complexity

It is true that the systemic impact of a bank's distress or failure is expected to be positively related to its overall complexity but more weight needs to be given to financial and operational complexity.

The greater the number of non-centrally cleared OTC derivatives a bank enters into, the more complex a bank's activities. It is good that banks are asked to report the figure for total notional amount for all types of risk categories and instruments (ie sum of foreign exchange, interest rate, equity, commodities, CDS and unallocated).

Level 3 assets - Assets whose fair value cannot be determined using observable measures, such as market prices or models. Level 3 assets are illiquid, and fair values can only be calculated using estimates or risk-adjusted value ranges. This classification system aims to bring clarity to the balance sheet assets of corporations. Banks with a high proportion of Level 3 assets on their balance sheets would face severe problems in market valuation in case of distress, thus affecting market confidence.

Trading book value and Available for Sale value - Holding of financial securities in the trading book and available for sale securities could also generate spillovers through mark to market loss and subsequent fire sale of these securities in case an institution experiences severe stress. This in turn can drive down the prices of these securities and force other financial institutions to write-down their holdings of the same securities.

**B. Bucketing approach**

The bucketing approach is based on a sample of 73 banks, chosen on the basis of size and supervisory judgement by Basel Committee member authorities. TA tentative cut-off point

was set between the 27th and 28th banks, based on the clustering of scores produced by the methodology.

It is good to note that the committee is flexible and is of the view that this number would evolve over time as banks change their behaviour in response to the incentives of the G-SIB framework.

## C. Supervisory judgement

There are four principles for supervisory judgement namely that the bar for judgemental adjustment to the scores should be high, the process should focus on factors pertaining to a bank's global systemic impact, the views on the quality of the policy/resolution framework within a jurisdiction should not play a role in the G-SIB identification process and the judgemental overlay should comprise well-documented and verifiable quantitative as well as qualitative information.

It is important to note that the banking sector is a highly sensitive industry as it deals with money from the general public and from the businesses and it is a key institution in every economy. As such insufficient board oversight of senior management, inadequate risk management and unduly complex or opaque bank organisational structures and activities is not in the right direction of transparency and accountability. This is why it is agreed that the board should actively carry out its overall responsibility for the bank, including its business and risk strategy, organisation, financial soundness and governance. The board should also provide effective oversight of senior management.

Under the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board. A bank should have a risk management function (including a chief risk officer or equivalent for large banks and internationally active banks), a compliance function and an internal audit function, each with sufficient authority, stature, independence, resources and access to the board.

Risks should be identified, assessed and monitored on an ongoing firm-wide and individual entity basis; An internal controls system which is effective in design and operation should be in place; The sophistication of a bank's risk management, compliance and internal control infrastructures should keep pace with any changes to its risk profile (including its growth) and to the external risk landscape; and effective risk management requires frank and timely internal communication within the bank about risk, both across the organisation and through reporting to the board and senior management.

Moreover, the bank or financial institution should fully compensate its compliance function as well as business related activities as they should not be remunerated based on profits or turnover. In fact a high compensation will help to deviate officers from other areas such as taking undue risks, engage in bribery or corruption and to give them a good status and let them do their work in all independence and integrity.

Transparency is one tool to help emphasise and implement the main principles for good corporate governance. The board and senior management should know, understand and guide the bank's overall corporate structure and its evolution, ensuring that the structure (and the entities that form the structure) is justified and does not involve undue or

inappropriate complexity; and senior management, and the board as appropriate, should understand the purpose of any structures that impede transparency, be aware of the special risks that such structures may pose and seek to mitigate the risks identified.

It is positive that the supervisory judgement input to the results of the indicator-based measurement approach should be conducted in an effective and transparent way

**D. Periodic review and refinement**

It is good that the assessment methodology provides a framework for periodically reviewing the G-SIB status of a given institution. Hence, banks have incentives to change their risk profile and business models in ways that reduce their systemic spillover effects.

It is also a positive thing that the methodology, including the indicator-based measurement approach itself and the cut-off/threshold scores, will be reviewed every three to five years in order to capture developments in the banking sector and any progress in the technology to measure systemic importance.

The Basel Committee proposal is also flexible by acknowledging that the data used to construct the indicator-based measurement approach currently may not be sufficiently reliable or complete.