Basel Committee on Banking Supervision
Consultative Document
Globally systemically important banks:
Assessment methodology and the additional loss absorbency requirement

Response by RBS Group plc

Executive Summary

Introduction

RBS Group plc ('RBS') welcomes the opportunity to comment on this important consultation.

Some key comments on the principles around globally systemically important banks (G-SIBs) are detailed in this Executive Summary section. More detailed comments on the consultative document are contained in the sections that follow, reflecting that paper's headings.

We would be happy to elaborate further on any of the points made in this response and look forward to engaging with, and supporting, the authorities as they take forward the extensive work that these reforms will require. In the first instance, any questions should be addressed to:

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Key Comments

- In line with the rest of the industry, and given the scale and scope of other regulatory reforms designed to reduce risks in the financial system, RBS is unconvinced that the case for additional capital for G-SIBs has been proven.

- We remain of the view that designation as a systemic bank increases the risk of moral hazard and competitive distortions. This risk is increased by focussing on banks alone in this initial stage, when other financial services sub-sectors also generate their own forms of systemic risk, international capital flows and trade.

- We are also disappointed that we do not yet benefit from the output from the Macroeconomic Assessment Group, although we understand the demanding timetable that the Committee is working to. The analysis that has been provided also seems quite light on detail and so we urge that no final decisions be made before the Committee and the industry have reviewed and discussed the impacts. To reduce the risks of unintended consequences, we also suggest that the industry and the authorities work closely together during the implementation period to assess actual impacts and that flexibility be maintained to adjust the requirements in the light of that evidence.

- However, we acknowledge that the introduction of a G-SIB buffer is at an advanced state of agreement and so we focus in the rest of this response on the details of the proposals and how these can best work effectively.

- We are concerned that the proposals operate by combining the G-SIB buffer with the capital conservation buffer (and with the countercyclical buffer at certain periods in the credit cycle). Given that restrictions on distributions are set at a high level (40%) even at the upper reaches of the buffer, this will effectively become a hard limit which, in practice, will oblige banks to hold

a substantial management buffer above this, compounding wider economic effects and unintended consequences. The restrictions could also impede management from implementing recovery actions in a stress situation and restrict regulators' freedom of action.

- Accordingly we propose that regulators be permitted to tailor the restrictions according to guided discretion. Additionally, the restrictions should be tapered to reduce the cliff effects of entering the buffer and helping reduce the market distortions between G-SIBs and smaller banks. We propose that entry into the upper half of the buffer should act as a trigger for management and regulators agreeing recovery actions. The lower half of the buffer could then lead to a (discretionary) restriction of 20% on distributions.
- We favour inclusion of Contingent Capital (CoCo) instruments in the G-SIB buffer as these provide banks with greater flexibility and we argue that some of the arguments against this in the consultative paper are overstated.

Detailed Comments

Assessment methodology for systemic importance of G-SIBS

- We agree that an indicator based approach is preferable to the benchmarking approach which was also considered. An indicator approach is much more transparent and quantifiable.
- The methodology is broadly clear for the numerator of the calculations (the various indicator scores) but we would welcome more detail about the denominator (total scores for the population of banks used). The determination of the initial population of 73 banks is critical to an effective reduction in systemic risk because, as the crisis showed, even quite small institutions could cause wide ranging systemic effects (the most obvious example in the UK being Northern Rock) and these could be missed in an approach focussed on G-SIBs. The process is described as based on "size and supervisory judgement" (paragraph 53 of the consultation) but there should be much more transparency about this aspect.
- It is not clear whether there will always be a minimum population of G-SIBs spread across the buffer bandings. It would seem to us inappropriate that if all banks took action to reduce systemic risk that there might be no reduction of buffer requirements on the full population whereas a genuine reduction in systemic risk should see lower capital requirements across the sector.
- We perceive a risk that whatever changes are made by banks to alter risk profiles, reducing their G-SIB 'score', supervisors may ultimately wish to retain a certain number of G-SIBs. The definition of buckets should, as far as possible, be absolute and not relative so that banks reducing indicator risks generate an absolute benefit to their Common Equity Tier 1 (CET1) requirements, whatever other organisations achieve.
- RBS is keen to ensure that the data definitions and reporting requirements are as consistent and simple as possible and we ask that the Committee works closely with the industry to develop this aspect.
- *Cross-jurisdictional activity*. The presence of the single market in Europe justifies the European Union being treated as a single jurisdiction for the purposes of this indicator.
- *Interconnectedness – intra-financial system assets/liabilities*. We note that the majority of the contributors to these indicators are limited to transactions with other financial institutions. However, repos are an exception to this and it is unclear why this is the case, especially as securities lending/borrowing (another type of securities financing transaction) is not.
- *Interconnectedness – wholesale funding ratio*. We disagree with the approach which deducts retail funding from total liabilities. This would capture within the ratio a number of items which would not generally be considered to be wholesale funding (for example mid-corporate deposits).
- *Complexity – OTC derivatives notional value*. We are concerned that notional OTC value is too blunt a tool, especially if no netting is allowed. As a minimum, netting in line with Basel II requirements should be permitted, to better reflect the relative systemic risk of a G-SIB's

trades. Considerations should also be given to alternative measures such as numbers of derivatives (which we think gives a better indication of complexity).

- *Supervisory judgement*. We agree that the rules should offer scope for this and that a combination of qualitative and quantitative measures is appropriate. However, we would welcome more details of how the qualitative aspects will operate and particularly what factors will be taken into account here. The banks should also have the opportunity to discuss with the authorities their status as G-SIBs and the buckets they are allocated to.

- *Periodic review and refinement*. As a new initiative, it is inevitable that the indicators are an imperfect set, which will create inequalities and lead to arbitrage opportunities. The supervisory authorities should ensure that the methodology is reviewed as frequently as practical to ensure it remains relevant. The methodology review should be more frequent than 3-5 years at the outset to reduce the risk and impact of unintended consequences.

- Supervisory authorities should gather input from annual bank reviews to determine speed of revision. In the event of rapidly changing indicators, it must be made clear that the G-SIB buffer will be rapidly revised. If it is not revised rapidly a restructured group could be required to carry capital in excess of its altered state for a prolonged period after actual changes have been executed. Supervisors should be able to take account of known changes to business models and structure (eg a disposal) when determining which, if any, bucket a firm falls into.

The magnitude of additional loss absorbency and its impact

- Combining the G-SIB buffer with the countercyclical and capital conservation buffers creates a very wide band for the largest banks which would face substantial restrictions of 40% on distributions immediately upon CET1 falling below a minimum of 9.5%, and even higher when the countercyclical buffer is in operation. However, unlike the countercyclical buffer, the G-SIB buffer cannot be withdrawn in any circumstances and so it cannot act as a stress buffer.

- This will force banks to hold incremental “stress buffers” substantially above 9.5% to maintain control of distributions in a stress. Combined with other regulatory changes, this is likely to lead to unintended business model changes such as reduced lending, specialisation to areas of strength, increased risk taking and higher pricing which will, in turn, impact credit growth, consumer choice and could increase systemic risks and concentrations.

- Moreover, markets may perceive CET1 of 9.5% as a hard floor and a “confidence” trigger in a stress scenario. This may not be limited to the affected bank(s) but could apply more widely to the sector once one or more banks approach the point at which material restrictions affect dividends and distributions on Tier 1 instruments. Regulators would then be unable to relax the G-SIB buffer, even in an extreme stress, to signal to the market that CET1 of 7% would be sufficient in a stress. This could then lead to a contagious “adverse spiral” of loss of confidence, with falling share prices and limited funding, across the financial sector, even if banks were well capitalised.

- Therefore, we suggest that the G-SIB buffer should be more akin to the countercyclical buffer and able to be used in periods of stress with regulators able to tailor restrictions to the situation and needs of recovery plans. As an example, it might be excessive to apply restrictions in the case of a temporary entry into the buffer due to a one-off fraud. In particular, regulators should have the flexibility to reduce the G-SIB buffer completely in an extreme stress (ie in line with non-G-SIBS) before market confidence is adversely impacted.

- Further, we feel that the maximum distributable amount (MDA) assessment is too formulaic and does not allow management or regulators the flexibility to tailor distribution levels to protect the franchise during an extreme stress and subsequent recovery phase. This could lead to long-term damage to a bank’s franchise if the restrictions are not commensurate with the situation (ie the 40% restriction occurs even at the upper end of the buffer).

- The formula does not recognise that there is, in practice, a minimum level of variable remuneration required to retain key staff, even in a loss making year. We do accept the principle of “capping” variable remuneration but a more tailored approach is essential to avoid hampering recovery plans.

- Whilst the restrictions encourage the right capital/risk decisions for forward planning, if banks still make risk mistakes (as in the last crisis), such 'formulaic' rules could severely inhibit a credible restructuring/recovery plan under a new management by creating unintended consequences which could lead to an increase in overall risk ie:
    - It is likely to be more difficult to raise new equity to increase CET1 above the 9.5% level at a time when distributions are restricted.
    - There would be no scope to relax restrictions to facilitate restructuring plans to flush out past mistakes.
    - Restrictions will hamper the retention/recruitment of key staff.
    - Some banks may try to maintain overall distributions by: increasing levels of fixed remuneration and/or increasing risk taking for short term P&L gains.
- RBS proposes that instead the G-SIB buffer should be redesigned as a flexible buffer above the capital conservation buffer with guided discretionary powers given to local regulators and tailored for management actions, recovery plans and the severity of the stress situation.
- However, as a guideline, we suggest that in the upper half of the G-SIB buffer there should be no formal distribution restrictions but instead requirements to agree and implement recovery actions with regulators. The lower half of the buffer could then introduce restrictions of 20%, acting as a less abrupt stage of the process before the 40% restriction is invoked at the 7% CET1 level. This also has the merit of producing a less uneven playing field between G-SIBs and other banks.
- We have considered a more granular scaling of restrictions through the G-SIB buffer (ie from 0% to 40%) but this could still maintain the perception of the hard floor at 9.5% and distributions could still be at risk at the top end of the buffer if the G-SIB is loss making. Also a more granular scaling is less appropriate in the lower bucket where the G-SIB buffer is only 1%.
- The Appendix illustrates our proposed G-SIB model in graphical format (also showing how an element of CoCo could be incorporated – see our comments on these instruments below).
- Measures would of course need to be taken to promote global consistency in this more flexible model. This could be by way of peer review mechanisms by the Basel Committee of FSB.
- Other comments on this section are:
    - It is not clear why the loss absorbency of the empty bucket is set 1% above the next bucket, when the steps between the other buckets are all set at 0.5%.
    - We question why a further empty bucket is required once the initial empty bucket starts to become populated (and we infer that this process would repeat as soon as the new empty bucket becomes populated).
    - On impacts, there are clearly risks that economic impacts are greater than official estimates. We are keen to support the authorities in researching those impacts and monitoring actual impacts during transitional periods and as we suggest above, a flexible approach to implementation will allow the measure to be adjusted in the light of experience.

Instruments to meet the additional loss absorbency requirement

- We agree that gone concern loss absorption in the form of bail-ins is not appropriate for a measure designed to reduce the probability, rather than the impact, of failure.
- On Contingent Capital (CoCo), although we acknowledge that the 'simplest' way for loss absorbency requirement to be met is currently through CET1, it should be possible to achieve the same outcome through properly structured contingent core tier1 at relatively high triggers. There is not currently sufficient understanding of the depth and structure of the 'CoCo' model, but focus on CET1 will only serve to accentuate this such that the market for CoCo will not develop.

- If such a market for CoCos does develop, then this will help provide flexibility in banks' funding. Market forces would dictate the mix of CoCos and equity in the buffer, but in the event of a significant deterioration in CET1, then the buffer would comprise equity in its entirety.
- We agree with all the pros listed in section IV of the consultative document but have the following comments on the Cons:
  - Risk of Trigger failure can be reduced with more standardised and regular bank disclosures.
  - Maturity and mandatory coupon concerns are unfounded. The capital treatment will already be impacted by these features as the bank will be receiving Tier 2 credit for such CoCos and, moreover, when the institution is in sufficient difficulty, these features become irrelevant as the instrument becomes perpetual equity. Under normal circumstances, where no conversion has taken place and a maturity date is approaching, the bank would have the choice to issue CoCos or equity.
  - The death spiral can be contained with a pre-determined conversion price or price range and with capital based triggers (note market-based triggers can heighted this risk).
- With regard to Annex 3, we do not support market-based triggers which can be subject to market manipulation, can result in unwanted conversions and resulting loss of confidence and give rise to CDS or share price death spirals. Allowing markets to discipline bank risk taking would be overly optimistic as markets cannot assess what they cannot possibly know. In addition, investor feedback has averse to such triggers because they make the instruments more complex and very difficult to price accurately. CoCos issued to date have all included capital triggers and given that a CoCo is a capital instrument, this seems reasonable.
- Temporary write-downs should be allowed, with write-up permitted once measurable recovery has taken place. This allows for a wider range of investors to purchase CoCos as some may be restricted from buying convertible structures. It also gives issuers more flexibility if they cannot secure authorisations for further share issuance or if industry limits act as a constraining factor. A permanent write-down will make the CoCo very unattractive to investors as they would view themselves as effectively subordinated to equity.

Interaction with other elements of the Basel III framework

- We believe that rather than a hard mechanism, the committee should establish a framework within which local supervisors agree remediation plans utilising the full range of management options rather than restricting actions to dividends and remuneration using the quartile approach.
- As set out, the combination of buffers requires application of the quartile bandings, triggering remuneration and dividend blocks. The first quartile leads to a 40% block which is particularly disproportionate when applying to a much higher buffer (up to 5% total before countercyclical). We would propose that such an approach, if applied at all, should increase in severity as the quartile level increases.
- It is stated earlier in the consultation that data used to determine G-SIB status will relate to consolidated activities. It must be made clear how the consolidated criteria will apply where there is substantial ring fencing put in place between activities within a banking group. Ring fencing is in itself designed to reduce systemic effects.
- We propose that the proposals have to be modified to reflect ring fencing and that criteria be established defining where ring fencing is sufficient to merit deconsolidated G-SIB analysis/status.

Appendix – Illustration of RBS's proposal for more flexible operation of the G-SIB buffer (including CoCos)