Sent by e-mail to: baselcommittee@bis.org

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

26th August 2011

Dear Sir or Madam,

We are pleased to provide our response to the Basel Committee on Banking Supervision's ("BCBS") consultative document *"Global systemically important banks: Assessment methodology and the additional loss absorbency requirement"* (BCBS 201). Whilst we recognise that tackling systemic risk is a critical component of the overall regulatory framework, we have serious concerns with the approach set out in the consultative document. We believe that identifying and categorising banks as systemically important will increase moral hazard, create market-distorting effects and lead to a two-tier banking system. We are already aware of international banks who are actively marketing themselves as G-SIBs in order to gain more business. G-SIB classification may also complicate resolution of failing firms by discouraging acquisitions by other institutions due to concerns about becoming a G-SIB. These concerns have been shared by many others, not just the banks that are likely to be directly affected, due to the far-reaching consequences of singling out specific institutions for special treatment.

The proposed G-SIB capital approach adds a level of artificiality and complexity to an already complex regulatory capital framework. It seeks to satisfy a desire for higher capital add-ons in the simplistic belief that this will make banks more resilient and it does this without any sense for the impact on the economies that those banks serve and moreover without any attempt to address the quality and definition of the risk weighted assets that the capital supports. The new framework is based on an incorrect and politically driven narrative about the causes of the crisis. It is worth recalling that the Financial Stability Board's (FSB) original proposals were entitled "Reducing the moral hazard posed by systemically important financial institutions" but that the FSB has since conceded that such moral hazard was not a significant cause of the crisis and it now appears to justify the proposals on the basis of a supposed need for increased loss absorbency. The irony is that the FSB's proposals look likely to create the very moral hazard that the FSB set out to prevent. As a result the net effect on financial stability may well be negative; while the impact on economic growth and job creation will undoubtedly be so.

The proposal highlights a lack of confidence in the ability of the Basel III capital framework to ensure that unexpected losses are capable of being absorbed to an acceptable level of confidence. The Pillar 2 framework is an existing mechanism which can be used to set higher capital requirements, calibrated to the risks of individual institutions based on supervisory

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judgment, and we are surprised that its role has not been enhanced as part of the Basel III reform package.

It is our strong view that greater focus should be placed on ensuring that the Pillar 1 methodologies for calculating risk weighted assets better allocate capital to the underlying risks assumed by banks and on developing an effective resolution regime. The Financial Stability Board's ("FSB") consultative paper on resolution published on 19th July gets at the heart of the solution for tackling systemic risk, and whilst we do not agree with all of the proposals made in that paper, we feel that working through the advantages and disadvantages of the various mechanisms proposed will enable the development of an appropriate resolution regime, if supported by efforts to update and align national resolution laws and requirements for regulators to cooperate in times of crisis to resolve a failing institution. There will be considerable challenges in coordinating the changes required to complex legislation across national jurisdictions, but it is important to recognise that without the necessary empowering legislation in place, an effective international approach to resolution will be impossible to achieve and could result in a less stable banking system. In addition, a material change in the level of cooperation between regulators would be necessary to achieve the FSB's goals, and appropriate checks and balances required to offset the new regulatory powers granted.

In addition, it is important to consider the extent to which the higher Basel III capital and liquidity standards, and other regulatory developments such as recovery and resolution planning, bail-in debt and improvements to depositor protection schemes, will help to improve the resilience of the financial system, before imposing additional regulatory capital requirements for certain firms. The Committee acknowledged the diminishing returns from progressively higher capital levels in its paper *"An assessment of the long-term economic impact of stronger capital and liquidity requirements"* published in August 2010, in which it stated that "...they [the benefits of higher capital and liquidity requirements] are relatively larger when increasing bank capital ratios from lower levels and they decline as standards are progressively tightened. As an illustration, the models suggest that the decrease in the likelihood of crises is three times larger when capital is increased from 7% to 8% than when it is raised from 10% to 11%. Intuitively, the further away banks are from insolvency, the lower is the marginal benefit of additional protection." It is critical that the limitations of regulatory capital in improving the resilience of the banking system are recognised and a more balanced package of measures employed which will not adversely impact the broader economy.

We set out below our views on more specific aspects of the approach which we believe require further work, notwithstanding our concern with the overall approach being proposed.

It is a positive development to see that the debate on systemic importance has moved away from a simple focus on balance sheet size. We believe that the five categories of (i) size, (ii) interconnectedness, (iii) lack of substitutability for products and services provided, (iv) global (cross-jurisdictional) activity and (v) complexity are a step in the right direction in creating an approach that enables us to frame the issue, and the 12 indicators provide a fairly simplistic mechanism for attempting to measure systemic risk. However, the approach is academic and we suspect has been developed to substantiate the *a priori* judgements of the various regulators involved in the exercise. We have to question whether an additional 2.5%, or even 3.5% of Common Equity Tier 1 capital would have prevented the failures of the larger and more

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systemically important institutions that occurred in the global financial crisis. It is widely accepted that a lack of capital was not a fundamental cause of the crisis, so its role in the new regulatory framework needs to be more balanced than in current proposals.

We believe that any approach implemented should be absolutely transparent, including the detailed mechanics and calibration of the methodology (the approach has been calibrated using data provided by a sample of 73 banks, although the paper does not list the banks involved or how the data was validated for accuracy). It is critical that the assessment methodology is credible and built on true measures of systemic risk. We believe that many of the indicators proposed are simply a function of size; none of them are risk-focused and nor do they take into account risk mitigants. It is not at all clear whether the methodology contains any form of incentive structure that would enable a bank to take action to reduce its perceived systemic risk and reduce its additional loss absorbency requirement.

The methodology does not provide credit for any particular characteristics or work undertaken by a bank to make itself less systemically important, such as increasing its diversification, and developing effective recovery and resolution plans. Whilst we are not convinced about the efficacy of the approach proposed, we believe that it should have a much more explicit incentive mechanism incorporating factors that both increase and decrease the overall score by providing recognition of steps taken to reduce or mitigate systemic risk.

The exclusion of contingent capital to meet the proposed additional loss absorbency requirement of G-SIBs is welcome and we were pleased to note the analysis of the pros and cons of high-trigger contingent capital included in the consultative paper. Given the range and potentially high risks associated with the cons identified, we were surprised at the Committee's conclusion to support the use of such untested instruments to meet higher national loss absorbency requirements. This may send a conflicting message on the viability of contingent capital instruments as an integral component of regulatory capital and may be a missed opportunity to promote a consistent international approach. We have expressed our concerns about the use of contingent capital in our responses to the Committee's earlier consultations, but must stress that we remain opposed to their mandatory imposition due, in particular, to their complexity, negative signalling effects and potential to actually cause a firm's demise (the so-called 'death spiral').

The proposed approach provides significant scope for national differences to emerge. It is clear that a number of national regulatory authorities believe that the Basel III minimum capital levels have been set too low and it is likely that the Committee's proposed approach would be used to substantially increase minimum capital levels in such jurisdictions. As an internationally active bank, we are particularly sensitive to the importance of a level playing field and are strongly opposed to the apparent encouragement of national differences proposed in the consultative paper. We are already seeing signs of fragmentation even before the policy has been finalised, with some national authorities announcing plans to implement higher capital levels for systemically important institutions in their jurisdictions. This is a worrying development at this stage of the policy debate, particularly if decisions are being taken without consultation. We believe that the Committee should set out clear guidance on how national approaches should be integrated with the global approach it is developing as a matter of urgency, to ensure that there is consistency in approach. The Committee proposes applying

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the additional loss absorbency requirement to the consolidated group, but leaves the way open for application at a legal entity or sub-consolidation level. We believe that the Committee should set out an explicit requirement for the imposition of any additional loss absorbency requirement to ensure that banking groups are not faced with having to maintain multiple overlapping capital buffers with no clarity on how they are expected to be used across the constituent parts of the group.

The proposal to implement the additional loss absorbency requirement as an extension of the capital conservation buffer (and the countercyclical capital buffer when imposed by national regulators), imposes an unprecedented level of supervisory intrusion in the operation of a firm. With the Basel III Common Equity Tier 1 ratio minimum set at 7.0% including the capital conservation buffer, and where a bank is faced with a countercyclical capital buffer of 2.5% and a G-SIBs additional loss absorbency requirement of 2.5%, this would result in restrictions on dividends and other distributions being imposed if the bank's Common Equity Tier 1 ratio were to fall below 10.125%. The G-SIBs additional loss absorbency requirement should not be treated as an extension to the Basel III capital buffers; instead its breach should require a bank to provide suitable explanations to its lead regulator and to set out its plans to restore its capital position in a timely manner.

The debate on the impact on the banking industry and the broader economy of the various regulatory reforms being developed has seen very different opinions expressed, supported by various analyses. It is clear that the range of regulatory reforms proposed for the banking industry is unprecedented, and the impact on the industry and the economy will take some time to work its way through the system and be fully understood. Banking returns will certainly decrease, making bank equity much less attractive to investors, and requiring banks to deleverage with a consequential impact on the wider economy.

None of the impact assessments conducted to date have reviewed the cumulative impact of all of the changes proposed, including those in this consultative paper. We note from the Committee's paper that the Macroeconomic Assessment Group's impact assessment of the recommendations for addressing global systemically important financial institutions ("G-SIFIs") is planned to be published in September 2011, although it is not clear whether this will be a comprehensive impact assessment of all of the Committee's recommendations using the data collected in the latest Quantitative Impact Study or whether its scope will be narrower. We would urge that a comprehensive assessment is undertaken as without this analysis, a full cost / benefit assessment cannot be completed or potential "cliff edge" effects considered. The implementation timelines in the consultative paper provide insufficient time to complete this very important analysis, and the timetable should be extended despite political pressures to finalise the policy in time for endorsement at the G20 Leaders meeting in November 2011. It is also important to have a clear understanding of the relationships between the various sectors of the financial services industry and to consider the impact of measures taken to address other G-SIFIs, such as insurance firms, on the banking industry and the wider economy. Given the fragility of the global economic recovery, it is critical that we achieve the right balance with the reforms that will be implemented to ensure that the banking industry is capable of playing its part in supporting a sustainable recovery.

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We welcome the points made in the paper on how the proposed approach will interact with other elements of the Basel II and Basel III frameworks. However, more clarity is needed, particularly on the role of Pillar 2 when Basel III is implemented, e.g. the interaction of Pillar 2 capital buffers with the Basel III and G-SIB buffers.

In conclusion, we welcome the contribution made by the Committee's proposed approach to tackling systemic risk, but are very concerned that the proposed solution could lead to the situation where some institutions benefit from implicit state support being replaced by one where a select number of institutions are given explicit support (certainly that will be the perception). This seems to be at odds with the objective of ensuring that taxpayers are not required to bail-out failing financial institutions. We would urge the Committee to focus its efforts on developing an effective resolution regime capable of being implemented internationally through harmonisation of national resolution legislation, implementation of supervisory cooperation agreements and supported by comprehensive recovery and resolution planning.

Yours faithfully,

PMWalkden.

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Group Treasurer

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