POSITION PAPER
Our reference: 2011/0112

26/08/2011

Basel Committee on Banking Supervision
By e-mail to: baselcommittee@bis.org

Consultative document on Global systemically important banks: Assessment methodology and the additional loss absorbency requirement

Introduction

The Swedish Bankers' Association supports the comments submitted by the European Banking Federation. In addition to this, we have chosen to comment on some issues of special importance to Swedish banks and the Swedish financial market.

We focus primarily on the indicators in the BCBS proposal. In some specific cases we see there is a risk that the indicators will unintentionally create incentives for increased risk taking and unsound behavior – cases where we give examples based on the situation in the Swedish market. We also give examples of where the indicators unintentionally may punish institutions that take sound and prudent approaches to e.g. funding of cross-border business.

General comments

To find a methodology that properly determines the fundamentals of systemic importance is indeed a hazardous exercise that could easily give rise to unintended consequences. The BCBS starting point for measuring systemic importance is the impact a failure can have on the financial system, while disregarding the probability of such a failure. In our view, such a methodology could stand in contrast to sound risk management practices. Therefore we believe that the model should to a larger extent include risk-sensitive measures and incentives to decrease risky behavior.

Against this background, and in order to minimize the distortive effects and possible other negative side effects, we find it important that the ongoing and future work in this regard is guided by certain principles. First and foremost the framework needs to be *legally certain*. Furthermore, it needs to be *transparent and predictable* for all

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market players. Last but not least, it should *encourage sound behavior*. These principles are certainly logical but need to be kept in mind at all times in order to avoid creating a framework that misses the target or that is even counterproductive. These principles, all of which are also stressed in the EBF consultation response, have been the starting point for the detailed comments outlined below.

The indicator based measurement approach

General comments on the approach

One major disadvantage with the proposed indicators is double counting. Consider a bank that decides to reduce its liquidity and funding risk. The bank may then decide to diversify its funding base and issue bonds, CD's and CP's in foreign markets. At the same time the bank decides to increase its liquidity reserve through building a diversified portfolio of high quality bonds. Some of the liquidity will also be placed in central banks. If the bank would do this in a balanced manner it would reduce its risk but would at the same time score higher on several of the proposed indicators: cross jurisdictional activity, size and interconnectedness.

Cross-jurisdictional activity

In paragraph 18 it is stated that the purpose of this indicator is to measure the importance of the banks activities outside its home (here defined as headquarter) jurisdiction relative to the activity of other banks in the sample. It is argued that the greater the global reach of a bank, the more difficult it is to coordinate its resolution.

We believe that the proposal regarding cross-jurisdictional claims may punish banks that actively reduce funding risks. An important part of good liquidity risk management is to diversify funding sources (not least long term funding) over different markets, instruments and countries and thus to reduce the exposure to one single market. A bank that achieves this would – under the proposed regime – both reduce the probability of distress and receive increased capital requirements. For larger banks increased funding diversification will be a necessity and a consequence of the Basel III liquidity rules and should rather be considered as a mitigating factor in this framework. The proposed measure would give no regard to risk profiles or benefits of large cross-border banks and will destroy economic value, entail loss of efficiency and increase the likelihood of local systemic events as banks become again more local. Based on these arguments global activity indicators should be changed to merit banks' diversification and to better reflect the risk profiles.

We are also of the opinion that this measure does not correctly take into account banks that are present mainly in a limited market/region, and hence cannot be

considered global. As an example, the larger Swedish banks are not global banks but focus only on a limited region in Europe. It is natural that banks which are not systemically important on a global level, but systemically important on a local or regional level, are excluded from the intercontinental agreement on additional capital surcharges. This is also supported by the fact that there are well functioning supranational supervisory systems and routines in place for the region. Consequently, the global activity indicators should be revised to take into account the local/regional nature of such banks, as well as the degree of supervisory integration.

Size

Size, outlined in paragraph 27 and 28, is also a risk insensitive measure, as in the case of Cross-jurisdictional activity or Leverage ratio. It may induce banks to increase off balance sheet risk taking in an attempt to improve the return profile, while reducing the size of the balance sheet. Market players in the financial system will also get additional incentives – as they will through the leverage ratio requirement – to transfer assets to the shadow banking system, which may increase systemic risk rather than reducing it.

Another important issue is that the size indicator is based on accounting values, with some exceptions (e.g. derivatives). However, accounting frameworks differ, raising issues regarding level playing field. A bank may be classified as a G-SIB in one jurisdiction but would not be considered as a G-SIB if another country's accounting principles were used to determine the size indicator. This is in our opinion an unfortunate consequence, given that the framework aims at regulating institutions that by definition act and do business in several jurisdictions. Of a particular concern are repurchase agreements which are accounted for on a gross basis in the international accounting standards (IAS) but on a net basis according to US GAAP. Thus, European banks will be considered to be larger than its US peers, due to differences in accounting for repurchase agreements.

Interconnectedness

BCBS (paragraphs 29-34) argues that financial distress in one institution can materially raise the likelihood of distress in another institution given the network of contractual obligations in which these firms operate. Interconnectedness within the financial system is in principle an appropriate criterion for the definition of a systemically important bank, however some caveats need to be taken into account.

In particular, incentivizing banks to reduce their interconnections and their role in e.g. interbank markets may have severe negative consequences for market liquidity. This

could effectively increase systemic risk rather than reduce it. This is of a particularly concern in countries with a small currency, such as Sweden.

This is why the impact of changes in individual large cross-border bank behavior on liquidity and dynamics of different market segments should be carefully analyzed before proceeding further with extra regulatory requirements on G-SIBs that could induce behavior that may be counterproductive to financial stability.

We also find it important that the wholesale funding ratio indicator is modified. We fully agree that short term funding used to buy illiquid assets was one of the key problems behind the past financial crisis and certainly is an important issue. However, as now proposed, the concept of wholesale funding includes long term wholesale funding as well as short term wholesale funding. We believe the indicator should be modified in this respect in order to avoid effects that may threaten financial stability. In our opinion, it would from a risk perspective be better to have long term wholesale funding in a severe stress situation, rather than to rely on deposits. The indicator should be changed to reflect this fact.

Complexity

BCBS (paragraph 43-51) argues that the more complex a bank is, the greater the costs and time needed to resolve the bank. Complexity is measured by notional value of OTC derivatives, size of assets valuated using non-observable data (level 3), trading book value and value of available-for-sale assets. Complexity indicators point to difficulties in e.g. resolving an entity owing to complex agreements it has created with different customers. Since the aim of the regulation is to strengthen the resolution framework for banks classified as G-SIBs, it is also natural to include the complexity dimension in the definition of a G-SIB.

However, the meaningfulness of the proxies as well as the impact from the new incentives should be carefully considered. First of all, OTC derivatives are in general plain vanilla instruments such as interest rate swaps and FX-swaps. For this sub-indicator to be relevant it should focus on truly complex OTC derivatives and not on *all* such instruments. Furthermore, it can be questioned whether the chosen sub-indicators promote behavior that improves financial stability. For example, large companies are the main beneficiaries of OTC derivatives. With this proposal, they are likely to suffer even higher hedging costs on top of costs induced by the Basel III requirements.

Level 3 assets consist of those financial instruments whose fair values cannot be obtained directly from quoted market prices or indirectly using valuation techniques or models supported by observable market prices or rates. A high complexity of the valuation model or complex financial instruments does not necessary result in that

assets are categorized into level 3. It is the use of model parameters and the extent of non observability of publicly available price/rate quotes that defines the fair value hierarchy levels.

It is unclear why available for sale value and trading book value should be used as a measure for complexity. Available for sale financial assets, for example, is an accounting term for instruments measured at fair value but where the changes in fair values are booked directly in equity and not through the income statement. An available for sale book or a trading book could for example consist of government bonds, covered bonds and corporate bonds, i.e. non complex instruments. For this sub-indicator to be relevant it should focus on *truly* complex assets irrespective of the accounting classification, which is of little relevance when it comes to complexity of assets.

Problems with the data quality in the sample

The BCBS conducted a data collection in January 2011. Authorities did not clearly state the purpose of the data collection and in the end some data used for ranking banks is likely to have come from public sources. The consultative document acknowledges that the data used to construct the indicator based measurement approach may currently not be sufficiently reliable or complete. It is important to ensure that a common international framework for reporting the data that feeds into the calculation would be in place and that the quality of the data is properly validated before the proposal is implemented. Careful data analyses across institutions will most likely reveal the accounting differences and problems in making comparisons based on the data. This is especially important due to the construction of the calculation of individual bank scores, where the banks' individual score is compared with the average of the sample.

One example is the indicator used for cross border claims. The cross border liability indicator is the sum "Total foreign liabilities" minus "Liabilities to related offices" plus "local liabilities in local currency" divided by the total of such numbers across the sample. Looking at the results of the calculation, especially figures in the sample for the denominator, leads us to believe that many banks could have reported incorrect numbers (double counted their figures). In addition, the BCBS specifically states that the quality of the cross border liability indicator is low.

Due to the identified shortfalls we are of the opinion that a re-run should be done prior to the publication of the numbers. It is our firm belief that the outcome will look quite different if banks would have more time to control the quality of the reported data.

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Instruments to meet the additional loss absorbency requirements

The BCBS proposes that global SIBs shall be required to meet their additional loss absorbency requirement with Common Equity Tier 1 capital only (paragraph 88). Consequently, global SIBs will not be allowed to use contingent capital to meet any additional loss absorbency requirement.

Our view is that any requirement on global SIBs to hold additional loss absorbency should be allowed to be met with a broad range of going-concern capital instruments, e.g. high trigger contingent capital. The Common Equity Tier 1 requirements under Basel III, including capital buffers, will be tough in themselves and it would therefore be justified to allow global SIBs to meet any additional loss absorbency requirement with instruments that could be issued at a lower cost than common equity. To be able to meet the additional loss absorbency requirement with flexible instruments is also essential from a capital management perspective, since paragraph 93 of the proposal says that if a G-SIB progresses to a bucket that generates a higher loss absorbency requirement, it will be required to meet the additional requirement within a timeframe of 12 months. Against this background, it is justified to allow contingent capital as a means to manage potential increases and decreases in additional loss absorbency requirements. We believe that high trigger contingent capital could achieve the same prudential outcome as common equity.

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