Basel Committee
on Banking Supervision

Global systemically important banks: assessment methodology and the additional loss absorbency requirement

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I. Introduction

1. At its September 2011 meeting, the Basel Committee on Banking Supervision (the Committee) agreed to finalise the assessment methodology for global systemically important banks (G-SIBs).[1] This was based on a careful review of the comment letters received on its July 2011 consultative document *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*.[2] The revised rules text, which includes the G-SIBs assessment methodology, is attached to this note.

2. This section summarises the Committee's views on the major themes of the public comments received in connection with the July 2011 consultative document. Section II details the changes agreed by the Committee to improve the assessment methodology, including certain changes subject to additional testing by March 2012 using updated bank data. Section III sets out in more detail the main themes of the public comments and the Committee's evaluation.

3. The rationale for adopting additional policy measures for G-SIBs is based on the "negative externalities" (ie adverse side effects) created by systemically important banks which current regulatory policies do not fully address. In maximising their private benefits, individual financial institutions may rationally choose outcomes that, from a system-wide level, are sub-optimal because they do not take into account these externalities. These negative externalities include the impact of the failure or impairment of large, interconnected global financial institutions that can send shocks through the financial system which, in turn, can harm the real economy. This scenario played out in the recent crisis during which authorities had limited options other than the provision of public support as a means for avoiding the transmission of such shocks. Such interventions also have implications for fiscal budgets and taxpayers. Moreover, the moral hazard costs associated with direct support and implicit government guarantees may amplify risk-taking, reduce market discipline, create competitive distortions, and further increase the probability of distress in the future. As a result, the costs associated with moral hazard add to any direct costs of support that may be borne by taxpayers.

4. There is no single solution to the negative externalities posed by G-SIBs. Hence the official community is addressing the issues through a multipronged approach. The broad aim of the policies is to:

- reduce the probability of failure of G-SIBs by increasing their going-concern loss absorbency; and
- reduce the extent or impact of failure of G-SIBs by improving global recovery and resolution frameworks.

5. The measures adopted by the Committee in the present rules text address the first objective of requiring additional going-concern loss absorbency for G-SIBs, thereby reducing

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1 See *Outcome of the September 2011 Basel Committee meeting* at www.bis.org/press/p110928.htm.

2 See www.bis.org/publ/bcbs201/cacomments.htm for the comments received.

the probability of failure. This is a critical and necessary measure. They complement the measures adopted by the Financial Stability Board (FSB) to establish robust national resolution and recovery regimes and to improve cross-border harmonisation and coordination.[3] However, even with improved resolution capacity, the failure of the largest and most complex international banks will continue to pose disproportionate risks to the global economy.

6. Whether the costs associated with additional loss absorbency for G-SIBs outweigh the benefits has been a matter of debate. Empirical analysis carried out by the Macroeconomic Assessment Group (MAG) indicates that the costs of requiring additional loss absorbency for G-SIBs are smaller than the associated benefits, reflecting the reduced probability of a systemic financial crisis. In addition, if the objective is to lower the probability of a G-SIB failure such that the expected impact (ie probability of failure times impact) becomes equal between G-SIBs and the largest non G-SIBs, empirical analysis carried out by the Committee points to additional loss absorbency generally in the range of around 1% to 8% of risk-weighted assets. The Committee's calibration of the additional loss absorbency requirement ranging from 1% to 2.5% with an additional empty bucket of 3.5% is in the lower half of this estimated range. This will help ensure that the benefits truly outweigh the costs given the degree of measurement uncertainty associated with the assessment of systemic risk.

7. It should be stressed that identifying systemic importance is a process that is at an early stage of development. The indicators do not measure precisely specific attributes of G-SIBs, but, rather, are proxies designed to identify the main aspects of G-SIB status. In that context, the Committee's guiding principle was that the indicators should be considered as a suite of approximate measures that capture the potential impact of a G-SIB's distress or failure on the broader financial system. The indicators produce a robust ranking of firms' systemic impact which is consistent with experience and sound judgement.

8. The indicators should not be considered as risk metrics or prescriptive ratios per se. The Committee, therefore, chose not to take into account comments that called for the use of indicators that are more risk sensitive in measuring a bank's exposures, but rather to focus on the impact of the bank's distress or failure should that occur. On the other hand, the Committee has agreed to incorporate suggestions that lead to improvements in the indicators' measurement of systemic impact, subject to testing using updated data.

9. The Committee plans to update on an annual basis the banks' indicator scores and systemic importance bucket positions. Therefore, the list of G-SIBs will not be fixed – there can be new entries and exits every year, as well as movement among buckets. This should provide incentives for banks to reduce their systemic importance. If individual banks materially reduce their systemic footprint, they will benefit from a reduction in their additional loss absorbency requirement by being assigned to a lower capital surcharge bucket.

10. The Committee agreed that, prior to implementation of the G-SIB policy on 1 January 2016, it will disclose the denominators used to normalise the indicator scores and the cut-off/threshold scores that define the buckets in the assessment methodology. It expects all banks identified as G-SIBs to publicly disclose the relevant data when the G-SIB policy is implemented. By combining the information disclosed by the Committee and G-SIBs, it will be possible for market participants to replicate the methodology.

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[3] See Financial Stability Board, *Key attributes of effective resolution regimes for financial institutions* (November 2011).

II. Major comments that were accepted

1. Indicators

(a) Intrafinancial system assets/liabilities

11. A few commenters asked for clarification as to why repos are the only component which is not limited to financial institutions (paragraphs 30, 31). The Committee agreed that it would be appropriate to add the underlined text "*net mark to market (reverse) repurchase agreements <u>with other financial institutions</u>"*, as suggested by the commenters.

12. In light of the comments received, the Committee also discussed one of the components of intrafinancial system liabilities (paragraph 31). It agreed that securities issued by banks that are owned by other financial institutions represent a measure that banks are not able to report as these are traded on secondary markets. As a result, the Committee concluded that it would be appropriate to delete the text "*that are owned by other financial institutions"* and rename the component "*all marketable securities issued by the bank"*.

(b) Substitutability

13. The Committee agreed that the term "*substitutability*" may be confusing and it would be better to rename the category "*substitutability/financial institution infrastructure"*, as this better reflects the nature of the indicators for this category.

(c) Trading book value and available for sale value

14. The current term "*trading book value and available for sale value"* was also discussed. The Committee agreed that it could be confusing as the "trading book" is a regulatory construct and "available for sale" is an accounting one. It is possible that the trading book could include securities that are accounted for in the available for sale category. It was agreed, therefore, that the term "*trading book"* should be replaced by "*held for trading"*.

15. In addition to the changes noted above, the Committee further agreed that it would be appropriate to make the following changes set out in paragraphs 16-19 subject to a review of the updated scores based on end-2010 data. The Committee will conduct additional testing by March 2012 to ensure that changes to the indicators do not inadvertently give rise to results that are not intuitively plausible. Thus, these proposed changes are not reflected in the attached revised rules text.

(a) Intrafinancial system assets/liabilities and wholesale funding ratio

16. A number of commenters suggested that the wholesale funding ratio should not be included as an indicator for interconnectedness. They interpreted the wholesale funding ratio as a regulatory requirement and reasoned that it is not appropriate to require banks to meet a new liquidity ratio that is not part of the Basel III liquidity requirements. Other commenters suggested that the current definition of the wholesale funding ratio is too broad and should only target short-term liabilities, ie by excluding any funding in excess of one year.

17. The Committee agreed that the purpose of including the wholesale funding ratio was to capture the extent to which banks are connected to other parts of the financial system. It was not meant to be a liquidity constraint as suggested by some commenters. However, many Committee members sympathised with the view that the normalisation method for the

wholesale funding ratio is different from that of the other indicators and that this may lead to confusion.[4] On the other hand, other members were of the view that maintaining the wholesale funding ratio would be beneficial as it would help capture a bank's vulnerability to funding shocks and the risk of spillover to the broader financial system. There were also concerns that replacing this measure with a balance sheet item could exacerbate the issue many commenters had raised that many of the indicators are correlated with size. Having weighed the range of views, the Committee tentatively agreed that it would be appropriate to replace the indicator with "*all marketable securities issued by banks"*. The Committee also agreed, as suggested by some commenters, to look into the possibility of focusing on a maturity of one year or less. This would be in line with the definition of stable funding in the Basel III liquidity framework's Net Stable Funding Ratio.

(b) Payments cleared and settled through payment systems

18. Given the difficulties in collecting payments data from banks on a payment system basis, the Committee proposes to instead collect it on a currency basis. This will effectively capture all of the intended payment systems.

(c) Trading book value and available for sale value

19. The Committee also agreed to remove from this indicator those assets that qualify for inclusion in the stock of high liquid assets under the Liquidity Coverage Ratio (LCR). This is because these qualifying liquid assets, if sold quickly, are less likely to depress market prices than other assets held for trading or available for sale. It also responds to the view of some that banks should not be penalised for holding liquid assets to meet the LCR requirement.

2. Periodic refinement of the assessment methodology

20. The July 2011 consultative document mentioned that the methodology will be reviewed every three to five years (paragraph 70). Some commenters were of the view that it would be appropriate to have a rather short review period to ensure ongoing suitability and effectiveness. In light of these comments, the Committee agreed that it would be appropriate to conduct a review every three years. The denominators for the indicators used in the methodology are to be fixed for the full three year period, which is elaborated later in this document.

21. Some commenters requested clarification about the periodic refinement of the methodology. The Committee agreed that the broad objective of a periodic review is to adjust the measurement framework for changes that are not related to the overall systemic importance of the banking industry at the global level (eg GDP growth or major exchange rate movements). The Committee expects the number of G-SIBs and their allocation across buckets to change over time as bank business models are adjusted in response to the incentives provided by the framework. The Committee will flesh out further the principles of the periodic review, including objectives and possible tools.

22. The Committee also reconfirmed that it does not plan to conduct a fundamental review of the methodology every three years. In this context, the Committee believes that the

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[4] The wholesale funding ratio is normalised by the sum of the ratios across all banks in the sample while the other indicators are normalised by the sum of relevant quantities (eg euro amounts of foreign claims) for all banks in the sample. This benchmarks each bank not to the sum total of amounts but to the average ratio across all banks in the sample.

number of buckets (4 buckets + 1 empty bucket), the increments of the additional loss absorbency (0.5%) and the requirement for the current top populated bucket (2.5%) should be maintained. If a bank moves to the current empty bucket and a new empty bucket is therefore created, then the new structure will be maintained through the subsequent three year review period.

23. Under the methodology, each indicator is normalised by the sample total, which means that a firm's score is its proportion of the sample total, ie initially a relative score. The reason for adopting this concept was to make sure the various indicators were comparable by normalising them. Another reason was to capture the structural aspect of systemic importance rather than the cyclical ones, thus providing appropriate incentives for banks to reduce their systemic impact. In this context, commenters asked for clarification about the frequency of updating the denominators used in the methodology. They were concerned that annual updates of both the numerators and the denominators would produce relative scores and not absolute ones negating the efforts by an individual bank to reduce its systemic importance. The Committee agreed that it would be appropriate to fix the denominators until the next periodic review of the methodology, meaning that the scores will effectively be absolute measures that recognise an individual bank's reduction in systemic impact.

24. Some commenters also suggested that a method to ease the impact of exchange rate fluctuation should be considered. The Committee agreed that it may be appropriate to flesh out these issues and give them further consideration.

C. Disclosure/transparency

25. Many banks criticised what they perceived as the methodology's lack of transparency. As signalled in the July 2011 consultative document, the Committee will disclose the values of the buckets' thresholds and the denominators used to normalise the indicator values. This will allow banks, regulators and market participants to better understand how potential actions taken by banks could affect their systemic importance score and thereby the applicable magnitude of additional loss absorbency. The Committee will disclose the denominators and the cut-off score for a bank to be a G-SIB as well as the threshold scores for the five buckets by November 2014 based on end-2013 data. This will provide those banks subject to the additional loss absorbency requirement on this date with an appropriate capital planning horizon and address concerns about transparency. It will also provide banks with sufficient time to prepare before the implementation of the additional loss absorbency requirement, which will take effect on January 2016.[5] The first three year review will be conducted by November 2017.

26. The Committee also agreed that the sample of 73 banks currently being tracked should be reviewed every three years. The current 73 bank sample was agreed based on size and supervisory judgement by supervisors. Going forward, the Committee will flesh out a more transparent methodology to set the sample, as requested by some commenters.

27. The Committee expects all banks in the sample to publicly disclose the relevant data when the G-SIB policy is implemented and it will provide reporting guidance to assist with this.

28. By combining the information disclosed by the Committee and the banks, it will be possible for market participants to fully replicate the methodology.

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[5] The additional loss absorbency requirement in January 2016 will also be based on end-2013 data.

III. Major comments that were not accepted

A. Additional loss absorbency requirement

29. Some commenters challenged the merits of imposing additional loss absorbency requirements on G-SIBs. The Committee reconfirmed its view that the additional policy measures for G-SIBs are based on the cross-border negative externalities created by SIBs which current regulatory policies do not fully address. In addition, the moral hazard costs associated with implicit guarantees derived from the perceived expectation of government support may amplify risk-taking, reduce market discipline, create competitive distortions and further increase the probability/impact of distress in the future. As a result, the costs associated with moral hazard add to any direct costs of support that may be borne by taxpayers.

30. A number of commenters emphasised that the proposed size of the additional loss absorbency requirement lacks empirical justification. As set out in the July 2011 consultative document, the Committee conducted empirical analysis to assess the appropriate additional loss absorbency requirement. The analysis produced additional loss absorbency generally in the range of around 1% to 8% of risk-weighted assets, in terms of Common Equity Tier 1 equivalent, with a central tendency of around 2% to 4%. This analysis helped inform the policy judgement of the Committee and the Governors and Heads of Supervision (GHOS), the Committee's governing body. It should also be emphasised that the agreed 2.5% additional loss absorbency requirement for the top populated bucket is closer to the lower end of the central tendency referred to above, and that most G-SIBs are expected to face lower additional loss absorbency requirements in practice.

31. When it comes to the economic impact, the MAG report finds that a one percentage point increase in capital applied to G-SIBs would dampen growth by an additional 0.7 basis points per year for an eight year implementation period.[6] For a four year implementation period, the impact is 1.1 basis point per year on average over the transition. In both cases, growth is forecast to accelerate above its trend level for several quarters after the point of peak impact is reached, as it recovers towards its baseline. Meanwhile, drawing on the findings of the Committee's long-term assessment of the economic costs and benefits associated with increasing regulatory capital requirements (the "LEI report"), the MAG estimates that the G-SIB framework should provide an annual benefit of about 40 to 50 basis points of GDP, reflecting the reduced probability of a systemic financial crisis.

B. Assessment methodology

32. Identifying systemic importance is a process that is at an early stage of development. This was the Committee's starting point as it developed the assessment methodology. The indicators are proxies designed to identify the main aspects of G-SIB status. In that context, the Committee's guiding principle was that the indicators should be considered as measures that capture the potential impact on the broader financial system of a G-SIB's distress or failure. The Committee, therefore, did not take into account comments that called for the use of indicators that measure the riskiness of a bank's exposures. Taken together, the indicators produce a robust ranking of a firm's systemic impact which is consistent with experience and sound judgement.

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[6] See Macroeconomic Assessment Group, *Assessment of the macroeconomic impact of higher loss absorbency for globally systemically important banks*, Bank for International Settlements (October 2011) at www.bis.org/publ/bcbs202.htm.

1. Indicators

(a) Cross-jurisdictional activity

33. Some commenters stressed that the definition of cross-jurisdictional activity is flawed as it makes no distinction between local currency assets funded with local currency liabilities versus local currency assets funded with non-local currency liabilities. In their view, the methodology would penalise local assets in foreign jurisdictions that are funded by local liabilities as compared to those that are funded by liabilities in the bank's home country, even though matching the funding of local assets with local liabilities is argued to be less risky and more readily resolvable. They were of the view that the methodology would incentivise cross-border funding of foreign operations, a practice that is considered to be objectively riskier.

34. The Committee discussed this issue at length. The question here is, if local currency claims and liabilities are less relevant for global systemic importance than other cross-border claims and liabilities, should an allowance be made for the proportion of the global activity indicators accounted for by local currency claims and liabilities? To assess the relevance of local currency claims and liabilities for global systemic importance, the Committee discussed whether local currency-denominated foreign activities are less likely to be a source of cross-border spillover than other forms of cross-border claims and liabilities. The Committee's view was that, even if funded locally, the local entity has a funding advantage of being supported by a G-SIB parent. In addition, the crisis has shown that foreign subsidiaries may not have been completely isolated from problems at the parent level and that the behaviour of multinational banks creates channels through which spillover could occur. Thus, the Committee was of the view that it is not necessary to revisit the conclusions.

35. Some European commenters suggested that the European Union should be viewed as a single market for purposes of the methodology. This issue was discussed intensively by the Committee and the GHOS. Agreement was reached that this issue will be revisited as progress is made on topics such as a common supervisory system, a common resolution framework and burden-sharing.

(b) Size

36. Many commenters argued that more risk-sensitive indicators should be used in measuring the systemic importance of a bank. In this context, a few suggested that risk-weighted assets should be used as a size indicator instead of the proposed total exposures measure.

37. The Committee decided to use the same definition for total exposures used for the Basel III leverage ratio because the objective of the size indicator is simply to obtain a measure of how large a bank is. This reflects the fact that systemic importance is a measure of the potential impact the failure of a bank has and not the likelihood of failure, which is the objective of the risk sensitive measures. Therefore, the Committee was of the view that it is appropriate to retain the current total exposures indicator as the sole indicator for size.

(c) Values of underwritten transactions in debt and equity markets

38. A number of commenters were of the view that the value of underwritten transactions should not be included as an indicator for substitutability/financial institution infrastructure because the underwriting markets are both deep and competitive.

39. The Committee had considered such arguments. It maintains its view, however, that this indicator captures the importance of banks in the global capital markets regardless of the underwriting markets' competitiveness. It continues to believe that the value of underwritten transactions is an effective indicator for capturing the global activity of investment banks.

Thus, the Committee was of the view that it is not appropriate to remove the indicator from the methodology.

(d) OTC derivatives notional value and Level 3 assets

40. Many commenters stressed that OTC derivatives' notional value should focus on net rather than gross value, since the size aspect of the notional value is already captured under the size category. A few commenters emphasised that non-centrally cleared OTC derivatives may be less liquid and harder to value and hence may converge with Level 3 assets in the future. A few commenters suggested that transactions executed via Continuous Link Settlement should be excluded from the definition because there is no settlement risk.

41. As noted above, the Committee had agreed that the objective of the methodology is not to control risks per se. This is the role of other aspects of the Basel framework. Instead, the objective of this type of indicator is to obtain an indication of a banks' relative complexity. That is why derivative positions measured on a gross notional basis was selected as an indicator. It was also the Committee's intention to exclude exposures handled via central counterparties. This was noted in the July 2011 consultative document. The Committee, therefore, did not believe it was necessary to revisit the conclusions.

2. Supervisory judgement

42. Many commenters suggested that the methodology should take account of situations in which banks operate in jurisdictions having in place laws that establish clear recovery and resolution frameworks. They stressed that a credible recovery and resolution plan should be recognised to set off and reduce the additional loss absorbency requirement.

43. The Committee discussed this issue at length and whether the quality of a jurisdiction's resolution framework should be factored into the judgement process. The FSB's November 2010 publication *Reducing the moral hazard posed by systemically important financial institutions* states that the policy framework for SIFIs should combine a resolution framework to ensure that all financial institutions can be resolved safely and an additional loss absorbency requirement.[7] Progress is being made in the establishment of robust national resolution and recovery regimes and of the criteria for resolvability. The implementation of these initiatives will need to be carefully observed. The failure of a G-SIB will continue to pose disproportionate risks to the global economy. Against this backdrop, it was agreed that it is not appropriate at this juncture to reduce the amount of additional loss absorbency requirement in relation to the existence of a reliable resolution framework in a jurisdiction.

44. The Committee also agreed that national supervisors could impose higher capital surcharges beyond the additional loss absorbency requirements for those G-SIBs which are not subject to an effective and credible recovery and resolution plan. The Committee was of the view that this treatment should not be changed at this stage. The issue could be revisited in the future as tangible verifiable progress is made in enhancing resolution processes.

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[7] See *www.financialstabilityboard.org/publications/r_101111a.pdf*. These recommendations also state that in addition to the two factors, more intensive supervisory oversight, robust core financial market infrastructure and other supplementary prudential requirements should be combined (paragraph 2).

C. Contingent capital

45. On the issue of contingent capital, a number of commenters supported the Committee's proposal not to include contingent capital to meet the additional loss absorbency requirement. On the other hand, others argued that high-trigger contingent capital should be allowed to meet the additional loss absorbency requirement.

46. The pros and cons of high-trigger contingent capital set out in the July 2011 consultative document were broadly supported by those commenters who were of the view that contingent capital should not be used to meet the additional loss absorbency requirement. By contrast, those that supported the inclusion of contingent capital to meet the requirement questioned some of the Committee's analysis. However, the Committee continues to believe that the potential impediments associated with using contingent capital still have not been addressed and the use of contingent capital therefore should be ruled out at this time.

D. Interaction with the capital buffers

47. A number of commenters expressed the view that the Committee's proposal to implement the additional loss absorbency requirement through an extension of the capital conservation buffer was unduly harsh. They commented that the current proposal will effectively set the minimum capital standard as high as 9.5% for the most systemic G-SIBs. These commenters proposed that there should be no restrictions on distributions for G-SIBs with capital ratios in the upper half of the buffer (ie 8.25% to 9.5%). Instead, they believe that this should act as a trigger for management and regulators to undertake remedial actions. Further down the buffer (eg lower half of the buffer: 7.0% to 8.25%), restrictions could be applied at 20% as an interim step to the 40% restriction which applies upon entering the capital conservation buffer. However, the Committee concluded that this approach effectively would make the breach of the surcharge non-binding, thus reducing the incentives of the framework to address systemic importance.