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

A framework for dealing with domestic systemically important banks

Please find attached the ABA's submission on the Committee's consultative document, *A framework for dealing with domestic systemically important banks*.

Yours sincerely,

Tony Burke

AUSTRALIAN BANKERS' ASSOCIATION INC.

Submission

ABA response to 'A framework for dealing with domestic systemically important banks'

1 August 2012

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The Australian Bankers' Association (ABA) welcomes the opportunity to provide comment on the Basel Committee of Banking Supervision's (the Committee) consultative document, *A framework for dealing with domestic systemically important banks* (the consultative document). The ABA supports the Committee's ongoing efforts at a time of increased regulatory change. The volume and pace of regulatory change being proposed increases the risk of inefficient regulation being developed. This may introduce unforeseen negative side effects, especially when differences across jurisdictions are not fully considered. The careful consideration of new proposals and ongoing consultation with industry will reduce the occurrence of these outcomes.

1. General comments

The ABA and its members support the Committees initiative's to respond to regulatory shortfalls, a number of which became evident during the Global Financial Crisis (GFC). Events during the GFC also highlighted the need for regulators to consider the (moral) hazards potentially stemming from systemically significant institutions. Most importantly, these events emphasised the advantages of strong prudential supervision.

Effective supervision must be the cornerstone of any regulatory regime. While the need for sufficient (high quality) capital and liquidity buffers is evident, adding more capital and/or liquidity requirements does not necessarily lead to a safer financial system. As seen in a number of jurisdictions in recent years, the failure of regulators to properly understand, monitor and respond to financial developments has led to considerable negative outcomes. It is important that regulators have the ability to monitor (and react to) developments both within particular markets as well as across different industries. A holistic view of the finance industry (and the wider economy) is required to ensure effective and efficient policies are developed and implemented.

Initiatives by the Committee to improve the regulation of systemically significant institutions are a step in the right direction to raising the standard to regulation globally. The ABA welcomes these developments, especially in light of the Committee's most recent report on the global implementation of its standards, which highlighted that a number of jurisdictions have not achieved substantial progress in their implementation programs.[1]

While the ABA supports the aim of the current proposal, it does have a number of concerns, including:

- the imposition of additional capital requirements when new, tougher rules are currently being implemented and the world economy faces considerable uncertainty;
- the fact that the framework for prudential supervision in some member countries, such as Australia, already factors in the size and impact of failure;
- the use of a methodology for measuring systemic importance that does not provide either flexibility in application or clear motivation for financial institutions to reduce risk that contributes to systemic importance; and
- the lack of an implementation timeline.

The ABA provides the following more detailed comments for consideration.

2. National discretion

The consultative document rightly highlights the need for 'an appropriate degree of national discretion'. Some flexibility is required to allow regulators to adapt the Committee's framework to their national circumstances, noting some jurisdictions such as Australia already have a framework in place to

[1] http://www.bis.org/press/p120611.htm

recognise the risks highlighted in the consultative document (for more information, please see Sections 3 and 4). However, those jurisdictions in which regulators have been shown to be lacking must not be allowed to use this clause as an excuse for inaction. The Committee, as part of its peer review process and other mechanisms, must work to ensure that regulators which have failed to adequately implement the Committee's rules are identified and that leadership is provided for the necessary improvements.

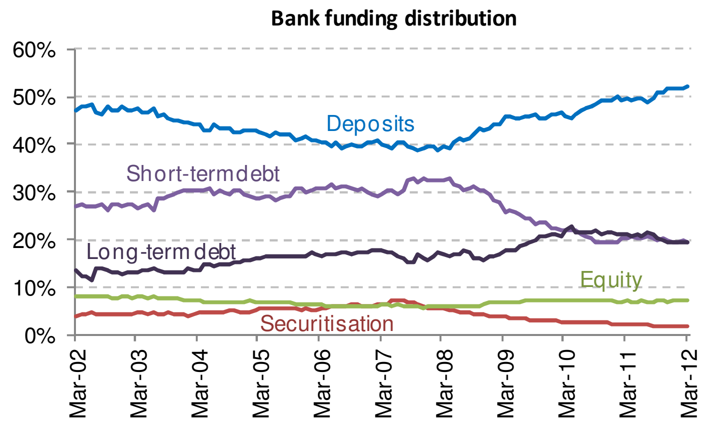
3. Higher Loss Absorbency

Regulators globally are currently implementing, or looking to implement, higher and more restrictive capital and liquidity requirements. The current Basel III capital and liquidity requirements are expected to have a significant impact on the balance sheets and funding requirements of financial institutions over the coming years. Financial institutions have already started to adjust their capital and funding positions in response to these measures. The Reserve Bank of Australia has noted, that for banks operating in Australia:

> *"...an increasing share of funding has been sourced from deposits. There has also been a shift away from short-term wholesale funding towards long-term wholesale funding, as banks have sought to reduce their rollover risk (that is, the risk associated with replacing maturing wholesale debt). These trends are consistent with the objectives of the Basel III global liquidity standards."*[2]

This shift has continued since 2008. Currently, short-term debt equates to less than 20 per cent of bank funding with domestic deposits representing above 50 per cent (Graph 1).

Graph 1



Given these large adjustments, which are expected to continue over the coming years, the imposition of a higher loss absorbency (HLA) capacity (for D-SIBs) may, at the least, be ill-timed. Furthermore, any HLA requirement for D-SIBs would equate to an additional buffer, on top of the numerous buffers already included in the Basel III framework. The array of buffers in the Basel III framework are not only untested, but will not be fully implemented for a number of years, and the effect of the increase in capital and liquidity requirements will not be fully understood for some time. Given this and the uncertainty in the global economy, further capital requirements may have significant negative side effects, especially in those countries currently facing economic and financial challenges.

However, if the Committee proceeds with a D-SIB framework that includes HLA requirements, the ABA believes national supervisors should take into account a number of factors in determining the appropriate size of the HLA, or whether an HLA requirement is warranted in their jurisdiction.

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[2] http://www.rba.gov.au/publications/bulletin/2012/mar/pdf/bu-0312-5.pdf

Principle 10 in the consultative document states, "The Committee is of the view that any form of double-counting should be avoided"[3]. While the consultative document appears to be focussed on avoiding double-counting of G-SIB and D-SIB HLA requirements, this should also be extended more broadly to cover double-counting that could arise from the introduction of D-SIB HLA requirements in jurisdictions that already have implicit HLA requirements through a more conservative implementation of Basel III. The ABA also believes that the other policy tools that the national supervisor employs in supervising D-SIBs should be considered in determining the appropriateness of HLA requirements for D-SIBs.

As an example, the Australian Prudential Regulation Authority (APRA) has adopted a more conservative approach to the implementation of Basel III in Australia, including higher deductions from capital, a more conservative calculation of risk-weighted assets and an accelerated implementation timetable. The impact of APRA's conservative implementation on the Common Equity Tier 1 ratios for the major Australian banks is in the order of 200 basis points.

In addition to this, APRA employs a Probability and Impact Rating System (PAIRS) and Supervisory Oversight and Response System (SOARS) framework, which includes the use of, *inter alia*, an impact rating scale.[4] The PAIRS/SOARS framework is designed to result in earlier supervisory intervention for larger banks that are assessed to have a higher potential impact on financial system stability. This should be taken into account in determining the HLA that is appropriate for Australian D-SIBs.

4. Moral hazard

A real risk that must be considered by the Committee is the formalisation of moral hazard through identifying certain institutions as being D-SIBs, and as such being 'too big to fail'. Even if regulators do not explicitly state those identified institutions (as has been done with G-SIBs), the Committee must be mindful of the ability of analysts to deduce such a list from publically available data and disclosure methodologies.

An approach that could reduce this risk is that adopted by the APRA. Under APRA's approach, each Authorised Deposit-taking Institution (ADI) is set a prudential capital requirement (PCR). The PCR is a risk and impact adjusted capital requirement, "set at a level proportional to each ADI's overall risk profile",[5] in addition to the regulatory minimum. Individual PCRs are not disclosed publically. Advantages of this system include the ability of regulators to set and adjust PCRs (i.e. total regulatory capital requirements) without publically disclosing the perceived riskiness or systemic importance of individual institutions.

In addition, the determination of the PCRs is assisted by APRA's PAIRS/SOARS framework. Institutions that are deemed to have a higher risk of failure, or a larger impact if they do fail, are subject to 'more intensive' supervision (and possibly higher regulatory capital requirements). In the ABA's view, APRA's PAIRS/SOARS framework represents a working model that achieves the outcomes of the Committee's proposal without some of the potential shortfalls.

5. Conclusion

The ABA is supportive of the Committee's ongoing work to improve the level of supervision globally. The cornerstone of any regulatory regime must be effective supervision. Those jurisdictions that do not meet the implementation timetable for the Committee's rules expose the global economy to increased risk and

[3] Basel Committee on Banking Supervision Consultative Document, A framework for dealing with domestically systemically important banks, page 9.
[4] Further information on APRA's PAIRS and SOARS framework can be found on the APRA website: www.apra.gov.au.
[5] http://www.apra.gov.au/adi/Documents/cfdocs/Discussion-paper-Supervisory-Review-Process.pdf

put compliant jurisdictions at a competitive disadvantage. The Committee must continue to monitor implementation and act to motivate noncompliant jurisdictions.

A D-SIB framework must also be based on effective supervision. While capital and liquidity requirements have their place, the proven method to reduce the risk of perverse outcomes in the financial sector is effective supervision.

Finally, a D-SIB framework must reduce moral hazard, not formalise it, provide institutions with clear motivation to reduce their systemic risk and be implemented according to a globally consistent timetable.