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A framework for dealing with domestic systemically important banks

The Division Bank and Insurance of the Austrian Federal Economic Chamber, as representative of the entire Austrian banking industry, appreciates the possibility to comment on the document "A framework for dealing with domestic systemically important banks" and would like to submit the following position:

General Remarks and Summary of the main points

- The document does not give any indication about potential amounts or meaningful indications about other supervisory measures which might be used.

- The steering incentives put more stress on the relationship between home and host supervisors reducing clear guidance while potentially adding burden at the group level for banks.

- If the envisaged additional solo check of capitalisation (par 37) includes a deduction of bank participations held it contradicts Basel 3/CRR and yields significant disruptions for international banking groups.

- The consequences of this paper are additional CET-1 requirements, which will further aggravate the granting of loans by credit institutions. Higher capital requirements as the key measure to reduce the risk of D-SIBs increase the impact of harming the real economy, a discussion held already in connection with Basel III.

- Given the much smaller size of national markets a lot more institutions will become D-SIBs than on an EU-wide scale. This is especially disadvantageous for smaller countries as members of international banking groups will more likely become D-SIBs while this will not always be the case for similar banking groups from bigger countries.

- When fixing the level of D-SIB HLA, the maximum level of the HLA should not be higher than the minimum level of G-SIFI rules. Furthermore D-SIB HLA imposed by host authorities should be recognised as minimum capital requirements.

- We believe that further consideration should be given to the possibility of D-SIBs to meet additional capital requirements with non-common equity instruments, in particular Contingent Convertible instruments. The framework could specify that at least a proportion of the capital add-on could be met with such instruments. This would provide sufficient loss-absorbency to the entity while allowing for a diversified capital base that does not necessarily rely on Common Equity.

In our view the implementation could have the following consequences:

- The implementation could lead to a transfer of parent banks of small jurisdictions into big jurisdictions while leaving behind the local banking operations in the small jurisdiction thus making the former home country to a host country. This scenario would make them loose D-SIBs as issuers in the local stock market, which might not be intended.

- Reduction/sale of cross-border business of D-SIBs could weaken the macroeconomic position of D-SIB home countries, which might not be intended and contradicts the principle of freedom of capital within the EU.

- Further fragmentation of the individual markets creating considerable gaps between various jurisdictions and adversely affecting lending activities for both parent as well as subsidiary banks. Ultimately, this will restrict the trade between countries and investments within countries and will lead to a reduced economic growth.

European bank union vs. national supervision
The paper does not take note of the ongoing discussion in the EU to transfer supervision (or at least parts of it) on a supranational level. It clearly states in principle 1 that national authorities are in the lead and should assess "*the degree to which banks are systemically important in a domestic context*". One can expect that a transfer on a supranational EU level will take some time. Until then national authorities will prevail.

In order to avoid an undue undermining effect to the EU single market we would suggest to consider the application of these principles merely on an EU level. This seems justified especially in regard to the recently envisaged banking and fiscal union. If the present document is applied by all the different regulators of EU member states this might lead to uncoordinated capital requirements set by different regulators and thereby might undermine the whole EU single banking market in that the very foundation of the single banking market is that a bank may register under the more or less same conditions in one or another member state, regardless of its size. If the present document is applied by all EU member states banks of the same size and interconnectedness would probably be treated differently in terms of capital requirements because of their different home countries. As already outlined above this would clearly contradict the principle of freedom of capital within the EU.

Avoiding an unlevel playing field
The establishment of a common and coherent methodology applicable by each competent authority based on a comprehensive approach is of crucial importance to avoid an unlevel playing field and to preserve the value of the economic unity of integrated cross border groups.

The document gives ample scope for national discretions and will not help creating a level playing field for international banks even though a "*consistent, coherent and non discriminatory treatment regardless of ownership*" is demanded (in pt. 36). Therefore: a certain degree of

discretion for national authorities is welcomed, however a minimum set of a framework should be ensured.

We strongly suggest BCBS therefore to define such a common methodology, as it is the case for the G-SIFI framework, and also consider an effective way to enforce it.

Moreover we suggest a public disclosure not only of "*an outline of the methodology employed*" – as foreseen by the Basel Committee - but also of the data used and of the input based on supervisory judgment (if any). This will ensure that markets and institutions have all the elements to fully understand the evaluation process performed by the competent authorities.

Impact on the organizational set up of cross border banking groups
The suggested framework will have an impact on the internal organization of cross border banking groups and its business model. The suggested framework may privilege a "flat" organization (with branches) over a pyramidal one (with subsidiaries). The European banking groups would be particularly penalised in view of their organisational set-up that has been envisaged in the context of the single market and an ever closer union. Having legal entities designated as D-SIBs might therefore compromise the business models or strategic plans of financial entities.

Framework for cooperation
We consider it is the responsibility of the BCBS to establish a framework to ensure effective cooperation and limit inappropriate unilateral actions by each competent authority. The relationship between home and host regulators suggested in the framework gives rise to many doubts. There is a significant possibility that host regulators will tend to maximize capital requirements for the unit domiciled in their country. This contradicts the rule of free movement of business and capital. Instead of a "stand alone" approach, the Committee should consider a comprehensive approach clearly defining also ways of enforcing cooperation among authorities.

Different incentives concerning capital management between Basel III and D-SIB paper
The approach to capital management and capital calculation differs between Basel III and the D-SIB paper. Effectively, capital at parent solo level has to be managed on a base of deducting participations in fully consolidated subsidiaries (par. 37). This does not take into account the dualism of solo and fully consolidated capital calculations in the Basel III environment, where fully consolidated subsidiaries need not be deducted from the capital of the parent company. Such an approach requires different corporate structures than Basel III and sets significantly different incentives.

A similar topic exists with minority interest. Basel III had the target to limit this type of capital at the consolidated level. The system envisaged for D-SIBs shows significant advantages for minority interest as that type of capital fulfils local host requirements but has not to be deducted at the home regulator's solo-view.

Fragmentation of the individual countries and reduced economic growth
The approach ultimately largely restricts the free allocation of capital within cross-border banking groups and therefore creates the basis for huge imbalances and inefficiencies between national markets.

1. With a view on adverse implications on their own solo balance sheet as well as possible restrictions for re-allocations, the parent companies of multi-national banking groups will allocate capital to their subsidiaries in a much more restricted manner in order to maintain freedom to use capital on parent company level or elsewhere when needed. This automatically restricts the ability of local banks to extend loans to their clients.

2. At the same time, whenever there has been excess capital allocated to subsidiaries and is not anymore needed there, parent companies face significant obstacles to effectively employ such capital on parent company level which also restricts genuine banking business in the parent's home country.

Considering this, the approach ultimately creates a huge pressure on economic growth and wealth within countries.

<u>Detailed comments</u>

1. **The establishment of a common and coherent methodology applicable by each competent authority based on a comprehensive approach is of crucial importance to avoid an unlevel playing field and to preserve the value of the economic unity of integrated cross border groups. The framework introduces an excessively high level of uncertainty and an unlevel playing field when compared to the G-SIB framework. [Principles 1, 5, 8, 9, and 12]**

We strongly disagree with the proposal that each national authority establishes its own methodology (principle 1)**.** We are particularly concerned about the level of uncertainty and discretion, embedded in the suggested framework, for instance: *"national authorities can consider other measures/data that would inform these bank-specific indicators within each of the above factors, such as size of the domestic economy."* (Principle 5), or *"The level of HLA calibrated for D-SIBs should be informed by quantitative methodologies (where available) and country-specific factors without prejudice to the use of supervisory judgement."* (Principle 8). In addition, "*national authorities should put in place any additional requirements and other policy measures [..] to address the risks posed by a D-SIB*" (Principle 12).

The proposed framework is conducive to a high level of uncertainty, also in view of principle 9 which allows for differentiation in D-SIB buckets, without any cap and consistency across jurisdictions and with the G-SIFI framework. Without any coherent approach and methodology, uncertainty arises with reference to the inability to assess which capital surcharge to pay (either D-SIB or G-SIFI surcharge) as foreseen in principle 10.

A comprehensive approach is a *conditio sine qua non* for integrated cross border banking groups whose economic unity, despite the multiplicity of legal entities, should be fully preserved. A fragmentation of the regulatory framework is undesirable and highly costly especially for cross border groups. Complexity is costly and it is not a firms' choice: the more heterogeneous and fragmented the exogenous factors, the more complex the firm structure is.

The suggested framework is not effective in providing a sound and coherent assessment [Principles 2 and 3]
As the crisis has shown, national competent authorities are not always best suited to assess the impact of a failure of a D-SIB. In fact, national authorities often tend to weight more the negative externalities arising in their domestic perimeter of actions, without following a comprehensive approach. The proposed draft does not seem to address this important problem. For instance, in the EU such assessment is being managed in an increasingly coordinated fashion by a central authority (the European Systemic Risk Board).

The proposed common methodology should be subject to a sort of certification based on pre-defined common agreed criteria. This would also ensure that the output (e.g. buckets) should be comparable across countries.

As for a G-SIB framework, we suggest that not only an outline of the methodology employed will be publicly disclosed (principle 7), but also the relevant inputs and considerations related

to supervisory judgment (if any) in order to ensure that markets and institutions are in a position to understand the evaluation process performed by the competent authorities. No data on individual banks should be disclosed.

Moreover we would encourage the Basel Committee to consider giving firms the option of satisfying the additional capital requirement through the use of Contingent Convertibles (CoCos) or any other additional loss absorbing capital.

Furthermore regarding Principle 5 it should be explicitly stated that the bank-specific factors should be assessed in a cumulative way.

2. **The suggested framework will have an impact on the internal organization of cross border banking groups and their business model. European banks are likely to be more penalised versus their competitors.**

The suggested framework may privilege a "flat" organization over a pyramidal one.

The European banking groups would be particularly penalised in view of their organisational set-up that has been envisaged in the context of the single market and an ever closer Union. Having legal entities **designated as D-SIBs might therefore compromise the business models or strategic plans of financial entities. Negative effects will culminate at banks active as D-SIB in a multitude of jurisdictions where international banking groups have dominant market shares (e.g. CEE).**

3. **We consider it is the responsibility of the BCBS to establish an framework to ensure effective cooperation against a stand alone approach and to strongly discourage misaligned incentives or inappropriate unilateral actions by each competent authority.**

The suggested framework does not enhance effective cooperation among supervisors, since it does not define roles and responsibilities of the authorities involved in D-SIB evaluation process (Principles 10 and 11). On the other hand, we strongly advise that the comprehensive approach that we encourage will be adequately supported and strengthened by ways to ensure effective cooperation.

While we fully support the intention of a "consistent, coherent and non-discriminatory treatment regardless the ownership" (see par 36), however, the BCBS does not provide rules and tools to enforce it. We deem that the suggested peer review process, as proposed in par 8 and hinted in par 29, is not sufficient to achieve a coherent framework and to enforce it. Based on the experience of cross border group operating across several jurisdictions, in the current environment, a generic request of coordination is not enough, if not supported by a clear definition of roles and responsibilities. This is of crucial importance also with reference to recovery and resolution plans. It is difficult to foresee how "authorities could effectively discuss the recovery and resolution plans and how this can influence the HLA requirements" (par 42) without a clear indication of roles and responsibilities.

Moreover, the BCBS seems favouring a "stand alone approach" for defining capitalization needs. The proposal (principle 10) states that "the home authority should test that the parent bank is adequately capitalized on a stand alone basis, including case in which a D-SIB HLA requirement is applied at the subsidiary level". This is in contrast with the Principles 3 and 4 stating that any authority should assess the bank taking into consideration the subsidiaries in their jurisdiction and their impact on the domestic economy. Also, par 29 expresses the intention of the Committee to ensure consistency across jurisdictions in the implementation of the D-SIB

framework. However, this appears in contrast with par 30, where it is stated that "the level of HLA for D-SIBs should be subject to policy judgement by national authorities". The decision of the adequate capital structure for a cross border banking group should be taken considering the group as a single economic entity, at least in the case of banking groups with integrated and centralised functions for capital and liquidity management.

The paper correctly analyses that "*an action by the host authorities to impose a D-SIB HLA requirement leads to increases in capital at the subsidiary level which can be viewed as a shift in capital from the parent bank to the subsidiary*" (pt. 37). Asking home and host authorities to "*make arrangements to coordinate and cooperate on the appropriate HLA requirement*" as stated in principle 11 will probably remain wishful thinking as host authorities can always argue that they have to stay "*within the constraints imposed by relevant laws in the host jurisdiction*". As "*host authorities currently have the capacity to set and impose capital requirements they consider appropriate to banks within their jurisdictions*" (pt. 35) home authorities will be more or less dependant of host regulators which in general set the legal capital requirements in their jurisdictions.

To "*additionally raise capital by the subsidiary from outside investors*" as suggested in pt 37 is not an option. It may lead to deductable minorities interest on parent level acc. to Basel III and consequently further weaken the position of the parent bank or else will significantly increase the cost of capital for RWA driven business.

For all the arguments mentioned above, the BCBS should consider elaborating an "International Cooperation Accord" , clearly describing the appropriate rules and procedures in order to make cooperation and coordination really effective among home and host authorities. This should also take into account the role of supranational authorities (that for instance are being strengthened in some areas such as in the EU and Euro area).

The "International Cooperation Accord" should be built on the "Key Attributes of Effective Resolution Regimes for Financial Institutions" of the Financial Stability Board (FSB) from November 2011. As such the "International Cooperation Framework" should refer to a single, coherent, group-wide RRP, with:

- an active involvement of main foreign subsidiaries/legal entities (LE) in order to take into account their specific needs/peculiarities/constraints (e.g. scenarios tailored to local jurisdictions and contingency actions to be developed at local level) and identify local impediments to be removed in order to allow the group to exit the crisis safely, quickly and without destabilizing the financial system;
- a strong interaction between national competent authorities, leveraging on the Crisis Management Group (CMG). Otherwise, if relevant authorities that are part of the CMG were to define different requirements (both in terms of information and time line), the efforts to integrate the jurisdiction-specific requirements would be likely to jeopardise the whole process and result;
- a set of common definitions: clear and common definition should be set for: 1) data requirement (i.e. accounting, regulatory and managerial); 2) boundary between recovery and resolution; 3) scenarios to be analysed (systemic vs idiosyncratic).

The "International Cooperation Accord" will also contribute to contain the widespread misaligned incentives and limit unilateral actions by local authorities. In our view, the BCBS suggested framework for D-SIBs not only is useless in preventing unilateral actions, but it somehow legitimate them: "*…national authorities should put in place any additional requirements and other policy measures they consider to be appropriate to address the risks posed by a D-SIB"* (principle 12). This outcome is in contrast with the increasing need to achieve

joint decisions, for G-SIBs, for banks operating across borders (also including a D-SIB in its group) and for banks having potentially spillover effects across borders.

The "International Cooperation Accord" should clearly state the elements and areas where joint decisions should be pursued and how cases of disagreement could be solved in a timely fashion, including some limited mediation tasks performed by BCBS.

Kindly give our remarks due consideration.

Sincerely,

Dr. Franz Rudorfer
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