

Basel Committee on Banking Supervision – Consultative Document: A framework for dealing with domestic systemically important banks

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Dear Sir or Madam,

In June 2012, the Basel Committee on Banking Supervision started a public consultation on a framework for dealing with domestic systemically important banks. On behalf of the German Banking Industry Committee we welcome the opportunity to comment on this consultation paper.

General Comments

The German Banking Industry Committee endorses the regulators' international initiatives aimed at a sustainable enhancement of the financial system's resilience in an attempt to prevent future financial crises or mitigate the respective negative externalities. This involves both the question of an orderly resolution of firms and, respectively, an appropriate crisis management policy for banks that could potentially jeopardise system stability. At the same time, it also involves a general reduction of the financial sector's systemic risks.

Given that they leave the root causes of systemic risks unaddressed, we do not view the proposed prudential measures in the form of stricter capital [adequacy] requirements as constructive. The regulatory scope should not only cover banks or a sub-group of banks. Instead, it should also include other market players such as shadow banks or CCPs which, in some jurisdictions, have already been categorised as "systemically important". We have particular doubts as to whether capital buffers will be able to unfold their envisaged preventive effect during a systemic crisis. At this juncture, we would also like to point out that the capital adequacy requirements are seeing a considerable expansion under Basel III. This holds true both in quantitative and in qualitative terms meaning that, for the time being, the banking industry is already deploying all its resources to the maximum. Regardless whether this is at a global or at a domestic level, any assessment of systemically important banks further cements the status of "systemically important" thus, in the final analysis, also increasing moral hazard. It equally undermines a level playing field since G-SIBs and D-SIBs can obtain funding at more favourable rates. It would be far more appropriate to establish a crisis prevention and crisis intervention mechanism that is fit for purpose. For instance, in Germany such a mechanism has already been established in the form of the German Restructuring Act. Currently there is also a corresponding debate at the level of the European Union. Hence, the FSB's work on establishing a framework for the orderly resolution of firms is moving into the right direction. Over and above this, in lieu of imposing additional capital adequacy requirements, when it comes to minimising systemic risks, we feel that globally harmonised limits for interbank lending would also be an appropriate policy measure. Based on the large exposures rules, Europe already features an upper limit where 25% of a bank's own funds must not be exceeded.

Detailed comments

Assessment methodology (Principles 1–7)

Whilst the indicator based methodology envisaged under the G-SIB regulatory framework for identification and measurement of G-SIB's higher loss absorbency (HLA) requirements allows a ranking within a predetermined sample, it does not yield any ratio for banks' actual systemic importance within the worldwide financial sector. More specifically, the fact that the focus tends to be on internationally active banks means that systemically important banks which are smaller and are primarily featuring domestic activities remain unaddressed.

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Whilst modelling the regulatory scope for D-SIBs on the rules for G-SIBs is perfectly understandable this shall and must not become a knee-jerk automatism. In addition to this, we perceive a need to create rules for other systemically important market participants, e.g. hedge funds.

We subscribe to BCBS's view that – last but not least due to methodological shortcomings – the indicator based approach for G-SIBs does not really lend itself to D-SIBs on a 1:1 basis. The degree of systemic importance pertaining to a bank as regards the respective financial system stability can be assessed best by national supervisors.

However, once a bank has been categorised as systemically important, it will become subject to stricter capital requirements under prudential supervision rules. This, in turn, can have an impact on banks' competitiveness. In order to prevent any instrumentalization of D-SIBs rules for competition purposes, the D-SIB regulatory framework should indeed allow for an appropriate degree of national discretion so as to accommodate the structural characteristics of individual jurisdictions but, at the same time, its language should be specific enough in order to ensure an internationally consistent approach for D-SIBs across all national jurisdictions. Since we feel that this has proven to be a viable approach, we welcome BCBS' proposal that the indicators shall only serve for illustration purposes and covering country-specific factors in the form of other measures/data.

We welcome the proposal under Principle 7, i.e. that national authorities should publicly disclose the methodology employed to assess the systemic importance of banks. This creates transparency and facilitates comparisons. In our view it is paramount that the methodology for assessing the systemic importance of banks as well as the basis for adopting prudential measures may only be changed under exceptional circumstances. This provides banks and market participants with a reliable idea of the systemic importance which, on the part of banks, constitutes the foundation for valid capital planning.

Contingency plans and plans for an orderly resolution that are both comprehensive and that can be operationalised are examples for qualitative factors that reduce the negative externalities created by a bank's failure. Therefore, these factors should be taken into account during the assessment of banks' systemic importance. During the assessment, along with the legitimate focus on the externalities arising from the failure of a bank, at least to some extent it may also be worth taking into account risk management or internal control systems. This would add one more dimension to this assessment of a banks' systemic relevance.

We would appreciate a clarification that the assessment of a banks' systemic importance shall refer exclusively to those subsidiaries that are included under the banking group's consolidation scope i.e. non-banking companies shall be exempt from this focus.

In terms of content, Principle 3 and no. 16 under Principle 4 are identical. From our point of view, Principle 3 can be deleted.

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Higher Loss Absorbency (Principles 8-12)

The BCBS emphasises the policy judgement on the level of HLA requirements by national authorities and that the additional capital requirements for banks of systemic importance should be understood as minimum requirements. It also stresses that this shall be subject to the national supervisory authorities' discretion. We view this as a dangerous approach. Including the countercyclical capital buffer, Basel III and the G-SIB regulatory framework alone already require a total capital ratio of 16.5% max. Yet, there is a paucity of reliable studies as to the practical externalities for the real economy. However, constantly rising capital adequacy requirements might cause a credit crunch in the long run. We strongly advocate in favour of keeping the policy judgement on the level of HLA requirements by national authorities within reasonable bounds.

In our view, the interaction between the G-SIB and D-SIB regulatory frameworks results difficult. We feel that the current proposal does not resolve this friction in a satisfactory or, moreover, smooth manner. Under the current language, national authorities are afforded a high degree of policy judgement. This applies both in terms of the methodology and in terms of the assessment of the level of banks' systemic importance. Last but not least it applies to the calibration of the HLA requirement. Whilst the G-SIB HLA was assigned a corridor between 1% - 2.5% up to a maximum of 3.5%, such limits are absent from the proposals for D-SIBs. Thus, it is the home authority who should calibrate the actual level of the D-SIB HLA based on their supervisory judgement. For G-SIBs which have been categorised as D-SIBs this approach can lead to a higher value than the 3.5% maximum proposed by the Basel Committee. Yet, in the final analysis, this room for discretion translates into an erosion of the G-SIB framework by the D-SIB rules.

Also, the G-SIB HLA could potentially exceed the HLA laid down by the Basel Committee if and when the HLA level imposed on non-domestic group subsidiaries is high and if the group's consolidated HLA level exceeds the envisaged level. The proposed coordination of home and host authorities is based on soft requirements and potentially involves many parties. In addition to this, it lacks any escalation mechanism. We therefore doubt its practical efficacy. Whilst at the level of the EU, the European Banking Supervisor could act as an arbitrator, no such body is envisaged at the international level.

We strongly suggest that the D-SIB HLA requirement be geared towards the lowest level permissible for G-SIBs (preferably even lower). Alternatively, should national authorities decide to refrain from the aforementioned proposal, they should at least be given a fixed corridor between 0% - 2.5%, in exceptional cases up to 3.5% max. (on a stand-alone and consolidated basis). This promotes transparency in the capital market and allows banks to carry out their capital adequacy planning on a reliable basis.

Notwithstanding the foregoing, after inclusion of potential HLA requirements for subsidiaries categorised as D-SIBs, G-SIB HLA requirements on a consolidated basis must never exceed the G-SIB HLA requirement level defined by the Basel Committee.

In our view, internationally-active banking groups require a binding arrangement with clear rules for coordination and cooperation in the field of individual, national D-SIB HLAs and, if needs be, G-SIB HLAs. At this point, the final decision on the HLA requirement imposed at group level should be incumbent upon

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home authorities. The respective national D-SIB HLAs need to be calibrated in a way that ensures that the group level HLA requirement will not exceed the envisaged overall amount. At this juncture, the HLA determined under the G-SIB regulatory framework would be generally applicable to G-SIBs.

No. 28 clarifies that the higher loss absorbency requirement should reduce further the probability of failure for D-SIBs compared to non-SIBs. We would like to reiterate our aforementioned observation that there is a need for careful contingency plans and plans for orderly resolution of firms; in addition to this, since this will mitigate the externalities of a potential failure, the going concern should take an effective risk management into account in the calibration of HLA levels. We hold the view that the proposal under Principle 12 pursuant to which the HLA requirement should be met fully by Common Equity Tier 1 (CET 1) is excessively strict. Additional Tier 1 capital has been assigned but a minor role already under the Basel III requirements. A further capital buffer which equally would have to be met fully by CET 1 constitutes a further erosion of Additional Tier 1. However, given that, by definition, the absorbency capacity of Additional Tier 1 is on a par with that of common equity, we hold the view that it would be appropriate to allow meeting the SIB requirements by Additional Tier 1 capital and to hold the capital buffer entirely in the form of common equity.

At the same time, however, we would welcome it if the SIB capital buffer requirements could be met at least partly by convertible capital instruments (contingent capital). The actual capital structure mix, however, should be left to the discretion of the bank.

We would appreciate it if our views were taken into account in the ongoing consultation process. We would be happy to provide further information about any of the issues raised.

Yours faithfully,

On behalf of the German Banking Industry Committee
Federal Association of German Cooperative Banks



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