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Sent by e-mail to: baselcommittee@bis.org

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

1st August 2012

Dear Sir or Madam,

We are pleased to provide our response to the Basel Committee on Banking Supervision's ("BCBS") consultative document *"A framework for dealing with domestic systemically important banks"* (BCBS 224). As an internationally-active banking group, we are very conscious of the need for harmonised banking regulation, hence have been calling for a consistent international approach to be developed for addressing systemic risk. We believe that the approach should be capable of allowing failing banks to be resolved in an orderly manner, without recourse to the taxpayer, and should be part of the overall regulatory framework for banks including their supervision. We are concerned that the focus has been on creating a special regime for banks deemed to be systemically important which we believe will increase moral hazard, create market-distorting effects and lead to a two-tier banking system. The proposed solution is likely to result in a situation where the current implicit state support given to some institutions is replaced by a situation where a select number of institutions are given explicit support (certainly that will be the perception). Furthermore, the creation of a special category of bank may complicate the resolution of failing firms by discouraging acquisitions by other institutions due to concerns about becoming similarly categorised. A better approach would be to focus on developing an effective resolution regime that would allow all banks to fail in an orderly manner with limited recourse to the taxpayer.

In the remainder of this response, we will also comment on the principles-based framework developed by the Committee (including the "loss given default" approach), the degree of discretion afforded to national authorities in the setting of higher loss absorbency requirements, the potential for overlapping buffers to be imposed on an internationally-active banking group, and the complexity of the emerging regulatory framework.

Principles-based framework – further prescription required

Whilst we are broadly supportive of a principles-based framework for dealing with D-SIBs as this enables variations in domestic banking sectors and economies to be recognised, we are concerned that the approach proposed provides considerable scope for national approaches to vary significantly, leading to an unlevel playing field. We have seen this already with the

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divergent approaches that have been adopted by national regulators in the implementation of the Pillar 2 requirements of Basel II. We also endorse the Committee's efforts to promote transparency in the national approaches developed for dealing with D-SIBs, particularly as steps taken to date to identify D-SIBs in some jurisdictions have not been supported by any publicly available analysis.

The Committee's proposal is silent on how the higher loss absorbency requirement should be integrated with the Basel III capital buffers, compared to the G-SIB framework which requires the G-SIB buffer to be applied as an extension of the capital conservation buffer. This provides further scope for varying national practices to develop.

We would like to see the Committee work closely with its members and the global banking industry to further develop its framework for tackling the systemic risk contributed by individual banks, including the development of an extensive list of systemic risk indicators that could be applied internationally. Given the time available before the proposed framework is planned to be implemented, we believe that it is important to reflect on the lessons of recent financial crises, including the global financial crisis, and to ensure that the various components of an effective regulatory framework are in place, including supervision and macropudential regulation. Otherwise, we fear that the Committee's efforts to develop an internationally consistent capital framework through Basel III are likely to be undermined.

The peer review process mentioned in the consultative paper will be an essential mechanism for ensuring that the final framework developed by the Committee is adopted in a consistent manner. It would be very helpful for the Committee to set out in more detail how it envisages the peer review process working in practice and how it would encourage national regulators to fall into line with the framework if their approaches are seen to be inconsistent. It is important that the peer review process considers the economic impact of the higher loss absorbency requirements imposed by national regimes to ensure that there is an appropriate balance between economic growth and financial stability.

Potential for overlapping buffers

Another major concern is that international banking groups may be required to hold overlapping capital buffers at the group, sub-group and subsidiary levels for the same underlying risks, if they are deemed to be systemically important within a number of jurisdictions and / or globally. Such an inefficient use of capital would reduce the extent of credit provision that could be extended by the groups affected. The BCBS proposes cooperation between the home and host supervisors in the setting of the HLA requirement, but does not suggest any mechanism to prevent overlapping buffers from being set if the degree of cooperation is inadequate. Indeed, it seems to encourage such a situation by proposing that home supervisors set capital buffers at the group level recognising that foreign exposures within the group could give rise to systemic risks in the home economy; in such instances, host regulators setting capital buffers for the exposures within their jurisdictions would result in overlapping buffers being set for the group (unless there is explicit recognition of the buffers set for foreign subsidiaries and branches).

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We believe that the Committee should set out clear guidelines on how the regulatory capital held by an internationally-active banking group should be deployed to support the activities and underlying risks of the constituent parts of the group. Current regulatory practices vary significantly in a number of areas, e.g. for solo entities and for foreign branches, and the D-SIB framework is likely to lead to further divergences. A clear set of guidelines should help to minimise the extent of overlapping buffers imposed across a banking group which would enable capital to be deployed more efficiently to support credit provision.

It is also important to consider the degree of overlap between existing capital buffers set under Pillar 2 and buffers set for D-SIBs and G-SIBs. Given the significant number of capital buffers that are being implemented or proposed for banks, we believe that the Committee should publish a comprehensive guide to explain how the various capital buffers should be applied and their interaction (e.g. whether or not they are intended to be additive), particularly now that the buffers seem to be higher than the Basel III minimum capital requirements. Otherwise, there is a risk that the various buffers will begin to merge into a single buffer.

"Loss given default" approach overly conservative

We believe that it is inappropriate to base the framework on a "loss given default" approach as this ignores one of the key factors underpinning the risk-based approach of the Basel II capital framework, namely the "probability of default". It is important that the likelihood of banks failing is taken into account when assessing the contribution to systemic risk, which should be an integral part of banking supervision. There should be an explicit recognition of the net contribution to systemic risk that a bank poses based on its (i) its business model and strategy, (ii) the strength of its management, systems and controls, and (iii) its underlying risks and its ability to mitigate them. Without including an assessment of the likelihood of D-SIBs failing, the level of buffer imposed to deal with a remote event will be considerably higher and this will have an impact on the extent of credit provision and maturity transformation that such banks will be able to provide. This could result in non-regulated entities entering the market which may contribute to systemic risk.

National discretion likely to lead to unlevel playing field

Leaving the setting of the HLA requirement purely to the discretion of national supervisors will inevitably lead to an unlevel playing field and result in regulatory arbitrage. We recognise that the intention is to ensure compatibility between the G-SIB and D-SIB frameworks, and that the G-SIB framework sets minimum capital requirements. However, we believe that the Basel Committee should set an upper limit for the D-SIB buffer, much in the same way as it has done for the countercyclical capital buffer. Furthermore, it should not be set higher than 2.5%, unless national supervisors are able to support a higher requirement with robust analysis that demonstrates that such a requirement is appropriate for the level of systemic risk contributed by the banks deemed to be D-SIBs. Otherwise, there is a risk that non D-SIB banks within a jurisdiction and large D-SIB banks within a region will be forced to raise their capital levels significantly higher than the levels set by their national regulators in order to 'compete' with their peers and meet market expectations and those of key stakeholders.

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It should be noted that the amount of risk weighted assets determined for a subsidiary's risk exposures often differ significantly from the amount determined in the Group calculation of risk weighted assets for the same underlying exposures. Hence national variations in the setting of capital buffers for parts of an internationally-active banking group will compound this, leading to even greater capital inefficiencies with a consequent reduction in credit provision.

Higher loss absorbency requirements for foreign D-SIBs should not be set at a level that discourages investment by international banks in smaller markets since there are many positive spill-over effects for host countries from having international banks present in their markets.

Complexity of the capital regime for internationally-active groups

The capital regime for internationally-active banking groups will become extremely complex with the various capital buffers that are being proposed. It is important that the setting of capital buffers across an international banking group should be coordinated by the home supervisor, using a formal mechanism, in cooperation with the host supervisors of all the jurisdictions in which the group is assessed as contributing to systemic risk at the domestic level (through the supervisory college / crisis management group process).

Recovery and resolution planning should be a key factor in the assessment of systemic risk and in the setting of higher loss-absorbency requirements. We would like to see group level RRPs more clearly built into both the assessment methodology and the setting of higher capital requirements. It is also very important that the impacts of the higher capital requirements on the economies that are served by the banks affected are carefully evaluated, and that it is not assumed that credit provision will be unaffected.

The case for higher loss-absorbency requirements

It is important to consider the extent to which the higher Basel III capital and liquidity standards, and other regulatory developments such as recovery and resolution planning, bail-in debt and improvements to depositor protection schemes, will help to improve the resilience of the financial system, before imposing additional regulatory capital requirements for certain firms. The Committee acknowledged the diminishing returns from progressively higher capital levels in its paper *"An assessment of the long-term economic impact of stronger capital and liquidity requirements"* published in August 2010, in which it stated that "...they [the benefits of higher capital and liquidity requirements] are relatively larger when increasing bank capital ratios from lower levels and they decline as standards are progressively tightened. As an illustration, the models suggest that the decrease in the likelihood of crises is three times larger when capital is increased from 7% to 8% than when it is raised from 10% to 11%. Intuitively, the further away banks are from insolvency, the lower is the marginal benefit of additional protection." It is critical that the limitations of regulatory capital in improving the resilience of the banking system are recognised. It is widely accepted that a lack of capital was not a fundamental cause of the financial crisis, so its role in the new regulatory framework needs to be more balanced.

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We note with interest the Committee's decision to propose that the higher loss-absorbency requirements of D-SIBs should be met by Common Equity Tier 1 capital, regardless of the level set compared to the levels proposed by the Committee for G-SIBs. This is in contrast to the Committee's conclusion to support the use of contingent capital instruments to meet higher national loss absorbency requirements than the global requirement in its G-SIBs rules text. We have expressed our concerns about the use of contingent capital in our responses to the Committee's earlier consultations due to their complexity, negative signalling effects and potential to actually cause a firm's demise. We believe that the Committee should make an unambiguous statement about the enforced use of contingent capital by national authorities.

Concluding remarks

We are supportive of certain aspects of the proposed framework for tackling systemic risk at the domestic level, but are concerned that the proposed solution is likely to lead to the situation where the current implicit state support given to some institutions is replaced by a situation where a select number of institutions are given explicit support. This would seem to be at odds with the objective of ensuring that taxpayers are not required to bail-out failing financial institutions. We have noted that the G-SIB framework was introduced despite the concerns on creating explicit state support that were expressed by many respondents including us and, on that basis, the Committee may be likely to set aside similar concerns on the proposed approach for tackling D-SIBs. However, we call upon the Committee to develop a more prescriptive approach that takes into account the potential interaction between domestic and global requirements for systemically important banks and other regulatory reforms, and seeks to promote a harmonised framework internationally.

Yours faithfully,

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