The voice of banking
& financial services

June 2017

Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Bill

Re: Basel Committee on Banking Supervision Consultative document
Global systemically important banks - revised assessment framework
Issued for comment by 30 June 2017[1]

We are pleased to reply to the Committee's consultative document. This response represents the views of the members of the British Bankers' Association (BBA).

London is the headquarters of 4 G-SIBs (HSBC, Barclays, RBS and Standard Chartered). These banks operate globally through subsidiaries and branches. Some of our members use EU passporting to operate branches across the EU. Nearly all the designated G-SIBs, as well as most of the other 45 banks in the sample, have a subsidiary incorporated in the UK. Some of these subsidiaries are material to their parent groups. In addition some G-SIBs have UK branches and also take advantage of EU passporting.

Summary of the BBA response

The BBA is supportive of a framework that aims to reduce systemic risk as well as mitigate the impact of the distress or failure of large banks globally. We also support a rolling three year review of the assessment methodology.

However we think that the current proposal does not achieve the thorough evaluation and recalibration of the G-SIB framework as proposed in earlier BCBS publications.

In forming this view, we have reviewed the many comments submitted in August 2011, in response to the initial consultation.[2]

Most of the issues raised by the 2011 comments are even more pressing today. We suggest that the BCBS re-consider the value of those responses.

[1] https://www.bis.org/bcbs/publ/d402.pdf

[2] https://www.bis.org/publ/bcbs201/cacomments.htm

The current consultation proposes:

1. Removal of the cap on the substitutability category;
2. Expansion of the scope of consolidation to include insurance subsidiaries for three categories;
3. Amendments to the definition of cross-jurisdictional activity;
4. Modification of the weights in the substitutability category and introduction of a trading volume indicator;
5. Revisions to the disclosure requirements;
6. Further guidance on bucket migration and associated higher loss absorbency (HLA) surcharge; and
7. Consideration to include short-term wholesale funding (STWF) within the scope.

We do not support the majority of these proposals for the following reasons:

- BCBS stated in 2013 that it would reconsider the **cap on the substitutability category** taking into account "*revisions to the methodology (*that*) may allow it to be removed at that time*".

- Yet a thorough review of the systemic risk scoring methodology, which would eliminate the need for caps, has not been conducted. Instead, it is proposed to remove the cap as an isolated action.

- We recommend that a full review is completed, to recalibrate the assessment framework, taking into account the systemic importance of the three substitutability indicators. In our view:

    1. The risk arising from assets under custody is mainly operational in nature and so is fundamentally different to principal risk.

    2. The risks measured by the three indicators, assets under custody, payments and underwritten transactions in debt and equity markets, are substitutable.

    3. There are many assets held in custody by sub-custodians that duplicate the assets held by primary custodians.

    4. The aggregate of assets in custody excludes a significant volume of assets held outside the banking sector, including those held by non-bank custodians.

    5. In the US the Method 2 approach replaces the substitutability category with a US-specific definition of short-term wholesale funding (U-STWF). This seems to confirm that these risks represent a different and potentially less systemic type of risk.

- **Insurance activities** should not be included because the risk of insurance business is already covered by the ring-fenced nature of subsidiarisation. Including insurance runs counter to the Basel framework, which leaves insurance out of consolidation. The proposed change would introduce unfair competition in insurance business between insurance companies and banks and between G-SIB and non-G-SIB banks.

- We object to including derivatives in the **cross-jurisdictional activity definition.** This double-counts risk, as other indicators also capture derivative exposures.

- We also ask that the substantial progress made on resolution planning be taken into account and the G-SIB assessment be aligned with the wider resolution framework.

- We are disappointed that BCBS has not revised the cross-jurisdictional definition. This should exclude the local claims and liabilities of foreign subsidiaries which are locally funded and potentially subject to local D-SIBs requirements.

- We strongly object to including a trading volume indicator. It will be highly unstable and may have unintended consequences on market liquidity. Capturing intra-group trades will be complex. The requirement is anomalous because the rest of the framework is based on consolidated data. More research should be carried out before moving forwards with this element.

- The revisions to the **disclosure requirements** do not go far enough to achieve transparency. We suggest that the Committee publishes the sample bank data set and scores with its annual assessment.

- We support the proposal to release the associated HLA charge immediately, should a G-SIB move buckets downward. We agree that this will incentivise banks to reduce their systemic risk. But it would be more effective to switch the framework to an absolute scoring method. Please clarify the date when this proposal will be implemented.

- We do not support the proposal to include a **generic** indicator of **short-term wholesale funding** (G-STWF), contributing 3.33% to the overall score. The use of the Liquidity Coverage Ratio (LCR) and net Stable Funding Ratio (NSFR) in the existing framework already incentivises banks to rely less on STWF. And the proposed indicator would mean that STWF would feature twice in the US domestic approach. The STWF indicator would make the framework more complex and confusing. We note that the approach was originally considered and rejected in favour of the measurement of securities outstanding. We do not see the reason for reconsidering this, or for reducing the weights of the existing four indicators.

- We support a transitional approach as well as the intention to pay attention to any overlap with other Basel reforms which might compound the impact on banks' capital.

We also note that some points set out in paragraph 39 of the July 2013 framework have not been reviewed:

1. *The methodology, including the indicator-based measurement approach itself*

2. *The cut-off / threshold scores,*

3. *Particular attention will be paid to branches.*

4. *As regards the structural changes in regional arrangements – in particular, the European Union – they will be reviewed as actual changes are made.*

5. *The size of the sample of banks will be reviewed every three years.*

In addition, although the November 2011 cover note said that the impact of exchange rate movements would be reviewed, this has not been done. This issue is a major concern to the majority of non-EUR based banks in the sample. To reduce volatility, we suggest either creating a basket currency, representing the weighted contribution of the reported currencies, and or using a three-year average exchange rate.

We are concerned that the methodology (being based on the redistribution of the total aggregate global systemic HLA between the 75 sample banks, using a relative measure) does not either reflect changes in the aggregate level of systemic risk, or give a bank enough incentive to reduce its own systemic risk. In our response we set out ideas on how to address this. For example, by linking the aggregate score to global GDP and so take into account changes in the absolute measure of systemic risk relative to changes in GDP. In this way all banks could benefit from becoming less systemic.

We do not think that BCBS has assessed the current and revised proposals against its own requirement to balance risk sensitivity, simplicity and comparability, as set out in its discussion paper published in October 2013, soon after the publication of the current G-SIB framework. This makes the review incomplete and it should be reconsidered through a further revision.

We are also concerned there has not been either a review or validation of the assumptions set out in the August 2010 and October 2011 Macroeconomic Assessment Group (MAG) reports. The Committee should publish an updated MAG report covering the past 5 years and giving its expectations for the future, taking into account the anticipated state of the global economy and the evolving regulatory framework. This report should assess whether the framework is achieving its objectives, as originally envisaged.

We note that since 2013 many competent authorities have implemented local D-SIB HLA that, in many cases, are different to and often much simpler than the Committee’s approach, but result in the same or higher HLA. This fragmented approach seems to undermine the BCBS objective of implementing a consistent and comparable global framework.

We think that competent authorities, banks, investors and the market place would benefit were BCBS to complete a thorough review of the existing framework, also reviewing and comparing the frameworks being introduced by competent authorities. This should take into account the broader regulatory reforms and the important steps large banks have taken to reduce their systemic risk.

We note the references to competition in the consultation, where it suggests that smaller banks should fill the gap left by larger banks, in the provision of certain financial activities. An example is the proposal to include a trading volume indicator. In our response we raise concerns about these points.

The proposals may have unintended consequences for the real economy, considering the ever increasing low profitability and higher cost of capital banks face today, especially in the provision of certain high volume IT-intensive activities.

Rather than rushing to complete this process, we suggest that it would be better to take a measured approach, allowing time to assess the wider context and implications of the G-SIB framework before proceeding. Given the importance of the issues, we suggest holding an open hearing. And we would welcome an opportunity to discuss our concerns with you.

In conclusion, we recommend that BCBS should publish a revised consultation later this year, after considering all responses and re-visiting the responses to the first consultation from August 2011.

Yours sincerely

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Q1. What are respondents' views on each of the proposed changes in the G-SIB assessment methodology?

1. Removal of cap on Substitutability

BCBS originally stated that the cap of 500 b.p. for substitutability was introduced because "*the substitutability category has a greater impact on the assessment of systemic importance than the Committee intended for banks that are dominant in the provision of payment, underwriting and asset custody services.*[3]

It planned to reconsider the cap on substitutability, taking into account "*revisions to the methodology may allow it to be removed at that time*".

But it has not yet carried out a thorough review of the systemic risk scoring methodology, which would enable it to eliminate the use of caps in the framework.

We recommend the completion of a review to recalibrate the three substitutability indicators and the wider assessment framework:

1. The risk of assets under custody is primarily operational in nature and differs from principal risk.

2. The risk derived from the three indicators, assets under custody, payments and underwritten transactions in debt and equity markets, are substitutable.

3. There are many assets held under custody by sub-custodians that duplicate the assets held by primary custodians.

4. The aggregate assets under custody exclude significant value of assets held outside the banking sector including assets held by non-bank custodians.

5. In the US the Method 2 approach replaces the substitutability category with a US-specific definition of short-term wholesale funding (U-STWF). In our view this suggests that these risks represent a different and potentially less systemic measure of risk.

[3] set out in paragraph 19 of the current guidance

2. Expansion of the scope of consolidation to include exposures under insurance subsidiaries

We disagree with the proposal to extend the scope of three categories to include Insurance subsidiaries.

We strongly support the following statement in the consultation: "*the modification should take into consideration further work that is being undertaken jointly with the IAIS to address any inconsistencies in the overall G-SIB and G-SII frameworks".* .

Paragraph 24 of the finalised Basel Accord (2006) excluded insurance from its scope:[4]

> *To the greatest extent possible, all banking and other relevant financial activities (both regulated and unregulated) conducted within a group containing an internationally active bank will be captured through consolidation. Thus, majority-owned or –controlled banking entities, securities entities (where subject to broadly similar regulation or where securities activities are deemed banking activities) and other financial entities should generally be fully consolidated*.
>
> Footnotes clarified this interpretation:
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> > Footnote 6: "*Financial activities" do not include insurance activities and "financial entities" do not include insurance*
> >
> > Footnote 7: *Examples of the types of activities that financial entities might be involved in include financial leasing, issuing credit cards, portfolio management, investment advisory, custodial and safekeeping services and other similar activities that are ancillary to the business of banking*.

Section IV of The Accord, (paragraphs 30-34) confirms that insurance entities are outside the regulatory scope of consolidation.

The paragraph 25 of the recent BCBS consultative document – "*Guidelines for the Identification and management of step-in risk"*, reiterated this point: "*Insurance entities that are currently specifically excluded from the regulatory scope of consolidation while attracting a specific prudential treatment are presumed not to be included within the types of entity considered here. As they are already subject to specific prudential treatment, the same applies to banking regulated entities supervised by banking supervisors"*. [5]

The current prudential capital requirement already reflects the business, including insurance interests. We think the capital regulation of Insurance Companies as it applies to banks should remain unchanged.

However, the consultation paper suggests that insurance companies which are subsidiaries of G-SIBs pose a greater systemic risk than stand-alone insurance companies. By extension, this could be taken as implying that the treatment of investments in insurance companies (capital deduction in most jurisdictions) is insufficient for the risk they pose. But rather than closing the gap, if there is one, by changing the macro-prudential framework, it would be more consistent to do this in the insurance systemic risk framework.

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[4] http://www.bis.org/publ/bcbs128.pdf

[5] http://www.bis.org/bcbs/publ/d398.pdf

We also disagree with the consultation's statement that: "*The G-SIB framework does not explicitly capture the systemic impact of insurance subsidiaries of banking groups*." The insurance and financial risks are an integral component of a Bank's capital and risk management.

Most jurisdictions now follow the Basel Accord. This means that the investment in insurance subsidiaries is recorded at cost and reflected in Pillar 1 via a risk-weighting or deducted from CET1 (subject to thresholds). The framework implicitly recognises the ring-fenced nature of this business subject to its own prudential capital regime and this is why the current prudential regulatory framework in many jurisdictions specifically excludes these insurance entities from regulatory consolidation.

In a stress, or on the failure of a bank, any insurance loss does not directly impact the Group's regulatory capital because the post-acquisition reserves are excluded from Group capital and the cost of investment treatment.

The consultation notes that "*certain member jurisdictions do require G-SIBs to include insurance subsidiaries in their regulatory scope of consolidation while others do not, which creates inconsistencies in the systemic assessment of banking groups across jurisdictions".* We suggest that those jurisdictions currently including insurance subsidiaries (for example the US and Canada) should exclude these entities, to restore consistency in the scope of consolidation globally. This would be an easier solution. BCBS could alternatively disaggregate regulatory data to create comparable values for G-SIB scoring and the calculation of the HLA.

The consultation also states that "*the proposal should both reduce the potential for regulatory arbitrage by moving activities from banking groups into their insurance subsidiaries and by reflecting some of the systemic risks stemming from the insurance businesses"*. We suggest that, even if a group were to attempt this type of arbitrage, the competent authorities already have tools to address this, without the need to alter the G-SIB framework.

We do not support the proposal that "*the expansion of the regulatory scope of consolidation to include insurance activities would be limited to assessing G-SIBs".* It put the 75 banks in the sample at an unfair disadvantage relative to other banks or to insurance companies.

3. Amendment to the definition of cross-jurisdictional indicators

The consultation notes that: "*The greater a bank's global reach, the more difficult it is to coordinate its resolution and the more widespread the spill-over effects from its failure".*

But we continue to be concerned that cross-border international banking groups, with non-domestic banking subsidiaries or branches that are separately capitalised and locally funded, are being unfairly treated.

We suggest that BCBS should conduct a review of the strengths and weaknesses of the different types of structures and business models, as evidenced during 2006 – 2009, to assess the systemic risk of this category, given the current and future regulatory framework.

This issue has been a concern since original proposals were published in July 2011. We still do not think that either the current definition and scope or the revised proposals, appropriately measure the systemic risk from these entities. Many banking groups and associations criticised the original proposals in August 2011.[6] We recommend re-visiting those comments because they are as relevant now as they were then.

Our views are that:

1. We are concerned that the proposals do not revise the cross-jurisdictional definition, which would still capture local claims and liabilities of foreign subsidiaries which are locally funded and potentially subject to local D-SIBs requirements. The following example of the treatment of local claims explains our concern:

    > Under the current and proposed definition a Canadian Dollar deposit by a Canadian resident in a Canadian incorporated bank regulated and supervised by OSFI is classified as a cross border liability if the deposit is held in the Canadian regulated and capitalised subsidiary of a non-Canadian bank. Whereas the same deposit domiciled in a Canadian headquartered domestic bank is not included in the scope.

    We think this definition is flawed. It needlessly penalises a legal structure that minimises cross border assets and liabilities and thus systemic risk.

    We recommend that local claims and liabilities should be excluded in the calculation of cross-jurisdictional activities.

    If the Committee still intends to include local claims and liabilities of foreign subsidiaries among the indicators of global activities, local claims should be evaluated net of local liabilities.

2. Given the substantial progress made in the context of resolution planning, it would seem reasonable to align the G-SIB assessment with the wider resolution framework.

3. We do not support the proposal to include derivatives in the cross-jurisdictional activity definition. This duplicates other indicators which capture derivative exposures.

Paragraph 39 of the July 2013 final framework commented on the review that "*particular attention will be paid to branches, and as regards the structural changes in regional arrangements – in particular, the European Union – they will be reviewed as actual changes are made".*

[6] https://www.bis.org/publ/bcbs201/cacomments.htm

It is unclear whether these important topics were included in the review. We understand BCBS has been gathering relevant information. If the conclusion was to propose that the activities of cross-border branches within the EU were to be excluded, this would be an important revision which we suggest would require a further recalibration.

We also suggest that attention needs to be paid to the BCBS response to the comments set out in the "*assessment methodology and the additional loss absorbency requirement: Cover note published in November 2011*" [7], in particular *1. Indicators: (a) Cross-jurisdictional activity"* paragraphs 33, 34 and 35 on page 7.

Derivatives

In principle we support the proposals for the improvements to the approach for derivatives.

However, there is a need to clarify what this measure is intended to achieve and how intra-group transactions should be treated.

We suggest that there should be a carve-out for non-financial institutions' derivatives, because the proposal may have a significant impact on the real economy, for example, on hedging provided to small and large corporates.

There should be a clear proposal on how take into account centrally cleared derivatives. We suggest removing these trades from the scope.

There is some double or triple counting where the same derivatives data appears under multiple categories, such as complexity, interconnectedness and size. This needs to be resolved.

[7] http://www.bis.org/publ/bcbs207cn.pdf

Modification of the weights in the substitutability category and introduction of a trading volume indicator

We do not support the inclusion of a trading volume indicator. It would be too volatile to be reliable. It is also not an effective measure of system risk.

It would also be inconsistent with the G-SIB assessment methodology guiding Principle 2, because of the lack of 'clear specifications', as the consultation document does not include a formal definition.

We are unsure why the proposal reduces the weighting for the indicator 'securities outstanding'. We assume that 'securities outstanding' is no longer seen as being as systemically important within the substitutability category as it was before. We would welcome clarification on this.

We are also unclear about the correlation of risk of 5,961bn of securities outstanding to c 321,000bn of trading volume and would like to understand the rationale for this.

The halving of the contribution and inclusion of two trading volume indicators adds further to the need for a full recalibration of the framework rather than just the elimination of the cap, as proposed.

In the event that the indicators were to be included, we strongly suggest that all intragroup business should be excluded from the denominator.

Similar indicators have been considered by individual jurisdictions and disregarded as being unreliable. The complexity of requiring institutions to report trading volumes may lead to different interpretations and the submission of poor quality data. This would misalign with Principles 2 and 3.

4. Revisions to the disclosure requirements

We welcome the change allowing banks to update their disclosed figures if they are changed after the review by the Committee, which aligns with the Pillar 3 disclosure requirements published in March, 2017. [8]

However, to achieve transparency and comparability, the market needs to download each bank's disclosure and create a database to apply the scoring methodology. But this is not straight-forward because there is no single public source of the data submitted to BCBS.

The formats used by banks are different. Banks report in their own reporting currency and some in units, some in thousands and others in millions. Of the 30 G-SIBs only 10 have Euros as their reporting currency. Of the 75 banks in the sample, 27 have Euros as their reporting currency. Other banks' data have to be converted into Euros.

There is also no published timetable of bank disclosures or links to the disclosures. In many cases, the BCBS website does not provide a direct link to these disclosures.

The Office of Financial Research (OFR) [9] publishes a user-friendly set of information on the scores of the 12 indicators for the 30 G-SIBs together with an accompanying commentary. But this does not include the other 45 banks in the sample.

The EBA publishes the underlying data of the 36 EU banks in the sample annually. This covers 27 banks with the Euro as a reporting currency. [10]

The proposal states that "*on an annual basis, banks are required to disclose at least the 12 high-level indicators used in the G-SIB assessment based on financial year-end data. Banks should note in their disclosures that those figures are subject to revision and re-statement.* And *the reporting instructions for the G-SIB assessment methodology state that banks should disclose the 12 indicators no later than four months after the financial year-end and, in any case, no later than end-July of the calendar year.* And *Banks disclosures must follow Pillar 3 reporting requirements and timelines".*

These revisions align the G-SIB assessment framework with Pillar 3 reporting, from March 2017. However, we suggest that BCBS allows that any re-statements can be fulfilled by a signpost link to another part of the bank's website, this avoids the need to include the template within Pillar 3.

We are concerned that some authorities require disclosure of the entire data template while others only require that the 12 indicators are disclosed. We recommend that the Committee sets out a harmonised approach to the disclosure of values used to calculate the aggregate exposure for each indicator. This would allow the replication of the calculation of the scores and HLA.

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[8] See Page 4 of "Pillar 3 disclosure requirements - consolidated and enhanced framework"
https://www.bis.org/bcbs/publ/d400.pdf

[9] https://www.financialresearch.gov/G-SIB-scores-chart/

[10] https://www.eba.europa.eu/-/eba-publishes-indicators-from-36-global-systemically-important-institutions-g-siis- The current data published in August 2016 is as of 31 December 2015 and thus would have been used in November 2016 HLA.

We recommend that, on the day the FSB releases the G-SIB list, BCBS should also publish all of the data (both in the reporting currency and in Euros) and the scores for the 75 sample banks, in a spreadsheet used to calculate the scores.

We also think it would be helpful for the FSB to publish the data of the other banks for which it collected data, but were not included in the sample set, for the calculation of scores. We recommend that BCBS establishes a standard format, with the OFR and EBA.

On the timing of public disclosures, we think that it would be preferable if this was on one day each year. There is no need to follow the Pillar 3 timetable.

It would be also helpful if the FSB website included each bank's disclosure report, with a link to its website. All banks should be required to publish the data in Euros, to facilitate easier comparison, as well as in their reporting currency.

5. Further guidance on bucket migration and associated HLA surcharge

We support the Committee's proposal to immediately release the associated HLA charge should a G-SIB move buckets downward. We agree that this will incentivise banks to reduce their systemic risk. But it would be more effective to switch the framework to an absolute scoring method.

6. A proposed transition schedule

We note that the revised approach will only be fully implemented with effect from 2019 based on 2018 year-end data and seek clarity when the release of HLA would apply for banks that have already been notified of a reduction in HLA as at November 2017.

7. Quantitative assessment of the impact of the proposed changes

Section 9 sets out in Table 5 the revisions to the indicators, in the case that the proposals are adopted.

The changes affect the following indicators.

- Cross-jurisdictional claims and liabilities.
- Intra-financial assets and liabilities
- Securities outstanding
- Notional amount of OTC derivatives
- Trading and available for sale securities
- Short-term wholesale funding

We note in Appendix A and B the revisions to the data items are set out. However, the details of the values for each of the 75 sample banks are not published, only the totals in Euros.

We request that BCBS publishes the underlying data.

To assess the impact fully we would need a data base setting out the templates of the 75 banks, with the two values in the table 5.

Without this data, banks cannot validate the Committee's numbers, or assess the business implications of their score.

Q2. What are respondents' views on potentially including STWF as an indicator in the interconnectedness category?

The original BCBS proposals included a Wholesale funding ratio.[11]

But in the 2013 amendment preface on page 1 the "*Wholesale Funding Ratio, which was one of the three indicators in the interconnectedness category in the November 2011 publication, has been replaced with a Securities Outstanding indicator. This change was previously highlighted in paragraphs 16 and 17 of the cover note to the November 2011 publication"*.

We agree that a bank which is reliant on short term wholesale funding poses a higher risk than a bank funded entirely by stable core deposits. We support the approaches the Committee has set out to reduce the reliance on short-term funding.

But we do not see the benefit in introducing this indicator into the category of interconnectedness, because the risk posed by an over-reliance on short-term wholesale funding has been addressed by the Basel framework's liquidity reforms, the LCR and the NSFR. These requirements, together with heightened market expectations, have driven improvements in banks' liquidity management since the crisis, and the implementation of the NSFR in 2018 will continue this, and ensure that it is maintained. Banks and competent authorities in each jurisdiction are ensuring NSFR implementation and compliance.

Consequently, the existing Basel III framework already has a short-term wholesale funding factor, creating a disincentive for banks to rely on such funding sources.

Including the indicator adds complexity, for little benefit. The consultative document notes that its inclusion will have little or no impact on individual bank G-SIB scores. This confirms that the indicator is not needed and that effective tools are already in place.

Were it included, this reduces the weighting of the three other indicators. And this would only be coherent if the systemic importance of these indicators has reduced. The consultation does not seem to support this conclusion.

We note that interbank transactions are a competent of wholesale funding, and are therefore already included in the interconnectedness category.

We are particularly concerned about the inclusion of data item 'G-SIB 1188', 'secured funding' captured within the NSFR. Within the banking sector short-term secured funding is essentially a zero-sum game. The pledged asset will have been received by a counterparty. So we do not agree that this funding represents a systemic risk.

The addition would result in double-counting for US banks. This is because STWF is already included as 20% weighting in the alternative method 2 US FED approach as it replaces the substitutability category. The US FED treats short term funding as systemic risk to the US. It requires US banks to calculate two approaches. Although we do not have the data, we presume within the total of EUR 25,076bn the 11 US banks in the 2015 sample [12] represent a material percentage of this total.

[11] https://www.bis.org/publ/bcbs207.pdf refer to paragraphs 33 and 34

[12] Bank of America, BNY Mellon, Capital One, Citigroup, Goldman Sachs, JP Morgan, Morgan Stanley, PNC, State Street, US Bancorp and Wells Fargo

Also we expect that the approach to calculate the STWF indicator is consistent with the US approach, but without evidence to support this assumption, we cannot be sure. We recommend a full review of the approaches to the definition and calculation of STWF, before moving forwards.

We think that the inclusion of this indicator may reduce the systemic importance of non-US banks. As most balance sheets are funded in domestic currency, and are not interchangeable, we doubt that this is appropriate.

A further implication is that 25,076bn of short term funding ranks pari passu as systemic risk with 12,266bn of Securities Outstanding, and c 8,500bn each of intra-financial system assets and liabilities. We find this surprising.

We think that short-term funding – however it is measured – poses a greater risk than the value of securities outstanding. This is why BCBS has established the NSFR as a primary measurement of the funding risk of a bank. We agree with this approach and suggest that this is another reason for excluding the STWF from the BCBS G-SIB framework.

Additional comments

1. Background – methodology – conceptual framework

It was as a consequence of a review of 2009-2011 data submitted by 73 banks, in July 2013 that an updated final framework was published. [13] It contained a few amendments:

1. The denominators used to calculate banks' scores would be updated on an annual basis,
2. The Wholesale Funding Ratio was replaced with the Securities Outstanding indicator,
3. High-quality liquid assets were excluded from the trading and available-for-sale indicator and
4. A cap was introduced on the substitutability indicator.

The Committee also clarified the sample size as the 75 largest global banks, based on the financial year-end Basel III leverage ratio exposure measure, broadly equating to banks with an overall size of exceeding EUR 200 billion using the exchange rate applicable at the financial year-end.

We note that the industry did not have an opportunity to comment on the previous revisions. We ask that when BCBS publishes the outcome of this consultation we will have a further opportunity to comment before any revised approach is finalised.

We also ask that BCBS publishes a response to the public comments on the consultation, to explain why it accepts or rejects suggestions made. It may also be beneficial to hold a public hearing.

Improvements to the regulatory framework since 2013 have focussed on 4 aspects: Capital, (quality and quantum to cover RWAs (losses)), Leverage, Funding and Liquidity. The G-SIB indicators embrace all four of these aspects. But in all cases, BCBS concluded that more capital (defined as a % of credit, market and operational risk losses) is the answer to address systemic risk across the entire regulatory framework including leverage, funding, liquidity and other activity.

The Committee's rationale is the higher loss absorbency (HLA) methodology. This amounts to an additional capital requirement, devised to translate the Committee's estimate of large banks total losses (derived from credit, operational and market risk exposures) into a percentage of Risk-Weighted Assets (RWAs).

An additional capital charge, based on RWAs, is a blunt tool for measuring systemic risk and for influencing the behaviour of banks. But it is unclear whether this approach has changed bank's behaviour. We are concerned that the G-SIB framework may just amount to an additional minimum capital requirement for a sub-set of the 75 banks.

The approach also gives banks the challenge of how to allocate the HLA. A bank is likely to allocate the additional HLA across its risks and businesses on a regulatory or economic capital basis. It is unclear how this additional HLA is comparable for banks with very differing business models.

It would be helpful if BCBS could share its views on these issues to stimulate a wider discussion on systemic risk and how it can best be mitigated.

[13] https://www.bis.org/publ/bcbs255.htm

2. Comparability of indicators and the role of caps

The BCBS approach assumes that all indicators and thus all categories in the assessment methodology relate to a relative and comparable amount of systemic risk. It also implies that relativity is only a function of the overall aggregate measure of all banks in the sample.

We do not share that view. A year-on-year change in the aggregate measurement of the indicators is simply a measurement of the aggregate. It is not a comparable measurement of one risk relative to another risk and or necessarily a change in systemic risk.

Thus the aggregate is merely an undefined % - a concentration - of a wider undefined total. As global and local economies grow or contract, the nature of systemic risk changes. But the absolute measurement of systemic risk, as defined, is fixed. The measurement of the 75 sample banks may decrease even when there is increasing systemic risk for the global economy. The proposed approach does not take this into account.

As we will explain later, some major economies are not represented in the G-SIB list and/or are under-represented relative to their share of global GDP. It is possible the banks in those countries are affecting the aggregate measurement and thus HLA of the banks in the countries with a G-SIB. We think this may undermine the methodology.

The methodology equates different measures by a relative ranking of the indicators by importance. We are concerned that the rank ordering may not be robust. We expected the consultation to review of the assessment methodology and use recent empirical evidence to test the method's assumptions.

We suggest using different statistical methods to check whether there has been an excessive concentration of exposure for each indicator, across the financial system, since the inception of the framework. It may also help to check this at country level and/or EU level for the 75 sample banks.

This would inform the debate on recalibration of the overall framework to level the playing field in the way banks are assessed. That is why we support a revision of the overall scoring methodology, which may now be statistically biased, resulting in systemic risk scores that are distorted by the most volatile categories and or the evidence of the differing concentration of exposure by different indicators. We think this issue undermines the original intention of the framework, which was to apply equal weights to all categories.

3. D-SIB surcharges – comparison with G-SIB

Competent authorities' views on the measurement of systemic risk do not all align with the BCBS approach. Different approaches have been taken to determine the local D-SIB HLA. In many jurisdictions the D-SIB HLA replaces the G-SIB HLA and in many cases this is a simplified approach, which includes caps and broad buckets.

The consequence is that some national D-SIB framework resulting in supplementary HLA is held not only for banks headquartered in those jurisdictions, but also subsidiaries for those banks head-quartered elsewhere.

For example please refer to KPMG's briefing note dated 25 May 2016 [14] setting out some of the different approaches adopted in some countries. Countries such as Greece, Malta and Romania have introduced a D-SIB HLA. In Malta this impacts two local banks and one G-SIB.

This shows the fragmentation of the approach to assessing systemic risk, locally, regionally and globally. In consequence, some G-SIBs and purely domestic banks are rightly subject to a HLA in the host country because they are seen to be locally systemically important. But at the same time the sample banks are also required to adopt the G-SIB approach on a consolidated basis and are required to hold additional HLA globally. And it is quite possible that this additional global HLA is in fact held in the local D-SIB. This seems to be a confusion of the purposes of the approach.

As part of its review, we think it would have been beneficial for BCBS to have conducted a review of all the different approaches of competent authorities, comparing them to the BCBS approach. This would also have enabled us to enhance our assessment of the methodology.

In conclusion, we think it would be beneficial for BCBS to publish an analysis and details of the approaches adopted by all competent authorities.

[14] https://home.kpmg.com/xx/en/home/insights/2016/05/d-sib-designation-and-capital-surcharges-fs.html

4. The regulatory framework: Balancing risk sensitivity, simplicity and comparability[15]

We understand that the principles set out in the BCBS publication on this subject, issued for comment by 11 October 2013, are a guiding light for changes to the prudential regime. The current framework predates the BCBS work to balance risk sensitivity, simplicity and comparability.

Neither the current nor the proposed framework seems to meet the standard for **simplicity** in a capital standard or calculation. It demands considerable effort to understand the wide range of terms which need to be cross-referenced to many other standards to grasp their meaning. The calculation to derive the capital charge HLA is complex and lacks transparency. A bank cannot calculate its own charge. This is because it requires a large number of unaudited inputs, some of which are not normally captured. But crucially, the outcome depends on the other banks in a sample, which is not known in advance.

We do not think that the approach meets the standard for **comparability**. The desired outcome is that banks with broadly the same level of systemic risk would have the same HLA. But the complexity of the approach means that this is not possible. The desired outcome, that a banks' capital should not change if the underlying risks remain unchanged (and only change proportionally when risks do change) is not achieved because the HLA is a relative not an absolute measure.

A further BCBS requirement is **risk sensitivity.** This should be both a design feature and an outcome of a regulatory framework. On the one hand this is achieved via the ex-ante granularity of the indicators. But equally there needs to be an "*ex post risk sensitivity: a standard is risk-sensitive if, other things being equal, it can accurately differentiate in advance between different risk profiles. For a capital framework, this implies that it can distinguish with reasonable accuracy between sound banks and those that are likely to fail".*

We are concerned that the lack of transparency, complexity and comparability makes it difficult to assess the effect of the HLA. This is because the HLA is designed to change the LGD in the event a failure to be equal to the LGD of banks without the HLA. However, because the additional HLA RWAs are covered by capital and thus included in the capital ratios, an outcome is that for both types of banks (the G-SIBs with HLA and those without or with less HLA) the capital ratios may be the same. The effect is to mask the additional HLA.

Our view is that the current and proposed revised framework is not risk sensitive. It is overly complex and significantly so compared to the Bank of England approach. In conclusion, we think that the measure of HLA, as represented by the additional RWAs, is not comparable.

[15] http://www.bis.org/publ/bcbs258.pdf

5. Sample size and approach to measuring systemic risk

In July 2013 the BCBS included a description of the approach to determining the sample of banks to be used in the scoring exercise.[16] We note the footnotes on the BCBS website:[17]

- *The main sample includes the largest 75 banks as determined by the Basel III leverage ratio exposure measure, along with any banks that were designated as a G-SIB in the previous year but are not otherwise part of the top 75. These are the banks which contribute to the global denominators presented and are part of the sample used in the scoring exercise.*

- *The additional sample includes all banks with a leverage ratio exposures measure greater than €200 billion that are not included in the main sample. These banks do not contribute to the global denominators and are not part of the scoring exercise.* This numbered 15 in end of 2014 exercise and 17 in end of 2015.

It is unclear why the additional 15 or 17 banks are not included in the sample to calculate the denominator.

Paragraph 39 of the July 2013 final framework states that there would be review of '*the size of the sample of banks'* every three years*.* And in its cover note published in November 2013, '*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'.* But the Consultation does not include any such review.

There has been significant progress on strengthening the prudential and conduct frameworks, as evidenced in the recent Basel III Monitoring Report (September 2016). The report sampled 228 banks including 100 Group 1 banks with Tier 1 capital of more than €3 billion that are internationally active and 128 Group 2 banks based upon data at the consolidated level as of 31 December 2015.[18] This confirms that 100 banks and internationally active, from a BCBS perspective.

The framework is intended to provide incentives for existing G-SIBs to reduce their systemic footprint and encourage a dispersion of risk and activity across a wider group of banks. We do not understand why all 100 banks are not included in its sample, as well as calculating the denominator based upon the full sample of 100 internationally active banks.

We therefore question whether the sample size of 75 banks is an adequate '*proxy for the global banking sector'.* We suggest that BCBS should publish clear criteria for what constitutes an international active bank.

[16] *26. The indicator-based measurement approach uses a large sample of banks as its proxy for the global banking sector. Data supplied by this sample of banks is then used to calculate banks' scores. Banks fulfilling any of the following criteria will be included in the sample:*

- *Banks that the Committee identifies as the 75 largest global banks, based on the financial year- end Basel III leverage ratio exposure measure.*
- *Banks that were designated as G-SIBs in the previous year (unless supervisors agree that there is compelling reason to exclude them).*
- *Banks that have been added to the sample by national supervisors using supervisory judgment (subject to certain criteria).*

These banks will be required to submit the full set of data used in the assessment methodology to their supervisors.

[17] End of 2014 and end of 2015 exercises https://www.bis.org/bcbs/G-SIB/G-SIB_assessment_samples.htm

[18] http://www.bis.org/bcbs/publ/d378.pdf

We also note that there are banks in the sample from countries without any HLA. Each of these banks has an overall score less than 130 i.e. the minimum score for a 1% HLA, But we understand that that there are some banks with concentrations of exposure in some indicators in excess of 1.3%.

The following countries are not represented by a G-SIB.

• 3 banks in Brazil	ranked by GDP	9th
• 5 banks in Canada	"	10th
• 3 banks in Korea	"	11th
• 4 banks in Australia	"	13th

In addition, there are 15 banks from China (ranked now 2nd in the world GDP league table) in the sample, yet only 4 banks with an aggregate HLA of 4.5% are included.

However, there are many G-SIBs operating in all of these countries, principally through local subsidiaries subject to a HLA.

This suggests that the approach has shortcomings.

On the one hand the Committee is concerned about the percentage of idiosyncratic systemic risk that a bank contributes to the global sample of 75 banks in 20 countries but does not seem to be concerned about the overall percentage of country systemic risk contributed by 15 banks in the 4 countries and or the 11 other Chinese banks.

The effect of this approach is that the banks in the four countries can grow, contributing in aggregate more systemic risk to the global economy. But providing each bank in those countries remains less than 1.3% individually, even though in aggregate the contribution could be greater than a G-SIB bank from say Italy, Sweden or the Netherlands, there will be no G-SIB HLA for those banks, or that country.

In consequence, BCBS has to rely on the competent authorities to implement local D-SIB HLA.

This may cause unintended consequences and a lack of fairness in the application of the methodology.

It may be advisable for BCBS to reconsider the approach, to take into account the systemic risk created by a country to the global banking system. This may also help to reduce the difference between G-SIB and D-SIB methodologies.

6. Methodology – absolute vs relative share

Paragraph 39 of the July 2013 final framework stated that every three years BCBS would review '*the methodology, including the indicator-based measurement approach itself'.*

The consultation does not include results of this review.

The conceptual approach is to use the aggregate value of each indicator across the 75 sample banks as a proxy for the global banking sector. As these banks change in the size, the overall proxy also changes.

For example:

> "*it is important to note that a bank's ranking for the purpose of allocation of a capital charge on the scale 0% to 3.5% will therefore be driven by its relative complexity, substitutability, etc. compared with the entire reference group of banks, materially influenced by those of the largest banks in the group. Thus, if a bank was significantly to shrink its size, simplify operations and reduce complexity, but others were to take even greater steps in this regard, then that bank might nevertheless rise in the overall ranking and potentially incur an increased capital buffer". [19]*

In August 2011, the BBA commented to the BCBS that there should be incentives to reduce systemic risk, rather than to merely move systemic risk around the global banking sector. [20]

In our comments we suggested that using a relative measure would not achieve the desired outcome:

> "*The score assigned to each bank is calculated in accordance with each bank's weight relevant to the other banks regulated by the requirements. However, we would appreciate clarification that the framework's intention it to be based on absolute measures of systemic importance rather than simply relative to other banks. This is important in order to provide sufficient incentive for banks to reduce their size, interconnectedness and risk. There needs to be scope for all G-SIB banks to collectively reduce their additional loss absorbency requirement, and to move down the buckets scale collectively over time. The parameters need to provide clear incentives for the reduction of systemic risk, and the defined possibility to move down buckets as well as upwards. It needs to be acknowledged that collective action would reduce both individual and collective risk. A potential issue here is if rankings are based on parameters that are based mostly on size, all firms could reduce their size and therefore systemic risk, but proportionately they may not change, and therefore would retain their position in the respective buckets despite the reduction or risk. This reduces the incentives to reduce systemic risk and must be avoided.*

BCBS initially chose to keep the denominator fixed for a three-year period, as set out in its cover note November 2011:

> *In this context, commentators 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.*

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[19] Extract from HSBC Holdings plc G-SIB Indicators disclosure 31 December 2016

[20] https://www.bis.org/publ/bcbs201/bba.pdf BBA comments August 2011

> *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*.

While this approach could have provided incentives to banks to reduce their systemic importance, the final rules published in July 2013, adopted a different method:

> ***Frequency of updating the denominators.*** *The Committee originally intended to fix the denominators used to calculate banks' scores until the completion of the first three-year review of the G-SIB methodology. The intention was to provide an absolute measure that banks could target to reduce their scores (i.e. the measure of their systemic impact). However, the Committee found that it is not practicable to adequately neutralise the impact of exchange rate movements under a regime of fixed denominators. Furthermore, updating the denominators only after 3 years risks creating "cliff effects", where banks experience large changes in their scores simply as a result of the denominator being updated. As a consequence, the Committee has decided that the denominators used to calculate banks' scores will be updated on an annual basis.*

Although we recognise the difficulty, we think that the current approach does not provide a methodology for a bank to review and address its systemic risk and thus HLA. This lack of risk sensitivity is an important shortcoming of the methodology. The use of a fixed aggregate denominator results in a reallocation of the HLA amongst the 75 banks within the sample with a bias to a continuing HLA for each bank in excess of c. 1.3% of the sample.

In conclusion we think that there is a need to review the approach to enable appropriate incentives for a bank to reduce its systemic risk independently of the actions of the other 74 banks in the sample.

Recalculating the scores, using year-end data, introduces a random volatility that is compounded by the volatility in exchange rates.

A solution could be to derive each indicator from the average of the past three years' data.

Another approach could be to assess systemic risk by taking into account the GDP of the countries represented by the 75 banks in the sample and so take into account changes in the absolute measure of systemic risk relative to changes in GDP. In this way all banks within the sample could benefit from becoming less systemic.

We also suggest that the method should take into account inflation.

7. FX Rates

A reason given for not fixing the denominator for a three-year period is the uncertainty over how to adjust for changing exchange rates versus the EUR.

But this is not only an issue for 38 non-EUR banks in the sample of 75, it leads to a bias against all banks, including random impacts on EUR banks.

So, a consequence of the method is that exchange rate movement is a risk that cannot be mitigated or hedged.

The effect of combing EUR values, which do not change, with non-EUR values, which do change, is to introduce random impacts to all banks in the sample.

Paragraph 24 of the BCBS cover note of November 2011 commented:

> *Some commentators 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.*

But the issue has not been reviewed. Neither has there been an assessment of the effect of exchange rates on banks' scores.

We see this as a serious gap. The effects of exchange rate movements should be reduced.

One option is to use the average exchange rate of the year to translate end of year values into EUR. Another is to publish a rolling three-year exchange rate.

A further option would be to publish a set of basket currency rates called 'SIB' (Systemic Important Bank). This would be derived from the weighted composition of the 75 banks for each indicator. Each indicator would have its own weighted composite exchange rate derived from the component currencies. BCBS could then calculate the SIB equivalent for each banks reported currency. If this was also the average of the past 3 years' rates, this could significantly reduce exchange rate volatility.

We recommend reviewing the approach and choosing a method that minimises the impact of exchange rate movements.

END