Domestic Systemically Important Banks: A New Framework for Assessment and Loss Absorptency

October 25, 2012

On October 11, 2012 the Basel Committee on Banking Supervision (Basel Committee), working with the Financial Stability Board, finalized and released its twelve principles for the assessment methodology and higher loss absorbency (HLA) requirements for domestic systemically important banks (D-SIBs). A Framework for Dealing with Domestic Systemically Important Banks (D-SIB Framework) is complementary to the Basel Committee’s November 2011 framework related to global systemically important banks (G-SIBs).

To date, no domestic Canadian bank has been identified as a G-SIB. In light of the factors identified in the D-SIB Framework, it is likely that the largest Canadian banks could be categorized as D-SIBs based on an assessment methodology, the details of which are yet to be developed by the Canadian bank regulator, that would consider, among other factors, those banks’ relative concentration within the banking sector as a whole. Banks identified as D-SIBs may be required to increase their capital buffers beyond the level required by their non-D-SIB competitors, thereby increasing their cost of doing business.

The D-SIB Framework recognizes that a failure of a D-SIB could have greater impact on a domestic financial system and economy than that of a non-systemically important institution, and possibly could have cross-border, if not global, impacts as well. The expectation is that banks identified by national regulators as D-SIBs will comply with these principles from January 2016 in line with the phase-in arrangements for the G-SIB rules.

National regulators will conduct an assessment of banks they regulate (including international banks) to identify those whose distress or failure could have significant impacts on the domestic financial system and economy. Unlike the prescriptive approach adopted for G-SIBs, the Basel Committee has recognized that national regulators will need discretion in the application of policy to take into account the structural characteristics of their jurisdictions. Nevertheless, because the failure of a D-SIB may have cross-border impacts, the effectiveness of national implementation to address risk is of interest on a multi-lateral level. Consequently, a minimum set of principles has been identified to promote a level playing field across jurisdictions. A D-SIB Framework peer review process will be built into the Basel III regulatory consistency assessment program. National regulators may choose to adopt additional requirements beyond the D-SIB principles depending on the unique features of domestic financial systems.

The D-SIB principles may be applied at a consolidated group or subsidiary level, and thus could also apply to domestic systemically important branches or subsidiaries of international banks. Thus, the D-SIB Framework may have relevance not only for the largest Canadian banks on a domestic level, but also in respect of their locally significant banking operations in other jurisdictions if those operations are determined by local regulatory authorities to be D-SIBs in those jurisdictions.

The D-SIB Framework principles focus on an assessment methodology and HLA. Nonetheless, the D-SIB Framework recognizes that more intensive supervision may also be effective in dealing with D-SIBs as regulatory authorities may determine. Seven of the twelve principles deal with assessment methodology:

1. National regulators should establish a methodology for assessing the degree to which banks are systemically important domestically;

2. As with the G-SIB rules, the D-SIB methodology should reflect the potential impact of, or externality imposed by, a bank’s failure, not the risk of failure;

3. The domestic economy is the reference system for assessing the impact of failure;

4. Home regulators should assess banks on a consolidated basis. Home jurisdictions with bank groups that engage in cross-border activities may be impacted by the failure of the whole group, not just the part of the group that operates domestically, particularly since home governments may have to resolve foreign operations in the absence of cross-border agreements. Host regulators should assess subsidiaries in their jurisdictions on a stand-alone and locally consolidated basis, including both local and any international downstream subsidiaries that could impact on the host economy. Thus banks may be qualified as D-SIBs in either or both of their home and host jurisdictions depending on how the relevant regulatory authorities apply the D-SIB Framework and on bank-specific factors applicable in the relevant domestic economy;

5. As with the G-SIB approach, the impact of D-SIB failure should in principle consider bank-specific factors like size, interconnectedness, substitutability (concentration in the sector) and complexity (including cross-border activity) as well as any other country-specific measures that national regulators consider informative, all relatively weighted depending on national circumstances. The D-SIB Framework suggests, for example, that the size of a bank relative to domestic GDP may be a more relevant measure than institutional size on an absolute basis;

6. Regular assessments of systemic importance should be undertaken to ensure currency with any structural changes in national financial systems, and the interval of assessments should not be significantly different from the annual assessments of G-SIBs; and

7. An outline of the methodology for the assessment of systemic importance should be publicly disclosed.
The remaining five principles deal with HLA:

8. National regulators should document transparently the methodologies and considerations used to calibrate the level of HLA required for D-SIBs, which would be informed by quantitative methodologies and country-specific factors, but would be subject to supervisory judgment. For example, concentration in the banking sector and size relative to domestic GDP may be relevant country-specific factors, which could justify different degrees of policy responses in different countries (see principles 4 and 5 above);

9. The HLA requirement should be commensurate with a bank’s assessed degree of systemic importance domestically;

10. As with the assessment methodology, home regulators should calibrate HLA requirements on a parent and/or consolidated basis, but should also test parent bank capitalization on a stand-alone basis. Host regulators should calibrate subsidiaries in their jurisdictions consolidated to include local and international downstream subsidiaries. Domestic banks and subsidiaries or branches of foreign banks with the same degree of systemic importance domestically should be subject to the same HLA requirements. Between the G-SIB and D-SIB frameworks, double counting of HLA requirements should be avoided as the two frameworks should be complementary;

11. If a subsidiary of a bank is considered a D-SIB by a host authority, host and home regulators should coordinate and cooperate on HLA requirements. This will assist to ensure that home authorities consider implications of D-SIB requirements of their banks’ significant foreign subsidiaries, for example, in respect of implications for the allocation of financial resources across a banking group. Home and host authorities should understand each other’s resolution regimes and their impacts on HLA requirements; and

12. The HLA requirement should be fully met by common equity Tier 1 capital to ensure consistency in approach and to allow comparability in the application of HLA requirements across jurisdictions. Authorities, however, may impose any additional requirements or policies they consider appropriate. The HLA requirement should be an extension of the capital conservation buffer on top of the Basel III capital buffers and minimum capital requirement. To the extent that Pillar 2 capital captures risks not directly related to D-SIB factors, HLA requirements should not be permitted to be used simultaneously to meet Pillar 2 requirements.

The Office of the Superintendent of Financial Institutions (Canada) now has the task of developing and articulating an assessment methodology and setting out Canadian HLA requirements for D-SIBs, and implementing the D-SIB Framework before 2016. In light of the concentration of a small number of larger banks in the Canadian financial system, several with significant cross-border operations, it is likely that larger banks may be categorized as D-SIBs and may be expected to establish additional core capital buffers in line with the D-SIB Framework. Coordination among national regulators across jurisdictions in the imposition of the new HLA requirements may be an important concern for larger Canadian banks with significant cross-border operations.