



Defining Global Systemically Important Banks and Additional Loss Absorbency Requirements

On 19 July 2011, the Basel Committee on Banking Supervision (“BCBS”) and the Financial Stability Board (“FSB”) published two papers relating to entities regarded as globally systemic important financial institutions (“G-SIFIs”). The first paper prepared by the BCBS which we consider in more detail below sets out proposals for an assessment methodology for determining whether a banking institution should be regarded as a globally systemically important bank (“G-SIB”) and the additional capital requirements that G-SIBs should be subject to.¹ The second paper prepared by the FSB, which we will discuss in a separate alert, sets out proposals for a framework for the resolution of failing institutions.²

Background

In finalising its new Basel III framework at the end of 2010, the BCBS mandated all banks to hold significantly more capital than is currently the case as well as introducing new leverage and liquidity ratios.³ The changes included increasing the minimum amount of common equity (principally ordinary shares and retained earnings) to be held by banks from 2% to 4.5% of risk weighted assets during a transitional period between 1 January 2013 and 1 January 2015, with total tier 1 capital rising from 4% of risk weighted assets to 6% during the same period. Banks will also be required to build up a capital conservation buffer to be comprised of common equity of up to 2.5% of risk weighted assets and may also be subject to additional counter cyclical buffers that can be imposed by local regulators.

The Basel III rules apply to all banks. In addition, the FSB and the BCBS have been considering additional rules to apply to the largest global banks to deal with concerns that such banks are regarded as too big to fail (meaning relevant governments would, as in the financial crisis, be prepared to use public funds to bail them out rather than face the systemic consequences of their failure). The FSB has previously outlined the moral hazard risks it believes arise from such institutions being regarded as too big to fail⁴ and mandated the BCBS to develop a methodology to assess the systemic importance of G-SIBs and additional measures that should be put in place to enhance their ability to absorb losses. This work was endorsed by the G-20 group of nations at their meeting in Seoul in November 2010. The BCBS paper referred to above sets out its proposals in this regard and, following the end of the consultation process, the BCBS is expected to present its final proposals to the next G-20 meeting in Cannes in November 2011.

¹ “Globally systemically important banks: Assessment methodology and the additional loss absorbency requirement,” <http://www.bis.org/publ/bcbs201.pdf>.

² “Effective Resolution of Systemically Important Financial Institutions,” http://www.financialstabilityboard.org/publications/r_110719.pdf.

³ See our client alerts, “Basel III: The (Nearly) Full Picture,” <http://www.mofo.com/files/Uploads/Images/101223-Basel-III-The-Nearly-Full-Picture.pdf> and “The Minimum “Bail-in Criteria for Regulatory Capital,” <http://www.mofo.com/files/Uploads/Images/110121-Minimum-Bail-In-Criteria.pdf>.

⁴ “Reducing the moral hazard posed by systemically important institutions,” www.financialstabilityboard.org/publications/r_101111a.pdf.

As set out further below, when combined with the new Basel III requirements, the BCBS proposals will result in the minimum common equity requirement for the largest global banks increasing from the current 2% of risk weighted assets to 9.5% by 2019 (and potentially 10.5% thereafter).

Assessment Methodology

The BCBS sets out what it terms an “indicator based measurement approach” in determining whether an institution is regarded as a G-SIB. Each of these indicators is given a 20% weighting and, as specified below, most of the indicators are made up of two or more sub-indicators (with each sub-indicator given equal weighting within such category). For each bank, the score for a particular indicator or sub-indicator is calculated by dividing the relevant amount for that bank in respect of such indicator by the aggregate amount total for all banks in the sample for that indicator. In the case of sub-indicators, the score is adjusted by the relevant weighting within each category. Each indicator’s score is then aggregated. The maximum possible score (if there were only a single bank in the world) would be 5.

The indicators are as follows:

1. Cross-jurisdictional activity. This indicator would measure the global footprint of the bank with the aim that the international impact from a bank’s distress or failure should vary in line with its share of cross jurisdictional assets and liabilities. The BCBS concludes that the greater the global reach of a bank, the more difficult it is to coordinate its resolution and the more widespread the effects of its failure. There are two sub-indicators for this category:

- **Cross-jurisdictional claims.** It is proposed that this sub-indicator uses the same data used to calculate international banks’ activities outside their home jurisdiction by the Bank for International Settlements (“BIS”).
- **Cross-jurisdictional liabilities.** This sub-indicator would use the same BIS data referred to above and combine figures reported as part of the local banking statistics for the bank’s home jurisdiction with its consolidated statistics. The calculation will take into account the liabilities of all offices of the relevant bank to entities outside the home market and include all liabilities to non-residents of its home jurisdiction.

2. Size. Size will be included as an indicator on the basis that a bank’s distress or failure is more likely to damage the global economy or financial markets if its activities comprise a large share of global activity. The BCBS states that the larger the bank, the more difficult it is for its activities to be replaced by other banks in the event of its failure. Its failure is therefore more likely to damage confidence in the global financial system. It is proposed that there will be only a single indicator for size using the same definition for total exposures of a bank in calculating its leverage ratio under Basel III.

3. Interconnectedness. The BCBS states that financial distress at an institution can materially raise the likelihood of contagion in respect of other institutions depending on the network of contractual obligations in which it operates. This indicator is made up of three sub-indicators:

- **Intra-financial system assets.** The sum of (i) lending to financial institutions (including undrawn commitments), (ii) holdings of securities issued by other financial institutions, (iii) net mark to market reverse repos, (iv) net mark to market securities lending to other financial institutions, and (v) net mark to market OTC derivatives with financial institutions.
- **Intra-financial system liabilities.** The sum of (i) deposits by financial institutions at the relevant bank, (ii) securities issued by the bank owned by other financial institutions and liabilities of the nature specified under (iii) to (v) of intra-financial system assets above.

- **Wholesale funding ratio.** This sub-indicator is related to the degree to which a bank funds itself from other financial institutions through the wholesale financial market. by dividing total liabilities net of retail funding by total liabilities.

4. Substitutability. The BCBS states that the systemic impact of a bank's distress or failure is expected to be negatively related to the substitutability of its services. Where there is a lack of realistic alternatives to a major business line or service of the bank, the greater the effect its failure is likely to cause. It is also noted that the cost to the failed bank's customers in having to seek the same service at another institution is likely to be higher for a failed bank with a large market share in respect of the relevant service. There are three sub-indicators:

- **Assets under custody.** The BCBS notes that the failure of a large custodian bank holding client assets could disrupt the operation of financial markets, and this indicator is the value of assets that a bank holds as a custodian divided by the sum total reported by the banks in the sample.
- **Payments cleared and settled through payment systems.** The BCBS concludes that a bank which is involved in a large volume of payments is likely to act on behalf of a large number of other institutions and customers including retail customers. If it were to fail, these institutions and customers may be unable to process payments immediately, affecting their liquidity. This sub-indicator is calculated as the value of a bank's payments sent through all of the main payment systems of which it is a member divided by the total reported by all the banks in the sample.
- **Value of underwritten transactions in debt and equity markets.** The BCBS states that the failure of a bank with a large share of debt and equity underwriting in the global markets may significantly impede new securities issuance. The indicator is calculated as the annual value of debt and equity instruments underwritten by the bank divided by the aggregate figure for all the banks in the sample.

5. Complexity. The BCBS states that the systemic impact of a bank's distress or failure is likely to be greater, the more complex its business, structure, and operations are. It specifies three sub-indicators:

- **Notional value of OTC derivatives.** The calculation is made by reference to the gross nominal or notional value of all OTC derivatives not cleared through a central counterparty and not settled at the reporting date.
- **Level 3 assets.** These are defined as assets whose fair value cannot be determined using observable measures (such as market prices or models) and are therefore illiquid. The indicator for each bank is calculated as the ratio of its reported value of level 3 assets and the aggregate of such values reported by all banks in the sample.
- **Trading book value and "available for sale" value.** The BCBS states that banks holding financial securities in the trading book and "available for sale" securities are vulnerable to mark to market losses and subsequent fire sales of the securities in situations of financial stress. This can drive down the price of such securities leading to the write-down in the value of the same securities held by other institutions. This sub-indicator is calculated as the ratio of the total value of the banks' holding of securities in the trading book and available for sale securities to the total value of such securities held by banks in the sample.

The BCBS provides some opportunity for individual supervisors of banks to make adjustments to a bank's G-SIB criteria determined by reference to the above criteria but states that it believes the bar for any such adjustment should be high, and it only expects such adjustments in exceptional cases. It indicates that the process for any such adjustment should focus on factors relating to a bank's global systemic importance and the impact of a failure of such bank and should not be based on the probability of failure of the bank. The BCBS sets out a number of ancillary indicators that can be used by supervisors in deciding whether an adjustment is appropriate. These include the gross or net revenue of the bank or its equity market capitalisation (in relation to the size indicator) and the number of jurisdictions in which the bank operates (in relation to the complexity indicator).

The BCBS states that there should be a continuing review of banks against the relevant indicators, giving them an opportunity to change their risk profile and business models to reduce their aggregate indicator score. The BCBS stresses that it is not proposing to develop a fixed list of G-SIBs. Banks could therefore migrate in and out of SIB status over time.

For banks that are determined to be G-SIBs, each bank will be grouped into a category of systemic importance based on its score under the indicator based test specified above. From an initial sample of 73 major banks, the BCBS' initial view is that there will be 28 G-SIBs.⁵ We observe that, notwithstanding the objectivity of the scoring system that the BCBS has proposed, the BCBS has not specified the threshold score that presumptively will cause a bank to become a G-SIB.

Additional Loss Absorbency Requirement

The BCBS states that there should initially be four categories of G-SIB depending on the relevant bank's indicator score. Depending upon its individual score, the bank should be subject to an additional loss absorbency capital requirement of either 1%, 1.5%, 2%, or 2.5% of risk weighted assets. In addition, it proposes an initially empty top bucket of 3.5%.

In terms of what instruments should be eligible to comprise this additional capital requirement, a number of banks had lobbied for contingent capital ("CoCos") or other forms of hybrid capital to be permitted. CoCos are instruments whose terms provide for them to be converted into equity or to be subject to a principal write down upon the occurrence of a specified trigger. There have already been a number of issuances of CoCos in the EU in recent years, including by Lloyds Bank, Rabobank and Credit Suisse, and the terms vary in respect of whether they convert into equity or have a write-down feature. The trigger has generally been set by reference to the common equity tier 1 ratio of the issuer falling below a certain level. The BCBS states, however, that it believes the additional loss absorbency requirement should be met with common equity tier 1 capital only.

Despite this conclusion, the paper considers the advantages and disadvantages of contingent capital at some length, the first time the BCBS has done so. It makes a distinction between bail-in debt and contingent capital instruments that have a "low trigger" and absorb losses only at the point of non viability of the entity (which it dismisses without discussion as being inappropriate for the additional loss absorbency requirement) and going-concern contingent capital instruments that are designed to convert into common equity or be written down whilst the bank remains a going concern in advance of it becoming non viable (a "high trigger"). Although the BCBS ultimately dismisses such instruments as being inappropriate for the loss absorbency requirement, it considers the relative pros and cons of such instruments relative to common equity at some length:

Pros

- **Agency problems.** The debt nature of contingent capital may give debt discipline to the issuer and help avoid agency problems associated with equity finance.
- **Shareholder discipline.** The threat of contingent capital converting and diluting existing shareholders may provide an incentive for shareholders and bank management to avoid taking excessive risks.
- **Contingent capital holder discipline.** Contingent capital holders are likely to have an extra incentive to monitor the risks taken by the issuing bank due to the principal losses that would be suffered on a conversion.

⁵ We note that this number is substantially less than the number of banks that are deemed systemically important in the U.S., by virtue of the single \$50 billion threshold set forth in the Dodd-Frank Act. This disparity underscores the need for international cooperation in the regulation of SIFIs.

- **Market information.** Contingent capital may provide information to supervisors about the market's perception of the health of the relevant firm if the conversion rate is such that they receive a low number of shares on conversion.
- **Cost effectiveness.** Contingent capital may achieve a prudential outcome similar to equity but at a lower cost to the bank which may enable banks to issue a higher quantity of capital as contingent capital than as common equity and generate more loss absorbency capacity.

Cons

- **Trigger failure.** The benefits of contingent capital are only obtained if the instrument's trigger works as intended prior to the point of non-viability. There is, however, no historic data as to whether, in practice, such instruments will be triggered as designed.
- **Cost effectiveness.** Although the potential lower cost of contingent capital may offer advantages, the BCBS states that if the lower cost is not explained by tax deductibility or a broader investor base, it may be evidence that it is less loss-absorbing than common equity (on the basis that the debt features such as a fixed coupon and maturity date may undermine the ability of the instrument to absorb losses on a going-concern basis).
- **Complexity.** Contingent capital is a new instrument, and there is considerable uncertainty as to how such instruments and the conversion provisions will operate in practice and how investors will behave in a situation of financial stress.
- **Death spiral.** This is the concern that as a firm approaches the conversion point, downward pressure could be placed on equity prices as equity holders seek to sell their shares to avoid dilution.
- **Adverse signalling.** Banks are likely to seek to avoid the triggers in their contingent capital instruments being activated. There would inevitably be an adverse investor reaction if the trigger is hit, which may create financing problems and undermine the market's confidence in that and other banks.
- **Negative shareholder incentives.** The prospect of a punitive dilution may have some negative effects on shareholder incentives and management behavior. This could include management seeking to scale back risk weighted assets through restricting lending or making assets sales. Such action could have negative effects on financial markets and the real economy.

Although the BCBS indicates that contingent capital should not be capable of meeting the additional loss absorbency requirement for G-SIBs, it states that it will continue to review contingent capital and believes high trigger contingent capital can help absorb losses on a going-concern basis. It states that it will support its use to meet higher national loss absorbency requirements than the minimum levels it has specified.

Next Steps

Although it seems unlikely the BCBS will make significant changes to its proposals, submissions to its consultation paper should be made by 26 August 2011. Once it has finalized its recommendations, they will be submitted for consideration at the next G-20 meeting in November 2011, and it is expected they will be endorsed at such meeting.

As indicated above, the BCBS believes around 28 banks will initially be specified as G-SIBs, which represents a small percentage of the overall banking market. The effect on such banks will, however, be significant, although the overall additional capital charge is lower than some banks and commentators had feared. Combined with the new Basel III minimum capital requirements and buffers, it will, however, result in the common equity requirement for the largest global banks increasing from the current 2% of risk weighted assets to 9.5% (and potentially 10.5%). A consequence of the additional buffers being set at their proposed level is, however, the requirement that they be comprised solely of common equity, whereas many banks had petitioned for contingent capital to be eligible in providing the additional loss absorbency requirement. The BCBS have, however, indicated

that it does see a role for contingent capital providing loss absorbency for banks, particularly any additional requirements imposed by national regulators. Banks are also likely to seek to use CoCos to meet the element of tier 1 that does not need to comprise common equity and as tier 2 capital.

It should also be noted that G-SIBs will have some time to plan for the new loss absorbency requirement. The BCBS is proposing that the requirement will be phased in at the same time as the new capital conservation and countercyclical buffers between 1 January 2016, becoming fully effective at the start of 2019. It envisages that the minimum “cut-off score” in relation to which banks will be regarded as G-SIBs will be set by 1 January 2014, and national jurisdictions will be expected to incorporate the new rules into legislation by 1 January 2015.

Contacts

Peter J. Green
+44 20 7920 4013
pgreen@mofo.com

Jeremy C. Jennings-Mares
+44 20 7920 4072
jjenningsmares@mofo.com

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