European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel

baselcommittee@bis.org

Brussels, 26 August 2011

HG/VH/WSC/B2/11-111

Consultative Document 'Global Systematically important banks: Assessment methodology and additional Loss absorbency requirement'

Ladies, Gentlemen,

The European Association of Co-operative Banks (EACB) welcomes the opportunity to comment on the Basel Committee on Banking Supervision's Consultative Document on *"Global Systematically important banks: Assessment methodology and additional Loss absorbency requirement".*

Please find our general, specific remarks and answers to the questions on the following pages.

We will remain at your disposal,

Yours sincerely,

Hervé Guider
General Manager

Volker Heegemann
Head of Legal Department

Preliminary Remarks

- The proposal does as such not address the question of moral hazard nor does it provide a solution to it. To the contrary, even if the G-SIB status has the inconvenience of higher capital requirements, it also has the advantage of the likeliness of being bailed out in case of problems and the related funding and commercial benefits.
- Nevertheless, we would expect that the proposal would reduce the consequences of moral hazard for the system. In particular, it would put more pressure on supervisors and other stakeholders (supervisory boards, rating agencies, etc.) to prevent moral hazard.
- The assessment methodology as well as its justification do not appeal as very stringent. While the assessment methodology is supposed to allow to identify global systematically important banks, a number of 28 banks has been fixed as “systemically important” in advance and the methodology only allows the class banks according to their “SiFi-ness”. Since not all criteria are based on publicly available information, the method may appear to be somewhat deliberate.
- Moreover, this feeling of arbitrariness regarding the determination of the number of SIBs makes it even more important to establish a justification why the application of higher capital requirements is appropriate for 28 banks, but not so for e.g. 40 or 50 banks. For the time being, the rationale for cuting the line between SIBs and non-SIBs at just that point remains unclear.
- Thus, the proposed methodology does not fully define the standards for global SIFI's but only results in establishing an order of 'SIB-ness' for the chosen sample. The supervisors still have to determine (arbitrarily and on a subjective basis) the final set of SIBs. This makes the approach complex, not transparent and to some degree even arbitrary
- Although the document covers only banks (global SIBs), one has to keep in mind that there are also other types of financial institutions (e.g. insurance companies), which can involve risks that could also affect the financial markets as a whole.
- The assessment of banks as well as the imposition of additional requirements should be made on a group level only. There must be no additional national add-ons for groups’ member banks.
- While the G-SIB notion at least implicitly suggests government intervention in case of severe problems, bondholders’ involvement in resolution is left out of the scope of the loss-absorption measures.
- The condition to accept only Common Equity for the additional capital requirements seems by far too restrictive. The analysis regarding the loss-absorbing character of contingent capital seems inappropriate. We do not think that the Committee’s reasoning is very convincing. There even seems to be prejudice against any “new” instruments. We also regret that the analysis is only based on the presumption of convertible capital, while there could also be a write-off. Thus we ask the Committee to reconsider its preliminary judgment.

The indicator based measurement approach.

- At first sight most indicators appear to be rather intuitively appealing. The methodology suggests a scientific underpinning, which at this stage is simply not given. The rounded (10%, 20%) and equal (6.67%) weightings illustrate the still arbitrary character of the model as it is presented.

- Nevertheless, when looking closely at the indicators, we have the impression that the entire approach boils down to "size" in the end. We expect most indicators to be highly correlated, in the sense that the weighting model duplicates the size factor. For more detailed comments on the indicators one should have access to the complete picture and all data. For some of the indicators it is impossible for a bank to have even the slightest idea about relative positions.
- While it is clear that banks can migrate and become more or less systemically important, mere volatility in the measurement is undesirable. It is unclear to us to what extent the current method may lead to unstable results (hence requirements) over time.
- Given the importance of "size", accounting issues such as netting may be disturbing. Differing practices under US GAAP and IFRS will most likely turn out to be an issue and have an effect on the comparability..
- Some detailed comments:
    - We think intra-financial system liabilities are far more relevant to systemic risk than intra-financial assets.
    - Values of underwritten transactions in debt and equity markets seems less relevant to systemic risk.
    - The indicator "cross-jurisdictional activity" introduces a concept of relative importance. If banks of the same size are compared, this figure is likely to be higher for a bank that is situated in a smaller country. While such result may seem to be consequent, the question remains whether the differentiation is convincing in the end.
    - The introduction of a wholesale funding ratio to the measurement approach seems to add another liquidity indicator to the already fairly extensive liquidity framework introduced by Basel III.

Capital – loss absorption

We strongly disagree with the analysis and the conclusions of the Committee regarding Instruments to meet the additional loss absorbency requirement.

- Going concern contingent capital (high-trigger contingent capital) should under certain circumstances be eligible for the surcharge since it can be structured in such a way that it meets the additional loss absorbency requirements.
- We regret that the analysis is only examining contingent capital under the presumption that it would be converted into share capital, while the concept of a write-off is not considered.
- There are indeed a number of caveats regarding the structuring and the issuance of such instruments as illustrated in the proposal (para. 87ss). However, we contest the complete exclusion, especially since some of the arguments given are questionable or even not valid, like e.g.:
    - The trigger level

      Contingent capital instruments will only be less loss absorbing than common equity from a certain point (trigger level) onwards. From that level on they will be equally loss absorbing. Moreover, to refuse an instrument as capital for the simple reason that it is new, cannot be a valid argument.

- Cost effectiveness

Common equity is not only rewarded for severe losses but also for normal P&L volatility. Contingent capital would only be impacted by more severe losses. The different characteristics lead to pricing and cost differences. However, the loss-absorbency of the capital as such, which is available to the system as intended by the proposal would not be harmed by the fact that the loss absorption only starts from a certain point on, given that trigger levels are appropriately set and transparent.

- Tax Treatment

It is difficult to understand that unequal tax treatment is brought forward as an argument against the use of contingent capital (see footnote Unequal tax treatment does not only hold for contingent capital but to all instruments all over the globe.

- Shareholders versus contingent capital holders

If common shareholders have a preferential right to subscribe contingent capital instruments (which would be converted into shares) at the same conditions as other investors, they would not suffer from any ex-ante inequality. E.g. the dilution risk would be adequately priced. It has to be underlined, however, that no dilution will exist in case contingent capital is not converted, but written down. Moreover, capital dilution is not a valid argument in all kinds of companies: Dilution is not relevant in co-operative banks, where retained earnings are not allocated to shares. The value of members' shares would not be affected at all. There simply is no dilution

- Complexity

We believe that contingent capital is not necessarily more complex than other financial instruments. Certainly, ensuring a certain standardization is recommendable to exclude overly complex structures. Moreover, not least due to the Committee's criteria regarding the loss-absorbency of lower Tier 1 and Tier 2 instruments published in January 2011, those capital instruments do not lack a degree of complexity. Contingent capital could be much less complex.

- Negative shareholder incentives

The prospect of dilution is not more an incentive to deleveraging than e.g. all capital requirements, leverage ratio, LCR, NSFR etc. Moreover, it has to be recalled again that the incentives of member shareholders in a co-operative bank are fairly different from those of shareholders in a joint stock company. An increase of the share value is excluded.

- Other Financial Instruments

Finally, we would like to recall that the Committee has introduced new criteria regarding the loss-absorbency of lower Tier 1 and Tier 2 instruments, which were published in January 2011. These new standards require that the instruments in question can be written off or converted into capital in case of a certain trigger event. It makes it difficult to understand many of the arguments brought forward against contingent capital and its potential criteria, when they were imposed for other instruments already.

- We would therefore welcome a framework for eligible contingent capital, imposing a number of constraints contributing to transparency and the well-functioning of the loss absorbency. Allowing contingent capital to (partly) meet the additional loss absorbency requirements would broaden the investor base of banks.