



## Domestic Systemically Important Banks: New Framework Published

Earlier today, the Financial Stability Board (the “FSB”) approved and the Basel Committee on Banking Supervision (the “Basel Committee”) published a new set of regulatory guidelines for domestically systemically important banks (“D-SIBs”).<sup>1</sup> This framework follows the publication almost a year ago of a process for identifying and supervising globally systemically important banks (“G-SIBs”).<sup>2</sup> Today’s document similarly provides for enhanced regulation of D-SIBs, although it appears to be somewhat less stringent and prescriptive than that for G-SIBs. For example, the D-SIB Framework calls for an additional loss absorbency requirement but does not offer any specifics as the G-SIB Framework does.

A D-SIB is a banking organization whose failure or impairment would have external effects that would damage the real economy. The purpose of the D-SIB Framework is to limit those effects, as well as the likelihood of failure or impairment, through better supervision, risk management, and, if necessary, higher capital requirements.

To these ends, the D-SIB Framework sets forth twelve principles for supervision (which are included in the appendix hereto). Seven of the twelve discuss the methods for determining whether a bank is a D-SIB. The process outlined provides for broad national discretion. Principle 5 identifies four bank-specific factors that a regulator should evaluate: size, interconnectedness, substitutability and the financial institution infrastructure, and complexity (including those that may arise from cross-border activity). The G-SIB Framework includes these factors as well.

Five of the twelve address a higher loss absorbency (“HLA”) requirement that may be appropriate for a D-SIB. The HLA requirement is modeled on a similar requirement for G-SIBs, but the D-SIB Framework does not provide a scoring system or specific buckets of additional capital requirements. As with the assessment methodology principles, the HLA principles allow for considerable national discretion. Nevertheless, three important points emerge from these principles. First, an HLA requirement should be tied to the factors assessed under Principle 5. Second, the imposition of such requirements may involve significant cross-border communication and coordination issues. The home regulator may impose an HLA requirement at the parent and/or consolidated level, while a host regulator may impose one at the relevant subsidiary level. Indeed, a subsidiary of a bank already regulated in its home country as a G-SIB could be subject to a D-SIB HLA requirement in a host country. Third, a D-SIB must satisfy any HLA requirement with common equity tier 1 capital (as must a G-SIB).

<sup>1</sup> Basel Committee, *A framework for dealing with domestic systemically important banks* (Oct. 2012), available at <http://www.bis.org/publ/bcbs233.pdf> (hereinafter, the “D-SIB Framework”). Unless otherwise apparent from the context, the term “bank” refers to bank holding companies and their subsidiary banks.

<sup>2</sup> Basel Committee, *Global systemically important banks: assessment methodology and the additional loss absorbency requirement* (Nov. 2011), available at <http://www.bis.org/publ/bcbs207.htm> (hereinafter, the “G-SIB Framework”).

The immediate question is which banks may be captured under the D-SIB Framework, and the short answer is that we do not know. Readers will recall that shortly after the publication last year of the G-SIB Framework, the FSB identified 29 G-SIBs that would be subject to HLA requirements ranging from 1.0% to 2.5%. By contrast, most of the risk of a D-SIB is national, and the home regulator is expected to have the expertise to designate such banks.

For U.S. banking organizations, a possible universe of D-SIBs is those organizations with more than \$50 billion in consolidated assets – for which the Dodd-Frank Act mandates enhanced regulation – but that have not been designated as G-SIBs. This method could result in approximately 20 D-SIBs among U.S. banking organizations.<sup>3</sup>

We are continuing to analyse this framework and other approaches to systemic risk regulation and expect to report further on them in the near future.

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<sup>3</sup> The banking institutions with assets of more than \$50 billion that may be subject to enhanced U.S. regulation under the Dodd-Frank Act nominally include foreign banking organizations with a U.S. bank, branch, or agency office that have consolidated assets of more than \$50 billion, wherever those assets are located. We assume, however, that the United States would defer to designations by the home countries of these institutions, a result that the D-SIB Framework encourages. One indication may be that the Federal Reserve Board has proposed enhanced prudential regulations for U.S.-based institutions but has not proposed applying these standards to foreign banking organizations.

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## Appendix

### *Assessment Methodology*

**Principle 1:** National authorities should establish a methodology for assessing the degree to which banks are systemically important in a domestic context.

**Principle 2:** The assessment methodology for a D-SIB should reflect the potential impact of, or externality imposed by, a bank's failure.

**Principle 3:** The reference system for assessing the impact of failure of a D-SIB should be the domestic economy.

**Principle 4:** Home authorities should assess banks for their degree of systemic importance at the consolidated group level, while host authorities should assess subsidiaries in their jurisdictions, consolidated to include any of their own downstream subsidiaries, for their degree of systemic importance.

**Principle 5:** The impact of a D-SIB's failure on the domestic economy should, in principle, be assessed having regard to bank-specific factors:

- (a) Size;
- (b) Interconnectedness;
- (c) Substitutability/financial institution infrastructure (including considerations related to the concentrated nature of the banking sector); and
- (d) Complexity (including the additional complexities from cross-border activity).

In addition, national authorities can consider other measures/data that would inform these bank-specific indicators within each of the above factors, such as size of the domestic economy.

**Principle 6:** National authorities should undertake regular assessments of the systemic importance of the banks in their jurisdictions to ensure that their assessment reflects the current state of the relevant financial systems and that the interval between D-SIB assessments not be significantly longer than the G-SIB assessment frequency.

**Principle 7:** National authorities should publicly disclose information that provides an outline of the methodology employed to assess the systemic importance of banks in their domestic economy.

### *Higher Loss Absorbency*

**Principle 8:** National authorities should document the methodologies and considerations used to calibrate the level of HLA that the framework would require for D-SIBs in their jurisdiction. The level of HLA calibrated for D-SIBs should be informed by quantitative methodologies (where available) and country-specific factors without prejudice to the use of supervisory judgment.

**Principle 9:** The HLA requirement imposed on a bank should be commensurate with the degree of systemic importance, as identified under Principle 5.

**Principle 10:** National authorities should ensure that the application of the G-SIB and D-SIB frameworks is compatible within their jurisdictions. Home authorities should impose HLA requirements that they calibrate at the parent and/or consolidated level, and host authorities should impose HLA requirements that they calibrate at the sub-consolidated/subsidiary level. The home authority should test that the parent bank is adequately capitalised on a stand-alone basis, including cases in which a D-SIB HLA requirement is applied at the subsidiary level. Home authorities should impose the higher of either the D-SIB or G-SIB HLA requirements in the case where the banking group has been identified as a D-SIB in the home jurisdiction as well as a G-SIB.

**Principle 11:** In cases where the subsidiary of a bank is considered to be a D-SIB by a host authority, home and host authorities should make arrangements to coordinate and cooperate on the appropriate HLA requirement, within the constraints imposed by relevant laws in the host jurisdiction.

**Principle 12:** The HLA requirement should be met fully by Common Equity Tier 1 (CET1). In addition, national authorities should put in place any additional requirements and other policy measures they consider to be appropriate to address the risks posed by a D-SIB.