Response to feedback received

Domestic Systemically Important Banks Framework

Introduction

The Bank issued the policy document on the Domestic Systemically Important Banks Framework today. In finalising the requirements, the Bank has considered feedback received during the consultation period and has incorporated them where appropriate. Comments that are of wider interest have been set out in this document, together with the Bank's responses. The Bank would like to thank all respondents for the feedback and suggestions received during the consultation period.

Bank Negara Malaysia
5 February 2020

1. Scope of financial institutions subject to the framework requirements

Feedback received

A few respondents sought clarification on the scope of financial institutions subject to requirements of the Domestic Systemically Important Banks (D-SIB) framework. Comments included suggestions to –

a) Exclude small financial institutions from the framework given that small financial institutions are unlikely to be designated as D-SIBs;
b) Expand the scope of framework to include development financial institutions (DFIs) given DFIs may pose significant systemic risks to the domestic financial system; and
c) Exclude internationally-active financial institutions that are designated as global systemically important banks (G-SIB) from the framework. This is to minimise financial institutions having to maintain overlapping capital buffers for the 'same underlying risks'.

The Bank's view

1.1. The Bank acknowledges that size is a key determinant of systemic importance. As such, the Bank has decided to limit the scope of D-SIB framework to financial institutions with total consolidated assets equal to or exceeding RM30 billion.

1.2. The Bank also notes respondents' reasoning that large DFIs may pose significant systemic risks to the financial system, regardless of the nature and scope of their mandated activities. As such, the framework shall be expanded to include DFIs with total consolidated assets equal to or exceeding RM30 billion.

1.3. The D-SIB framework takes a complementary perspective to the G-SIB framework whereby the reference system used for the assessment is the domestic financial system and economy. As such, the Bank views that the inclusion of internationally-active financial institutions in the D-SIB assessment remains appropriate.

2. Transparency of assessment methodology

Feedback received

Most respondents expressed preference for detailed disclosure on the assessment methodology, including weights of indicators used as part of the indicator-based measurement approach (IBA), financial institutions' individual IBA scores and the rationale for D-SIB designation. This will empower financial institutions to take proactive steps to manage their systemic importance and better facilitate business and capital planning.

Respondents also sought further information on the proposed supervisory overlay process to complement IBA. They also commented on the need to ensure consistency in the proposed supervisory overlay process.

The Bank's view

2.1. The Bank acknowledges the need for sufficient transparency on the D-SIB framework, particularly on the assessment methodology to ensure financial institutions are able to understand the drivers of their systemic importance and therefore to respond more effectively in line with the aim of the framework.

2.2. In line with this, the Bank shall provide further details on the assessment methodology, particularly the IBA category and indicator weights as well as the annual assessment timeline in the policy document.

2.3. The Bank shall also provide the information listed below on a bilateral basis to financial institutions upon completion of the annual assessment exercise -

a) financial institutions' individual scores;
b) the cut-off thresholds used for bucketing approach; and
c) rationale for designation as D-SIB, including considerations used as part of the supervisory overlay process (if any).

3. Public disclosure of list of D-SIBs

Feedback received

Respondents were generally agreeable for the public disclosure of designated D-SIBs, noting that this is consistent with international best practice.

However, most respondents highlighted the need to safeguard against potential adverse implications of publicly disclosing the name of D-SIBs through effective communication of the framework. On one hand, the disclosure may be misconstrued as D-SIBs being safer and enjoying Government support, giving an unfair advantage to D-SIBs over non-D-SIBs. On the other hand, designation may be viewed negatively by investors given the requirement for D-SIBs to maintain higher capital buffers, thereby affecting investment returns.

Some respondents also expressed concerns that public disclosure of list of D-SIBs may exacerbate market fragmentation and affect non-D-SIBs ability to raise funds in the interbank and capital markets.

The Bank's view

3.1. The Bank believes that the disclosure of designated D-SIBs is in the best interest of the market participants as it facilitates a thorough and detailed understanding of the systemic importance and risk profile of financial institutions. Disclosure is also intended to promote better market discipline among financial institutions in Malaysia. With this in mind, the Bank will be disclosing the names of the D-SIBs.

3.2. However, the Bank acknowledges respondents' concern on mis-information and the need for the framework to be clearly explained and effectively communicated. To this end, in addition to making the list of D-SIBs and framework available to public, a 'Frequently Asked Questions' document is also published to promote better understanding on the D-SIB framework and to address any potential misconceptions on the designation of financial institutions as D-SIBs.

4. Higher loss absorbency (HLA) requirement

Feedback received

A few respondents commented that the proposed level of HLA requirement appears low or moderate relative to other jurisdictions.

Some respondents also sought clarification on –

a) instruments that could be used to meet the HLA requirement;
b) interaction of HLA requirement with other capital buffers; and
c) applicability of the HLA requirement to the D-SIB at the entity (solo) level.

The Bank's view

4.1. The HLA calibration for Malaysian D-SIBs had taken into consideration (i) insights gathered from the quantitative Expected Impact Approach[1]; (ii) country-specific considerations in line with principles outlined by the BCBS and (iii) the levels of HLA prescribed by the BCBS for G-SIBs and the HLA prescribed by peer economies for D-SIBs in their jurisdiction. In particular, the calibration of the HLA requirement is supported by the historical loss experience of Malaysian financial institutions and is commensurate to the size of Malaysian financial institutions relative to the domestic economy.

4.2. The HLA requirement is only applicable to financial institutions designated as D-SIBs at the consolidated level. Nonetheless, the Bank may also impose the HLA requirement at the entity level, for example, when the Bank deems additional capital buffers held by the D-SIB on a consolidated basis is not reflective of the loss absorption capacity of entities registered in Malaysia. Financial institutions will be notified by the Bank if they are required to comply with the HLA requirement at the entity level.

4.3. As set out in paragraphs 10.3 and 10.4 of the policy document -
   a) a financial institution except for a prescribed development financial institution, that is designated as D-SIB, is required to meet the HLA requirement using CET 1 Capital instruments;
   b) a prescribed development financial institution designated as a D-SIB is required to meet the HLA requirement using Tier 1 Capital instruments, unless otherwise specified by the Bank.

4.4. For further information on the eligible instruments that qualify as CET 1 Capital or Tier 1 Capital instruments as well as the interaction of the HLA requirement with other capital requirements, please refer to the Bank's *Capital Adequacy Framework (Capital Components)*, *Capital Adequacy Framework for Islamic Banks (Capital Components) and Capital Framework for Development Financial Institutions.*

[1] For further details, refer to Annex 2 of BCBS, Global systemically important banks: revised assessment methodology and the higher loss absorbency requirement, July 2018 (https://www.bis.org/bcbs/publ/d445.htm).

5. Transitional arrangement for D-SIBs to comply with HLA requirement

Feedback received

Most respondents commented that the proposed 12-month transition period for D-SIBs to comply with higher HLA requirement is reasonable given the implementation does not overlap with any other capital requirements and financial institutions maintain sizeable capital buffers in excess of the minimum requirements.

Several respondents however proposed a longer transition period, particularly for the initial implementation of HLA requirement in line with the Basel Committee's G-SIB framework and other D-SIB frameworks internationally. This is intended to minimise the impact of higher capital requirement on financial institutions' operations and profitability levels amid the challenging economic environment. Few respondents commented that a longer period may be warranted citing the lengthy process involved in raising equity capital.

The Bank's view

5.1. The Bank has considered industry feedback on this issue and decided to maintain the 12-month transition period for D-SIBs to comply with the HLA requirement. This is in view of the level of capital buffers currently maintained by financial institutions in Malaysia.

5.2. The Bank also does not see the need for a transitional (or phase-in) arrangement similar to the G-SIB framework and other D-SIB frameworks internationally for financial institutions to comply with the HLA requirement. This accounts for the fact that the implementation of the HLA requirement does not overlap with any impending regulatory capital requirements on Malaysian financial institutions.

6. Assessment methodology – Suitability of indicators used under the IBA

a. General feedback

Feedback received

Some respondents commented that the indicators used for the assessment should measure financial institutions' domestic exposures rather than capturing financial institutions' consolidated exposures. This is because the focus of the D-SIB framework is primarily to assess systemic impact posed by financial institutions to the domestic financial system and economy.

Few respondents also suggested using additional indicators such as total investment accounts to capture Islamic banking business.

The Bank's view

- The measurement of financial institutions' group-wide consolidated exposures for the assessment of domestic systemic importance is cognisant of the contagion risk arising from intra-group interdependencies (e.g. operational, financial and reputational associations) among banking and non-banking entities within a financial group.

- The current indicators capture consolidated exposures of financial institutions, including activities and exposures of Islamic financial institutions within the financial group. As such, there is little merit to introduce indicators to additionally capture or distinguish Islamic banking business in assessing systemic importance.

b. Substitutability category

Feedback received

Some respondents suggested that additional indicators that reflect major financial services provided by financial institutions such as deposit-taking and lending, should be considered for the Substitutability assessment.

One respondent suggested the following indicators to be excluded from the IBA approach and assessed qualitatively –

a) 'Underwriting activity' due to small size of the domestic market; and
b) 'Assets under custody' as custodian service is highly substitutable and the distress or failure of the bank will not result in the loss of the underlying assets.

Some respondents queried if the score for the Substitutability category would be capped similar to the G-SIB framework.

The Bank's view

- The Bank notes feedback to capture indicators that reflect major financial services for the Substitutability category to further strengthen the robustness of the IBA. In light of this, the Bank has decided to include two additional indicators that can reflect the critical functions performed by Malaysian financial institutions, namely (i) total deposits accepted from non-financial institution customers and (ii) total loans extended to non-financial institution customers.

- The Bank will retain the 'Underwriting activity' and 'Assets under custody' indicators as they are intended to capture financial institutions' critical functions. The failure or discontinuance of such functions due to distress or failure of the financial institution could still lead to the disruption of services that are essential for the functioning of the real economy and financial stability.

- The cap for the Substitutability category was introduced in the G-SIB framework as data collected by the BCBS showed a highly skewed distribution that would have led to a greater impact on the overall G-SIB score than intended. Based on the analysis of Malaysian financial institutions' data received as part of the industry consultation, the Bank has not observed such a distribution that would disproportionately reduce the robustness of the proposed IBA framework. Hence, a financial institution's score for the Substitutability category will not be subject to a cap.

c. Assessment of financial institutions' complexity

Feedback received

Some respondents sought clarification on the lack of indicators to assess financial institutions' complexity under the proposed IBA. This recognises that the more complex a financial institution is, the greater the time, effort and cost required to resolve the financial institution thus increasing its systemic impact upon distress or failure. They proposed the inclusion of several indicators to assess financial institutions' complexity, including that arising from cross-jurisdictional activities thereby standardising the consideration of complexity in the computation of overall scores (i.e. assessment of systemic importance).

The Bank's view

- The Bank shares respondents' view that financial institutions' degree of complexity is an important consideration in assessing systemic importance. Nevertheless, the Bank has decided to assess complexity as part of the supervisory overlay process given (i) the multi-faceted nature of financial institutions' complexity; and (ii) the limited range of quantitative indicators currently available to reliably measure Malaysian financial institutions' complexity.

- The Bank however intends to revisit this decision as part of the periodic review of the assessment methodology and policy requirements applicable on D-SIBs to ensure the framework remains relevant on an on-going basis.

7. Assessment methodology – Indicator weights in computing financial institutions' IBA scores

Feedback received

Majority of respondents suggested applying differentiated weights to the indicators for the computation of IBA scores based on the relative importance of the indicators in reflecting financial institutions' degree of systemic importance.

Most respondents proposed higher weights to be applied to the Size category compared to other categories given large financial institutions are also typically more interconnected and less substitutable. Some respondents also suggested applying higher weights for Interconnectedness category.

The Bank's view

7.1. The Bank agrees with industry feedback to apply differentiated weights based on the relative importance of the IBA indicators in reflecting financial institutions' degree of systemic importance. Internal analyses conducted by the Bank also supports that size stands out as a key determinant of systemic importance for a less complex banking system in an emerging economy such as in Malaysia. In line with this, the Size category shall carry a higher weight.

8. Other requirements applicable on D-SIBs

Feedback received
Few respondents sought clarification on other requirements e.g. Recovery and Resolution Planning (RRP) and additional disclosures applicable to a D-SIB, aside from the HLA requirement.

The Bank's view

8.1. Currently, D-SIBs are only subjected to the HLA requirement. Nonetheless, the Bank has the discretion to subject D-SIBs to any additional prudential requirements as deemed necessary by the Bank. D-SIBs will be notified by the Bank if they are required to comply with other requirements.