Bank of Mauritius

Guideline for dealing with Domestic – Systemically Important Banks

June 2014

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Introduction

1. In November 2011, the Basel Committee on Banking Supervision (BCBS) issued rules on the methodology for assessing Global Systemically Important Banks (G-SIBs) and their loss absorbency requirements. Additional policy measures are warranted for systemically important banks as in maximising their private benefits, these institutions may choose outcomes without taking into account the potential negative externalities. These externalities include the impact of the failure of a large interconnected global financial institution on the real economy.

2. Although the externalities created by G-SIBs will be felt globally, the possibility of externalities being generated on the domestic front by a large bank cannot be overlooked. There are many banks that are not significant from an international perspective but, nevertheless, can have an important impact on the domestic financial system and economy compared to non-systemic institutions.

3. In recognition of the fact that many domestic banks can have systemic impact on the domestic economy because of their size, interconnectedness, complexity and lack of substitutability, it was considered appropriate to review ways to address the externalities posed by Domestic-Systemically Important Banks (D-SIBs). Against this backdrop, at their November 2011 meeting, the G-20 leaders asked the BCBS and the Financial Stability Board to work on modalities to extend the G-SIB framework to D-SIBs. D-SIBs are institutions whose failure will have spill-over effects on the financial system and will affect the real economy.

4. The BCBS issued a paper on "A framework for dealing with domestic systemically important banks" in October 2012. The D-SIB framework focuses on the impact that the distress or failure of banks will have on the domestic economy. As opposed to the G-SIB framework, the D-SIB framework is based on the assessment conducted by national authorities which are best placed to evaluate the impact of failure of the large banks on the local financial system and the local economy. National authorities have discretion in the identification of D-SIBs and in determining the additional loss absorbency requirements applicable to these financial institutions.

5. In line with international developments, the Bank of Mauritius (Bank) is issuing the Guideline for dealing with Domestic-Systemically Important Banks, which sets out the assessment methodology to be applied by the Bank for classifying an institution as being systemically important.

Objectives

6. The objectives of the guideline are:

   (i) to put in place a reference system for assessing the systemic importance of banks;

   (ii) to assess the systemic importance of banks along the lines of the reference system;

   (iii) to identify the potential systemically important banks; and

   (iv) to ensure that the systemically important banks have the capacity to absorb losses through higher capital.

Authority

7. This guideline is issued under the authority of Section 50 of the Bank of Mauritius Act 2004 and Section 100 of the Banking Act 2004.

Scope of Application

8. This guideline applies to all banks licensed by the Bank under the Banking Act 2004. Banks which are identified as systemically important will be subject to additional loss absorbency requirements.

Effective Date

9. This guideline shall come into effect on 30 June 2014.

Section 1: The proposed methodology

10. The Bank's methodology to assess D-SIBs starts with the four key indicators of systemic importance recommended by the BCBS: size, interconnectedness, substitutability/financial institution infrastructure and complexity.

11. The BCBS has developed 12 principles, categorised into two groups, to constitute the D-SIB framework. The first group (Principles 1 to 7) focusses mainly on the assessment methodology for D-SIBs while the second group (Principles 8 to 12) focusses on "Higher Loss Absorbency" (HLA) for D-SIBs.

12. Principle 2 of the framework recommends that all national authorities should undertake an assessment of the degree to which banks are systemically important in the domestic context. In line with this principle, the Bank has established a framework to identify D-SIBs in the banking sector and to require these banks to have the capacity to absorb losses through higher capital.

13. The systemic importance of all the banks will not be computed, as many smaller banks will be of lower systemic importance and their failure may not have a significant impact on the wider economy. The sample will, therefore, exclude the small banks. Once the list of potential systemically important banks has been finalised, the computation of their systemic importance will be initiated.

14. The banks having systemic importance above a threshold will be designated as D-SIBs. D-SIBs will be segregated into different buckets, based on their systemic importance scores, and will be subject to loss absorbency capital surcharge in a graded manner depending on the buckets in which they are placed. A D-SIB in lower bucket will attract lower capital charge while a D-SIB in higher bucket will attract higher capital charge.

15. The BCBS has suggested that the methodology for assessing capital surcharge for D-SIBs may be calibrated on the methodology it has developed to evaluate the capital surcharge for G-SIBs in its November 2011 paper entitled *the rules text on the assessment methodology for globally systemically important banks (G-SIBs) and their additional loss absorbency requirements*.

16. Basel III has recommended the imposition of a capital surcharge ranging from 1.0 per cent to 2.5 per cent on G-SIBs, depending on the degree of their systemic importance. An additional loss absorbency of 1.0 per cent can be applied to G-SIBs as a disincentive to increase materially their global systemic importance in the future.

Section 2: The indicators

17. Based on the methodology developed by the BCBS to identify G-SIBs, the Bank has chosen the indicator-based measurement approach to determine whether a bank is reckoned as a D-SIB. On the basis of the importance of a D-SIB, the level of capital surcharge to be applied will then be calibrated.

18. Only those banks whose total Segment A assets represent at least 3.5 per cent of the total GDP will be assessed.

19. Principle 5 recommends four parameters in the evaluation of D-SIBs, instead of the five used in the case of G-SIBs. The BCBS views that, among the five factors of the G-SIB framework, the parameters

    a. size,
    b. interconnectedness,
    c. substitutability/financial institution infrastructure, and
    d. structure and complexity

    are all relevant for D-SIBs as well. Cross-jurisdictional activity, the remaining category, may not be directly relevant since it measures the degree of global activity of a bank which is not the focus of D-SIB framework and, therefore, has not been taken on board.

20. In view of the specific characteristics of the Mauritian economy where banks have high exposures to large groups, a new category “Exposure to Large Groups” has been included as a fifth parameter.

21. An equal weight of 20 per cent has been assigned to each parameter. The extent of systemic relevance is expressed by a score that is given to a bank as the sum of its five scores in the five categories.

Table 1: Indicator-based measurement approach

Category	**Indicator weighting** *(Per cent)*
Size	20
Exposure to large groups	20
Interconnectedness	20
Substitutability/financial institutions infrastructure	20
Complexity	20

21.1 **Size:** The failure of a large bank is more likely to damage confidence in the banking system as a whole. The indicator takes into account both on- and off-balance sheet items as reported in the monthly statement of assets and liabilities.

21.2 **Exposure to Large Groups:** As there are many financial institutions which are exposed to the large groups to varying degree, it is important to take into account this factor in order to show the importance of the financial institution in the financing of large groups.

Large groups are defined as those groups/large corporates which have borrowed at least an aggregate amount of Rs2 billion, consisting of fund-based and non-fund based facilities, from financial institutions which include banks and non-banks deposit taking institutions. A list of the groups/large corporates has already been circulated to banks in February 2014.

21.3 **Interconnectedness:** The systemic impact of a bank depends on the degree of its interconnection with other banks. Interconnections operate on both sides of the balance sheet. The larger the number and size of the links, the higher the potential for systemic risk getting magnified. To measure this component, the following three indicators are considered:

a. Intra-financial system assets,
b. Intra financial system liabilities,
c. Total marketable securities issued by the bank.

a) Intra-financial system assets comprise the following:

i. lending to financial institutions (including undrawn committed lines),
ii. placements with financial institutions,
iii. holding of securities issued by other financial institutions,
iv. net mark-to-market[1] reverse repurchase agreements with other financial institutions,
v. net mark-to-market securities lending to financial institution, and
vi. net mark-to-market securities and over-the-counter (OTC) derivatives traded with other financial institutions.

b) Intra-financial system liabilities comprise the following:

i. deposits by other financial institutions (including undrawn committed lines),
ii. interbank borrowings,
iii. short-term and long-term borrowings from banks,
iv. securities issued by the bank that are owned by other financial institutions,
v. net mark-to-market repurchase agreements with other financial institutions,
vi. net mark-to-market securities borrowings from financial institutions, and
vii. net mark-to-market securities and over-the-counter (OTC) derivatives traded with other financial institutions.

c) The total marketable securities (or securities outstanding) issued by the bank comprise debt securities, commercial paper, certificate of deposit, and equity market capitalisation.

[1] *"Net mark-to-market" is the sum of the positive and negative mark-to-market values.*

21.4 **Substitutability/financial institution infrastructure:** The systemic importance of a bank is negatively related to the substitutability of its services. Banks may lack immediate substitutes for the banking activities and services they provide. They are systemically important because other financial market participants and customers rely on them for the provision of key services.

If an institution plays a dominant role in a specific business segment or as a provider of market infrastructure, it becomes difficult to find alternative suppliers of these services. Consequently, a failure of that bank will not only cause inconvenience to customers in seeking the same service from another institutions but also increase the degree of distress at other banks in terms of service gaps and reduced market liquidity. The following indicators are considered:

i. Assets under custody,
ii. Payments cleared and settled through payment systems over the last one year,
iii. Values of underwritten transactions in debt and equity markets over the last one year.

21.5 **Complexity:** Large and interconnected banks are likely to be of great concern when they are complex. Complexity is often associated with lack of transparency or visibility which leads to difficulty in understanding the exposures of a bank. The more complex a bank is, the greater the costs and time needed to resolve it in case of failure. The indicators that are being used are:

i. Size of assets valued using non-observable data (Level 3 assets),
ii. Holdings of trading and available for sale securities,
iii. Notional amount of OTC derivatives.

22. With the exception of the components 'Size' and 'Exposure to large groups' that will be assigned a weight of 20%, the weight of the remaining three components will be divided equally between the number of indicators each category will be made up of.

23. The score of the potential systemically important banks will be calculated each year based on their June figures. A format of the return detailing the information to be submitted to the Bank every year is provided at Annex 1. The return should reach the Bank by 15th August of each year.

24. The score for a particular indicator is calculated by dividing the amount for an individual bank by the aggregate amount summed up across all the banks being assessed. This score is then multiplied by the weight assigned to the indicator. This exercise is performed for each indicator and all the weighted scores are added. The sum of the weighted scores is then mapped to their corresponding bucket to determine the additional loss absorbency requirement.

25. As per Principle 9 of the BCBS framework, the Higher Loss Absorbency (HLA) requirement imposed on a bank should be commensurate with the degree of its importance. The objective is to encourage banks, which are subject to the HLA

requirement, to reduce their systemic importance over time and to reduce further the probability of their failure.

26. The magnitude of additional loss absorbency for the highest populated bucket is 2.5 per cent of risk-weighted assets at all times, with an initially empty top bucket of 3.5 per cent of risk-weighted assets. The magnitude of additional loss absorbency for the lowest bucket is 1.0 per cent of risk-weighted assets.

    Banks classified as D-SIBs will be subjected to additional Common Equity Tier 1 (CET1) capital requirement.

    Table 2 below shows the buckets which will determine the level of additional capital that a bank will have to maintain, based on the score it has obtained.

    Table 2: Bucketing approach

Bucket	**Score range**	**Minimum additional loss absorbency (common equity as a % of risk-weighted assets)** *(Per cent)*
5	Above …	3.5
4	…	2.5
3	…	2.0
2	…	1.5
1	…	1.0

    The score range will be calculated based on the information to be collected from banks. The additional loss absorbency requirement that will be calculated thereon will be effective as from 1 January 2016.

    The systemic importance score will be calibrated in such a manner that the bucket 5 will not have any bank initially. An empty bucket with higher CET1 requirement will incentivise D-SIBs with higher scores not to increase their systemic importance in future. In the event of the fifth bucket getting populated, an additional empty (sixth) bucket would be added with same range and same differential additional CET1.

    The score range will be reviewed every three years as from June 2014 such that the next review of the score range will be carried out in June 2017.

27. In line with the recommendations of the BCBS, it is expected that the additional loss absorbency requirement of D-SIBs will have to be met with Common Equity Tier 1 (as defined by the Basel III framework). This additional capital will be in the form of a surcharge for D-SIBs and will be included as a special category in the computation of the capital adequacy ratio under Basel III.

28. If a D-SIB breaches the additional loss absorbency requirement, it will be required to submit a plan to return to compliance over a timeframe to be established by the Bank. Until the D-SIB returns to compliance, it will be subject to the limitations on dividend pay-out and to other restrictions as may be required by the Bank.

29. If a D-SIB progresses to a bucket requiring a higher loss absorbency requirement, it will be required to meet the additional requirement within a timeframe of 12 months. After this grace period, if the bank does not meet the additional loss absorbency requirement, it will be subject to the limitations on dividend pay-out and to other restrictions as may be required by the Bank.

Section 3: Phase-in arrangements

30. The additional loss absorbency requirement would become effective as from 1 January 2016 and any capital surcharge required as from this date will be based on data as at 30 June 2014.

31. The higher capital requirements applicable to D-SIBs will be applicable from 1 January 2016 in a phased manner and would become fully effective from 1 January 2019. The phasing-in of additional common equity requirement will be as follows:

Bucket	**1st January 2016**	**1st January 2017**	**1st January 2018**	**1st January 2019**
	(Per cent)			
5 (Empty)				3.5
4	0.625	1.25	1.875	2.5
3	0.5	1.0	1.5	2.0
2	0.375	0.75	1.125	1.5
1	0.25	0.5	0.75	1.0

Section 4: Disclosures

32. The Bank will disclose the score range as well as the denominators for each category of indicators every year in November so that each bank is able to calculate its systemic importance score.

Bank of Mauritius
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Annex 1

Domestic - Systemically Important Banks
Statement as at:

		Segment A	Segment B	Total
		Rs	Rs	Rs
I	**Intra financial system assets**			
1	*Lending to financial institutions (including undrawn committed lines)*			
2	*Placements with financial institutions*			
3	*Holdings of securities issued by other financial institutions*			
4	*Net mark to market reverse repurchase agreements with other financial institutions*			
5	*Net mark to market securities lending to financial institutions*			
6	*Net mark to market OTC derivatives with financial institutions*			
II	**Intra-financial system liabilities**			
1	*Deposits by financial institutions (including undrawn committed lines)*			
2	*Interbank borrowings*			
3	*Short term and long term borrowing from banks*			
4	*Securities issued by the bank that are owned by other financial institutions*			
5	*Net mark to market repurchase agreements with other financial institutions*			
6	*Net mark to market securities borrowing from financial institutions*			
7	*Net mark to market securities and OTC derivatives traded with financial institutions*			
III	**Marketable securities issued by the bank (Securities Outstanding)**			
1	*Debt securities*			
2	*Commercial paper*			
3	*Certificate of deposit*			
4	*Equity market capitalisation*			
IV	**Assets under custody**			
V	**Payments cleared and settled through the payment systems in Mauritius over the last one year**			
VI	**Values of underwritten transactions in debt and equity markets**			
VII	**Level 3 assets**			
VIII	**Holdings of trading and available for sale securities**			
IX	**Notional amount of OTC Derivatives**			

Note: Figures should be reported only in the Rs row.