

Framework for Domestic Systemically Important Banks (D-SIBs)

STATE BANK OF PAKISTAN

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Framework for Domestic – Systemically Important Banks (D-SIBs)

1. Introduction

The need for enhanced supervisory focus on ‘Systemically Important Financial Institutions’ (SIFIs) gained attention in the wake of Global Financial Crisis of 2007-08. In November 2011, Basel Committee on Banking Supervision (BCBS) issued a ‘Global Systemically Important Financial Institutions (G-SIFIs) framework’ for enhancing the resilience of large financial institutions, active internationally. Later, in October 2012, the framework was extended to Domestic Systemically Important Banks (D-SIBs) with the realization that some banks might not be big enough to cause disruptions in the global economy but owing to their significant size and nature of business for domestic economy, their failure may jeopardize the overall financial stability of a country. Keeping in view the indicator based approach of BCBS and the local regulatory and supervisory requirements in perspective; State Bank of Pakistan (SBP) has developed following framework for designation and supervision of D-SIBs.

2. Objective and Scope

Objectives of this framework is to enhance resilience of the systemically important banks in Pakistan through strengthening the prevailing regulatory and supervisory regime for these banks. This framework applies to all banks regulated by the SBP.

3. Identification and Designation of D-SIBs:

3.1 Identification of Sample of D-SIBs:

Identification of sample of D-SIBs shall be made on the following quantitative and qualitative criteria:

3.1.1 Systemic Score Based Criteria: Banks having total exposure (as defined in Chapter#3 of BPRD Circular # 6 of 2013 dated August 15, 2013 as amended from time to time) greater than 3% of Pakistan’s GDP at market prices shall be included in the sample of D-SIBs. Total exposure as reported in the annual audited CAR statement will be used to measure the ratio.

3.1.2 Qualitative Criteria: The qualitative factors shall include the segment’s largest bank (e.g. Islamic banks etc.) and the bank(s) operating as subsidiary or branch of any G-SIFI.

3.1.3 SBP will identify sample D-SIBs, based on the above criteria.

3.2 Designation of D-SIBs: Designation of D-SIBs shall be made out of the pool of sample D-SIBs identified as per the criteria mentioned at 3.1 above. Designation shall be made on the basis of a composite systemic score designed in the light of indicator based approach as suggested by BCBS and structure of the banking system in Pakistan. This

composite systemic score shall be calculated based on following indicators as reported in annual financial statements and other related information:

Category	Weightage	Indicator
Size	45%	Total Exposure
Interconnectedness	25%	<ul style="list-style-type: none"> • Intra Financial System Assets & income earned thereon; • Intra Financial System Liabilities and expense incurred thereon; • Securities Outstanding
Substitutability	20%	<ul style="list-style-type: none"> • Payments activity; • Assets under custody; • Underwriting activity
Complexity	10%	<ul style="list-style-type: none"> • Trading and Available for Sale Securities which do not qualify as Level 1 and Level 2 assets for the purpose of Liquidity Coverage Ratio; • Level 3 Assets (i.e. assets fair valued using Level-3 inputs under IFRS-13); • Notional amount of OTC Derivatives

3.2.1 Size: Size of the financial institution is considered to be the most important measure. A bank's total exposure (*as defined in Chapter#3 of BPRD Circular # 6 of 2013 dated August 15, 2013*) has been taken as a measure of size to calculate systemic score.

3.2.2 Interconnectedness: Financial distress at one institution can raise the likelihood of distress at other institutions given the network of contractual obligations in which these firms operate. As such, higher interconnectedness with other banks may increase systemic importance of the bank(s). Interconnectedness operates on both sides of the balance sheet. Accordingly, this component is measured based on intra-financial system assets, intra-financial system liabilities, related income and expenses, and securities outstanding.

3.2.3 Substitutability: The default of a financial institution can inflict greater damage on the financial system and real economy if certain critical services provided by the bank cannot be easily replaced by other banks. Measures of substitutability include assets under custody, values of underwritten transactions and value of payments cleared and settled through payment system.

3.2.4 Complexity: Systemic impact of a bank's failure is expected to be positively related to its business, structural and operational complexity. The more complex a bank is, the greater will be the costs to resolve it. For the purpose of assessing complexity, notional value of OTC derivatives, Level 3 assets and held for trading and available for sale securities are considered.

4. Enhanced Regulatory and Supervisory Requirements for D-SIBs:

4.1 Higher Loss Absorbency capital surcharge:

4.1.1 Designated D-SIBs shall be required to meet Higher Loss Absorbency (HLA) capital surcharge in the form of additional Common Equity Tier 1 (CET1). This additional CET1 requirement will be as an extension of capital conservation buffer and will be applicable on solo and consolidated bases. This regulatory requirement follows bucketing approach, with level of capital surcharge increasing with the systemic importance of the bank as determined by the composite systemic score. The designated D-SIB graded in lower bucket based on composite systemic score will attract lower capital charge and a DSIB falling in higher bucket will attract higher charge.

4.1.2 The HLA capital surcharge for designated D-SIBs, based on the bucketing approach shall be as follows:

BUCKET	Additional CET1 Requirement
D	3.5%
C	2%
B	1.5%
A	1%

4.1.3 Bucketing criteria is based on four buckets with the top bucket indicating the highest systemic importance. The top bucket D will be kept empty. However, if systemic importance of any bank increases significantly based on the composite systemic score, another bucket may be added on the top with higher capital requirement.

4.1.4 A G-SIB's branch operations in Pakistan that are also designated as D-SIB (based on above bucketing approach) will be required to hold additional CET1 capital on its risk-weighted assets in Pakistan at the rate prescribed above or as applicable on the G-SIB, whichever is higher. If such branch of G-SIB is not designated as D-SIB in Pakistan, it will hold additional CET1 capital on its risk-weighted assets in Pakistan at the rate as applicable on the G-SIB. However, a locally incorporated subsidiary (bank) of a G-SIB that is not designated as D-SIB (as per above bucketing criteria), such subsidiary bank will not be required to hold the additional CET1 capital for systemic risk, as it will be treated as locally incorporated bank.

4.2 Enhanced Supervisory Requirements

4.2.1 All the banks identified in the sample of D-SIBs will be required to meet following enhanced supervisory requirements, except otherwise specifically mentioned:

- i. Prepare comprehensive risk appetite framework, which includes risk limits that the bank is willing to assume for achieving its strategic objectives and business plans. Additionally, the banks shall conduct macro stress tests/scenario analysis that commensurate with bank's size, complexity and business lines¹. Both the risk appetite framework and the macro stress testing results shall be incorporated in the Internal Capital Adequacy Assessment Process (ICAAP) document in the relevant sections. The D-SIBs shall submit the ICAAP statement to SBP on annual basis.

¹ For guidance, refer to BSD Circular No. 01 of 2012 dated 11-05-2012 i.e. Guidelines on Stress Testing

- ii. Prepare effective recovery plans that commensurate with size and complexity of the bank. The designated D-SIBs shall submit plans on annual basis; while, remaining banks identified in the sample of D-SIBs shall share these recovery plans, if specifically called by the SBP.
- iii. Enhanced supervisory engagement with bank's senior management and meeting with Board of Directors and Risk Committee.

4.2.2 In addition to above, SBP may specify enhanced regulatory and disclosure requirements for the D-SIBs from time to time.

5. Implementation:

5.1 SBP would select sample D-SIBs based on criteria stated in section 3.1 above and communicate identification to each sample D-SIBs by end May every year. Banks selected as sample of D-SIBs shall be required to meet enhanced supervisory requirements only, as prescribed in Section 4.2 by end March following year.

5.2 SBP would designate D-SIBs based on designation criteria mentioned in section 3.2 and announce designation of D-SIB(s) by end June every year. All the banks designated as D-SIBs shall meet enhanced regulatory and supervisory requirements as mentioned in Section 4 above by end March of following year. First such designation shall be announced by end June, 2018.

5.3 The D-SIBs falling short of Additional CET1 and enhanced CAR on the date of announcement shall withhold adequate earnings and submit BoD approved time bound capital plan to meet the requirements to the SBP within 2 months from the date of designation.

5.4 In case, the composite systemic score of the designated D-SIB remains below the cut off level in next year's assessment, it will remain in the same bucket for an observatory period of at least one year and shall continue to meet the higher regulatory and supervisory requirements as prescribed in Section 4 above.

5.5 Non-compliance with enhanced regulatory and supervisory requirements will attract punitive action under the relevant laws.

5.6 SBP may review the framework in the light of new developments both at domestic and international fronts.
