What are 'Too-Big-To-Fail' banks, and what makes Indian banks safe

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Experts have mentioned that recent events of collapse of a bank, similar to Silicon Valley Bank, is unlikely in India due to different balance sheet structure of Indian banks as well as protection measures including domestic systemically important banks (D-SIBs).

[ref: reuter]

Which banks are classified as D-SIBs?

The list of D-SIBs is as follows:

Bucket	Banks	Additional Common Equity Tier 1 requirement as a percentage of Risk Weighted Assets (RWAs)
5	-	1%
4	-	0.80%
3	State Bank of India	0.60%
2	-	0.40%
1	ICICI Bank, HDFC Bank	0.20%

[ref: economics time]

- They are also known as **Too big to fail banks.**

- Reasons for their **importance**:
    - Big size, cross- jurisdictional activities, complexity and lack of substitute
    - Banks whose assets exceed 2% of GDP are considered part of this group.
    - A different set of policy measures regarding systemic risks and moral hazard issues
- Under the **D-SIB framework** announced by RBI in 2014, RBI was required, **from 2015**, to disclose the **names of banks designated as D-SIBs**, and to place them in appropriate buckets depending upon their **Systemic Importance Scores (SISs).**
    - Depending on the bucket in which a D-SIB is placed, an additional common equity requirement is applicable to it.
- The additional Common Equity Tier 1 (CET1) requirement for D-SIBs became fully effective from April 1, 2019.
    - The additional CET1 requirement was in **addition to the capital conservation buffer**.
        - It means that these banks have to **earmark additional capital** and provisions **to safeguard their operations.**
- RBI has **classified SBI, ICICI Bank, and HDFC** Bank as D-SIBs.

Global D-SIBs

- **The Basel, Switzerland-based Financial Stability Board** (FSB), an **initiative of G20** nations, has identified, in consultation with the **Basel Committee on Banking Supervision (BCBS)** and Swiss national authorities, a list of **global systemically important banks (G-SIBs**).
    - There are **30 G-SIBs** currently, including JP Morgan, Citibank, HSBC, Bank of America, Bank of China, Barclays, BNP Paribas, Deutsche Bank, and Goldman Sachs.
    - **No Indian bank is on the list**.
- A **Global Systemically Important Bank (G-SIB) foreign bank** having branch presence in India has to maintain additional CET1 capital surcharge proportionate to its **Risk Weighted Assets (RWAs)** in India.

How does RBI select D-SIBs?

The RBI follows a **two-step process**:

- First, a **sample of banks** to be assessed for their systemic importance is decided.
    - All banks are not considered- many smaller banks would be of lower systemic importance, and burdening them with onerous data requirements on a regular basis may not be prudent.
- Banks are selected for computation of systemic **importance based on an analysis of their size** (based on Basel-III Leverage Ratio Exposure Measure) **as a percentage of GDP**.
    - Banks having a **size beyond 2% of GDP** will be selected in the sample.
    - Based on a range of indicators, a composite score of systemic importance is computed for each bank.
    - Banks that have a systemic importance above a certain threshold are designated as D-SIBs.
- Next, the D-SIBs are **segregated into buckets** based on their systemic importance scores, and subjected to a graded loss absorbency capital surcharge, depending on the buckets in which they are placed.
    - A D-SIB in the **lower bucket** will **attract a lower capital charge**, and a D-SIB in the

higher bucket will **attract a higher capital charge**.

Impact of failure of large banks

- Could cause **greater damage to the domestic real economy.**
- Could **damage confidence in the banking** system as a whole.
- Failure of one bank could potentially increase the probability of **impairment or failure of other banks** if there is a high **degree of interconnectedness** (contractual obligations) between them.
    - This **chain effect** operates on both sides of the balance sheet there may be interconnections on the funding side as well as the asset side.
    - The larger the number of linkages and size of individual exposures, the greater is the potential for the **systemic risk getting magnified**, which can lead to nervousness in the financial sector.
- The greater the role of a bank as a **service provider** in underlying market, the larger is the disruption it is likely to cause in terms of **range of services and infrastructure liquidity**.
- The **costs for customers** of a failed bank for the same service at another bank would be much higher if the failed bank had a **greater market share** in providing that particular service.

Why was it felt important to create SIBs?

- The 2008 crisis caused problems for large financial institutions, negatively affecting global financial system.
    - Thus, Government intervention was needed to ensure stability.
- The cost of public **sector intervention** required that future regulatory policies should aim at reducing the probability and the impact of the failure of SIBs.
- **In 2010, the FSB recommended** that all member countries should put in place a framework to reduce risks attributable to **Systemically Important Financial Institutions (SIFIs)** in their jurisdictions.
- SIBs are perceived as banks that are '**Too Big To Fail (TBTF)'**, due to which these banks enjoy certain advantages in the funding markets.
    - However, this perception creates an expectation of government support at times of distress, which encourages risk-taking, reduces market discipline, creates competitive distortions, and increases the probability of distress in the future.
- It is therefore felt that SIBs should be subjected to **additional policy measures** to guard against systemic risks and moral hazard issues.
- While the **Basel-III Norms** prescribe a **capital adequacy ratio (CAR**) of **8 %**, the **RBI has** mandated a **CAR of 9 % for scheduled commercial** banks and **12 % for public sector banks**.
    - **Basel norms** are the **international banking regulations** issued by the **Basel Committee on Banking Supervision**.
    - It focuses on the risks to banks and the financial system.
    - It is an effort to **coordinate banking regulations across the globe**, with the goal of strengthening the international banking system.

