FRAMEWORK FOR DOMESTIC SYSTEMICALLY IMPORTANT BANKS IN BRUNEI DARUSSALAM

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1.   INTRODUCTION

1.1   The experience of the Global Financial Crisis of 2007 – 2008 showed that the failure or impairment of a number of large and highly interconnected financial institutions can transmit severe shocks through the financial system which, in turn, can seriously affect the health of the real economy. These important, big, inter-connected and complex international financial institutions are called global systemically important financial institutions (G-SIFIs).

1.2   Supervisors and other relevant policy makers found limited policy options to address these serious problems affecting individual financial institutions from spreading and thereby adversely affecting financial stability. As a result, large governments' intervention was required in many jurisdictions to address the financial instability during the crisis. This public sector intervention involved huge financial and economic costs in the form of bailouts as well as a consequential increase in moral hazard problems. In view of this, regulatory policies need to aim at reducing the probability of failure of G-SIFIs and the impact of their failure. It is of utmost importance to employ additional and enhanced supervisory focus and measures for G-SIFIs in order to reduce the instability in the financial system arising out of the failure of G-SIFIs.

1.3   In November 2011, Basel Committee on Banking Supervision (BCBS) proposed an assessment methodology and regulatory and supervisory requirements including additional loss absorbency requirement for global systemically important banks (G-SIBs) that are active internationally for enhancing their resilience against instability.[1]

1.4   In October 2012, BCBS extended the above G-SIB assessment methodology framework to Domestic Systemically Important Banks (D-SIBs) as some banks may not be important and large enough to create shocks or disruptions in the global economy, but their failure can harm the overall financial stability of a

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[1] Subsequently, in July 2013, BCBS came up with an updated guideline on the assessment methodology and the magnitude of additional loss absorbency capital requirements applicable to these G-SIBs. Finally, in July 2018, BCBS issued a further revised framework for the assessment methodology for the "Global Systemically Important Banks (G-SIB)". The Basel Committee plans to undertake the next review of the above framework by 2021.

country due to their large size, importance and nature of business in the domestic economy.

1.5 In July 2013, Basel Committee on Banking Supervision (BCBS) issued an updated guideline on the assessment methodology and the magnitude of additional loss absorbency capital requirements applicable to Global Systemically Important Banks (G-SIB)". Finally in July 2018, BCBS issued a further revised framework for the assessment methodology for the G-SIB.

1.6 The BCBS developed twelve (12) sets of principles under the D-SIB framework which broadly classified into two groups:
- Group 1 consists of seven principles (Principles 1 to 7) that constitute the D-SIB framework for the assessment methodology,
- Group 2 consists of five principles (Principles 8 to 12) that constitute the D-SIB framework on "Higher Loss Absorbency (HLA)" for selected D-SIBs.

1.7 Based on the aforementioned twelve (12) principles and taking into consideration the unique characteristics of the economy and the financial sector of Brunei Darussalam, AMBD has developed a suitable, simple and tailor-made methodology for identifying D-SIBs and the policy measure that apply to D-SIBs.

1.8 The framework covers the following:
- Overview of the D-SIB framework;
- Methodology for assessing D-SIBs together with the indicators for assessment in the context of Brunei Darussalam; and
- Policy Measure to designated D-SIBs

2. OVERVIEW OF THE D-SIB FRAMEWORK

2.1 The main objective of developing a D-SIB framework is to identify and manage the risk posed by systemically important banks which may cause significant damage and spill over impacts to the financial system and the economy.

2.2 AMBD will assess locally-incorporated banks and branches of foreign banks in the scope of assessment as some of these foreign bank branches may pose systemic risk to the financial system and wider economy. The assessment of banks for identifying D-SIBs will be on a consolidated basis including all subsidiaries of banks to the extent possible depending on the availability of data. Subsidiaries of banks in Brunei Darussalam include companies licensed or regulated under the Finance Companies Act (Cap. 89), Insurance Order, 2006, Takaful Order, 2008 and Securities Markets Order, 2013 (the relevant laws).

3.   ASSESSMENT METHDOLOGY

3.1   BCBS has suggested an indicator-based measurement approach for the assessment of D-SIBs based on the four categories of systemic importance, namely size, interconnectedness, substitutability/financial institution infrastructure, and complexity.

3.2   According to Principle 1 of BCBS, national authorities are responsible for establishing their own methodology for assessing the degree to which banks are systemically important in their domestic context. BCBS also recommended that countries may consider additional or different criteria to the above four categories based on specific national conditions and characteristics of the country, particularly relevant country-specific factors.

3.3   AMBD included an additional category, namely "Domestic Sentiment"[2] or "Public Confidence" in addition to above four categories to emphasise the domestic relevance or public confidence of a bank in Brunei Darussalam

3.4   Following this, AMBD will adopt an indicator based approach based on the following factors:
   - size;
   - interconnectedness;
   - substitutability;
   - complexity; and
   - domestic sentiment.

3.5   **Size**

   3.5.1   When a bank's activities account for a large share of the domestic financial market, there is a higher likelihood that its distress or failure would damage the domestic economy and financial markets. Furthermore, the distress or failure of a large bank would also be more likely to damage confidence in the financial sector as a whole. Size is therefore, the most important measure of systemic importance. It is evident that the impact of the failure of a bank or its

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[2] Australia, China and Oman also use this additional indicator. This is further explained at paragraph 3.9 (3.9.1 – 3.9.2)

systemic importance on the economy should be measured with respect to the size of the economy, such as GDP.

3.5.2   The following indicator will be used to measure the size of a bank:

- ***Share of total banking assets (including its subsidiaries) to nominal GDP***

3.6   **Interconnectedness**

3.6.1   Banks operate in a network of contractual obligations wherein financial distress or failure at one bank can generate spill over or contagion effects and enhance the likelihood of distress at other banks and financial institutions. Banks with large and many direct and indirect linkages within the financial sector are, therefore, considered to be systemically important. The measure for interconnectedness should reflect the extent of a bank's linkages with other financial institutions.

3.6.2   The interbank market in Brunei Darussalam is limited. Therefore, the indicators for interconnectedness should cover other financial institutions as some banks have companies licensed or regulated under the relevant laws as their subsidiaries. It is important to measure the extent a bank is linked to other financial institutions in terms of capital, deposits, credit and placement.

3.6.3   The following indicators will be used to measure interconnectedness:

- ***Share of the amount (capital, placement, loans/financing, and deposits) due from domestic financial institutions; and***

- ***Share of the amount (capital, placement, loans/financing, and deposits) due to domestic financial institutions.***

Financial institutions include banks, finance companies, takaful /insurance companies and other institutions licensed or regulated by AMBD under the relevant laws.

3.7 **Substitutability**

3.7.1   When a bank has a large role as a market participant and/or service provider in the financial sector, the disruption or failure to provide services by that bank can cause large widespread disruption in the financial sector. At the same time, identifying a substitute bank or banks that can provide the same service in a timely manner will also be difficult and potentially costly. Lack of readily available substitutes or financial institution infrastructure can cause market disruptions.

3.7.2   Specialised or unique functions and products provided by some banks in Brunei Darussalam, including sophisticated payment and settlement systems could be difficult to substitute on a short notice. In addition, households in Brunei Darussalam depend significantly on banks for loans/financing such as personal loans/financing, automobile loans/financing and residential housing loans/financing. On the other hand, business credit is crucial for economic development, achieving non-oil and gas diversification strategy and job creation in Brunei Darussalam.

3.7.3   Hence given the critical importance of the above functions to the public and businesses, the following indicators are to measure substitutability:

- *Share of payments received and made;*

- *Share of resident household credit including finance company subsidiaries; and*

- *Share of domestic business credit including finance company subsidiaries.[3]*

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[3] Share of domestic business credit includes credit to Government entities, GLCs, private limited companies, multinational corporations & etc. Domestic business credits will also include FDI companies availing credit in Brunei.

3.8   **Complexity**

3.8.1   Complexity depends on a bank's business model, and legal and operational structure. For a complex bank, it is difficult to assess risks, harder to resolve, and costly to wind up. Large cross-border or cross-jurisdictional activities also increase the complexities in operations and resolution.

3.8.2   Due to the low level of intermediation in Brunei Darussalam, the loans/financing to deposit ratio has remained low and stagnant for the banking sector. Banks in Brunei Darussalam, therefore, invest a large portion of their excess liquidity in offshore placements and investments. It is to be noted that the larger the offshore placements and investments of a bank, the more difficult it is to recover and resolve in the case of insolvency.

3.8.3   The following indicator will be used for assessing complexity:

- *Share of offshore placements and investments including Takaful/insurance company subsidiaries*

3.9   **Domestic Sentiment**

3.9.1   Domestic sentiment measures the domestic relevance of a bank in terms of the economy and bank customers, particularly depositors. It reflects the public confidence in the banks and captures the public perception of the domestic impact of the failure of a bank. Once a large bank is at risk of failure, the more likely anxiety and worriedness about financial instability will spread over the whole nation, particularly for a small country like Brunei Darussalam with highly digitally connected bank customers. This may cause a systemic risk of bank runs to spread over the banking sector.

3.9.2   The following indicator will be used to measure domestic sentiment:

- *Share of resident household deposits including finance company subsidiaries*

3.10 **Quantitative Indicator-based Approach**

3.10.1   In order to identify D-SIBs in Brunei Darussalam, AMBD, as the financial institutions regulatory and supervisory authority needs to assign a weight for each of the above factors/indicators.

3.10.2   As per the Principal 5 of BCBS framework for D-SIBs, "National authorities should have national discretion as to the appropriate relative weights they place on these factors depending on national circumstances".

3.10.3   The size is considered to be the most important factor for the measure of systemic importance compared to the other four categories. In addition, the bigger the size of the bank in distress, the more difficult it is to quickly substitute the activities of this bank by other banks.

3.10.4   With respect to identifying D-SIBs, AMBD does not adopt the "equal weighting" approach used in the G-SIB framework of BCBS. AMBD instead assign a higher weighting[4] of 35% to the "size" indicator.

3.10.5   The next most important indicator for systemic importance is "domestic sentiment" or public confidence. AMBD assigns a weight of 20% for domestic sentiment as the sudden lack of public confidence can cause banks runs in a small, and open economy with highly digitally connected bank customers.

3.10.6   Consequently, the quantitative indicators for interconnectedness, substitutability and complexity are given an equal weight, with a weighting of 15% for each factor respectively.

3.10.7   The sub-indicators in each of the above five categories will be weighted equally.

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[4] Several countries including Australia, Hong Kong, China, India, Isle of Mann and Pakistan use higher weighting for the size indicator.

3.11 **Qualitative Assessment**

3.11.1 As any methodology of assessment based on quantitative indicators may not be fully accurate and precise, the ultimate decision for designating a bank as a D-SIB should be based on a qualitative assessment including regulatory and supervisory judgements. After identifying D-SIBs using the indicator based approach, the qualitative criteria will be applied to finalize the designation of D-SIBs.

3.11.2 The following factors can be considered in coming up with the qualitative assessment:

- Subsidiary and branch of a G-SIB or a D-SIB bank in other jurisdiction;
- Provision of unique or specialized services such as Islamic banking services;
- Jurisdictions and number of business units including ATMs in which the bank operates domestically and internationally;
- Ownership structure;
- Provision of credit to priority and important sectors including government;
- Role of banks in assisting money changer and remittance companies; and
- Interconnectedness of banks and subsidiaries in terms of sharing resources.

4.   POLICY MEASURE

4.1   Besides more intensive supervision, the designated D-SIB will be subject to appropriate policy measure which is the higher loss absorbency (HLA) requirements.

4.2   **HIGHER LOSS ABSORBENCY (HLA) REQUIREMENTS**

    4.2.1   The main objective of HLA is to make sure that D-SIBs possess a higher share of their balance sheets funded by financial instruments for enhancing the resilience of the institution as a going concern.

    4.2.2   The calibration of the HLA requirement for D-SIBs in Brunei Darussalam by AMBD will take into the following consideration:-

- The results of the indicator based approach;

- The degree of systemic importance of the D-SIB; and

- The level of HLA prescribed by the BCBS and peer jurisdiction for D-SIBs.

    4.2.3   A bank which have been designated as D-SIB by AMBD shall hold and maintain capital buffer to meet the HLA requirement as follows:

- At solo and consolidated level;
- In the form of Tier 1 capital[5]; and
- To be met above the minimum regulatory capital adequacy ratio of 10%.

For the purpose of this paragraph, the minimum regulatory capital adequacy ratio is as defined in Section 11 of the Banking Order, 2008 and Islamic Banking Order, 2008 and AMBD Notice No. BU/N-3/2017/38 and AMBD Notice No. BU BU/N-3/2017/39 – Maintenance of Capital Adequacy Ratio.

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[5] Part D, Paragraph 14, Page 10 of the Capital Adequacy Framework

4.2.4　　The HLA requirement applicable to designated D-SIB shall correspond to the following bucket:-

Table 1: HLA requirement for D-SIBs

Bucket	HLA requirement (as % of risk weighted assets)
4 (empty)	3.5%
3	2.5%
2	2.0%
1	1.5%

4.2.5　　Top bucket that is four (4) with additional capital requirements of 3.5% will be kept un-populated in order to disincentivise designated D-SIB in the highest populated bucket from becoming more systemic.

4.2.6　　AMBD will re-assess the HLA requirement **annually** depending on the designated D-SIB further increase in their systemic importance or cessation of its D-SIB status.

4.2.7　　Where a bank is required to comply with the HLA requirement, the requirement shall become applicable to such bank within 12 months upon notification by AMBD, unless otherwise specified by AMBD.

4.2.8　　The cessation of a D-SIB status for a bank shall become applicable immediately upon notification by AMBD, unless otherwise specified by AMBD.

5   **Periodic review of D-SIBs and D-SIB Framework**

5.1   Similar to the BCBS' G-SIB framework, AMBD will conduct an **annual assessment** of all banks to identify and designate D-SIBs taking into account changes in their systemic importance as a result of changes in their business parameters, risk profiles and business models as well as structural changes in the financial sector over time.

5.2   AMBD will review the D-SIB framework including assessment methodology for assessing the systemic importance of banks, identifying D-SIBs and policy measure at least **once in three years**. During the review, AMBD will examine the functionality of the framework during the last three years, any new developments by BCBS or major structural changes to the banking sector, conceptual developments internationally in the field of systemic risk measurement as well as the experience of similar countries in implementing the D-SIB framework and the change in their methodologies and practices.

<div align="right">**Annex 1**</div>

List of Indicator/ Factor Weightings for the D-SIB Assessment in Brunei Darussalam

Factors	Indicators	Indicator Weighting
Size	(a) Share of total banking assets (including its subsidiaries) to nominal GDP	**35%**
Interconnectedness	(a) Share of amount *(capital, placement, loans/financing, and deposits)* due from domestic financial institutions	7.5%
	(b) Share of amount *(capital, placement, loans/financing, and deposits)* due to domestic financial institutions	7.5% **Total: 15%**
Substitutability	(a) Share of payments received and made	5%
	(b) Share of resident household credit including finance company subsidiaries	5%
	(c) Share of domestic business credit including finance company subsidiaries[6]	5% **Total 15%**
Complexity	(a) Share of offshore placements and investments including Takaful/insurance company subsidiaries	**15%**
Domestic Sentiment	(a) Share of resident household deposits including finance company subsidiaries	**20%**

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[6] Share of domestic business credit includes credit to Government entities, GLCs, private limited companies, multinational corporations & etc. Domestic business credits will also include FDI companies availing credit in Brunei.