Basel Committee on Banking Supervision
Consultative Document: Strengthening the Resilience of the Banking Sector
Position Paper

The implementation of the Basel II capital requirements in 2008 was celebrated as the introduction of a sophisticated, risk-sensitive framework which will ensure the financial soundness of the whole banking system in the future. Today a new document with the title "Strengthening the Resilience of the Banking Sector" is intended to propose adequate additional measures in order to improve the quality of the banks' capital base, to strengthen the risk coverage of the capital framework and to introduce a leverage ratio.

Primarily, the introduction of a leverage ratio retained our attention as the Basel Committee sees this measure as a supplementary step to the existing Basel II risk-based requirements, i.e. its intention is to introduce a double layer of protection in using the financial sector as a shock absorber in a period of financial crisis or economic disruption. Simultaneously the objective is also to prevent the financial sector from transmitting risks to the broader economy.

The recourse to a leverage ratio as additional instrument to the existing risk sensitive framework is a surprise to us as the financial turmoil started with a subprime crisis in one of the very few countries which, beside Canada and Switzerland, was imposing such a leverage ratio to banks located on its territory.

We feel that the obligation for banks to be subjected to a leverage ratio of binding nature is raising various questions and issues that would lead worldwide to fundamental and structural changes of the present financial landscape.

Given that the Basel II requirements have not yet been implemented on a global scale it would impose on banks already subject to the Basel II rules additional constraints and penalise these banks further as the present situation is far away from a level playing field. For instance, we understand that the Basel II rules will be introduced in the USA only in 2011 and be limited to the 20 biggest banks of the country. Simultaneously, the figures taken into account to calculate the ratio would be heterogenous as accounting rules differ substantially between Europe and North America, and more precisely between IFRS and US-GAAP. This decision would once again be detrimental to European banks and would decisively help to increase the gap existing in worldwide lead tables where banks located in Asia already took the lead although their regulative oversight and operational rules are not of the most transparent nature.

A substantial concern is the resort to gross figures while risk-weighted figures are key in the philosophy of Basel II. This parallel consideration of gross figures and weighted figures will trigger various consequences and competitive distortions on a global scale. For instance, banks involved in activities such as granting home loans or lending to public sector entities, that were judged under Basel II to be activities with low risk character and modest weightings, will no longer benefit from these advantages and be treated in a way similar to credit institutions engaging in a more speculative business or in trading activities. The entire business model of the specialised lenders will be in danger.

Credit institutions involved in a sound and "on balance sheet" activity like residential property lending or the financing of regional or local authorities will not be able – should the leverage ratio impose a cap on their future business expansion – to arbitrage between various business lines as a fully fledged banking group would do. Their range of activities is very often restricted by law or by their by-laws to a narrow range of products with the consequence that their structure is more transparent and less complex than a fully fledged international bank. This makes the job of supervisory authorities much easier. A leverage ratio leads to a situation where the specialised bank is penalised.

Furthermore the activities of specialised banks involved in property lending or public sector financing are of an extreme relevance to the economy of the country in which they are located. In all countries of the world the access to his own home is ranking first under the priorities of every citizen. Due to the lower inflow of tax revenues, the financial needs of public borrowers such as States, local or regional authorities have increased substantially. They will depend more than in past years on lenders prepared to extend loans to them and to support them in a time of declining tax revenues. A leverage ratio will impose additional constraints on them and restrict their capacity to lend, especially in a post crisis time when the demand for new loans is high and necessary for a restart of the economy.

Many specialised banks are funding themselves via covered bonds. They are obliged therefore to keep the funded assets and loans on their balance sheet to build up the collateral pool which will guarantee the repayment of the covered bonds they issue and place with investors. Therefore they are not enjoying the flexibility of universal banks in terms of transferability of their assets out of their balance sheet, for instance in using systematically securitisation vehicles or in setting up so-called SIV's out of the consolidation scope of their company.

Another concern on our side is due to the intention of the Basel Committee to include the OTC derivatives under the total exposure figure that will serve as a reference amount for the leverage ratio. Indeed, a bank specialised in property lending or public finance does not use derivatives as a product offered to customers as part of its product range or for trading reasons but exclusively to hedge some of its assets. Very often it is even prohibited to them by law to engage in derivative business unless they use these instruments exclusively to ensure a matching between the assets and the liabilities on their balance sheet, in terms of interest rates and/or currencies. This is particularly obvious when covered bonds are used as funding instruments.

Also we consider critical the bank's subjection to a capital charge for mark-to-market losses in association with an additional charge linked to an eventual deterioration of a counterparty creditworthiness. On one hand it will lead to a systematic preference for counterparties with a standing high enough to exclude substantial downside risks, a move that would automatically lead to a 2-Tier banking landscape. On the other hand, a permanent calculation and adjustment of the equity cover will be needed, which is a cumbersome and difficult administrative exercise for the bank's management as it cannot have a full command or control over external factors, like the expected evolution of the financial state of its relevant counterparties. Stability instead of volatility is needed.

We are also of the opinion that only calculations based on consolidated figures would make sense.

With regard to the measure of the derivatives exposures we feel that preference should be given to the Basel II current credit exposure methodology. A methodology that does not take bilateral contractual netting agreements into account would simply disregard the strategy followed regarding the choice of counterparts in bilateral arrangements and the methodology followed when a bank tends to minimise its counterparty risks. Furthermore, we understand that netting is systematically taking place under US-GAAP.

Conclusions

We feel that the introduction of an non-risk based leverage ratio cannot be the answer to contain a future build-up of excessive leverage in the banking system. We see the implementation of a non-risk related leverage ratio as very critical as it will impact all assets in an undifferentiated way, be it assets with speculative character or be it activities that contribute to the smooth functioning of an advanced liberal economy. Basel II with its risk-sensitive requirements cannot interrelate in a consistent way with a set of parameters based on gross figures.

- In any case we suggest strongly to adjust the figures representative of the exposures (1) and the own funds (2) under the leverage ratio in the following way:

  (1) High quality liquid assets as well as assets resulting from low risk activities should be deducted from the exposure figures;

  (2) The role of covered bonds as stable funding source of many banks in various countries deserves a closer consideration. Various supportive statements by prestigious financial personalities and the recent 60 billion € purchase program of the European Central Bank were the confirmations that this instrument ensures a funding with a high degree of stability for the issuers. It should be noted that for covered bonds acceleration clauses are contractually or legally prohibited and that they are traded on well structured markets. No covered bond defaulted up yet.

In view of these remarkable features we recommend to add covered bonds issued by a bank to its equity figures as reference magnitude for the leverage ratio. It looks consistent to us to take as reference for the leverage ratio figures that are not exclusively linked to loss absorbing capacities (i.e. equity) but primarily to funding permanency, as the developments during the recent crisis have demonstrated that a solid and reliable funding base would have avoided liquidity shortages and situations where banks were obliged to tap liquidity facilities made available by Central Banks in an emergency move.

- Also bilateral contractual netting agreements should be taken into account

The recourse to a – non-risk related – leverage ratio can certainly be used as a useful indicator by supervision authorities to assess the degree of leverage of a credit institution. Different levels of leverage could be imposed on banks with a specific calibration adapted to their business model. But the levels would only be indicative guidelines. Should these levels been hit so will the supervisor react and question the credibility of the strategic targets of the bank in a common meeting.

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