Association des Banques et Banquiers, Luxembourg
The Luxembourg Bankers' Association
Luxemburger Bankenvereinigung

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Response to the Basel Committee's Consultative Document "Strengthening the Resilience of the Banking Sector"

1. Introduction

The Luxembourg Bankers' Association (the ABBL) welcomes the opportunity to comment the Basel Committee consultative document "Strengthening the Resilience of the Banking Sector".

Our comments focus on the proposal introducing a leverage ratio described in paragraphs 202 to 238 of the consultative document.

2. Background

Any measure of leverage does not say anything about the level of risk incurred by a bank, whether market, credit or liquidity risks. In our view, **what is relevant is not the leverage as such, but rather the risks that are leveraged** by a bank. Hence, a leveraged portfolio composed of non-risky assets may well be less risky than a non-leveraged portfolio composed of risky assets.

If it were implemented as a binding "Pillar 1" limit, the leverage ratio would equally hit banks that leverage risky and/or illiquid assets (investment banks for example) and those leveraging non-risky and liquid asset. The Luxembourg banks belong to the latter category, because they are mostly involved in retail, private banking, asset management, custodian and also Covered Bonds activities.

Having said that, we understand the concerns of the regulatory community concerning the level of leverage in the financial sector. It is true that **the leverage amplifies the effects of risk** and increases the systemic vulnerability arising from the (risky) leveraged positions.

In that regard, the crisis has highlighted some loopholes in the banking regulatory framework coupled with incentives in favour of regulatory arbitrage, mainly:

- Some **risky and illiquid** products were not charged the right capital requirement by the Basel 2 framework because they were booked in the trading book instead of the banking book

- The liquidity risk framework failed to capture the big **maturity mismatches relying on excessive wholesale funding**

Leverage therefore amplified the impacts of such risky behaviours. Conversely, leverage remained neutral for banks active in conservative and well-diversified businesses.

The ABBL long standing position is that the current prudential framework must be improved by defining more severe rules for risky and speculative activities and by prohibiting any kind of regulatory arbitrage. The new Basel framework proposed for the trading book and for the liquidity rules, if properly calibrated, will reduce such risks. By addressing the roots of the problem, they will undoubtedly mitigate the potential effects of the leverage.

3. Proposed approach

Any form of leverage ratio should fulfil the following conditions:

- To be neutral versus the existing business models
- To prevent any regulatory arbitrage
- To be measured with reliable and comparable data, be they extracted from the prudential or from the accounting frameworks. In this area, we are in favour of applying:

  (i) The Basel II netting rules where applicable (for repurchase agreements, derivatives, etc.)
  (ii) The credit conversion factors set out in the Basel II Standardised Approach for the off-balance sheet items (excluding derivatives)

A leverage ratio should not be a static and binding floor likely to unduly interfere in the business models of banks. We think that a « traffic light approach » would make more sense in terms of supervisory efficiency. Under this approach, the leverage ratio should be rather a key risk indicator triggering a closer supervisory monitoring and potential remedial actions.

For that reason, we call for a leverage ratio under the form of a **Pillar 2 measure** taking into account the specificities of the banks' activities: there is indeed no point in comparing the leverage of an investment bank with that of a retail bank or of a Covered Bonds issuing bank, for example.

4. Illustration of the approach

The leverage ratio can be calibrated as a range of values from 2% and 4% (figures are given for illustrative purposes only). As long as the ratio is bigger than 4%, the bank is in a « green area ». If the ratio falls below 4%, then the bank enters into the « orange area », and a supervisory action is required. Such an action should first consist in understanding, by means of dialogue with the bank's senior management, the reasons of the ratio's evolution and its potential implications on the bank's financial soundness. Depending on the outcome of the dialogue, corrective measures like deleveraging may be (or not) imposed to the bank, taking into account its specific situation and business model. If the ratio falls below 2%, then the bank is in a « red area » triggering a more intrusive supervisory oversight.

In the EU, a similar mechanism already exists in the Capital Requirements Directive. In relation to non trading activities, the Directive 2006/48/EC requires under Article 124(5) that measures shall be taken by supervisory authorities in cases where an institution's economic value declines by more than 20% of own funds as a result of a standard shock (see also the CEBS guideline of October 3, 2006 on the interest rate risk in the banking book). The spirit of this provision could be transposed to the leverage ratio.

5. Scope of the leverage ratio

For cross border banks, the scope of the leverage ratio should be primarily the consolidated level. Some analysis at the solo level should not be excluded, provided they are justified, concerted and agreed within the college of supervisors.

6. Interaction with the new liquidity rules

6.1 Interaction with the Liquidity Coverage Ratio (the LCR)

The LCR defines a range of high quality and liquid assets banks must hold in order to cover the net cash outflows over a 30-day time period. Fulfilling this new requirement will inflate the banks' balance sheet, impacting negatively the leverage ratio: for that reason, we suggest to exclude the high quality and liquid assets from the calculation of the exposures.

6.2 Interaction with the Net Stable Funding Ratio (the NSFR)

There is a clear interconnection between the leverage ratio and the new concept of Available Stable Funding required by the NSFR.

Indeed, the roots of the crisis proved to be mainly the **liquidity risk issues** of some banks**,** i.e. excessive maturity transformation linked to insufficient stable funding, **amplified** by a high level of leverage.

Against this background, the current definition of the numerator (the Tier 1 capital) seems to us too restrictive. On the one hand, by focusing on the banks' loss-absorbency capacity, it does not capture this liquidity risk component. On the other hand, the Tier 1 capital definition does not reflect in a comprehensive manner "the required permanence on a going concern basis" of the banks' resources stated in paragraph 208 of the consultative document. Therefore, we think that there is a strong case **to extend the numerator's definition of the leverage ratio to the Available Stable Funding** calibrated by the NSFR.

The proposed NSFR aims at promoting more medium and long-term funding of the assets and activities of banks. Stable funding is defined as "those types and amounts of equity and liability financing expected to be reliable sources of funds over a one-year time horizon under conditions of extended stress", i.e.:

- Capital
- Preferred stocks
- Liabilities with effective maturities of one year or greater
- The portion of "stable" non-maturity deposits and/or term deposits

In order to capture the liquidity risk component and to better reflect the permanence of resources, we suggest measuring the leverage ratio as the ratio between the Available Stable Funding and the exposures. Our proposal would have the following benefits:

- It would give to regulators a more accurate view of the economic leverage incurred by banks

- It would preserve the basics of the leverage ratio: simplicity, easy implementation, comparability

- It would ensure a consistency between the measure of leverage and of liquidity risk

- It would introduce an incentive for banks to rely on stable funding, to the benefit of financial stability

- It would solve a main shortcoming of the proposed leverage ratio, which would, as such, unduly penalise banks active in prudent businesses refinanced by stable funding.

7. The macro-prudential view

The leverage ratio should also be a **macro-prudential risk indicator** for assessing the systemic risk in the whole financial sector. We believe that this macro-prudential analysis of the leverage should complement the analysis at the level of individual banks, which is proposed in the consultative document. In order to get a complete view of the leverage in the financial sector, the leverage of non-banking entities should therefore be captured and monitored.

In our views, the systemic regulators should focus on:

- The main contributors to the overall leverage in the financial sector, declined by type of institution and by type of activity (investment banking, retail banking, financial markets, etc.)

- The types of leverage: direct leverage in the balance sheets' institutions versus indirect leverage embedded in financial structures

- The dynamics of the leverage: analysing the evolution of the ratios would better indicate the potential areas of systemic concern rather than the pure monitoring of absolute levels

- The risks of the assets being leveraged in order to have an accurate assessment of the leverage's potential damage on the financial sector: **ultimately, the analysis of leverage cannot be dissociated from the analysis of risk.**

Regarding ABBL:
The Luxembourg Bankers' Association (ABBL) is the professional organisation representing the majority of banks and other financial intermediaries established in Luxembourg. Its purpose lies in defending and fostering the professional interests of its members. As such, it acts as the voice of the whole sector on various matters in both national and international organisations.

The ABBL counts amongst its members universal banks, covered bonds issuing banks, public banks, other professionals of the financial sector (PSF), financial service providers and ancillary service providers to the financial industry.

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