

# BNP Paribas' comments regarding the BCBS' consultation on revised Basel 3 leverage ratio framework and disclosure requirements

## General Comments

- BNP Paribas welcomes the opportunity to provide comments on the BCBS consultation related to the Basel 3 leverage ratio. We have some questions regarding the timing of the revision of the framework which does not seem most appropriate. Indeed, both the EU and the US have now translated the Basel 3 Accord in legal texts. We consider it would have been more beneficial for both the industry and the supervisors to await the full implementation of the initial Basel 3 Accord and to observe the first monitoring results instead of amending it prematurely. In the same vein, we stress that the leverage ratio should remain unchanged at 3% of Tier 1 capital.
- A leverage ratio is by essence meant to be a quite simple, non risk based metric. While we share the need to ensure an internationally harmonized standard, it seems contradictory to try to refine or amend it so quickly after the Basel 3 Accord. We recommend the BCBS to put most effort and focus on the enhancement of the risk based solvency ratio fully preserving the risk-based character of the ratio. Indeed, the objective of the Basel 3 Accord was to provide a more effective framework, based on 3 complementary metrics (risk based capital ratio, liquidity ratio and leverage ratio). We believe those 3 metrics should each keep their respective nature and purpose. Hence, we believe it would not be appropriate to introduce in the risk based solvency capital ratio all kind of floors and arbitrary parameters.
- First and most importantly, we fear that the proposed changes would fundamentally modify the capital regulatory framework applicable to banks. This consultation includes very significant changes in the calculation of the denominator of the leverage ratio, i.e. the exposure measure. In the Basel 3 Accord, the leverage ratio was inserted as a backstop measure to risk-based capital ratios. Our preliminary impact assessment shows however that, as a consequence of the significant increase of the denominator proposed by this framework, the leverage ratio would become the binding driver of regulatory capital and no longer the safety net measure as it is supposed to be. Putting into place a leverage ratio more binding than the risk sensitive regulatory capital ratio would be contradictory with the long standing principle of the Basel Accord and incentivise firms to shift to the riskiest assets. We urge the BCBS to adjust the proposed rules keeping avoiding the whole banking industry from reverting several decades backwards to a Basel 0 status.
- Second, this new version of the leverage ratio would introduce incentives in the regulatory framework that are not consistent with other major regulations such as derivatives and large exposure. This would induce unintended consequences in terms of risk management within the financial system. In particular, the on-going reforms on derivatives markets agreed at G20 level are imposing higher standards in terms of collateralization of derivatives transactions. The changes proposed by the BCBS would not recognize any value to this collateral and create reverse incentives to the ones provided in derivatives' regulations. It would also introduce a penalizing treatment of exposures to central counterparties, which would

disincentivize the central clearing and bring severe inconsistencies into the regulatory framework applicable to banks. All in all, we contest BCBS' view that these changes would improve banks' risk-management.

- Third, we would like to draw BCBS' attention to the impact of its proposals on the financing of the real economy. As a reminder, the repo markets are essential to the financing of many economic players. They are widely used to refinance stocks of public debt securities. They also enable companies to actively manage excess cash in a secure manner. The treatment of repo markets included in the BCBS proposal would have a severe impact on sovereign and corporates funding, which could hamper the recent slow economic recovery. On top, BNP Paribas is concerned that these negative economic impacts would particularly hit the European economy given its structural specificities. Indeed, the financing of the economy in Europe is for the largest part intermediated by banks while corporate securities markets are much more developed in the US giving clients direct access to markets financing<sup>a</sup>. Moreover, a significant part of the mortgages in the US are transferred to the Government-Sponsored Enterprises (GSEs)<sup>b</sup>. Overall this entails that European banks endure a comparatively heavier weight of leverage from financing the economy than the US banks and therefore a higher capital charge to comply with the leverage ratio. If the leverage ratio moves from a backstop to the binding driver of banks' capital management, it will constrain banks' balance sheet capacity to finance the European economy leading to a huge competitive disadvantage for Europe.
- In our detailed comments we drill into the main technical issues regarding the proposed exposure measure, i.e. the treatment of Securities Financing Transaction (SFT) exposures, the collaterals and the written credit derivatives. Overall, the proposed treatment would disproportionately increase the capital required to sustain essential banking activities in compliance with the leverage ratio and potentially make them unviable.
- Therefore, we urge the BCBS to allow netting of the SFTs and derivatives exposures under the condition they are legally enforceable by the relevant contracts. This measure is consistent with the provisions of IFRS 7 §13C(e) and US GAAP topic 210-20-50-3(e). These accounting standards have been developed by the standard setters in order to introduce the disclosure by the entities operating under different accounting frameworks of information that would be directly comparable with a consistent level of netting of the transactions concerned. This caters for BCBS' goal to neutralise the difference in accounting regimes for the level playing field purposes, without unreasonably and artificially inflating the exposures. Moreover, the adoption of the approach as proposed, coherent with IFRS 7 §13C(e) and US GAAP 210-10-50-3(e) would facilitate the market participants' understanding of the leverage ratio and the assets disclosed in the annual reports of the banks regardless of the accounting divergence. Hence, it would significantly improve the market transparency.

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<sup>a</sup> According to "Why Basel III and Solvency II Will Hurt Corporate Borrowing In Europe More Than In The U.S." published by Standard & Poors, at €2.2 trillion, the corporate Eurobond market was only about one-half the size of its U.S. equivalent of €4.5 trillion at the end of 2010.

<sup>b</sup> According to a Federal Reserves' study in 2009, about 20% of the US total credit market instruments held in financial sector accounts for GSE and GSE-backed pools.

## Detailed Comments

- SFTs

- The treatment proposed by the BCBS for repos, reverse repos and other securities financing transactions (SFTs) would result in those instruments being included in the exposure measure for an amount *higher* than their accounting value, which is unjustified and inappropriate. According to this consultative document, SFT exposures should be measured by adding gross accounting assets and a measure of counterparty credit risk calculated as the sum of positive and negative haircuts within the same netting agreement (with a floor at 0). Gross accounting assets correspond to the cash legs of reverse repos and security borrowing transactions, i.e. to the financing element inherent to those transactions (rightly pointed out in paragraph 34 of the consultation). Under the BCBS proposal, no netting would be allowed against the security leg of the same transactions, nor between reverse repos and security borrowing transactions on the asset side of the balance sheet and repos and security lending transactions on the liability side of the balance sheet; from that perspective, reverse repos and security borrowing transactions would receive the same treatment as unsecured financing despite their highly secured nature. To make things even worse, counterparty credit risk would be added, resulting in the SFT exposures exceeding not only their book value and the amount of financing extended through those transactions, but also the exposure measure of an unsecured loan of the same cash amount. Put it differently, gross exposure (as measured by gross accounting assets) and net exposure (measured by credit counterparty risk, as defined above) would be wrongly added, whereas only the latter is relevant.
- The examples provided in the Appendix 1 attached to this letter illustrate the above and show how the exposure measure would exceed the book value of SFTs. In example 4, where a bank enters into a reverse repo with a counterparty and a repo with the same counterparty (both transactions subject to the same legally enforceable netting agreement), the exposure measure would reach 102, whereas the balance sheet would increase by only 100 and the net 'economic' exposure would be only 2. Against the BCBS' very intention to provide the most appropriate measure of the activity, the proposed framework completely overstates the economic value of the SFTs.
- This very severe treatment would create significant additional capital requirements for banks in order to comply with the 3% leverage ratio. As a consequence, repo activities would potentially become unviable for banks hence forcing banks to tremendously reduce these activities.
- The BCBS seems to address its concern around shadow banking by introducing this punitive measure of SFTs into the banks' leverage ratio. We believe it would be more appropriate to deal with this topic directly through addressing shadow banking rather than indirectly via the banks' leverage ratio.
- We emphasize the useful role repo markets play in financing the real economy. Primary securities issuing activity is very useful for the economy, but the secondary market transactions through SFTs are as essential to supply liquidity to finance the economy. They are widely used to refinance stocks of public debt securities: in Europe about 80% of repo markets are against government debt collateral. They also enable companies to actively manage excess cash in a secure manner.

- In the context of the current discussions in Europe regarding a Financial Transaction Tax, Debt Management Office and Central Bankers have very clearly expressed the useful role of repo markets in terms of financial stability and financing the economy (cf. Appendix 2).
- The most important unintended consequences of the BCBS proposals are the following :
  - Economic players relying on repo markets (banks, sovereigns, corporates) would suffer rising funding costs due to the loss of liquidity in the securities markets financed through repos;
  - Especially the sovereign markets would suffer from severe disruptions as the sovereign bond market is mostly supplied by repo transactions;
  - A less efficient transmission of the central banks' monetary policy by discouraging banks to take on these collateralised transactions with other players;
  - A sharp increase in price for repos due to liquidity premium for both banks and corporates. The latter usually use repos to manage their cash balances;
  - A disastrous knock-on effect on corporate debt financing. Lots of corporates finance their activities by issuing debt. The liquidity of this primary market is ensured by banks through SFTs on the secondary market. The punitive rule of SFT in the leverage ratio will therefore seriously undermine the financing capacity of corporates by drying out the liquidity supplied into the debt market by SFTs.
- An appropriate SFT measure should recognise the highly secured nature of those transactions and allow for netting so that they are treated more favourably than unsecured financing transactions carrying more risks for banks and the financial system.

- **Collaterals**

- The consultative document states that “derivatives create two types of exposure: (a) an exposure arising from the underlying of the contract and (b) a counterparty credit risk exposure”, and proposes a framework to capture both of them: derivatives exposures should be calculated as the replacement cost plus an add-on for potential future exposure, taking into account bilateral netting when applicable. It means that within the same netting set, negative PVs (on the liability side of the balance sheet) would offset positive PVs (on the asset side of the balance sheet), and only the net amount (if positive) would be included in the denominator of the leverage ratio. However, under the current proposal, collateral received would not be allowed to be netted against derivatives, resulting in collateralised and uncollateralised exposures being treated the same way for the purpose of the leverage ratio. The risk-reducing effect of collateral would purely and simply be ignored, based on the assumption that collateral would create leverage (“the bank can use the collateral to leverage itself”).
- We strongly dispute that view and believe, on the contrary, that the exchange of collateral eliminates, or reduces, leverage within the banking system. Leverage would be created in the situation where counterparties would not exchange collateral and would build up exposure to each other, as market parameters evolve: in the absence of any collateral exchange, a transaction or a set of transactions entered into between counterparty A and counterparty B with an initial PV of zero would put A in a situation similar to that of a creditor of B assuming the PV of the trades becomes positive for A. The very purpose of variation margins is to avoid the building-up of such credit counterparty exposures, and, in the example above, to allow A to receive immediately from B the cash value of the variation of the PV, i.e. to lock in its gain

without bearing the risk of a default of B. The same economic objective would be achieved if the counterparties had agreed at inception to modify periodically the terms of the transactions in order to reset their PV at zero, thereby eliminating exposure, or if they agreed the same during the life of the trades. Such resets would be reflected in the PV of the derivatives themselves, reducing the derivatives exposures for the purpose of the leverage ratio. There is absolutely no reason why the treatment of the exchange of collateral should end up in a different result.

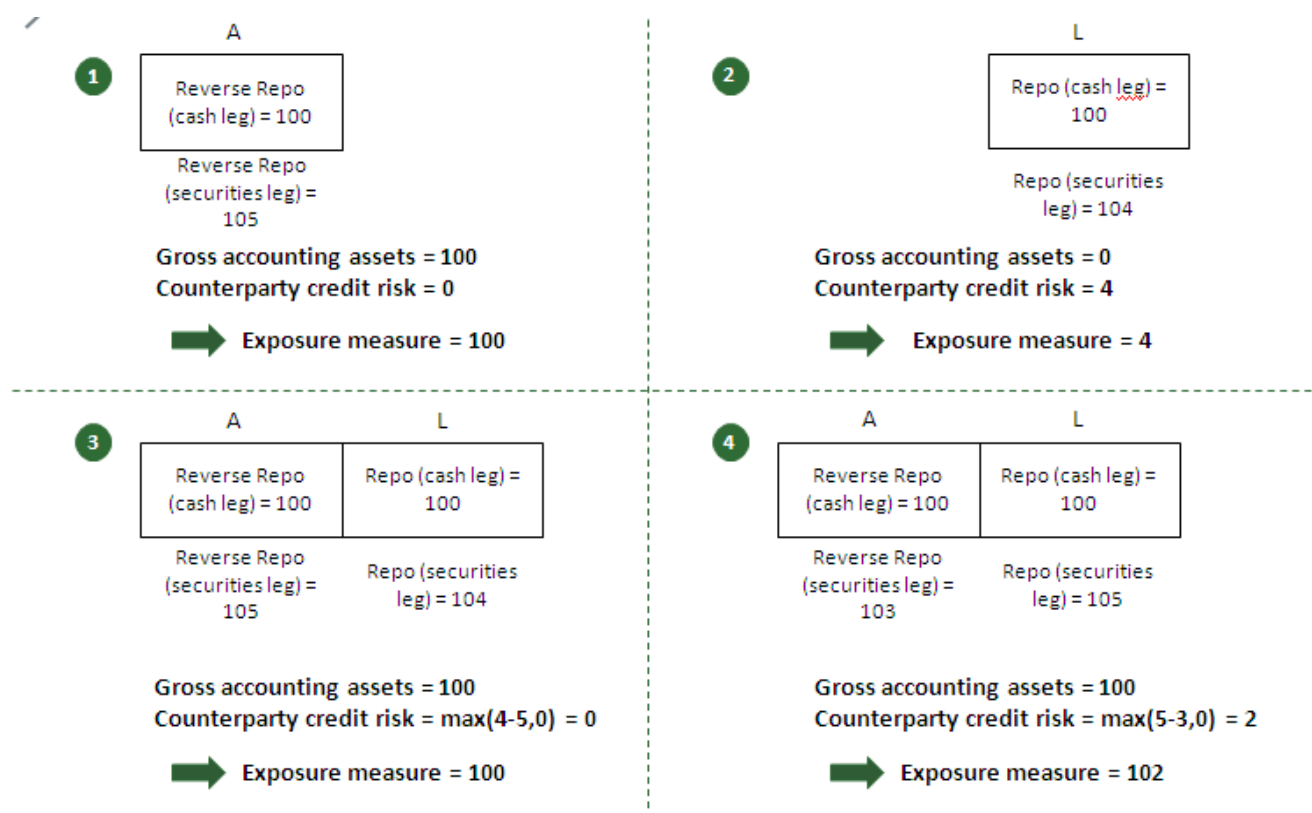
- The same reasoning applies to collateral posted, which should not be treated as an isolated asset, as envisaged in the current proposal, but aggregated with the derivatives positions it is intended to cover.
- On the listed derivatives market (futures), PV is reset every day with the CCP. This penalizing treatment of collateral in derivatives transactions would introduce wrong incentives as it does not recognize any regulatory value to collateral. The collateralization of derivatives transactions has been encouraged through CCPs margin requirements on cleared derivatives and regulators' margin requirements on un-cleared derivatives. Banks could revise their business model on cleared OTC by implementing a daily reset of PV with the CCP as a fallback solution to minimize the negative impact of this framework. However this involves such high costs for the industry as all contracts should be reviewed. We recommend that BCBS acknowledge this true nature of collaterals and allow recognising them by netting set.

- **Written credit derivatives**

- The proposed framework also introduces an additional treatment for written credit exposures. In addition to the CEM (or NIMM) treatment of derivatives and related collateral, the framework also incorporates the full effective notional value of written credit derivatives (the exposure measure for credit protection sellers) into the exposure measure to capture the credit exposure to the reference entity.
- There is no reason why written credit derivatives should be treated in a different way than other derivatives. Like any other derivative, credit derivative is a contract between two parties through which one party makes a payment based on the performance of an underlying asset, which is a debt obligation in case of a credit derivative: the purchaser seeks protection from credit risk on the debt obligation. G20 regulations on derivatives markets, including reporting, clearing and executing requirements, do not provide any specific treatment for credit derivatives. Therefore we do not see any justification to introduce a specific treatment for one category of derivatives for the purpose of the leverage ratio.
- This exceptional treatment would not reflect the actual economic exposure related to credit written derivatives. Exposure related to credit derivatives is already captured through the calculation of the replacement cost plus an add-on for potential future exposure, like other derivatives.
- We think the assimilation made by the Committee between credit derivatives on the one side, and bonds and loans, on the other side, is misleading. CDS are collateralised and related positions are marked to market every day. This is not the case on bonds held in the banking book, marked at cost or an amortising profile towards par at maturity; or of loans which are not marked at all, only showing accruals in the accounts. So for bonds and loans, the leverage is the full amount of the book value of the instruments. But for CDS, the leverage is limited to the NetPV and PFE like for any other derivative.

- Therefore we propose that the same NetPV+add-on approach be applied to written credit derivatives as to other derivatives.

## APPENDIX 1 – EXAMPLES OF COMPUTATION OF SFT EXPOSURES ACCORDING THE PROPOSED FRAMEWORK



## APPENDIX 2 – ROLE OF MARKET MAKET MAKING/HEDING AND REPURCHASE AGREEMENT

- **Market making:** Market makers stand ready on a continuous basis to act as counterparty in the sale or purchase of equities, bonds or other financial instruments once they have been issued. This activity takes the form of recurrent real trades, without which there would be no liquidity in the secondary market and issue conditions would be much more unfavourable in the primary market. Market making ensures the liquidity of securities in the secondary market, provides a permanent encounter between buyers and sellers and smoothes price volatility. Without an intermediary market maker prepared to buy or sell these instruments on an ongoing basis and to assume the risk of holding these securities, both corporate and sovereign issuers would see their capacity to place their debt and to ensure financing severely challenged.
- **Hedging operations:** These operations consist of being the counterparty for financial operations to cover the hedging needs of customers and to reduce their own risk exposure. For example, when a bank provides a customer (a company or savings investor) with an equity option to provide long-term protection against the risk of a decline in the underlying investment, it manages this coverage dynamically by carrying out daily risk adjustment transactions, buying and selling the underlying equities. Without this dynamic risk management, the bank would not be able to offer customers protection regardless of the market's level, which would force customers to assume unwanted risks. The same applies to all types of risk, such as foreign exchange risk for companies and interest rate risk for insurance companies.
- **Repurchase agreements:** Banks refinance securities by borrowing from investors with excess cash. The lender receives the securities as collateral, which makes these operations very safe. At any moment, the borrower may substitute these securities for others. Repurchase agreements provide lenders with security and borrowers with flexibility, making them an essential liquidity management tool that is competitive, flexible and secure. They are widely used to refinance stocks of public debt securities acquired as part of primary dealer activities. They also enable companies to actively manage excess cash in a secure manner. If banks no longer had this means of financing inventories, they would have to halt some of their market making activities, which would become less competitive.