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Basel Committee on Banking Supervision
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Dear Mr. Byres,

Deutsche Bank's response to the Basel Committee on Banking Supervision consultative document on the Revised Basel III leverage ratio framework and disclosure requirements

Deutsche Bank (DB) welcomes the opportunity to comment on the Basel Committee on Banking Supervision (BCBS) consultation paper (CP) on the Revised Basel III leverage ratio framework and related disclosure requirements.

We understand from the Basel Committee's consultation paper that the Leverage Ratio (i) is intended as a simple, transparent, non-risk based "backstop" to the risk-based capital framework, in order to (ii) restrict the build-up of leverage in the banking sector to avoid destabilizing deleveraging processes.

We agree with the Basel Committee's objectives. That said we would like to stress that the Committee's goal to design a non-risk sensitive, simple Leverage Ratio inevitably means that it has inherent weaknesses when measured against the objective of capturing banks risks and ensuring appropriate capitalization. Leverage - by design - treats more or less risky assets equally and therefore provides no insight into (i) the riskiness of a specific bank, or (ii) the amount of capital that must be held to ensure a bank is sufficiently protected in times of stress.

In order to maintain the very qualities that make a Leverage Ratio a useful complementary tool, namely simplicity and transparency, one must accept these shortcomings and the consequent (limited) role that the Leverage Ratio can play – a backstop to risk-based capital requirements that look at the genuine economic and systemic risk that bank balance-sheets and activities represent.

On this backdrop we encourage the Committee that – following the finalization of the exposure measure to be used for Leverage purposes – the calibration of the minimum threshold must be done such that the risk-based capital framework remains the primary constraint for banks and Leverage does not become the predominant factor.

Turning to the design of the Leverage exposure measure itself, we note that the Committee has chosen an approach to start from the accounting balance sheet but to adjust accounting values in a number of ways thereafter. We understand that the Committee has chosen this path in light of its desire to ensure broad and adequate capture of both the on- and off-balance sheet leverage of banks. However, it is our view that as currently proposed, the methodology in the Committee's CP does not meet this objective and will have several undesirable outcomes. The main reasons are that the proposed Exposure Measure of Leverage:

- Encourages banks to shift the asset mix on their balance sheet towards higher yielding, and therefore potentially more risky and/or less liquid assets;



- Is inconsistent with other parts of the Basel 3 framework, notably the new liquidity management standards under the Liquidity Coverage Ratio (LCR);
- Reduces firms' willingness to accommodate large increases in client cash balances or accept segregated deposits, both of which play a vital role in servicing the real economy;
- Is likely to impair the market for sovereign debt financing during normal times, reducing liquidity and increasing pricing, and hence adversely impacts the ability of this market to reach the levels of liquidity required to support efficient liquidity management; and
- May well put pressure on the banking system to sell assets in times of market stress, when the leverage ratio may simultaneously become a binding constraint for an increasing number of banks.

We are concerned that the Committee's Leverage proposal will lead to a shrinkage in credit capacity, with particularly harmful consequences in regions which are most reliant on bank financing such as Asia and Europe (in Europe ~70% of corporate funding is supplied by banks compared to ~30% in the US). The consequent constraint on lending supply will also have impacts on the price at which remaining lending can be offered.

To the extent that the leverage ratio ties up significant capital in low risk, low yielding assets, then other balance sheet activities will need to be re-priced in order to generate the necessary overall level of return. The reduced appetite of firms to hold sovereign debt will adversely impact the liquidity and efficient functioning of sovereign debt markets, leading to a consequent increase in sovereign debt funding costs. Any reduction in sovereign debt repurchase (repo) market capacity as a result of the proposed leverage definition means that firms may be less able to find appropriate private market refinancing and may instead be required to rely on Central Bank refinancing at a time of market stress.

We believe that these problems can and should be avoided, or at least substantially reduced, by changing the definition of the Exposure Measure of the leverage ratio – and setting a minimum threshold appropriate for a back-stop measure.

In view of the above we would like to highlight a number of specific areas where we believe changes to the proposed definition of Leverage should be considered.

Cash, level 1 High Quality Liquid Assets (HQLA) and SFTs

Under the LCR banks are required to hold sufficient High Quality Liquid Assets (HQLA), primarily cash and highly rated government bonds, to be able to withstand a 30 day stress period of liquidity outflows. As currently proposed, the Exposure Measure of the Leverage Ratio includes HQLA, which effectively imposes the same capital charge on these near risk-free assets as on the most risky securities or loans which banks may hold on their balance sheet. Furthermore, the liquidity of highly rated government bonds relies on the existence of an efficient interbank market for repurchase (repo) transactions. Under the Leverage Ratio, however, a repo transaction secured by government bonds may result in a higher exposure contribution than an uncollateralized loan, and a portfolio of repo transactions may result in exposure amounts significantly higher than the maximum amount a bank could lose from those transactions. This is a low margin business and the proposed provisions risk severely constricting the market – the margins necessary to justify balance sheet usage will be prohibitive, especially for the highest quality collateral. Consequently, to the extent that the leverage ratio actually became a binding constraint for an increasing number of banks in times of market stress, the interbank lending markets could become disrupted and the liquidity of government bond markets could fall. We question whether this systemic effect has been sufficiently analyzed with respect to the effects and effectiveness of monetary policy in times of market stress.



Related to the constraints around holding cash in the liquidity buffer, as the proposal stands today, banks are disincentivised from continuing to provide basic banking services like payment accounts for corporate and financial institutions. These basic low risk services are vital to the real economy and are being directly disincentivised by the leverage ratio treatment of cash balances placed with central banks.

Consequently, banks will be forced to adjust pricing in order to continue accepting large cash balances on behalf of clients, as well as excess balances arising from clearing and custody activities.

In order to avoid these problems we suggest that the constraints imposed by the Leverage Ratio should be neutral with respect to the amount of cash and highly rated government bonds held by any individual bank and within the banking sector overall. This could easily be achieved by excluding all holdings of assets that qualify as level 1 HQLA under the LCR. Furthermore, applying the already established non-internal model based exposure method for Secured Financing Transactions (SFTs) such as the 'supervisory volatility adjustment approach' would not unduly penalize banks for participating in the government bond repo markets.

Derivatives

A second major concern arises from the methodology prescribed for calculating the derivatives component of the Exposure Measure under the leverage ratio. As currently defined, the derivatives exposure of the entire banking sector would invariably rise in times of increased market volatility, even without any increase of derivatives trading activity. Furthermore, attempts to re-hedge risks would further increase the exposure measure for derivatives. In other words, whilst derivatives risk can be managed, there are market driven changes in the exposure measure for derivatives as currently proposed for Leverage which are not fully manageable, neither for individual banks nor for the banking sector overall. To the extent that the Leverage Ratio actually became a binding constraint for an increasing number of banks during times of market stress, the banking sector as a whole would be forced to sell assets in order to hold the overall Exposure Measure under the Leverage Ratio constant.

In order to avoid this problem we suggest that the exposure measure for derivatives should be neutral with respect to the level of market prices and market volatility. Efforts to reduce risk should also result in a reduction of the exposure measure for derivatives. In our view, adherence to these two principles is required (i) to ensure the exposure measure for derivatives can be managed, (ii) not to discourage banks from prudently managing their risks, and thereby (iii) to avoid perverse incentives for the banking sector to shed assets in times of stress. The new Non Internal Model Method (NIMM) which the Basel Committee is currently considering as a replacement for the standardised exposure measure in the Counterparty Credit Risk framework would, in our view, better reflect the above principles and consequently be more suitable as a starting point for defining the derivatives exposure measure under the Leverage Ratio.

We also urge the Committee to keep in mind the different nature of risk management for credit derivatives in the trading book. The proposed treatment does not reflect the actual economic exposure of written credit derivatives and fails to take into account the broader range of techniques banks use to hedge their credit risk exposures. This limiting of banks' tools to adequately manage risk is contrary to the objective of prudent risk management.

Cash management and committed facilities for the non-financial sector; including treatment of trade finance related exposures

The currently proposed application of a 100% weighting, to be uniformly applied across all off-balance sheet assets, does not reflect the relevant underlying risk and could incentivise banks to take riskier off-balance sheet positions in an attempt to attract yield. This incentive to substitute



lower-risk, lower return assets (such as letters of credit and trade finance guarantees) with higher-risk, higher return assets is imprudent and pro-cyclical – and an impediment to real economy support. We propose that appropriate weightings should be used to avoid such impacts, particularly in the areas of trade finance and export related off-balance sheet items. This approach has already been taken in the European framework where the importance of off balance sheet trade finance instruments for global trade has been recognized.

The use of varied weightings, based on the underlying risk of these off-balance sheet assets being drawn upon, would be aligned with the differentiated approach taken to committed facility instruments by the BCBS in the LCR where the outflow vectors range from 10%-100% depending on the nature of the instrument and the counterparty (Financial Institution or Non-Financial Institution). Because of the 100% weighting of HQLA within the Leverage Ratio exposure measure, essentially banks are required to hold a liquidity buffer against committed facilities (based on the outflow vector applied to reflect the risk), and are being additionally required, under the Leverage Ratio, to hold a capital buffer not only against the committed facility, but also against the HQLA held in the liquidity buffer which directly cover that liquidity risk of that facility in the LCR. This is a nonsensical double counting and again creates severe constraints for banks trying to meet all prudential ratios at the same time.

We provide below some more extensive analysis of the above points, and remain ready to discuss any of the points in our response.

Yours sincerely,

Andrew Procter
Global Head of Compliance, Government and Regulatory Affairs



Deutsche Bank detailed comments on the proposed framework

General

The debate about leverage ratios is fundamentally a question about how much credit we want in the economy. This impact will be felt especially strongly in the EU. In the EU, corporates are significantly more reliant on bank financing than in the US (70% of corporate funding is supplied by banks in the EU versus 30% in the US). At the same time, bank lending to corporate and private individuals does not entail the same level of risk in all regions, and is comparatively low in Europe – and as a result for even the same volume of lending leverage as proposed becomes a constraint in Europe more quickly than in a number of other places. Also, the US has a far broader range of credit providers than the EU or Asia – there is a policy choice to be made about whether increasing reliance on less regulated shadow banking is desirable or not. Resulting from the divergent credit models, EU banks have business and risk models based on Risk Weighted Assets (RWA) capital calculations whereas US banks are generally more leverage focused.

As noted above, the artificial balance-sheet constraint that the Leverage Ratio imposes will push banks away from sovereign debt markets and more heavily into higher-risk portfolios. This would also result in medium risk assets (including corporate and SME loans) becoming less attractive, or costing more as a result, and that resulting portfolio holdings may look more concentrated at extremes.

The fundamental tension between a binding Leverage Ratio and the liquidity provisions provides disincentives for banks to intermediate 'excess' client cash. At times of low interest rates, or at time of market stress, clients have a tendency to increase their cash balances and look to hold these at stronger institutions. Banks subject to a Leverage Ratio constraint may be unwilling to warehouse such cash and may have to set disincentives in their pricing. The BCBS must avoid a situation where banks are forced to refuse client deposits, due to the adverse impact on their leverage ratio if the deposit is in turn placed with central banks. It is our view that this is contrary to the principles of good prudential risk management and has no basis in real increases in risk.

A1 Cash and other level 1 High Quality Liquid Assets (HQLA)

As shown by the crisis, and supported by the design of the LCR cash and HQLAs are a fundamentally important source of stability and resilience during stressed markets.

The BCBS proposed Leverage Ratio does not take this into account; in fact it risks incentivising banks to hold as few low-yielding assets and as little cash as possible – even going so far as to risk banks being unwilling to offer clients basic cash management services. The opposing pressure to hold HQLA for buffer purposes in the LCR, and the disincentive to do so under the leverage ratio, creates a conflict between the two prudential ratios that seems to run counter to the objectives of both.

By exempting unencumbered cash and other level 1 HQLAs from the exposure calculation, banks would not be discouraged from increasing their liquid asset stocks above the minimum required level under the LCR where a bank deems this is prudent, albeit potentially costly to do. The result of exempting level 1 HQLA from the exposure measure of the Leverage Ratio would give banks the flexibility to implement more prudent risk management policies and lead to a counter-cyclical outcome which would provide much needed resilience during times of market stress. It would also ensure a continued source of liquidity for high quality government debt at times when attracting funding is most critical.

A2 Client cash services



As stated, the proposal disincentivizes banks from continuing to provide basic banking services like payment accounts for corporate and financial institutions maintaining the liquidity buffer accounts that are required by clients as part of their regulatory framework.

One of a bank's primary functions is to provide clients with current accounts, to facilitate payments and settlement services. By the nature of these accounts the balance is never at exactly zero and they tend to fluctuate daily. Banks themselves have very little control over how much cash is held in these accounts at any one time. For example, during the course of an M&A transaction, a client may deposit a vast amount of cash in an escrow account. It is usual practice for banks to take excess cash deposited on these accounts and keep this cash in an account at the central bank. Furthermore, we urge the Committee to note that these deposit taking services are essential for certain types of clients to confirm with regulatory requirements – for example money market funds, insurance companies, trust accounts and so on must maintain deposits with banks to comply with regulatory standards.

As the BCBS CP currently reads, cash balances placed with central banks increase the exposure measure in the Leverage Ratio. Punitive treatment may force banks to enter into discussions with corporate and financial institution clients to find ways to either avoid clients leaving large cash balances on an account or for the pricing to be adjusted accordingly. The corresponding adverse impact on the real economy represents an unintended consequence of the proposal. In summary, and in order to prevent such disincentives, we suggest removing unencumbered cash held by the bank with central banks from the Leverage Ratio exposure measure.

A3 Secured Financing Transactions (SFTs); use of supervisory volatility adjustment approach & inclusion of additional counterparty exposure

The consultation paper proposes calculating the exposure measure for securities financing transactions (SFT) as the sum of:

- Gross SFT receivables recognized for accounting purposes; And
- Net counterparty exposure, based on the supervisory volatility adjustment approach (without taking into account the add-on factors for Potential Future Exposure; PFE).

The consultation further states that gross recognition of SFT assets in the leverage ratio is prudent and has the benefit of avoiding inconsistencies from netting which may arise across different accounting regimes (see footnote 20 of the consultation). In our view this definition is not in-line with the rationale of prudent risk-management and a suboptimal measure of the exposure of an institution in several aspects:

- First, it is unclear why net counterparty exposure is added to gross SFT receivables. Applying this definition may lead to situations where the SFT exposure measure exceeds the maximum loss that the institution can suffer from the SFT;
- Secondly, it is not clear why regulatory netting of SFT cash legs contained within a regulatory netting set is not permitted. Without allowing for netting based on regulatory netting agreements (as it is the case for derivatives in the context of the Leverage Ratio), the exposure amount will be significantly overstated; and
- Thirdly, it is not clear why the Leverage Ratio is not based on already established non-internal model based exposure methods for SFTs such as the 'supervisory volatility adjustment approach'.



It is our concern that the proposed treatment of SFT strongly penalizes and discourages this form of financing. The SFT business is generally a low-margin business, therefore imposing inappropriate Leverage Ratio constraints is likely to result in a radical reduction in this form of financing. As a result, a dramatic withdrawal of liquidity from the markets may occur which, in turn, increases systemic risk.

Penalizing SFT will also affect the liquidity and marketability of securities most frequently used in these transactions, notably government bonds. We urge the Committee to consider the impact of radically reduced liquidity in the interbank repo markets and impaired effectiveness of monetary policy in times of crisis, when it is more likely that many banks will come close to their leverage ratio limits simultaneously. Contrary to the Committee's aim of limiting the chances of a radical deleveraging during a crisis, this SFT treatment risks exacerbating the risks.

In summary, we believe that the proposed treatment of SFT in the Leverage Ratio is highly likely to discourage this type of funding, resulting in negative consequences for both the orderly functioning of markets and the liquidity of individual institutions.

In order to address these concerns, we would recommend determining the Leverage Ratio exposure for SFT transactions based on the supervisory volatility adjustment approach.

This approach determines the net exposure for SFT in each regulatory netting set taking both cash and security legs into account. In addition, it recognizes add-ons for PFE to reflect changes in market valuations of the securities underlying the transactions and mismatches in settlement currencies within the netting set.

Note that using this method ensures that the asset exposure for Leverage Ratio purposes is independent of the accounting standard employed and that the exposure is adequately captured. In our view the inclusion of the security leg in the exposure measure does not contradict the general concept of the Leverage Ratio of not taking credit risk mitigation into account as the security leg is an integral part of the trade and does not represent credit risk mitigation.

In Annex 1, we provide some examples of negative effects we see resulting from the proposed SFT treatment.

B Derivatives

We are concerned that the proposed calculation method for derivatives in the calculation of the leverage exposure measure is inappropriate and may threaten financial stability in times of market stress. To illustrate our concerns we will describe the dynamics of the Leverage Ratio in a very small banking system in a stylized way. This will allow us to identify the reasons for the unintuitive and presumably unintended consequences, to derive changes we recommend the Committee may want to consider, and to demonstrate how the proposed changes would mitigate the financial stability concerns without impacting the prudence of the calculation. The changes we recommend are already under consideration in a separate consultation of the Basel Committee on a new Non Internal Model Method (NIMM) for calculating exposure values in the counterparty credit risk framework. For the reasons laid out below we are convinced that the NIMM approach, if it was applied to the Leverage Ratio calculation, would go a long way in mitigating our concerns from a systemic risk perspective. At the same time the NIMM would be conservative and effective in meeting the Committee's goal of limiting the interconnectedness and the build-up of leverage in the banking system.

Systemic risk created by treatment of replacement cost of derivatives and collateral received



Our stylized banking system consists only of three banks, a single market maker who trades with two other banks. For our purposes it is sufficient to assume that the market maker only intermediates a single 10 year interest rate swap. In practice, the market maker would enter into two trades: (1) Paying 5% fixed for 10 years on €10m notional to Bank A versus receiving Libor, and (2) receiving 5% fixed for 10 years on €10m notional from Bank B versus paying Libor. In this simple example, the market maker has no market risk, i.e. irrespective how interest rates change the market maker does not experience a loss. Bank A gains if interest rates fall, and Bank B gains if interest rates rise.

Next, assume that 10 year interest rates drop to 2%. The trade with Bank B is now in the money for the market maker with a positive market value of approximately +€2.5m. Conversely, the trade with Bank A has a market value of -€2.5m for the market maker. Although the position of the market maker has not changed, under the proposed rules for the Leverage Ratio the market maker's "exposure" has grown by €2.5m. The reason is that the market maker cannot offset the positive market value of the trade with Bank B with the negative MTM of the trade with Bank A. Similarly, Bank A has to record an "exposure" of €2.5m to the market maker, whereas Bank B has no "exposure". Overall, the total "leverage" of our small banking system has increased by €5m, simply as a result of a change in interest rates.

This fundamental feature of our stylized banking system extends to the general case of a more complex financial system and can become a serious problem for systemic stability: The proposed exposure measure for the derivatives component has a tendency to systematically increase during times of rapid directional market moves. The banking sector overall will appear to be "more leveraged" in times of market stress, without an increase in trading activity, simply in response to changes in market prices and market volatility. The reason for this unintuitive and presumably unintended behavior is the asymmetric treatment of derivative netting sets with positive and negative market value, which is represented by the "replacement cost" component in the exposure measure. As currently defined, the aggregate replacement cost of the derivatives in the banking sector changes irrespective of the direction of the market change (in our example: if interest rates had risen to 8% the increase in "leverage" for the system would have been the same).

We recognize that the Committee's intention for the Leverage Ratio, as stated at the beginning of the consultation paper, is to prevent the build-up of leverage in the banking system. However, the dynamic behaviour of the replacement cost component as described above could turn into a manifest threat to systemic stability in times of stress: If the replacement cost component was allowed to increase the leverage exposure measure of the banking system in response to changes in market parameters it would become an uncontrollable element of the framework. Banks who suddenly reached their leverage limits as a result of the derivatives component could be forced to reduce the contributions from other assets, which they can control, e.g. selling securities, not rolling over repos and securities lending transactions, cancelling credit lines, not extending new loans. In this respect, we are concerned that a banking system faced by an inappropriately defined leverage ratio constraint may actually contribute to instability during stress periods.

The detrimental behaviour of the derivatives component could easily be avoided by allowing collateral received to be deducted from the replacement cost component. The consultation paper makes the following points with respect to collateral received:

- It acknowledges that collateral received reduces counterparty exposure;
- Yet it notes that it can also increase the economic resources at the disposal of the bank, as the bank can use the collateral to "leverage itself".

The paper further states that "Collateral received in connection with derivatives contracts does not reduce the economic leverage inherent in a bank's derivatives position. In particular, the exposure from the underlying contract is not reduced. As such, collateral received (cash or non-cash) may



not be netted against derivatives exposures, whether or not netting is permitted under the bank's accounting or risk-based framework."

With respect, we do not believe these extracts accurately describe the build-up of leverage in the banking system which the Committee intends to limit, and that the argument for not recognizing the exposure reducing effect is flawed, for the following reasons:

1. The replacement cost (i.e. the current mark-to-market value recorded on banks' balance sheets) does not measure leverage; it measures the change in market values between prices at which transactions have been entered into historically relative to current market prices.
2. The "leverage" inherent in a bank's derivatives portfolio results from the exposure to the underlying contract. Under the proposed method this is captured through the Add-on component in the calculation and not the replacement cost component.
3. We acknowledge that collateral received can be used to fund additional activities, if certain conditions are met. However, the proposed methodology for the Leverage Ratio already captures situations where banks actually do use collateral received to "leverage themselves", e.g. by extending additional loans or purchasing securities. Therefore, the argument that collateral received (cash or non-cash) *could* be used by a bank to fund additional activities is unrelated to the question whether it *should* be allowed to reduce current derivatives replacement costs.

In our view, collateral received should always be allowed to reduce the replacement cost component of a derivative netting set. The key arguments are that, to the extent that collateral is in fact exchanged to mitigate current exposure between counterparties, it would be neutral for the leverage ratio of the banking system overall. In our stylized example, the market maker would receive €2.5m collateral from Bank B and post €2.5m of collateral to Bank A. If collateral received could not be deducted from current counterparty exposure, the market maker's and Bank A's leverage exposure would increase by €5m, as explained above. If collateral received could be offset, the leverage exposure of all participants would remain unchanged.

We recognise the Committee's concerns that collateral received may be used by the receiving bank to fund additional activities. However, the possibilities for re-using collateral for other purposes will be significantly constrained in the near future as a result of global reforms of the OTC derivatives markets:

1. For centrally cleared derivatives the counterparty receiving the collateral is a central counterparty (CCP) which is subject to strict segregation requirements for securities collateral and restrictions with respect to re-investing cash collateral under the *Principles for Financial Market Infrastructures* (PFMI) standards of the CPSS/IOSCO Committee.
2. For non-centrally cleared derivatives the final recommendations of the joint working group for minimum margin requirements (WGMMR) of the BCBS and IOSCO committees require that initial margin received must be held in segregated accounts and may not be re-hypothecated, re-pledged, or re-used¹

¹ The WGMMR recommendations allow the re-hypothecation of collateral received in the specific circumstances of customer transactions where the party collecting the IM is required to post collateral for entering into hedging transactions of the customer's transactions. However, the receiving party of the re-hypothecated collateral cannot re-use it, must treat the collateral received as customer assets, and hold it in a segregated manner.

² In this context we also want to highlight the asymmetric treatment of cash and securities collateral received under IFRS. The market standard is for VM to be paid in cash; however, cash received must be recognised as an asset on banks' balance sheet whereas securities collateral may not. We do not believe that a distinction should be made between cash and non-cash collateral received for the purpose of the leverage ratio. In fact, if cash collateral received had to be captured in the exposure measure of the



Consequently, the opportunities for the banking system of increasing leverage through the re-use of initial margin (IM) collateral against derivatives will no longer exist. For both centrally cleared and non-cleared derivatives between “covered entities”, which includes all banks, it will become a mandatory requirement to exchange variation margin (VM) with zero threshold. The WGMMR notes that the exchange of VM, which collateralizes the current counterparty exposure represented by the replacement cost, “is a prudent risk management tool that limits the build-up of systemic risk.” We urge the Committee to ensure consistency between the recommendations of the WGMMR and the treatment of collateral received under the leverage ratio: VM received against current counterparty exposure should be allowed to be netted, and IM collateral received should not increase the leverage exposure measure of the receiver².

Derivatives exposure measure must be sensitive to banks’ efforts to control risk in times of stress

In addition to the principle that the derivatives component of the exposure measure in the leverage ratio should be independent of market prices and market volatilities, we believe that a suitably defined leverage ratio that meets the Committee’s intention should also be responsive to banks’ attempts to reduce risk during times of market stress. The Add-on component of the methodology as proposed, the Current Exposure Method (CEM), does not achieve this: Under the CEM the Add-on component is essentially a function of the number of trades, their maturity, and asset class composition. On average, each new trade adds a specific percentage of the trade’s notional to the “leverage exposure” of the banking system, if the trade is between a bank and a non-bank, and twice this amount if the trade is between two banks. While we recognize the Committee’s intention to limit the level of activities that banks can undertake with a given amount of capital, irrespective of the riskiness of the activity, we question whether this is the right approach from the perspective of fostering systemic stability:

In times of market stress one typically observes a significant increase in the volume of derivative trading activities as market participants, both banks and non-banks, have an increased need to manage their risks. It is the function of market makers to provide liquidity in derivatives markets by intermediating between buyers and sellers. Ensuring the smooth functioning of markets is crucial in order to maintain stability in times of market stress. The leverage ratio, as currently proposed would hamper the risk intermediation function since the activities of market makers could become more constrained during times when their services are in particularly high demand. We therefore urge the Committee to consider a more risk sensitive calculation method for the Add-on component of the derivatives exposure measure in order not to constrain the economically beneficial, and indeed vital, activities of market makers in stressed market conditions.

In our view, the conceptual approach taken in the NIMM which the Committee is currently considering as a replacement for the CEM in the counterparty risk framework would meet the above requirements: It allows collateral received to be deducted from the replacement cost component, it recognizes whether new transactions are risk increasing or risk reducing, and therefore allows banks to manage their exposures to derivatives contracts both at the overall portfolio level as well as with each counterparty level. For purely directional derivative portfolios, it would result in exposure measures that resemble a portfolio of unhedged loans or securities, which the CEM does not. Therefore, the NIMM represents a more consistent approach to measuring a bank’s leverage across different types of products.

² In this context we also want to highlight the asymmetric treatment of cash and securities collateral received under IFRS. The market standard is for VM to be paid in cash; however, cash received must be recognised as an asset on banks’ balance sheet whereas securities collateral may not. We do not believe that a distinction should be made between cash and non-cash collateral received for the purpose of the leverage ratio. In fact, if cash collateral received had to be captured in the exposure measure of the Leverage Ratio, this would double the systematic increase of the derivatives exposure measure in times of market stress as explained. Since VM may be paid in cash or securities under the WGMMR recommendations, we consider that both cash and non-cash VM should be allowed to reduce the replacement cost component in the Leverage Ratio exposure measure.



In addition, as argued above, the NIMM approach would avoid unintended consequences in times of market stress, since it would not discourage banks from prudently managing their risks through derivatives and would not penalize the activities of market makers when their services are needed most. The NIMM would prevent banks from becoming net sellers of non-derivative assets in times of market stress. At the same time, the NIMM would be conservative and be effective in meeting the Committee's goal of limiting the interconnectedness and the build-up of leverage in the banking system.

Treatment of Credit derivatives

We acknowledge that the approach taken by the BCBS seeks to align the treatment of written credit derivatives and guarantees provided for purposes of the leverage ratio. With respect to the proposed netting rules for effective notionals we believe however that the rules are inappropriate for credit derivatives in the trading book. In contrast to positions in the banking book, positions in the trading book are actively managed based on a short time horizon. Therefore, for written credit derivatives in the trading book, the offsetting of notionals should be extended to allow an offset of effective notionals from a written credit derivative against a bought protection credit derivative, provided that the latter has a remaining maturity larger than a regulatorily defined threshold. We suggest that this threshold should be 1 year, as this would ensure ongoing protection in the event of a severe crisis if defaults occur.

We believe that the effective notionals underlying the formation of net positions should be adjusted for the market value of the respective credit derivatives according to the same logic that applies for the market risk standardized approach for credit derivatives. As an example, consider a written CDS with a notional of 100 and current market value of -10 to the institution: In our view, the effective notional for this CDS should equal $100 - 10 = 90$. The negative market value of -10 will already have been captured in the P&L of the institution and will therefore already have reduced its capital measure.

C Committed facilities

Including treatment of trade finance related exposures, as well as alignment of weighting factors to take into account assumed utilisation under the LCR.

The consultation re-affirms the view already taken in Basel 3 that off-balance sheet items should, in general, be subject to a uniform weighting factor of 100%, except for commitments that are unconditionally cancellable at any time by the bank without prior notice, which are subject to a weighting factor of 10%.

It is important to note though, that the undifferentiated application of the 100% weighting factor does not recognize the nature of the underlying business. For example, a contingent obligation arising from a financial guarantee would be recognized in the Leverage Ratio the same way as a contingent obligation related to the provision of a letter of credit for trade finance purposes.

Due to the undifferentiated application of the weight on off-balance sheet items, banks could be incentivized to focus on off-balance sheet business that attracts the highest margins which may result in a reduction of their off-balance sheet activities supporting the real economy.

In order to avoid such disincentives, a smaller weight should be applied to the latter off-balance sheet items, most notably to trade finance and export finance related off-balance sheet items.

It is therefore proposed to apply a weight of 20% to trade and export finance related off-balance sheet items which would be eligible for a Credit Conversion Factor (CCF) of 20% in the RWA context and a weight of 50% to trade and export finance related off-balance sheet items which would be eligible for a CCF of 50% in the RWA context.



Finally, and related to earlier points about the tension between this proposal and the Committee's proposals around liquidity, we would like to draw attention to the linkage between committed facility drawdown rates under the LCR and the proposed leverage exposure method. Banks with a committed facility with a 100% LCR drawdown must hold a liquidity buffer against this on balance sheet. To then bring the committed facility in at 100% is a double count. We would therefore propose that the leverage exposure conversion factors on committed facilities should adjust for the LCR drawdown rates.



ANNEX 1: Examples of negative impacts of proposed SFT treatment:

Impact of net counterparty exposure is added to gross SFT receivables.

As an illustration, assume that the institution has entered into a reverse repo where it has provided cash of 100 against securities to its counterparty. Further, assume that the value of the securities equals 95 at the time of calculation of the Leverage Ratio. In this example, the gross SFT receivable equals 100. However, adding the net SFT exposure on top of the gross receivable further increases the Leverage Ratio exposure measure from the SFT by $\max(100-95,0) = 5$. In sum, the total exposure measure from the SFT equals 105 which is clearly in excess of the maximum loss from the transaction that the institution might suffer which is equal to 100 (i.e. in case that the value of the securities drops to zero and the counterparty defaults at the same point in time).

Impact of regulatory netting of SFT cash legs contained within a regulatory netting not being permitted.

Without allowing for netting based on regulatory netting agreements (as it is the case for derivatives in the context of the leverage ratio), the exposure amount will be significantly overstated.

As an example, consider the situation where an institution has entered into a reverse repo resulting in a cash receivable of 100 and a repo which results in a cash payable of 95. Further, assume that both contracts are contained in the same regulatory netting set.

Neglecting the security legs from these transactions, the maximum loss that the institution can be exposed to is $100-95 = 5$ as the transactions will be settled net in case of a default of its counterparty. Using the gross SFT receivable in this case would result in an exposure measure of 100 which vastly overstates the actual exposure incurred.

As concerns the recognition of regulatory netting of SFT cash legs in relation to the statements of footnote 20 in the consultation (see above), some further comments are in order:

- Regulatory netting should not be confused with accounting netting. While recognition of accounting netting rules under different accounting standards for purposes of the leverage ratio would lead to inconsistencies, regulatory netting avoids these inconsistencies and allows for consistent representation of net SFT receivables across different accounting regimes.
- Allowing for regulatory netting leads to prudent outcomes as it is ensured that the SFT exposure measure will never be smaller than the loss that the institution could suffer from the transaction.

Impact of proposed SFT treatment on Government Bonds:

Consider an institution that holds government bonds and seeks to generate liquidity from these assets. The institution essentially has the following three options:

1. Use the security in a repurchase agreement with another financial institution; or
2. Sale of the security; or



3. Place the security at its central bank.

Option 1 provides by far the most efficient and common way of generating liquidity from the asset and is the preferred approach taken by institutions. Furthermore, the effect of repurchase transactions on the institution's P&L is minimal.

Note however that if the new proposals regarding the determination of the exposure measure for SFT were implemented the generation of liquidity by means of repurchase transactions would become highly unattractive to institutions such that they are likely to turn to options 2 or 3.

The repo markets are fundamental to the smooth functioning of bond markets, because they allow market makers to sell short. Disincentivising banks from being active in the repo markets would fundamentally undermine the ability of market makers to provide liquidity in these markets.

As regards option 2, outright sales of the assets that otherwise would have been used in repurchase agreements across all institutions subject to the leverage ratio requirement is likely to affect both their pricing and marketability. Referring to the example of government bonds, large sales volumes and lower demand for these assets by banks may lead to a widening of sovereign spreads and thereby negatively affect the governments' capabilities to refinance themselves.

Finally, option 3 constitutes the least preferred approach for both regulators and institutions. First, we believe the maintenance of a functioning interbank money market to be a key objective for regulators – both under market efficiency and systemic risk considerations. Further, note that pushing banks to heavily rely on central bank funding may result in negative reputational consequences for the institutions as market participants may cast doubts on their liquidity situation.