Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

- submitted via email to: baselcommittee@bis.org

20 September 2013

EAPB comments on the consultation of the Basel Committee on Banking Supervision on a revised Basel III leverage ratio framework and disclosure requirements

Dear Madam or Sir,

The EAPB welcomes the opportunity to participate in the consultation on "Revised Basel III leverage ratio framework and disclosure requirements".

General comments

In principle, EAPB members have strong reservations regarding the introduction of a leverage ratio as a non-risk based backstop measure. Among EAPB members there prevails the opinion that the leverage ratio provides only very limited information regarding the leverage and stability of banks. Hence, a further specification of the rules for calculating the leverage ratio does not increase the meaningfulness of the leverage ratio as such. Taking a step back and starting with the rationale for the introduction of the leverage ratio, "…the leverage ratio should be a simple, non-risk based measure supposed to act as a credible supplementary measure to the risk-based capital requirements. The leverage ratio is intended to reinforce the risk-based requirements with a simple, non-risk based backstop measure". There is a feeling that neither the scope of application nor the migration of the ratio to Pillar I is in line with these statements.

The EAPB understands the desire for a backstop which might be driven by the weakened credibility of risk-weightings and raised concerns about the even implementation of the internal rating-based approach to credit risk. Nevertheless, the current set up of the leverage ratio does not take into account the fact that banks using the standardized approach to credit risk are equally affected by the leverage ratio since it does not distinguish between the two approaches.

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Furthermore the application of one percentage ratio across all exposure classes excessively restricts the incentives introduced by the Basel II framework. The principle of the IRB approach to mitigate the regulatory capital burden is eroded if the actually binding capital requirements for comparably low-risk but high-volume business models with low margins are based on the leverage ratio and not on a risk-weight based approach. If you assume a 10% Basel III CET1 ratio as a risk based minimum, mathematically the leverage ratio will become the binding constraint if the average risk weighting is below 30%. This will punish genuinely lower risk assets, the main business of EAPB members and assets that provide banks with liquidity specifically[1] and thus would incentivize banks to engage in riskier activities. The proposed Basel III framework is clearly in contrast with such consequences. The concern raised about the assets providing liquidity can be more generalized. The interaction between LCR and leverage ratio can be substantial, as the following example shows: Assume that a liquidity facility is provided to an insurance company. According to the LCR requirements, the bank should assume a 100% drawdown of the undrawn portion of this liquidity facility provided. The credit conversion factor for the Exposure Measure as proposed in indent 40 in the consultation paper for such a facility equals 100% . Hence, this would imply a total conversion factor of 200%, being 100% due to liquid assets requirement (LCR) and 100% due to the Exposure Measure CCF.
EAPB members are concerned about the interaction between the different measures, i.e. LCR ratio, NSFR ratio and leverage ratio, which should be taken more into account. Given the numerous disadvantages mentioned above, a migration of the leverage ratio to Pillar II instead of Pillar I would serve better the aim of the ratio as a backstop and would prevent the leverage ratio from ruling out the risk-based capital regime.

Specific comments

Definition and minimum requirement

The technical and operational burden for calculating an average of three month-end ratios is substantial. This requirement diverges from usual regulatory and financial reporting obligations on a quarterly basis and due to this practice, valuations/adjustments are only made at the end of the last month of the quarter. The resulting data might not meet the expected quality standards.

The EAPB supports the Basel Committee's commitment to test the proposed 3% ratio during the transitional period, taking into account the rationale (weakened credibility of risk weightings) and the aim (being a backstop, not a binding constraint) of the leverage ratio. It

[1] The latter is recognized by the BOE stating that the liquidity requirements will be lowered for banks which fulfill the capital requirements (www.bankofengland.co.uk/publications/pages /news/2013/099.aspx)

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will be of particular importance to distinguish between different business models and between the approaches for measuring credit risk (standardized versus internal models).

Capital measure

EAPB members favor a capital measure that is based on a wider approach to an institution's capital rather than just its core equity tier 1 (CET1) capital. Such approach should include non-core capital instruments that are classified as Additional Tier 1 capital. This view is based on the fact that leverage requirements are a going concern approach measure which should be supported by the totality of an institution's Tier 1 capital. The loss absorbing capacity of Additional Tier 1 capital has been significantly improved by the Basel III framework and as a consequence, these improvements should be rewarded.

Extension of the scope of consolidation

According to the provisions of indent 12, an entity which is not included in the regulatory consolidation, its exposure has nevertheless to be included in the calculation of the leverage ratio. As a consequence, the rules of the regulatory consolidation are suspended when it comes to the leverage ratio. Accordingly, banks would have to define a divergent consolidation scope specifically for the purposes of the leverage ratio. The EAPB questions the rationale for this proposal ("because the investment in the commercial investee remains included in the capital of the bank"). Whilst it may be correct that the book value of the investment shall not be deducted from capital, entities that are not included under the regulatory consolidation scope (or, moreover, their *pro rata* contribution to the provisions) will not be included in the calculation of the capital. There is no necessity for further regulatory consolidation rules that are specifically designed for calculating the leverage ratio. Furthermore, the EAPB would like to stress the absolute need for clearing the definition of the leverage ratio to the greatest degree possible from differences in accounting standards. We object the proposed extension of the consolidation scope for the leverage ratio from a mere regulatory consolidation scope to an accounting consolidation scope since this is at odds with the above mentioned principle.

On balance sheet exposure

The EAPB criticizes the insufficient acknowledgement of interdependencies between the definition of the leverage ratio and the treatment of HQLA. The LCR requires banks to hold substantial volumes of highly liquid assets against potential liquidity stress scenarios. This requirement is in contradiction to the outline and provisions of the leverage ratio. The EAPB suggests that the Committee should revisit and change the treatment of highly liquid assets especially in light of the greatly expanded Exposure Measure now contemplated in the

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Proposed Framework and the ongoing work on the liquidity framework. Risk-free or very low-risk and highly liquid assets, such as cash and government securities, should either be excluded from the Exposure Measure or discounted according to their relative levels of liquidity. There is broad consensus that such assets do not generate the type of risk of loss that regulatory capital is meant to offset. At the same time, there are very strong prudential reasons to incentivize banks to hold higher levels of highly liquid assets, not lower levels. At times of economic stress banks are sometimes compelled to hold much higher levels of high quality liquid assets due to circumstances outside their control, such as when customers flood the banking system with deposits rather than invest sums in riskier assets. The leverage ratio should not penalize banks for conducting this core banking function. Moreover, it should not penalize the safest banks that are the most likely to be flooded with deposits in a time of crisis.

Apart from the special treatment it sets out for fiduciary loans, the consultation document does not mention specific business models. This results in significant disadvantages for banks which are specialised on business lines featuring a lower risk profile such as building finance, commercial property financing or housing finance. Under the provisions of Article 429(11) CRR, particularly loans under promotional schemes (e.g. by the German Reconstruction Loan Corporation (KfW) or the German state development banks) shall only be excluded from the leverage ratio if and when the loans constitute fiduciary assets. However, at present, the majority of loans from promotional schemes fails to meet this criterion and is thus not eligible for preferential treatment. This is inconsistent with the national promotion of, for instance, renewable energies. Hence, the current proposals should clarify in an unambiguous manner that also loans from promotional schemes shall be clearly excluded from the calculation of the total exposure measure.

Derivative exposure

The EAPB takes note that the Basel Committee's approach to derivatives seeks to ensure a consistent treatment of collateral for banks subject to different accounting frameworks. While we agree with the goal of ensuring a harmonized approached, we believe that the regulatory framework should incentivize the use of collateral to reduce exposures, and accordingly we are concerned about the proposed non-recognition of collateral to measure OTC exposures. Furthermore, though we agree with the statement that collateral can be used to increase the leverage, we do not agree that the sheer possibility should already be reflected in the leverage ratio. At the occasion when the collateral will actually be used, it will automatically be reflected in the leverage ratio.

Furthermore, we would ask for a clarification in respect to indent 28: in our preliminary understanding, the language under indent 28 is unclear because it does not stipulate clear proceedings for the treatment of off-balance sheet collateral. The EAPB therefore suggests a

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clarification that off-balance sheet collateral provided (e.g. from lending transactions) will not increase the exposure either.

Securities financing transactions

The EAPB is raising concern over the inability to net exposures in the calculation of the leverage ratio which is inconsistent with both GAAP and IFRS. There is no accounting, legal or economic basis for the proposed treatment.

For example, the netting of repos against reverse repos to the same counterparty that does not generate duplicative systematic exposure from an accounting or business view, but is at the heart of the processes for ensuring liquidity is appropriately distributed in the system. In addition, we believe that removing Basel II netting for SFT assets as proposed in the consultative document risks curtailing the repo market, which is a major source of liquidity for both financial and non-financial institutions, particularly during stress events. A smaller repo market will reduce short-term lending and can create greater reliance on government funding during a liquidity freeze, and will make government securities less liquid.

Where legally enforceable netting arrangements are in place (as is permitted in the Basel II framework) the EAPB strongly encourages the Basel Committee to re-consider its position.

The current provisions incur another disparity, we would like to point out: The leverage ratio definition does not distinguish between collateralised transactions and uncollateralised transactions. This results in disadvantages for collateralised securities lending / repo transactions compared to uncollateralised transactions thus creating a massive incentive for uncollateralised transactions. Given the fact that - compared to the reverse repo - the risk inherent in an uncollateralised credit exposure is clearly higher, this approach is unjustified. From a supervisory and macro-prudential point of view, these incentives for uncollateralised transactions will have negative repercussions for the financial stability. Since the repo market is an important monetary transmission mechanism which assists central banks in verifying the effectiveness of their decisions, the current proposals will also have negative repercussions on monetary policy.
We instead suggest the use of supervisory haircuts as a sufficiently prudent measure for calculating the leverage ratio.

Concerning the treatment of agent transactions in SFTs set out under indent 37 ff., the treatment of agent transactions in derivatives remains unclear. Banks generally act exclusively as financial intermediaries ("in its own name and on behalf of its customers"). As a consequence, when it comes to the underlying transactions they do not participate in risks or benefits, nor do these transactions have to be shown on the balance sheet. Hence, we

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hold the view that these transactions do not have to be included in the exposure calculation of the leverage ratio and we would welcome a corresponding clarification.

Other off balance sheet exposures

The EAPB appreciates the inclusion of a 10% credit conversion factor (CCF) for unconditionally cancellable facilities and the commitment to review the appropriateness of this to ensure it is appropriately calibrated. However, we also believe that the two bucket approach to CCFs is still too blunt. The approach taken here should be aligned with the approach taken under the LCR measure, whereby one has to keep in mind that the CCF's used there already incorporate a very severe stress scenario.

Disclosure Requirements

The EAPB holds the opinion that the requested quarterly disclosure of the leverage ratio is too frequent. In line with the disclosure requirements for the Pillar 3 reports, we suggest an annual disclosure interval. Furthermore, we are of the opinion that the disclosure in the annual financial statements proposed in the present consultation document is inappropriate. We suggest a disclosure in combination with the supervisory ratios in the Pillar 3 reports (this approach is also envisaged under the CRR). The consultation document refers to the possibility of incorporating a Pillar 3 reference in the financial statement. In our view, this is neither efficient, nor is it feasible and should be deleted.

In case of questions or comments, please do not hesitate to contact us.

Best regards,

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