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Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of some 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.

EBF response to consultation on Revised Basel III leverage ratio framework and disclosure requirements.

The EBF welcomes the possibility to give input to the BCBS consultation on the leverage ratio.

EBF Key Points

- The EBF supports the view of the BCBS that the leverage ratio should remain a simple backstop measure that complements the risk-based capital framework for banks.
- The EBF considers it positive that the BCBS in its proposal intends to achieve a uniform and consistently defined measure by seeking convergence in the treatment of assets and liabilities offsetting across accounting regimes in order to ensure an international level playing field. This, however, would have unintended consequences resulting in an Exposure Measure that is excessively inflated and too punitive for banks.
- The proposed Exposure Measure would make the leverage ratio the main constraint of regulatory capital and not a simple backstop measure, as it should be in the EBF’s view and as stated by the BCBS. The EBF therefore suggests that the BCBS adjusts the proposed rules to retain the leverage ratio as a backstop measure. This should be done by allowing for the incorporation of on balance sheet netting.
- The EBF is especially concerned about the proposed treatment of Securities Financing Transactions (SFT) exposures and derivatives. The main issues are: the gross measure of SFTs, derecognition of collateral and notional treatment of written credit derivatives. Those measures would disproportionately increase the capital required to sustain essential banking activities in compliance with the leverage ratio and potentially make them unviable. The EBF understands that the leverage ratio as a backstop measure does not intend to measure the risk of loss, but, at the same time the leverage ratio should be a fair reflection of the banks’ activity without requiring double counting, discouraging prudent risk practice and creating unintended effects on the real economy.
- Furthermore, the EBF is concerned that the proposed leverage ratio contradicts other newly implemented BCBS regulatory reforms like the liquidity coverage ratio (LCR) and OTC derivatives reform. Especially regarding the LCR it should be noted that it is contradictory to ask banks to build up regulatory enforced buffers of high quality liquid

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assets through the LCR and punish this through the leverage ratio. EBF therefore proposes to exclude cash and LCR level 1 assets from the leverage ratio.

- Also, the proposed 100% Credit Conversion factor (CCF) for trade and export finance would be detrimental to such activities. The EBF instead proposes a CCF of 20 % in accordance with the CRR leverage ratio. The importance of trade finance for the real economy has been acknowledged in the BCBS LCR reform and should also be reflected in the leverage ratio.
- The EBF encourages the BCBS to make full use of the transition period and to postpone the disclosure date until the leverage ratio has been finally calibrated. This is especially important as the significant increase in the Exposure Measure may very well result in undesired effects that the BCBS might want to revise during the transition period. In this respect the EBF also encourages the BCBS to not recalibrate the leverage ratio level of 3% before it has been decided how to measure bank total assets under the leverage ratio. In addition, the leverage ratio should be introduced at a consolidated level only.

1. General comments

The leverage ratio should remain an easily calculated backstop

The EBF is concerned that the Exposure Measure proposed by the BCBS would be too punitive without a specific offsetting and economic rationale. The BCBS states that the leverage ratio should only be a backstop measure to ensure sound and robust bank capitalisation. However, in the EBF's view, the proposed Exposure Measure would lead to such a significant increase of the denominator that the leverage ratio would become the binding constraint of regulatory capital. Putting into place a leverage ratio more binding than the risk sensitive regulatory capital ratio would incentivise firms to shift to riskier assets and it appears to contradict the position of the BCBS itself. Hence, in a recent discussion paper[1] the BCBS states that: "*The Committee believes that a risk-based capital regime should remain at the core of the regulatory framework for banks, supported by liquidity and funding metrics as well as other measures such as a leverage ratio*". The EBF therefore proposes that the BCBS adjusts the proposed rules to retain the leverage ratio as a backstop measure.

Furthermore, the leverage ratio should apply at a group level only and not as a backstop below group level. The EBF would welcome more clarity from the BCBS in defining the scope of application, also in order to enhance a level playing field. In this respect it is important that for mixed financial holdings the assets of the insurance entities should not be part of the group's assets and the exposure in connection with derivatives, repo's and off-balance sheet items of the insurance entities would not be taken into account.

[1] The regulatory framework: balancing risk sensitivity, simplicity and comparability – BCBS paper 258.

The Exposure Measure should allow for on balance sheet netting

In the EBF's view it is important that the leverage ratio is a measure that is consistently defined in order to secure an internationally level playing field. In this sense the EBF finds it positive that the BCBS attempts to bridge differences in accounting regimes by seeking convergence in the treatment of offsetting assets and liabilities. However, this being said, the BCBS proposal for converging netting rules - i.e. by not allowing netting for SFT exposures and collateral for derivatives - disregards existing accounting standards for netting and excessively inflates and exaggerates the exposure measure. Overall, this treatment would increase disproportionately the capital required to sustain some of the essential banking activities in compliance with the leverage ratio and potentially make them unviable. EBF therefore urges that the BCBS allows the netting between payables and receivables for SFTs and collateral for derivatives.

Consistency with BCBS reforms on OTC derivatives and Liquidity Coverage Ratio

The proposed leverage ratio would introduce incentives in the regulatory framework that are not consistent with other major regulations. For instance, the OTC derivatives reforms agreed by G20 impose higher standards in terms of collateralization of derivative transactions. The changes proposed by the BCBS would not recognize any value to this collateral and would create reverse incentives to the ones provided in derivatives' regulations. The EBF also challenges BCBS' view that these changes would improve banks' risk management.

Another example of inconsistency in the regulatory architecture is the LCR reform where banks are required to hold buffers of high quality liquid assets for which they would then be punished through the leverage ratio. During crises, a flight to quality occurs, which would inflate banks' leverage ratios. This could cause leverage constraints to occur in periods of heightened risk awareness. In such an environment, banks would have two options, either not to accept the deposits driven by the flight to quality or to increase riskiness in other portfolios in order to boost returns. Neither effect is desirable. The EBF hence proposes to exclude cash and LCR eligible level 1 assets from the leverage ratio calculation.

Differences in balance sheet structures across jurisdictions should be acknowledged

Although a common leverage ratio calculation would be beneficial, there would be problems when comparing European and US banks using this single yardstick. This is because the balance sheet structures in these two regions are materially different. European banks have balance sheets with an "originate and hold" profile where assets are originated and held on balance sheets until maturity. By contrast, US banks benefit from highly developed securities markets which facilitate their "originate and distribute" model. This means that European corporates rely more

heavily on bank loans than their US counterparts[2]. Furthermore, quite a significant portion of the residential mortgages in the US are transferred to the GSEs[3]. Clearly these different business models lead to different balance sheet structures with European banks retaining more high quality assets - e.g. low LTV mortgages - than their US peers. As a result of these high quality corporate/government/retail assets, European banks carry a comparatively heavier weight of leverage from financing the real economy than US banks and therefore bear a higher capital charge to comply with the leverage ratio.

Especially, the leverage ratio could have some unintended effects on the residential mortgage business in Europe. Given that this is a low risk portfolio with required capital typically around 1, 5% in Europe, the 3% leverage ratio represents in practice a doubling of capital requirements, regardless that these portfolios have a low risk profile both from a credit risk and a model risk point of view.

Hence, the application of a common leverage ratio standard across different banking systems would result in a competitive disadvantage for European banks. This would especially be the case if the leverage ratio becomes the binding driver of regulatory capital as envisaged in the BCBS proposal. EBF finds that the mentioned regional differences in balance sheet structures should be taken into consideration and neutralised as much as possible by the BCBS in the final calibration of the leverage ratio.

2. Specific comments

A. Exposure Measure

(ii) General measurement principle (points 16-42)

Regarding the Exposure Measure the EBF is mainly concerned about the proposed treatment of SFT exposures, collateral for derivatives, written credit derivatives and off-balance sheet exposures, notably trade and export finance. The EBF believes that this treatment will have a severe impact on a set of assets that are important to the financing of the real economy, potentially making these products unviable.

In order to minimise the distortive effect of the proposed measure, a possible approach for the BCBS to consider is to allow the netting of the SFTs and derivatives exposures and their collaterals if they are enforceable by the relevant contracts. This measure is consistent with the disclosure requirements provisions of under IFRS 7 §13C(e) and US GAAP topic 210-20-50-3(e). This caters for BCBS' goal to neutralise the difference in accounting regimes for the level

[2] 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.

[3] According to 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.

playing field purposes, without unreasonably and artificially inflating the exposures. Moreover, the coherent approach between IFRS 7 §13C(e) and US GAAP 210-10-50-3(e) provides an additional benefit of facilitating the market participants' understanding of the leverage ratio and the assets disclosed in the annual reports of the banks, regardless of the accounting divergence. It would significantly contribute to improving the market transparency.

This argument is further developed below for each of the asset types mentioned.

<u>(b) Derivative exposures (points 22- 33)</u>

Treatment of related collateral (points 26-29)
This framework suggests that derivatives be calculated as the replacement cost plus an add-on for potential future exposure. EBF would be comfortable with this *if it is within the same netting set* meaning that negative PVs (on the liability side of the balance sheet) offset positive PVs (on the asset side of the balance sheet), and therefore only the net amount (if positive) is included in the denominator of the leverage ratio.

In the revised leverage ratio proposal, however, 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. Hence, the risk-reducing effect of collateral would be ignored based on the assumption that collateral would create leverage as stated in point 26. The EBF does not agree with this view. If the bank re-uses collateral for another transaction to leverage itself, it would be required to include the assets generated in that transaction in the Exposure Measure. Thus, the bank would be compelled to hold additional capital resulting from those increased assets to meet the leverage ratio requirement. On the contrary we believe 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 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 no reason why the treatment of the exchange of collateral should end up in a different result. On the listed derivatives market (futures), PV is reset every day with the CCP. The EBF suggests reinstating the use of the Current Exposure Method (CEM) or the Non-Internal Model Method (NIMM) in this regard,

By penalizing the treatment of collateral in derivatives transactions the BCBS would introduce wrong incentives, as it would 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 uncleared derivatives. The EBF recommends that the BCBS acknowledges this true nature of collaterals and allows recognition of them by netting set.

Written credit derivatives (points 30-33)
In addition to the Current Exposure Method (CEM) or the Non-Internal Model Method (NIMM) treatment of derivatives and related collateral this 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 for credit derivatives to be treated any differently from other derivatives. Hence, the EBF proposes that the same Net PV + add-on approach be applied. The BCBS concern addressed here is particularly not relevant for a trading book activity.

(c) Securities financing transaction (SFT) exposures (points 34-39)

The proposed treatment for SFTs in the exposure measure of the leverage ratio seems to be based on a flawed vision on financing the economy via these market instruments. Primary securities issuing activity is of course very useful for the economy, but the secondary market transactions through SFTs are also absolutely essential to supply liquidity to finance the economy. They are not designed for excessive leverage or speculation. Furthermore, the proposed approach is somewhat inconsistent with structural reforms of the banking sector currently under way in the US and in Europe which to a certain extent recognises the important role played by these transactions by exempting them from the definition of speculative activities to be separated.

According to the proposed framework 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 repos and security borrowing transactions, i.e. to the financing element inherent to those transactions. No netting is allowed against the security leg of the same transactions or 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. Reverse repos and security borrowing transactions would receive the same treatment as unsecured financing despite their highly secured nature.

The EBF does not understand why the BCBS does not allow for netting cash received and paid to the same counterparty. Portfolios that are in essence risk and leverage neutral should not inflate the reported leverage. Furthermore, we believe that for "trading "portfolios in securities finance transactions one should only look at the net exposure and the credit exposure as reflected

in the haircuts. With regard to the latter EBF understands that comparability is sought. However, this will lead to double reporting requirements for banks who report on internal model methods (IMM and RepoVaR).

The unintended consequences of the proposed treatment of SFT exposures include the followings among others:

- A less efficient transmission of the central banks' monetary policy by discouraging banks to take on these collateralised transactions with other players;
- A less liquid sovereign bond market for which the liquidity is supplied mostly by repo transactions which could result in increased volatility and more exaggerated moves in bond prices;
- A sharp increase in price for repos due to liquidity premium for both banks and corporates. The latter usually uses repos to manage their cash balances;
- A knock-on effect on corporate debt financing. Many 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 therefore will seriously undermine the financing capacity of corporates by significantly reducing the liquidity supplied into the debt market by SFTs.

The EBF suggests that 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 which carry more risks for banks and the financial system.

(d) Other off-balance sheet exposures (OBS) (points 40-42)

Regarding the treatment of off-balance sheet exposures the BCBS proposes to grant exceptional treatment - i.e. a credit conversion factor (CCF) of 10% - for commitments that are unconditionally cancellable at any time by the bank without prior notice. All other OBS items should be included in the exposure measure by applying a uniform 100% CCF.

The EBF encourages the BCBS to introduce a preferential CCF of 20% for trade and export finance, aligning with the leverage ratio calculated in the CRR. These activities are generally considered as key to the real economy and a field where banks add value by helping corporates improve their export performance.

The proposed rule is detrimental to trade and export finance. The treatments of the most classical trade products, Letter of Credit (L/Cs) and Letter of Guarantee (L/Gs) are too limited to their Off-Balance-Sheet nature. For instance trade Finance L/Cs are in essence transactional, have a fixed and stress-invariant maturity and their exposures are liquidated by cash upon maturity. As for trade finance L/Gs they are backing for the technical execution of a contract according to calendar or technical milestones.

This important role played in the real economy in particular by trade finance has been recognised in the BCBS LCR reform earlier this year. The EBF sees no reason that this is ignored in the calculation of the leverage ratio.

B. Disclosure requirements (points 43-46)

<u>(i) Implementation date, frequency and location of reporting (points 47-51)</u>

Disclosure date to be postponed

The EBF discourages the Basel Committee from imposing regulatory disclosure before the requirements for the leverage ratio have been finalised. Hence, the EBF proposes that the disclosure date be pushed from 1st January 2015 to 2H 2017/ 1H 2018, when the parallel run period will have ended and necessary final adjustments to the definition and calibration of the leverage ratio will have been made, as set out in the transitional arrangements in points 65 and 66.

As was the case with the changes to the quality and quantity of capital, market participants are also expected to require banks to comply with the unfinished leverage ratio requirements ahead of time. This would impede the degrees of freedom the Basel Committee will have during this very important phase in the policy development. The EBF finds this to be especially important as the significant increase in the denominator value may very well result in undesired effects that the Basel Committee might want to revise.

The EBF also suggests that the BCBS conducts an additional QIS first to study the effects of the proposed changes on banks' leverage ratios.

Frequency of disclosures

The BCBS suggests that large banks - irrespective of the frequency of financial statement publication - disclose their leverage ratio on a quarterly basis based on the average of the monthly leverage ratios over the quarter. The requirement for three months average reporting will create an additional burden without any material benefit. The EBF instead suggests that the leverage ratio should be published alongside the relevant financial results.

The EBF believes that the leverage ratio should be reported quarterly and at a Group level. We do not see any value being added in having subsidiaries calculate the ratio. In the event that the Committee requests for individual reporting, we would welcome more clarity on the necessary adjustments. Offsetting of an investee's on- and off- balance sheet exposures towards its owner should also be allowed.

(iv) Disclosure template and explanatory table, reconciliation and other requirements (points 56-63)

As a general remark the EBF notes that the Financial Stability Board has provided an Enhanced Disclosure Task Force composed of banks, auditors and investors to clarify the information needs of the various stakeholders. Against this backdrop, it would have seemed more appropriate for the supervisory community to await the views of those stakeholders first before issuing the proposal in the area of disclosure requirements for the leverage ratio. Experience gained in the past (i.e. the consultation on capital disclosures) has demonstrated that the views held by supervisors on this do not coincide with those of the user community and, more particularly, that investors prefer the data that banks need to publish to be restricted to data which they consider to be mostly relevant to avoid information overload.

Indeed, the proposed amount of information to be reported seems excessive. A large amount of information is not used for the actual calculation of leverage ratio, e.g. the business model reporting requirements. EBF questions the need for and benefit of these information requirements.

Furthermore, the EBF considers the scope of consolidation misleading. Grossing up for insurance activity means that (to the extent it is not deducted) assets of the policy holder rather than bank exposure is included in the leverage ratio. Policy holder insurance assets should be excluded from the calculation of the leverage ratio.

C. Transitional arrangements

As stated above the EBF considers it very important that the BCBS makes full use of the transition period to observe the proposed design and possible impact of the leverage ratio allowing itself the room to make adjustments without any interference from premature disclosure requirements.

As pointed out earlier in the response the EBF has some concerns regarding the structural differences between jurisdictions especially with respect to the treatment of European mortgages which tend to be held off-balance sheet in other jurisdictions. It is therefore likely that the leverage ratio will have an outsize impact on European banks relative to their peers. The EBF encourages the BCBS to consider such structural differences among jurisdictions in the assessment of the leverage ratio in the transition period.
