The Goldman Sachs Group, Inc. | 200 West Street | New York, New York 10282-2198
Tel: 212-902-1000

Goldman Sachs

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

20 September 2013

Dear Committee Members,

"Revised Basel III leverage ratio framework and disclosure requirements – Consultative Document"

The Goldman Sachs Group, Inc. ("Goldman Sachs") is pleased to provide comments on the June 2013 consultative document entitled "Revised Basel III leverage ratio framework and disclosure requirements" ("the Proposal"). Goldman Sachs has long supported the need for improved international capital adequacy standards, and we appreciate the continued efforts of the Basel Committee ("the Committee") to strengthen such standards.

Goldman Sachs has participated in the preparation of several comment letters written by industry trade associations[1], and we support the comments and recommendations in those letters. Given the extent of our concerns that the Proposal would have negative consequences for market liquidity, including in sovereign debt markets, and thus for the broader economy, we have chosen to supplement those letters with our own.

<u>A binding leverage ratio may increase systemic risk</u>

We recognize that there is a role for a leverage ratio requirement for banking institutions, as articulated by the Committee, to "reinforce the risk-based requirements with a simple, non-risk based 'backstop' measure." However, we are concerned that the Proposal would transform the leverage ratio from a simple backstop to a binding constraint by causing many global banks to be primarily constrained in their capital management decisions by the leverage ratio rather than by a

[1] The joint letter submitted by The Global Financial Markets Association, American Bankers Association, Financial Services Roundtable, Institute of International Bankers, Institute of International Finance and International Swaps and Derivatives Association (the "Joint Letter"), plus other response letters from The Clearing House, the Futures Industry Association and the Risk Management Association.

risk-based capital ratio[2]. Given the (intentional) lack of risk sensitivity in the leverage ratio, we believe that, when binding, it may lead to sub-optimal capital allocation and may incentivize banks to make poor risk-management choices. For example, in order to manage its leverage ratio and maintain its return on capital, a bank may feel incentivized to reduce its holding of cash and other lower risk assets and increase its holding of riskier ones. While the bank's ability to do this is ultimately bounded by the risk-based capital ratio and by liquidity regulations, we believe it would be harmful to the financial system for any regulation to result in such incentives. The risks are not only to individual banks but to systemic stability more broadly. For example, the inclusion of cash in the measure of leverage could have damaging consequences during times of crisis if banks are unable to accept deposits in a flight to quality because they are forced to manage their balance sheets within the constraints of the leverage ratio.

The proposed ratio is inconsistent with other regulatory objectives

We believe that several aspects of the Proposal are inconsistent with other regulatory objectives. We also believe that the Proposal attempts to address a wider range of regulatory issues than is necessary in this measure. As a result the Proposal does not fully achieve the Committee's stated objective of "a simple leverage ratio framework [that] is critical and complementary to the risk-based capital framework[3]." We expand on these points below.

First, the proposed leverage ratio incorporates a number of methodologies borrowed from the risk-based capital ratio framework (such as use of the Current Exposure Method ("CEM") for derivatives future exposure which, as has been documented, is a flawed approach[4]), or otherwise reflects assessments of the extent of underlying leverage of different activities without explanation as to the logic behind these assessments. Examples of this include the proposal to include 100% of the notional of written credit derivatives and the effective inclusion of all derivative positions as "assets". As a result, the Proposal appears to be a hybrid ratio that is far removed from the simple measure of a traditional leverage ratio (i.e., capital over assets).

Second, several aspects of the Proposal are inconsistent with other regulations and good risk management practices. Given the breadth and depth of other actual and proposed regulatory changes (including the recent final rules established for mandatory minimum margin requirements for OTC derivatives[5], the requirement for much derivatives activity to be centrally cleared, higher minimum capital ratios for Global Systemically Important Banks, limits on exposures to any single

[2] We refer you to the results of industry studies submitted as part of the Joint Letter and The Clearing House letter.

[3] Paragraph 3 of the Committee's consultative document.

[4] The Committee's June 2013 consultative document "The non-internal model method for capitalizing counterparty credit risk exposures" ("NIMM") notes that the need for the development of the NIMM approach was a response to criticisms of the CEM approach, which the paper says "does not differentiate between margined and unmargined transactions; the supervisory add-on factors do not sufficiently capture the level of volatilities as observed over the recent stress periods; and the recognition of hedging and netting benefits through NGR is too simplistic and does not reflect economically meaningful relationships between the derivative positions." Also see our own letter in response to the Federal Reserve Board's Proposed Rules for implementing Sections 165 and 166 of the Dodd-Frank Act, submitted April 2012.

[5] The Basel Committee on Banking Supervision and the International Organization for Securities Commissions (IOSCO) final framework for "Margin requirements for non-centrally cleared derivatives" (September 2013).

counterparty, as well as stress tests and resolution plans), we do not believe that all of the proposed adjustments contained in the leverage ratio are required.

Elements of the Proposal that are inconsistent with accounting standards, risk-based capital ratio treatment and other regulatory objectives include:

- The disallowance of netting for securities financing transactions ("SFTs") even where these are supported by legally enforceable master netting agreements. This proposal, combined with the inclusion of sovereign bonds held on-balance sheet, may make it more expensive for banks to participate in sovereign debt markets. Doing so would likely reduce liquidity in these markets and raise the cost of borrowing for sovereigns, with potentially far-reaching negative economic consequences.
- The proposed requirement to gross-up cash collateral (received and posted) for derivatives, despite the fact that collateral recognition is premised on legally enforceable collateral agreements. This proposal also conflicts with good risk management practices and seems inconsistent with the recognition by the Committee and the International Organization for Securities Commissions ("IOSCO") of the importance of collateral in OTC derivative contracts[6]. In addition, concerns with respect to re-hypothecation of collateral have been fundamentally addressed in the new margin framework for OTC derivatives. We are concerned by the counterproductive incentives that arise from such a requirement, namely the fact that a bank would be incentivized to seek securities collateral rather than cash collateral.
- The treatment of exchange-traded derivatives and centrally cleared OTC derivative transactions (together, "cleared derivatives"). Concerns about re-hypothecation of collateral do not arise with exchange-traded derivatives, given the role of initial and variation margin in these markets and the segregation requirements with respect to a client's collateral (both cash and securities). In addition, we do not believe the application of the CEM (which is based on a nearly 30-year old assessment of the capital required for counterparty risk on OTC derivatives contracts) is appropriate. If adopted as proposed, these requirements would make it significantly more expensive to operate as a clearing member, and would be problematic for client transactions where a bank serves as an intermediary for its clients in its role as a clearing member of the central counterparty. As more and more activity is routed through central counterparties, it is increasingly important that the appropriate exposure measure for these activities is included in the leverage ratio in order to make clearing on a broader scale feasible.

<u>The Proposal results in more than 100% of the maximum possible loss being included</u>
In the case of written credit derivatives, the Proposal would result in more than 100% of the maximum possible loss being included in the measure of leverage exposure and would treat

---

[6] "Margin requirements can also have broader macroprudential benefits, by reducing the financial system's vulnerability to potentially destabilising procyclicality and limiting the build-up of uncollateralised exposures within the financial system" (The Basel Committee on Banking Supervision and IOSCO final framework for "Margin requirements for non-centrally cleared derivatives").

derivatives and cash positions inconsistently, contrary to the Committee's stated intentions[7]. Examples of this are provided in the Joint Letter.

Given these concerns, we believe the Proposal should be amended in a number of aspects, which we outline below. These recommendations are set out in detail in the Joint Letter and the response letters of the other industry trade associations:

1. Cash and the most highly-liquid assets (such as those secured through reverse repos on G7 sovereign debt) should be removed from the measure of leverage, since their inclusion conflicts with sound liquidity risk management practices. We believe that regulations should not penalize a banking institution for maintaining a large pool of liquid assets, as would be the case if these assets were included in the leverage measure.
2. The leverage ratio should recognize both counterparty netting and cash collateral where transactions are subject to enforceable master netting and collateral agreements. Unless this aspect of the Proposal is amended, cash collateral received by a bank would impair its leverage ratio, since it would be included on the balance sheet without a corresponding reduction in the exposure it is intended to mitigate. The use of collateral is a critical component of exposure and risk management and is beneficial to both individual banks and the broader financial system.
3. The treatment of written credit derivatives should be revised to more closely align with true economic exposures and at a minimum to ensure that no more than 100% of the maximum possible loss to the bank is included in the Exposure Measure. Greater recognition of hedges should be allowed, consistent with the offsetting rules within the Committee's existing standard market risk capital rules.
4. Any measure of derivatives potential future exposure should not be based on CEM because, as we have indicated and as is broadly recognized, CEM contains several well-understood flaws.
5. The proposed adjustments for derivatives need to be fundamentally re-assessed prior to their application to cleared derivatives, in order to fully reflect the role of initial and variation margin, as well as the segregation of clients' assets.
6. We believe that the inclusion of 100% of the notional amount of commitments and guarantees is far out of line with actual experience of draw-downs on such commitments, even in stressed conditions. This may have negative implications for the level of lending that banks can perform, requiring significant asset and exposure reductions across banks, with far-reaching negative consequences for the broader economy.

We encourage the Committee to undertake a comprehensive study of the potential macroeconomic impact of the Proposal, including its impact on sovereign debt markets, as well as to assess its implications for individual banks through the Quantitative Impact Studies (QIS).

---

[7] "The Committee believes that it is appropriate to treat written credit derivatives consistently with cash instruments (eg loans, bonds) for the purposes of the Exposure Measure" (The Basel Committee's consultative document 'Revised Basel III leverage ratio framework and disclosure requirements').

We hope that these comments are helpful to the Committee in its deliberations. Please do not hesitate to contact me should you require additional information or have any questions about these issues.

Yours sincerely,

Sarah Smith
Principal Accounting Officer

cc. Mr. Michael Silva, Federal Reserve Bank of New York
Mr. Greg Gaare, Federal Deposit Insurance Corporation
Mr. Russ Damitz, New York State Banking Department
Mr. Paul Sharma, The Prudential Regulation Authority
Mr. Masamichi Kono, Financial Services Agency