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By email: baselcommittee@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sirs

Consultation on Revised Basel III Leverage Ratio Framework and Disclosure Requirements

We refer to the consultative document on the "Revised Basel III Leverage Ratio Framework and Disclosure Requirements" published by the Basel Committee on Banking Supervision (BCBS) in June 2013.

On behalf of our members, we write to provide our views on the proposals in the consultative document highlighted as follows:

Key Points

- The Leverage Ratio (LR) should be a simple tool that can easily be compared across different bank balance sheets, countries and business models.
- The LR should be a back-stop capital measure under normal circumstances and should only curtail bank activity in extremis. The LR should not be the primary driver of bank capital adequacy and should not therefore drive bank asset accumulation.
- An agreed minimum LR target should be determined for all banks after an appropriate period of analysis and calibrations. The calculation of the LR should be consistent for all banks, globally.
- Total Tier 1 Capital should be the numerator of the LR given that it includes all capital instruments available to absorb losses on a going concern basis.
- High quality liquid assets (HQLA) for regulatory liquidity buffers should be excluded from the denominator of the LR.

- Recognition of some measures of credit risk mitigation that effectively eliminates or reduces an on-balance sheet exposure to risks, such as collateral or guarantees, should be allowed.

- Off balance sheet assets related to trade finance should only be included in the denominator of the LR after reflecting the risks arising from these assets. It is recommended that the proposed European Union trade finance filters are applied for the LR calculation.

Specific Comments

Internationally Consistent Definitions of the LR Components

In so far as practicable, there should be internationally consistent definitions of the LR components. Studies have shown that, aside from the minimum level of leverage imposed, differences in how the LR is calculated across jurisdictions are a barrier to comparability.

A Back-stop Capital Measure

We have an overall concern with the seeming drift in the LR away from its stated objective. The BCBS stated in December 2010 that the LR was intended to "reinforce the risk based requirements with a simple, non-risk based backstop measure".

We agree that in the run up to the recent financial crisis many bank balance sheets were over-levered and that this excessive leverage contributed to the rapid de-leveraging of the bank balance sheets and consequent adverse impact on economic activity. We note that the enhanced bank regulatory environment – Basel III – includes improvements to both capital adequacy and liquidity monitoring which should ensure bank balance sheets are constrained going forward and are better able to withstand future economic shocks. We therefore believe a risk-weighted assets-based capital approach should be the fundamental driver of capital requirements.

If non-risk-based capital constraints such as the LR are calibrated in such a way that they become the primary driver of capital requirements, this will incentivise the wrong behaviour, i.e. for banks to reduce relatively low risk exposures and take on high risk exposures, which cannot be the intended consequence of the adoption of this measure.

A Minimum Leverage Ratio

The BCBS states it may make "final adjustments to the definition and calibration of the Basel III leverage ratio". Whilst we understand this is part of the evaluation and parallel run process, we would not recommend increasing the LR above 3%. A 3% LR is an appropriate reinforcement to, and backstop for, the primary risk based capital measure. Any higher LR requirement could turn the LR into a

binding capital requirement instead of a "backstop" for risk-based capital. This is especially true given that the current proposal would tend to increase the exposure measure.

Making the LR the binding capital requirement, not a backstop, is a fundamental change that would encourage institutions to prefer more risky assets to those that are less risky; this incentive is perverse and could lead to substantial unintended consequences in the markets for less risky assets, such as short-term government securities.

Furthermore, work done by the industry indicates that if the LR is set at a level above 3% it can become the main constraint for banks with certain business models – such as prime mortgage lending (the exposures to which typically attract a risk weighting lower than the value of the exposure). The Independent Commission on Banking (ICB) report, in their "Financial Report Recommendations" from September 2011, recognised that a LR which became a binding constraint may result in perverse outcomes. Banks may be faced with a choice of either:

- increasing capital to continue to support their low risk business model; or
- reducing the size of the balance sheet by reducing the exposure to portfolios (which attract a low risk weight) to replace them with a smaller number of portfolios which attract a higher risk weighting but also higher returns.

This was a view shared by Mark Carney, Chairman of the Financial Stability Board, who commented that "banks are safer" as a result of what he termed the "belt and suspenders approach" in which the "risk-weighted test is ... calibrated to bind before the leverage ratio".

In any event, the 3% LR should apply uniformly across participant markets to reduce compliance burden, reduce competitive disparities, reduce the opportunities for regulatory arbitrage and improve consistency across jurisdictions.

Tier 1 Capital

The Committee states that it will "continue to collect data during the transition period to track the impact of using either total regulatory capital or Common Equity Tier 1 as the Capital Measure." This measure cannot be considered in isolation of the calibration. We recommend the retention of Tier 1 capital as the Capital Measure. Tier 1 capital is more appropriate because it includes all capital instruments available to absorb losses on a going concern basis, especially given the Basel III reforms to increase loss absorbency of Tier 1 capital. We do however have concerns over the differences in what constitutes Tier 1 across jurisdictions. As with the jurisdictional accounting treatments that affect the LR denominator, the numerator will be affected by what qualifies as Tier 1 in different jurisdictions, this adds further complexity to the comparison of LRs across borders.

Adjustments to the Capital Measure

Regulators in some jurisdictions may require banks to hold a regulatory reserve against the loan portfolio and for this to be deducted from Tier 1 Capital. In determining the capital for LR purposes, we suggest adding back any excess of regulatory reserve over expected losses to Tier 1 Capital, since this represents the general buffer banks are required to hold by the local regulators.

To be consistent, we also propose to add back the shortfall of the stock of provisions to expected losses and the total expected loss in excess of total eligible provisions to Tier 1 Capital, instead of deducting from the exposures as proposed in paragraph 20 of the consultative paper, for the LR purposes.

Adjustments to the Exposure Measure

High quality liquid assets

Banks are holding increased levels of HQLA, largely as a result of revisions to the regulatory liquidity framework, which we broadly support. Regulatory defined unencumbered HQLA includes cash, central bank reserves, highly liquid government securities and other highly rated securities. The LR framework makes no distinction for such assets and requires capital to be held against these assets held for regulatory liquidity buffers for LR purposes. The LR should not penalise banks for acquiring HQLA to meet other regulatory requirements and, as this is somewhat contradictory to the purpose and intent of the Basel III LCR, we propose a deduction from the exposure measure calculation for all HQLA.

Support the recognition of valid and applicable netting

The current exposure method (CEM) is risk insensitive and so penalises those actively providing markets for transferring financial risk out of the commercial sector, mainly because the potential future exposure is proportional to the notional value of such transactions (even if there is complete netting of all risk). The exposures measure should reflect the quality of collateral and the offsetting effect of the legally enforceable netting agreements when calculating the potential add-on. If the BCBS revisions to this method are appropriately calibrated, they should provide a better measure.

BCBS is now developing a Non Internal Model Method (NIMM) for capitalising counterparty credit risk in which NIMM is considered as a more risk sensitive measure over the CEM. It would be better if the exposure measure is also based on a comparable method. This will reduce the operational burden of banks to maintain two sets of exposures measurement.

Netting should be recognised for collateralised lending

Short term interbank and central bank financing is at the heart of the liquidity flows for the financial system. We believe that the representation of exposures should recognise valid and enforceable netting of collateralised lending, for example,

securities financing transactions.

Credit risk mitigation

The LR proposals have consistently ignored collateral, guarantees, and other credit risk mitigation (CRM) techniques which can effectively eliminate or substantially reduce an institution's actual exposures to credit risk. The current proposals would not permit banks to use these well accepted CRM methods to reduce on-balance sheet exposures. We would recommend that the BCBS allow banks to recognise some measures of CRM that effectively eliminates or reduces an on-balance sheet exposure to risk, such as cash collateral.

Exposures relating to the clearing business for banks providing clearing services

Central clearing of OTC derivatives is mandatory to facilitate better protection to the participants in case of counterparty default. If the measure becomes binding on a bank then this would be a strong disincentive to the bank for offering clearing services to its clients, because its own leverage would become dependent on the client's business volumes.

Similarly, clearing balances for banks acting as settlement bank for payment clearing system should also be excluded from the total exposures for the LR purposes.

Exposures resulting from central bank funding

When central banks execute their monetary policy with an aim to provide funding to the general public through banks (e.g. to boost the economy during recession) or provide official liquidity to the interbank markets, the leverage ratio will become a hindrance to these monetary policy intents. To avoid this unintended consequence, we urge the BCBS to consider building flexibility to allow the exclusion of exposures resulting from the central bank funding from the exposures measure if necessary.

Assets held for backing banknote issuance

Regarding assets held by note issuing banks for backing the issuance of banknote which is applicable to some jurisdictions, including Hong Kong, we propose these assets should be deducted from the total exposures for LR purposes given these assets are offset by the corresponding notes in circulation and therefore the impact should be neutralised for LR measurement.

The notional value is not the uniquely appropriate measure for credit exposures

Credit exposures rightly recognise risk offset and we agree that credit protection sold and purchased in the same underlying and same seniority should be offset in the calculation of the LR.

Where optionality exists in credit protection bought or sold the notional may be an

inappropriate exposure measure and the regulatory exposure might be more appropriate.

Credit conversion factor (CCF) for trade finance related off-balance sheet items

The proposed framework requires banks to include all other off-balance sheet items in the exposure measure by applying a uniform CCF of 100%. This proposed treatment would be unduly penal for the trade and export finance activities. The European Union has addressed these concerns by including a CCF of 20% for such forms of finance in the LR rules of the CRR. Using a CCF of 100% for all exposures would grossly overstate the actual exposures that banks have been exposed to on a historical basis. Furthermore, the importance of trade finance for the real economy has also been acknowledged in the BCBS LCR reform and should not be disadvantaged in the leverage calculation, otherwise it will risk the unintended consequence of banks reducing these types of exposures, in addition to being inherently low risk, which are critical to the facilitation of trade in the real economy. It is therefore recommended that the BCBS also adjusts the CCF for trade and export finance in the exposure measure to 20%.

Scope of Consolidation

The consultative document does not specify at what level the LR should be calculated. We suggest the LR should be measured and monitored on a consolidated level only instead of on both a solo and consolidated level.

Furthermore, as stated in paragraph 12 of the paper, where a banking, insurance and financial investee is included in the accounting consolidation but not in the regulatory consolidation, the investments in the capital of these entities are required to be deducted to the extent that they exceed certain thresholds according to the treatment outlined in paragraphs 84 to 89 of the Basel III standard. The exposures of such investees should then be excluded from the Exposure Measure of the bank on a pro-rata basis in proportion to the capital that is excluded.

In this connection, to the extent where the investments in the capital of a banking, insurance and financial associate are not deducted from the capital of the investing bank and the associate is consolidated using the equity method of accounting, we consider that the treatment would be to include the share of the net asset value as consolidated for the associate, within the exposure measure. Please confirm our understanding on this.

Disclosure and Reconciliation Requirements

Given that there are already significant amount of disclosure and reconciliation requirements under the Basel III liquidity and capital frameworks, we consider that a high level explanation of the material differences between the on-balance sheet exposures in line 1 of the common disclosure template and the total on-balance sheet assets in the financial statement will suffice, rather than a detail reconciliation between the two numbers.

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We hope you would find our comments useful. Should you have any questions, please do not hesitate to contact our Assistant Manager, Mr. Timothy Tam, at (852) 2526 6080.

Yours faithfully

Boey Wong
Secretary

cc. Ms. Karen Kemp, Executive Director (Banking Policy), Hong Kong Monetary Authority