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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland
baselcommittee@bis.org

20th September 2013

Dear Sir/Madam:

Re: Response to the BCBS consultation on revised Basel III leverage ratio framework and disclosure requirements[1]

The IBFed appreciates this opportunity to comment on the Basel Committee on Banking Supervision (BCBS) proposal to revised Basel III leverage ratio framework and disclosure requirements.

We note below our high level observations and concerns and then address each section of the consultation paper in turn.

IBFed supports the supplementary leverage ratio as a backstop

IBFed supports the Basel Committee's stated objectives of developing a universally applicable leverage ratio that is a simple, non-risk based backstop measure that complements the risk weighted minimum capital adequacy framework, which in our view is the most appropriate way of ensuring that banks hold sufficient capital against the risks to which they are exposed

We also support the objective of developing an approach to the leverage ratio that is not influenced by the particular accounting standard adopted by the reporting bank and that treats all on and off-balance sheet exposures equally, although, as we note later, there are some categories of on and off-balance sheet exposure that in our view merit further consideration in light of the damaging effect that they could have on the financing of the broader economy if these credit facilities were withdrawn.

We note that a form of the leverage ratio is used in a number of countries around the world – with varying degrees of success in terms of macroeconomic stability - and that in our view

[1] http://www.bis.org/publ/bcbs251.pdf

the Basel Committee's proposals address a number of drawbacks of earlier iterations of its application in different jurisdictions by seeking to capture not only balance sheet leverage but also economic leverage, arising from market dependent future cash flows as well as embedded leverage arising from market risk. We support this more comprehensive understanding of leverage although we do have some concerns as outlined below.

We fear that the backstop leverage ratio, as currently conceived, is in fact a binding constraint

The proposed revisions to the supplemental leverage ratio denominator go too far, beyond reasonable measures of exposure or risk, and should be modified as they potentially increase the exposure measurement to the point where this ratio would replace the risk-based capital regime as the binding constraint. Our support of the leverage ratio in the 2010 framework was contingent on it remaining a backstop.

Were the leverage ratio to become the binding constraint, banks would be incentivised to engage in riskier activities in order to earn adequate returns to attract the capital needed to support the leverage test. Furthermore banks would be discouraged from holding low-risk exposures as exposures in the leverage ratio are not adjusted for risk sensitivity, as we believe they should be, for instance in the case of liquid assets. Both these effects will lead to the general discouragement of good risk management practices.

We believe that a case can be made for some risk sensitive adjustment, that differentiates between business models and takes account of the transparency and the magnitude of the risks being taken. For instance an adjustment should be considered to the treatment of assets held to support liquidity requirements to ensure coherence between different 'silos' of the regulatory architecture.

Without taking the transparency and the risks associated with the various business models into consideration in the calibration of the leverage ratio, as we have described above, the effect on the access and price of credit for these transparent and low-risk groups (amongst others public sector financing) will be severe.

Netting should be respected

A significant contributor to our concern about the potential for the currently proposed leverage ratio is that it does not take into account the ability for an institution to net exposures to counterparties.

We firmly believe that where legally enforceable netting agreements, which are supported by an independent legal opinion, are in place the exposure-reduction benefits they bring should be recognised.

Consistent application is key

Inconsistently implemented supervision damages the benefits that internationally developed supervisory standards can bring. IBFed fundamentally supports harmonised implementation of any Basel standards even more so in the case of the proposed leverage ratio because minor changes in execution could result in significant divergences in reported ratios. It is evident that a fully compliant Basel III (as proposed) leverage ratio set at 3% may correspond to a figure that is 50% higher depending on the calculation methodology adopted in individual countries. Without complete harmonisation of calculation methodology the potency that transparency can bring to the analysis of different banks in different jurisdictions will be lost.

IBFed's support of the leverage ratio proposals is contingent on globally harmonised implementation of the finally agreed ratio being achieved in practice. Deviation as a result of national discretion would frustrate efforts to create harmonised global standards and would create potential structural disadvantages for international banks and raise concerns about regulatory arbitrage.

Accounting Treatment of Operating Leases

There appears to be an emerging accounting issue related to the International Accounting Standards Board (IASB)'s and Financial Accounting Standards Board (FASB)'s proposed standards on leases which will impact the Basel III leverage ratio. The IASB is of the view that all leases should be recorded on an entity's balance sheet. This includes leases which do not transfer substantially all the risks and rewards of ownership of the leased asset to the lessee (currently referred to as operating leases in IAS 17). The rationale for the proposed accounting change is that since the lessee has the right to control the use of the asset and receive the benefit from using it for a specified period of time, it should recognise this asset on its balance sheet (the Right-Of-Use or "ROU" asset) along with a corresponding lease liability.

The recognition of ROU assets on balance sheet would decrease the leverage ratio proposed by the Basel Committee simply through the gross up of assets on banks' balance sheets. It will also impact the Basel III risk-based capital ratios. More capital would be required to off-set these impacts.

In the remainder of the document we comment, section by section, on the consultation paper.

Specific comments on each section of the consolation paper

Definition and minimum requirement

We appreciate that the rules are trying to ensure that leverage is not manipulated on a monthly basis. However the additional requirement to use an average of three month-end ratios places additional regulatory burden on the production of monthly balance sheets that

are not normally reported externally. Specifically, we caution that some valuations/adjustments are only made quarterly, and thus would only be reflected in the last month of the quarter.

We therefore recommend that the leverage ratio be calculated as a quarter-end spot measure.

We support the Committee's reiteration of its commitment to test the proposed 3% ratio during the transitional period. Until the exact construction of the numerator and denominator (particularly in relation to the final approach to securities financing transactions (SFTs)) have been finalised we are unable to comment on the appropriateness or not of a 3% requirement but fear that without recalibration the leverage ratio may become the dominant capital constraint for significant elements of the industry, depending on their business model which we would not support.

It will be particularly important to understand the impact of the recalibrated ratio on different business models in order not to unduly penalise particular approaches, significantly 'originate to hold' or 'originate-to-repo'. For instance in Europe, where the corporate bond market is less developed, banks tend to have more exposure to corporate lending leading to bigger balance sheets. Similarly the absence of a government insured/supported mortgage bond market inflates EU bank balance sheet relative to US and Canadian peers.

Similarly an inappropriately calibrated leverage ratio could become a binding capital limitation for retail banks running truly low-risk strategies.

A second order effect may be a reduction in market liquidity as the proposals in relation to the treatment of repo are likely to have a significant impact on the provision of collateral as well as potentially discouraging credit risk mitigation via the provision of collateral, which we would not support and goes against recent regulatory initiatives. Further, US GAAP which was previously used in the U.S. regulatory leverage measure permits significant risk based collateral and netting reductions, and this has allowed short term interbank secured financing not to be impeded notwithstanding the leverage ratio limits. The impact of collateral and netting requirements under the Basel III leverage ratio are unknown. For instance EU banks have not previously had to work with a leverage constraint, so the effects on stability critical short term liquidity flows should be examined with care.

Capital Measure

We believe that the capital measure should be based on a wider approach to an institution's capital rather than just its core equity tier 1 (CET1) capital. This should include those non-core capital instruments that are classified as Additional Tier 1 capital. Our view is that the leverage measure takes a going concern approach which should be supported by the totality of an institution's potential Tier 1. It should be noted that the loss absorbing capacity of Additional Tier 1 capital has been significantly improved as a consequence of the Basel III revisions.

Exposure measure

i) Scope of consolidation

We support the Committee's premise that the scope of application of the leverage ratio should be consistent with that of the capital requirements with respect to the deductions from capital as required by the Basel III standards. We believe the proposals in the consultation paper achieve this and thank the Committee for clarifying some of the questions about the scope of the requirement that arose during the completion of the recent QIS.

We note that, for those institutions subject to it, IFRS 10 has introduced different principles of control as the basis for consolidation that may conflict with the scope of regulatory consolidation. We suggest that authorities should work towards a single consistent basis for treatment of consolidation. As we believe that the regulatory risk based capital approach should be the limiting measure for prudential purposes, in our view, leverage constraints should be similarly constructed, based on a single consistent view of consolidation.

We are concerned that the proposal requires recognition of joint venture exposures without an offsetting recognition of capital contributed into joint ventures and request that the Basel Committee modify the consolidation framework to correct this.

ii) General measures principles

a) On balance sheet exposures

We agree that all on-balance sheet assets should be included in the exposure measure, subject to the treatment of derivative and SFTs.

We believe however that an argument can be made for netting of on balance sheet exposures where there is a legally enforceable netting agreement in place. When taken to its extreme on a bilateral arrangement of €100 loans vs. €100 deposits a bank would have zero exposure and no ability for either party to create incremental leverage. The calculation however would suggest both the borrower and lender would have 200 of "fictional" leverage

In addition we believe the Committee should revisit and change the treatment of highly quality liquid assets (HQLAs) - especially in light of the greatly expanded exposure measure now contemplated in the proposed framework and the continuing 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, for instance in the case of LCR Level 1 HQLAs, 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 capital is meant to offset. At the same time, there are very strong prudential reasons to incentivise banks to hold higher levels of highly liquid assets, not lower levels. And, at times, banks are 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 in times of economic stress. The leverage ratio should not penalise banks for conducting this core banking function. Moreover, it should not penalise the safest banks that are the most likely to attract deposits in a time of crisis.

b) Derivative exposures

We note that the Committee's approach to derivatives seeks to ensure a consistent approach to collateral for banks subject to different accounting frameworks. While we agree with the goal of ensuring a harmonised approach, we believe that the regulatory framework should incentivise the use of collateral to reduce exposures, and accordingly we are concerned about the proposed non-recognition of collateral to measure OTC exposures. In particular, we recommend that the Committee consider the treatment of OTC derivatives collateral under NIMM as a possible guide to measuring leverage exposure.

We are concerned that the risk insensitive nature of the proposed approach is likely to penalise banks that contribute most to the effective distribution of risk through the system, and therefore believe this will have a negative knock-on effect on the liquidity of derivative markets and therefore the cost to the non-financial sector of reducing its market risks.

c) Written credit derivatives

The Basel Committee proposes to single out written credit derivatives for a unique exposure measurement based on the notional value of such instruments, reduced only by hedges that meet strict criteria. We believe that there is no conceptual or empirical foundation for the proposed treatment of written CDS in the leverage ratio, and that even if unique treatment should apply to this derivatives asset class, the proposed hedge recognition criteria are too narrow.

Written CDS exposures should be measured like other derivatives asset classes' exposures for purposes of the leverage ratio. The only difference between written CDS and most other derivatives asset classes is that they have a credit product underlier; otherwise these instruments have the same exposure characteristics as other derivatives, such as equity and commodity products. The proposed treatment of written CDS would make credit derivatives uneconomic and cannot be supported on either conceptual or economic grounds.

If, however, the Committee elects to treat written CDS as a unique asset class, we believe that recognition of offsetting hedges should be expanded. We appreciate that the proposed approach would permit netting of bought and sold credit protection on the same reference name. We agree with the Basel Committee that CDS exposures are reduced when effective hedges are in place. We are concerned, however, that the hedging criteria are not broad enough to recognise hedges that reduce economic exposure but are not same-name, same-maturity, same-seniority hedges. At a minimum, we believe the Committee must recognise exposure-reducing hedges even where maturities are not perfectly aligned, as these positions nonetheless reduce exposure.

In addition, we believe that the proposed approach in the leverage framework to derivatives in general, and to written CDS in particular, needs to be reevaluated and aligned with the Basel Committee's NIMM proposal.

d) Securities financing transaction exposures

We are most concerned with the Basel Committee's proposals in relation to SFTs as they appear to produce a situation where for leverage ratio purposes, there is a requirement to apply a credit add-on to the gross position, without netting the derivatives and the securities leg of the transaction. This seems counter-intuitive as we do not see how SFT exposures could ever exceed the gross amount of collateral.

Of more concern however is the inability to net exposures in the calculation of the leverage ratio. This is inconsistent with both U.S. GAAP and IFRS and 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, 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) we strongly encourage the Basel Committee to re-consider its position and allow the netting of cash payable and receivables.

e) Other off-balance sheet exposures

Trade finance

Trade finance, which we do not believe is a source of potentially significant leverage, is another category of off balance sheet exposure that we believe should be subject to a lower CCF given its importance in financing the wider economy. Trade finance is a low risk, short-term transaction, stand-alone that assists customers with their import and export requirements. A 100% CCF for trade finance, as is currently proposed as part of the leverage ratio requirements, will increase the cost and/or reduce the availability of such financing and adversely affect economic growth and we urge the Basel Committee to consider how this can be achieved in a harmonised way, perhaps for simplicity based on the approach taken in CRD IV/CRR.

Other off-balance sheet commitments

While off-balance sheet commitments are a source of future leverage due to borrowers' potential to drawdown, applying a 100% credit conversion factor (CCF) to undrawn committed facilities implies that all these commitments will be drawn simultaneously without exception. This ignores the business reality that banks could refuse funding based on the terms and covenants of the credit facilities. The proposed 100% CCF is overly conservative and is not in line with the 20% and 50% CCF permitted under the standardised approach, which reflects the reality that the drawdown of commitments is subject to terms and conditions of the credit arrangement. Alternatively, the CCF used in the LCR can be used. They are a very conservative set of CCF's that already incorporate a very severe stress scenario.

LCR effects

Furthermore, the 100% CCF is troubling when considering the liquidity framework. That is, the LCR requires a bank hold unencumbered cash or other liquid assets to cover the total net cash outflows over a 30-day period under a stress scenario. Off-balance sheet commitments must be included in the total net cash outflows according to drawdown percentages, and a bank must hold sufficient cash or other liquid assets for such commitments to meet the LCR. Such cash or other liquid assets will in turn be added to the exposure measure in addition to the 100 percent CCF for off-balance sheet commitments. As a result, the exposure measure for an off-balance sheet commitment would effectively be greater than 100 percent (line of credit plus highly liquid assets) for purposes of the leverage ratio.

Disclosure requirements

The IBFed discourages the Basel Committee from requiring regulatory disclosure before the requirements for the leverage ratio have been finalised. 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 is especially important as the significant increase in the denominator value may very well result in undesired effects that the Basel Committee may subsequently wish to revise. We also suggest the Basel Committee should conduct an additional QIS to study the effects of the proposed changes on banks' leverage ratios.

The proposals surrounding reporting and disclosure may give rise to various concerns regarding the level of detail of the disclosures on a quarterly basis. Under Pillar 3, most banks only disclose a limited amount of capital and risk information in the quarters in which financial statements are not published.

These tend to be confined to the key capital ratios, without a further breakdown of the numerator and denominator. To align disclosure of the leverage ratio with current capital

reporting requirements, we propose that for the quarters in which financial statements are not published, the minimum mandatory reporting requirements should be restricted only to the disclosure of the end of quarter leverage ratio.

Finally, we note that the aim of disclosure and Pillar 3 generally is to ensure transparency of information to the market and to enable the market to compare banks. For this reason, it is necessary that the leverage ratio be required to be calculated and disclosed on globally harmonised principles. Both the numerator and denominator should be globally harmonised and not be affected by national discretion.

We assume that providing the disclosure either in the financial statements or the supplemental financial information, which are both kept on the website, is sufficient for on-going archiving requirements.

To ensure accurate comparisons and a level playing field, the implementation of the disclosure requirements should start in the same time period across jurisdictions. Also, given that the leverage ratio is designed to be a back-stop measure, we feel inclusion in the supplemental package is more appropriate.

Yours sincerely

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