JFMC Japan Financial Markets Council

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Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland
Submitted by e-mail: baselcommittee@bis.org

Dear Secretariat

Comment on: Revised Basel III leverage ratio framework and disclosure requirements

1. Overall position

The Japan Financial Markets Council (JFMC)[1] is grateful for the opportunity to comment on the Basel Committee on Banking Supervision's consultative document on the revised Basel III leverage ratio framework and disclosure requirements. We support a leverage standard that acts as a backstop and complements and reinforces the risk-based capital and liquidity regimes, as well as enhancing other regulatory reform initiatives. However, we believe the proposals outlined in the consultative document to redefine and expand the scope of the leverage ratio denominator may not have the desired effect and may create a number of new problems.

The JFMC believes that as leverage ratios are designed to be a backstop measure of the risk-based capital regime, the proposed additions to the Basel III leverage ratio denominator for derivatives and Securities Financing Transaction (SFT) exposures are not appropriate. We are concerned that the introduction of these proposals will produce an exaggerated leverage ratio denominator that will elevate the risk-insensitive leverage ratio and will constrain business. Rather than act as a backstop the outcome of such a measure is likely to result in firms (particularly wholesale and investment banks which play an important role as a market-maker and provider of liquidity) reducing their holdings of low-yielding high quality assets. We believe the consultative proposal would damage financial market activities as it would limit the intermediary functions of market-making and the provision of liquidity. Firms would not be able to hold on their balance

[1] The JFMC is an association which includes representatives from five Japan-based and five international firms active in Japanese capital markets. Its aim is to ensure that authorities deciding on regulatory initiatives that have a global impact are aware of and take into account the effect of new regulations on Japanese capital markets. The current JFMC members are: Bank of Tokyo-Mitsubishi UFJ, Daiwa Securities Group, Mizuho Securities, Nomura Holdings, SMBC Nikko Securities Inc, Bank of America Merrill Lynch, BNP Paribas, Citigroup Japan Holdings Corp, Deutsche Bank Group, JPMorgan Securities Japan Co., Ltd. and Morgan Stanley Japan Holdings. The co-chairs of the JFMC are the representatives from Morgan Stanley and Nomura.

sheets large volumes of High Quality Liquid Assets (HQLA), including high quality sovereign debt like Japanese Government Bonds (JGBs). This would substantially reduce market liquidity for this type of asset and consequently risk the effective and efficient functioning of wider financial markets, which play such a critical role in ensuring financial system stability and economic growth.

The resulting unintended consequences could be considerable, including having a negative impact on repurchase and securities financing. This could in turn raise funding costs for governments and other issuers and end-users, and might even hamper the money market operations of central banks. The outcome would be in sharp contrast to other regulatory efforts and proposals to encourage institutions to hold more HQLAs rather than less.

The JFMC believes the leverage ratio should continue to act as a backstop measure in line with the original policy aim and respectively requests that the BCBS should reconsider its position and not expand the leverage ratio denominator.

2. Specific comments on proposed changes

The consultative document includes a number of specific changes which we believe are potentially problematic.

a. Netting, and collateral effects in derivatives and repos/SFTs

JGBs and other HQLAs are frequently used in securities financing transactions (SFTs). The consultative proposal would measure SFT exposures in the leverage ratio denominator on a gross basis, without taking into account offsetting receivables or payables or the effect of cash collateral received from SFT counterparties. Similarly, the proposal would not allow for netting between off-setting derivatives positions.

There are several problems with this approach: (i) it exaggerates SFT exposures by disregarding collateral and netting arrangements, which are recognised under accounting, economic and legal regimes as valid forms of exposure mitigation; (ii) it would substantively impair the market for JGBs and other HQLAs, which are heavily used in SFTs. The JFMC believes it would be better to reflect the exposure netting under a legally enforceable netting agreement for derivatives, for SFTs in general, and for re-purchase agreements in particular.

b. Exposure to CCPs

While the BCBS and other regulatory and standard-setting bodies have designed rules to incentivise firms to trade derivatives through central counter parties, the JFMC believes the consultative document's leverage ratio proposal should also incentivise firms to trade through central counterparties (CCP) by excluding CCP transactions from the leverage ratio denominator.

c. Liquidity risk management

Prudential regulators strongly encourage banks to hold substantial amounts of HQLAs for liquidity purposes, including through formal HQLA requirements in the Basel Committee's Liquidity Coverage Ratio (LCR). The JFMC believes the leverage ratio should not penalise firms for being compliant with the LCR and instead, the capital regime should complement and support the liquidity regime. As such, the JFMC believes the BCBS should consider excluding all Level 1 HQLAs from the leverage ratio calculation, as defined by the Basel III LCR.

d. Treatment of written CDS

Sovereign debt instruments are frequently protected through credit default swaps (CDS). The proposal in the consultative document would require banking organisations to count 100% of the notional value of written CDS in the leverage ratio denominator (with only limited reduction for hedge recognition). This would significantly curtail firms' ability to write CDS, including where they protect JGBs and other HQLAs held by other market participants.

e. Exposure measurements

The Basel Committee has recognised the conceptual and technical weaknesses in the Current Exposure Method (CEM) as a measurement of Potential Future Exposure because the CEM only partially recognises the exposure-reducing effects of offsetting positions, even where the transaction is subject to a legally enforceable netting agreement. The CEM also fails to recognise the exposure-reducing effects of HQLA, collecting daily variation margin, applying haircuts to non-cash collateral and diversifying the risk of a derivatives portfolio.

The JFMC therefore believes the measure of derivatives exposures in the proposed leverage ratio calculation should, at the very least, be modified to remedy deficiencies under the CEM framework. We suggest it should initially be replaced by the Internal Models Method (IMM) as a provisional measure, and ultimately the Non-Internal Models Method (NIMM) once it is finalised, provided that it fully takes into account collateral and netting.

3. Wider concerns with the proposed changes

The JFMC believes that if the specific concerns noted above are not addressed, a number of wider macro problems might materialise including concerns about financial stability and economic growth. We therefore believe it is important to continue to take account of well-established procedures which are likely to help avoid detrimental effects.

a. The Importance of maintaining Weighting Risk

By greatly expanding the leverage ratio denominator beyond reasonable measures of exposure, the

consultative proposal potentially elevates the leverage ratio, rather than the risk-based capital regime, as the capital-constraining metric for many internationally active banks. The JFMC believes that, rather than a leverage ratio, a risk-sensitive capital regime should be the capital-constraining metric, since this ensures appropriate risk management; manages systemic risk; preserves high-quality sovereigns' ability to fund themselves in the debt markets; and also ensures that banking organisations have sufficient HQLAs on their balance sheets to meet stressed funding requirements.

The Basel Committee has for many years consistently endorsed the importance of risk weighting building on its observation in the first Basel Accord in 1988, that "*a weighted risk ratio in which capital is related to different categories of asset or off-balance sheet exposure, weighted according to broad categories of relative riskiness, is the preferred method for calculating the capital adequacy of banks.*"[2]

The JFMC believes the experience from Basel I suggests that measures that are too simple do not necessarily ensure the safety and soundness of the financial sector, and can often exacerbate it. To the extent that the risk weightings have imperfections, they should be improved rather than de-emphasized by giving an expanded role to a leverage ratio.

b. Avoiding perverse incentives

The proposed leverage ratio is likely to result in a change of firm behavior. It is likely to incentivise them to reduce their holdings of high-quality assets but with a low yield in favour of riskier higher-yielding assets. This would encourage a perverse outcome and undermine risk management frameworks and controls.

c. Potential to damage Repos/HQLA markets

The proposals would limit firms' abilities to hold large amounts of HQLAs on their balance sheet. This would include JGBs which play such a pivotal role in the Japanese market. The outcome would be a weakening of demand for this type of government debt and repos, and the outcome would raise government borrowing costs with its knock-on macro-economic costs and also weaken firms' abilities to manage their liquidity.

d. Interaction with LCR requirements

The JFMC believes that the leverage ratio should be used as a backstop to risk-based capital. In doing so firms would be able to continue to act as market makers for high-quality sovereign debt instruments, and also to hold large volumes of such instruments, including JGBs, on their balance

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[2] Basel Committee, *International Convergence of Capital Measurement and Standards* (July 1988), ¶ 28

sheets. This would allow them to meet their liquidity requirements including those set out under the Basel Liquidity Coverage Ratio (LCR).

This approach also allows for a vibrant and deep market for high-quality sovereign debt instruments to thrive; to place artificial limits on firms' ability to hold large volumes of HQLAs on their balance sheets could impair the market. Using the leverage ratio as a backstop also guards against systemic risk by imposing a limit on firms' ability to hold excessively large volumes of assets relative to their capital bases, including low-risk sovereign instruments.

The JFMC therefore recommends that national regulators fully implement the Basel III capital accord and the related liquidity frameworks and the leverage ratio should not usurp this role but continue to act as a backstop which will complement and reinforce the risk-based capital and liquidity regimes.

4. Summary

The JFMC believes there are a number of problems with the proposals set out in the BCBS's consultation document which would have negative impact on a number of markets including the Japanese sovereign debt market. If there are any queries with any of our comments we would be happy to provide further information.

Yours faithfully,

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