Revised Basel III Leverage Ratio Framework and Disclosure Requirements[1]

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In view of the revisions relating to the denominator component of the Basel III Leverage Ratio – such proposals having recently been undertaken by the Basel Committee, as illustrated in its June 2013 guidelines, measures aimed at minimising regulatory capital arbitrage become all the more evident since banks are able to manipulate their way into increasing the leverage ratio by getting many assets allowed in the numerator and as little in the denominator: „cherry picking“ arbitrage having constituted a problem since the original Basel Capital Accord. Hence it could be argued that it is not the mere increase of leverage ratios that truly matters (even though this is also important), but measures aimed at ensuring that permissible contents/instruments are incorporated into the numerators and denominators of such leverage ratios.

Certain factors influential in the recent proposals and efforts aimed at achieving higher leverage capital requirements, according to U.S federal agencies,[3] include the belief that higher standards for the supplementary leverage ratio would reduce the likelihood of resolutions, and would allow regulators more time to tailor resolution efforts in the event those are needed. In their opinion, by further constraining their use of leverage, higher leverage standards could offset possible funding cost advantages that these institutions may enjoy as a result of the “too-big-to-fail” problem.

The Too Big to Fail Problem and Its Impact on Recent Legislative Proposals

According to a notice jointly issued by the Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance, „the perception continues to persist in the markets that some companies remain “too big to fail,” - posing, in their view, an ongoing threat to the financial system.[4] It is also added that:[5]

- First, the existence of the “too-big-to-fail” problem reduces the incentives of shareholders, creditors and counterparties of these companies to discipline excessive risk-taking by the companies.
- Second, it produces competitive distortions because companies perceived as “too big to fail” can often fund themselves at a lower cost than other companies. This distortion being regarded as unfair to smaller companies, damaging to fair competition, and such distortion tends to artificially encourage further consolidation and concentration in the financial system.

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1 Response to Basel Committee on Banking Supervision Consultative Document „Revised Basel III Leverage Ratio Framework and Disclosure Requirements, June 2013

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3 See Federal Reserve, 'Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions' at page 11 http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20130709a1.pdf.

4 See Federal Reserve, 'Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions' at page 7 http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20130709a1.pdf.

5 ibid

As well as the important objective of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) aimed at „mitigating the threat to financial stability posed by systemically-important financial companies“,[6] another vital and important means of fostering financial stability in averting another Financial Crisis, safeguarding and assisting financial institutions to navigate periods of financial or economic stress, in the agencies' experience, is strong capital. In their opinion, the „maintenance of a strong base of capital at the largest, systemically important institutions is particularly important because capital shortfalls at these institutions can contribute to systemic distress and can have material adverse economic effects. Further, they contend that higher capital standards for such institutions would place additional private capital at risk before the Federal deposit insurance fund and the Federal government's resolution mechanisms would be called upon, and reduce the likelihood of economic disruptions caused by problems at these institutions.[7]

The Basel Leverage Ratio's Role as a Supplementary Measure to The Risk Based Capital Adequacy Framework

According to Valladares, the June 2013 proposed leverage ratios by the Basel Committee, is a necessary supplement to the current risk-weighted asset credit risk measurement and is crucial to making banks better capitalized to sustain unexpected losses.[8] Even though many criticisms have arisen in relation to the risk taking incentives that could be induced by such recent Basel leverage proposals, the following observations highlight the importance of incorporating and supplementing risk based capital ratios, leverage ratios and the liquidity requirements with themselves since the implementation of one ratio in isolation, as will be highlighted, is likely to facilitate the tendencies for riskier ventures:

Valladares raises the point that even though critics of the proposed Basel guidelines argue that the leverage ratio would encourage banks to transact riskier on- or off-balance sheet instruments, that:

- if banks were to do so, such added riskiness would, however, raise banks' RWAs and force them to increase their capital. This action would also impact their liquidity coverage ratio by making the banks less liquid since most risky assets do not count for the LCR - which is another reason why the leverage ratio is an important complement to the RWA and liquidity buffers.[9]

In bolstering this viewpoint, Bundesbank Vice President Sabine Lautenschlaeger has re iterated that „the leverage ratio shouldn't be the main gauge because it doesn't demand more capital to back the more loss-prone investments, and thus can give bankers "unhealthy incentives" to take on more risk.“

6 Federal Reserve, 'Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions' page 8

7 Ibid at page 11

8 M Rodriguez Valladares, 'Why Basel' Latest Leverage Ratio is Better' http://www.americanbanker.com/bankthink/why-basels-latest-leverage-ratio-is-better-1060635-1.html

9 ibid

Arguments put forward by US Federal Agencies in Support of Recent Proposals

According to a report by the Federal Reserve, the following arguments were provided in support of the need for revisions to the Basel Leverage Ratios:[10]

- BCBS's approach for determining the minimum level of the Basel III leverage ratio was different than the calibration approach described above for the risk-based capital ratios.
- The BCBS used the most loss-absorbing measure of capital, common equity tier 1 capital, as the basis for calibration for the risk-based capital ratios, but not for the Basel III leverage ratio. In addition, the BCBS did not calibrate the minimum Basel III leverage ratio to meet explicit loss absorption and market confidence objectives as it did in calibrating the minimum risk-based capital requirements and did not implement a capital conservation buffer level above the minimum leverage ratio. Rather, the BCBS focused on calibrating the Basel III leverage ratio to be a backstop to the risk-based capital ratios and an overall constraint on leverage.
- The agencies believe that while the establishment of the Basel III leverage ratio internationally is an important achievement, further steps could be taken to ensure that the risk-based and leverage capital requirements effectively work together to enhance the safety and soundness of the largest, most systemically important banking organizations.

Furthermore, the agencies are of the opinion that the proposed rule would permit covered BHCs and their IDI subsidiaries to fund themselves more than 90 percent with debt while still satisfying the proposed leverage thresholds.[11]

Having highlighted the above, general consenus appears to favour proposals relating to the increase of Basel Leverage ratios in the U.S – with many commentators having considered the previous ratios to be inadequate.

Arguments Favouring Recent Basel Committee Revisions over those Updates Made to Basel Leverage Ratios in the U.S

In commencing this section, it needs to be highlighted that the recent moves and proposals in the U.S, in relation to the Basel Leverage Ratio, are very much welcomed and quite encouraging given the prior concerns that the implementation of Basel rules, regulations and initiatives appeared to be implemented at a slow pace in the U.S. The recent proposals in the U.S serve as indication, not only of the willingness to adopt Basel rules, but also reveal the extra steps being taken to ensure that financial stability is fostered and more rigid and stringent measures to avert another global scale crisis.

Arguments favouring recent Basel Committee updates over those proposals recently introduced in

10 Federal Reserve, 'Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions' pages 16 and 17

11 Ibid at page 24

the US, are partly based on the following:

1) The fact that revisions and proposals undertaken in the U.S are premised on Tier 1 capital, instead of higher-quality Core Tier 1.

2) Recent Basel Guidelines (June 2013) are more extensive in scope as opposed to the denominator of the U.S. leverage ratios which are based on original 2010 Basel Leverage ratios.

3)The cumbersome nature of the supplementary leverage ratio – which in the opinion of many commentators, will be more burdensome for subsidiaries of BHCs to comply with than the generally applicable leverage ratio for U.S. banks. It is calculated using a „tighter definition of Tier 1 capital in the numerator and the denominator includes off-balance sheet exposures such as the grossing-up of derivatives to include collateral and cash." (which is why many banks are likely to want to evade as much inclusion of such derivatives in the denominator – given the value/magnitude of derivatives). The 6% standard is considered by many to be onerous for bank subsidiaries covered by the proposal and may encourage banking groups to conduct certain activities, such as derivatives based activities, away from their subsidiaries. Furthermore, an introduction of the supplementary leverage ratio, it is most likely envisaged, will result in lower dividends being distributed by the BHCs.

4)The focus accorded to disclosures of the numerator and denominator components of the Basel Leverage Ratios in the Basel June 2013 Guidelines.

According to paragraph 43 of the Consultative Document on the Revised Basel III Leverage Ratio framework and Disclosure Requirements:[12]

- Public disclosure by banks of their Basel III leverage ratios commences on 1st January 2015
- To enable market participants reconcile leverage ratio disclosures with banks' published financial statements from period to period, and to compare the capital adequacy of banks across jurisdictions with varying accounting frameworks, it is important that banks adopt a consistent and common disclosure of the main components of the leverage ratios while reconciling to their published financial statements.

Paragraphs 44 as well as 45[13] underline the Committee's committments to, as well as its realisation of the need for focus on measures and initiatives aimed at facilitating the harmonisation and consistency of disclosure requirements across various jurisdictional frameworks which would also result in the facilitation of the realisation of the Basel Commitee's objectives and aims.

The need for consistency in the implementation of Basel requirements and regulations is all the more vital and necessary if practices relating to regulatory capital arbitrage are to be minimised and controlled. Differences in the implementation of Basel requirements and rules across various jurisdictions are evident from the very stringent application of rules in certain jurisdictions – as is recently evidenced by the U.S initiatives aimed at increasing Basel III Leverage ratios (above global standards) to those jurisdictions where more lax approaches have been adopted.

12 June 2013, Bank for International Settlements Publications, page 11

13 Which states that „to facilitate consistency and ease of use of disclosures relating to the composition of the leverage ratio, and to mitigate the risk of inconsistent formats undermining the objective of enhanced disclosure, the Basel Commiteee has agreed that internationally active banks across Basel member jurisdictions, will be required to publish their leverage ratio according to a common template."

Evidence which highlights the fact that different countries could be inconsistently implementing parts of the Basel rules and regulations – either by consolidating or weakening the original requirements , is illustrated through the following:[14]

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- In the EU, in relation to the Capital Requirements Directive/Regulation IV (CRD/RIV) - where based on evidence from latest proposals and negotiations, EU member states will assume greater independence in their ability to increase capital requirements.
- In China, where the implementation framework for Basel III is considered to be more stringent than the international standard (with a requirement of a higher core tier 1 capital adequacy ratio – 5% as opposed to 4.5%, as well as a higher leverage ratio requirement of 4% as opposed to 3%).
- In the U.S, as discussed through this paper, through recent proposals relating to standard and supplementary leverage ratios.

Having highlighted the above, it is also worth mentioning that over compliance with rules (and particularly where it appears that such rules or ratios appear to be insufficient) – as indicated by the increased ratios in the U.S, is certainly much better than under compliance.

Conclusion

The effects and consequences of the cumbersome nature of the supplementary leverage ratio, it is envisaged, will induce some banking groups to conduct certain activities, such as derivatives based ventures, away from their subsidiaries. Other consequences of recently introduced proposals in the U.S (on Basel III), include a reference by Myles to a separate Federal Reserve proposal – which from December 2012, „requires certain foreign banks to establish a U.S intermediate holding company to house their operations.“ In Myles opinion, if these holding companies' asset value is significantly high, they would have to comply with the higher leverage ratios.[15]

Despite the merits of improved consistency and harmonisation in the implementation of Basel rules and regulations – such merits including enhanced facilitation of disclosure and transparency, a balance also needs to be struck between the need to avoid a „one size fits all“ situation whereby the needs of respective jurisdictions are not met.

14 See JP Morgan, 'Basel III Implementation: Is the Industry Running Out of Time?' http://www.jpmorgan.com/tss/General/Basel_III_implementation_Is_the_industry_running_out_of_time_/1320504512062

15 Myles also adds that this is exacerbated by the fact that foreign banks are the biggest dealers in US treasuries – „which are penalised by un-weighted measures such as leverage ratios“ and that further, it is also possible that branches might have to comply with U.S leverage ratios – based on how the Fed Reserve construed its comparability test.“ See D Myles, 'How U.S 5% Leverage Ratio Could Catch Foreign Banks' <http://www.iflr.com/Article/3234308/Banking/How-US-5-leverage-ratio-could-catch-foreign-banks.html

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