Morgan Stanley

September 20, 2013

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

Re: Comments on Proposed Revisions to the Basel III Leverage Ratio

Ladies and Gentlemen:

Morgan Stanley appreciates the opportunity to provide comments to the Basel Committee on Banking Supervision (the "**Basel Committee**") regarding its June 2013 consultative document entitled *Revised Basel III leverage ratio framework and disclosure requirements* (the "**Proposal**").

Morgan Stanley is a global financial services firm that provides its products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. We are registered as a bank holding company with the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), and are subject to the Federal Reserve's consolidated regulation and supervision, including regulatory capital requirements that are based on standards developed by the Basel Committee.

We fully recognize and support the prudential and supplemental role that an appropriately calibrated leverage ratio can and should play in any capital adequacy framework. Indeed, as a U.S.-incorporated banking organization, Morgan Stanley has been subject to a leverage ratio requirement since it became a bank holding company. However, we are concerned that the Proposal's modifications to the Basel III leverage ratio would result in a regulatory capital metric that fails to measure accurately a banking organization's actual economic exposures, particularly for derivatives and securities financing transactions ("**SFTs**"); tends to create incentives that are at odds with policy objectives pursued in other financial regulatory frameworks; and does not strike an appropriate balance between the risk-based and leverage capital requirements—all of which can lead to undesirable and unintended consequences that undermine financial stability and increase systemic risk.

Morgan Stanley strongly supports the comments on the Proposal 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 as well as the separate comments submitted by The Clearing House Association (collectively, the "**Associations**"). These comments provide reasonable and practical suggestions for ensuring that the Basel III leverage ratio plays a meaningful and appropriate role in the regulatory capital framework.

Part I of this letter sets forth Morgan Stanley's primary conceptual comments on the Proposal. Part II includes our comments on specific aspects of the Proposal.

I. Conceptual Comments on the Proposal

Morgan Stanley has two primary conceptual comments on the Proposal: first, the Basel III leverage ratio should accurately measure economic exposure by, among other things, fully recognizing the exposure-reducing effects of legally enforceable netting and collateral arrangements; and second, the Basel Committee's regulatory capital standards should be consistent with and complement other elements of post-financial crisis regulatory reforms.

A. The Basel III Leverage Ratio Should Rely on Accurate Measures of Economic Exposure

In order for the Basel III leverage ratio to "act as a *credible* supplementary measure to the risk-based capital requirements,"[1] we believe that the denominator of the leverage ratio (the "**Exposure Measure**") should rely on accurate methods for calculating a banking organization's actual economic exposures to avoid overstating or understating such exposures. In this respect, we believe that the Exposure Measure should fully recognize collateral and netting arrangements in derivatives and SFTs since these arrangements meaningfully reduce banking organizations' economic exposures.

Collateral reduces exposure by creating a layer of loss-absorbing resources to protect banking organizations against loss. In the event of counterparty default, a banking organization may apply the collateral directly to reduce exposure from the default (in the case of cash collateral) or liquidate the collateral and apply the proceeds to reduce exposure (in the case of non-cash collateral). Regulators recognize this principle in other contexts by requiring banking organizations to collateralize their exposures, including through the exchange of mandatory initial and variation margin for uncleared derivatives.[2] By any capital standard or measure, it should be better to have collateral than not to have it; it would be illogical to assert that a banking organization's exposure (and capital requirements) should be the same for a

[1] Basel Committee, *Revised Basel III leverage ratio framework and disclosure requirements*, Consultative Document ¶ 2 (June 2013) (emphasis added), *available at* http://www.bis.org/publ/bcbs251.pdf.

[2] *See* Basel Committee and Board of the International Organization of Securities Commissions, *Margin requirements for non-centrally cleared derivatives* (Sept. 2013), *available at* http://www.bis.org/publ/bcbs261.pdf.

fully collateralized derivative transaction and an identical unsecured transaction. Accordingly, we believe that any regulatory capital regime, including the leverage ratio framework, must reflect the exposure-reducing effects of collateral to accurately measure banking organizations' exposures and serve as a credible regulatory capital measurement tool.

The leverage ratio framework should also fully reflect the exposure-reducing effects of legally enforceable netting agreements. The ability of legally enforceable netting agreements to reduce economic exposure is recognized and encouraged in various regulatory frameworks. As with collateral, a legally enforceable netting agreement has the effect of reducing a banking organization's exposure to a counterparty with which it has multiple transactions to a single net amount owing from or to the counterparty. Indeed, the role of central counterparties ("**CCPs**") in novating and netting trades hinges on the legal enforceability of netting. However, by requiring banking organizations to add gross SFT assets to the Exposure Measure, the Proposal ignores the exposure-reducing effects of netting, even though the Basel Committee acknowledges that SFT netting is "currently permitted under [both] the IFRS and US GAAP accounting frameworks."[3] For derivatives, the Proposal's measure for potential future exposure ("**PFE**") only recognizes netting to a very limited extent, which the Basel Committee itself describes as one of the "known deficiencies" of the current exposure method ("**CEM**").[4] The Proposal's failure to recognize the full benefits of legally enforceable netting agreements will result in inaccurate and overstated measures of economic exposure, which will reduce the value of the Basel III leverage ratio as a meaningful capital measure, weaken its relevance for risk management purposes, and impose real economic costs by potentially reducing the availability and affordability of credit and effective risk mitigation solutions in the form of derivative transactions and SFTs.

In addition, by introducing methods for measuring exposure that differ from those used in other regulatory frameworks (including the Basel Committee's own risk-based capital, liquidity and large exposures frameworks) and in major accounting regimes, the proposed Basel III leverage ratio would also introduce additional layers of complexity and internal inconsistency to the Basel capital framework and undermine the comparability of the Exposure Measure with other measures of economic exposure—all at a time when the Basel Committee is giving careful consideration to balancing risk sensitivity, simplicity and comparability within the Basel capital framework.[5]

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[3] Basel Committee, *Revised Basel III leverage ratio framework and disclosure requirements* at n.20.

[4] Basel Committee, *The non-internal model method for capitalising counterparty credit risk exposures*, Consultative Document, 3 (June 2013, rev. July 2013), *available at* http://www.bis.org/publ/bcbs254.pdf.

[5] Basel Committee, *The regulatory framework: balancing risk sensitivity, simplicity and comparability*, Discussion Paper (July 2013), *available at* http://www.bis.org/publ/bcbs258.pdf.

B. The Basel III Leverage Ratio Should Complement, and Not Be Inconsistent with, Other Post-Financial Crisis Regulatory Reforms

In the wake of the financial crisis, governments, regulators and banking organizations have all worked to develop appropriate safeguards to stabilize the financial system and prevent future crises. The Basel III leverage ratio should complement and support these reform efforts, which address idiosyncratic and systemic risks, with the goal of promoting a well-designed, consistent and coherent global regulatory framework. We are concerned that the Proposal is in tension with, and in some cases even undermines, other elements of the emerging global regulatory framework.

Since the financial crisis, banking organizations, working with national regulators, have restructured their balance sheets and raised additional capital to promote stability in the financial system. In the United States, for example, the largest U.S. bank holding companies, including Morgan Stanley, have increased their common equity to more than twice the amount they had during the 2008 financial crisis. Specifically, the weighted average Tier 1 common equity ratio of the 18 largest U.S. bank holding companies more than doubled from 5.6% at the end of 2008 to 11.3% in the fourth quarter of 2012, reflecting an increase in common equity from \$393 billion to \$792 billion during the same period.[6] These steps were taken even before implementation of Basel III in the United States. When implemented beginning in 2014,[7] Basel III will further strengthen the capital requirements applicable to, and the systemic resiliency of, U.S. banking organizations.

The regulatory framework for banking organizations, however, is not based on regulatory capital alone. In addition to imposing higher capital levels and more stringent capital standards, jurisdictions around the world are developing broader reform measures to address areas such as liquidity, central clearing, margin requirements for cleared and non-cleared derivatives as well as large exposures and concentration risk. In calibrating the Basel III leverage ratio, the Basel Committee should take into account these ongoing reforms with a view towards developing a coherent, consistent and effective set of global regulatory standards.

The Basel III leverage ratio should not undermine appropriate exposure and risk management incentives created by other regulatory reform measures, including those developed by the Basel Committee itself. In addition, to the extent an issue can be addressed

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[6] Federal Reserve, *Press Release: Federal Reserve Announces Results of Comprehensive Capital Analysis and Review (CCAR)* (Mar. 14, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20130314a.htm.

[7] The regulations implementing Basel III in the United States will become effective on January 1, 2014, for large and internationally active U.S. banking organizations, including Morgan Stanley.

directly and in a targeted manner through a specific reform measure, the Basel Committee should avoid addressing it indirectly and inefficiently through a blunt, non-risk based leverage ratio. The stated objective of the Basel III leverage ratio is to serve as a simple backstop measure to supplement the risk-based capital framework.[8] It should not be used to address policy objectives that are unrelated to capital adequacy because those objectives are more appropriately addressed through other regulatory reform measures.

In particular, we are concerned that the Proposal either directly conflicts or creates tension with other components of the global financial regulatory regime, including the Basel Committee's own rules and standards. Among other things, the Proposal would:

- Reduce the capacity of banking organizations to hold and manage large volumes of high-quality liquid assets ("**HQLAs**") on their balance sheets to meet the Basel Committee's liquidity coverage ratio ("**LCR**").[9] In its current form, the Basel III leverage ratio penalizes banking organizations for maintaining HQLAs to satisfy the LCR because it requires banking organizations to hold the same amount of capital against low-risk and low-yielding HQLAs as higher-risk and higher-yielding assets. It also incentivizes banking organizations to hold less, not more, HQLAs, which runs counter to the goals of the LCR and potentially increases systemic risk;[10]

- Create conceptual and practical conflicts with the Basel Committee's recently adopted margin requirements, which recognize the exposure-reducing effects of collateral and the benefits of appropriate margin arrangements to mitigate both idiosyncratic and systemic risks; and

[8] Basel Committee, *Revised Basel III leverage ratio framework and disclosure requirements* at ¶¶ 2-3 ("The Basel III reforms introduced a **simple, transparent**, non-risk based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements . . . . The Basel Committee is of the view that: a **simple** leverage ratio framework is critical and complementary to the risk-based capital framework." (emphasis added)).

[9] One of the Basel Committee's key reform measures, the LCR seeks to promote the resilience of a banking organization's liquidity risk profile by requiring the banking organization to maintain a sufficient stock of unencumbered HQLAs to meet its liquidity needs over a 30-day liquidity stress scenario. HQLAs include cash, highly rated sovereign and corporate debt securities and other low-risk and low-yielding asset classes. One of the goals of the LCR is to improve the banking sector's ability to absorb shocks arising from financial and economic stress and reduce the risk of spillover from the financial system to the real economy. *See* Basel Committee, *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* (Jan. 2013), *available at* http://www.bis.org/publ/bcbs238.pdf.

[10] In contrast, the risk-based capital framework assigns relatively low risk weights to HQLAs and therefore complements the objectives of the LCR.

- Work at cross-purposes with the G-20's mandate to move more derivatives into CCPs, since the Proposal would disregard the exposure-reducing effects of collateral and netting arrangements, and would potentially weaken banking organizations' ability and willingness to provide customer clearing services, which are a vital component of the emerging regulatory framework.[11]

II. Specific Comments on the Proposal

In addition to the two conceptual concerns discussed in Part I, we also have the following comments on specific aspects of the Proposal.

A. Securities Financing Transactions: Recognize Legally Enforceable Netting Agreements

We believe that the leverage ratio framework for SFT exposures should recognize legally enforceable netting agreements, and support the Associations' recommendations for a universal SFT netting standard in the Exposure Measure.

The Basel Committee has proposed to include gross SFT assets in the Exposure Measure with no netting of cash payables against cash receivables. This approach would significantly overstate a banking organization's actual exposure arising from SFTs and is inconsistent with the recognition of the exposure-reducing benefits of legally enforceable netting agreements in numerous other regulatory contexts.

In a footnote, the Proposal explains the inclusion of gross SFT assets in the Exposure Measure as "avoiding inconsistencies from netting which may arise across different accounting regimes."[12] However, in the same footnote, the Basel Committee itself acknowledges that netting of SFTs is "currently permitted under [both] the IFRS and U.S. GAAP accounting frameworks."[13] In other words, in an effort to neutralize certain differences between the two major accounting regimes, the Basel Committee has proposed an approach that prohibits a practice both sets of accounting principles recognize.

Morgan Stanley appreciates the importance of creating an internationally consistent method for calculating SFT exposures. We note that IFRS and U.S. GAAP apply similar criteria for recognizing SFT netting arrangements, and we recommend that the Basel

[11] Financial Stability Board, *OTC Derivatives Market Reforms: Fifth Progress Report on Implementation* 3 (Apr. 15, 2013), *available at* http://www.financialstabilityboard.org/publications/r_130415.pdf ("Jurisdictions must rapidly implement the G20 commitment to centrally clear all standardized products, in order to reduce systemic risk . . . .").

[12] Basel Committee, *Revised Basel III leverage ratio framework and disclosure requirements* at n.20.

[13] *Id.*

Committee adopt SFT netting recognition standards in the leverage ratio framework based on common elements of these two accounting regimes. In particular, the leverage ratio framework should recognize SFT netting where (i) transactions have the same explicit maturity; (ii) the right to set off the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable at a credit event; and (iii) the counterparties intend to settle net, settle simultaneously, or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement. This approach would more accurately measure actual economic exposures of SFTs, more closely align regulatory capital and accounting standards than the Proposal's non-recognition of netting arrangements, and would avoid potential disruptions to the markets for high-quality sovereign debt instruments, which are commonly used in SFTs.

B. Derivatives: Recognize the Exposure-Reducing Effects of Collateral and Legally Enforceable Netting Agreements and Measure Derivatives PFE Under NIMM

We also believe that the leverage ratio framework for derivatives exposures should fully recognize the exposure-reducing effects of netting and collateral arrangements, and that the derivatives potential future exposure ("**PFE**") measurement should reflect the Basel Committee's non-internal model method ("**NIMM**") proposal, as modified to reflect industry comments submitted to the Basel Committee.

The Basel Committee's proposal to "gross up" a banking organization's derivatives exposure by the amount of associated collateral disregards the exposure-reducing and risk mitigation benefits of collateral. The Basel Committee itself has endorsed collateralization of uncleared derivatives, and the G-20's mandate to move more derivatives towards central clearing is premised on the principle that systemic risk is reduced by full collateralization of centrally cleared (and netted) positions.

We understand that the Basel Committee's proposal to "gross up" a banking organization's derivatives exposures by the amount of associated collateral may be motivated, in part, by a concern that some forms of collateral received may "increase the economic resources at the disposal of the bank, as the bank can use the collateral to leverage itself (*e.g.*, cash collateral can be on-lent, non-cash collateral can be on-lent or sold)."[14] However, we believe that to the extent that re-hypothecation of collateral gives rise to legitimate policy concerns, these could be directly and most appropriately addressed in the specific context of derivatives regulatory reforms.

[14] Basel Committee, *Revised Basel III leverage ratio framework and disclosure requirements* at ¶ 26.

We also note that the Proposal's approach to measuring derivatives exposures is inconsistent with exposure measurement practices in other regulatory regimes and accounting frameworks, which recognize the exposure-reducing effects of collateral and netting for derivatives. The Proposal would not only fail to measure derivatives exposures accurately, but it would also lead to inconsistent and contradictory exposure measurements across these frameworks. We believe that a better approach would be to align regulatory and accounting exposure measurements based on accurate exposure calculations, grounded on common principles that reflect economic reality.

C. Written Credit Derivatives: Measure Exposures in the Most Accurate Manner Possible, Recognizing All Economically Effective Hedges

We believe that, to the extent the Basel Committee has specific concerns with written credit derivatives, these concerns are more appropriately addressed through regulatory tools outside the leverage ratio framework, including trading book capital requirements, central clearing determinations and margin requirements for uncleared trades. The Proposal's treatment of written credit derivatives would severely weaken the ability of market participants, including commercial firms, governmental entities, multilateral development banks and supranational organizations, to reduce risks in credit products and support economic recovery.

The treatment of written credit derivatives in the Proposal is significantly different from the treatment of other types of derivatives notwithstanding the conceptual, economic and practical similarities between written credit derivatives and derivatives referencing other asset classes such as rates, currencies, bullion and commodities. Specifically, the Proposal would require a banking organization to measure its exposure on a written credit derivative as including the full notional value of the derivative contract *plus* the value of any collateral provided by the bank in connection with the contract, potentially resulting in an Exposure Measure that exceeds the notional value of the contract. We believe that this approach significantly overstates a bank's economic exposure on a written credit derivative, frustrating the Basel Committee's objective of developing accurate exposure measurements.

Even if the Proposal's selective approach to written credit derivatives is adopted in the final leverage ratio framework, we respectfully recommend that the Basel Committee recognize a wider range of economic hedges. Credit products trade in deep and liquid markets, and banking organizations hedge exposures on these instruments through a variety of risk management practices. As in other areas of the leverage ratio framework, we support exposure measurement principles that result in the most accurate calculations of actual exposure. In the case of written credit derivatives, the Proposal should be revised to expand the eligible criteria beyond same-name, same-maturity, same-seniority purchased protection, which would disqualify many well-established and effective hedging practices from recognition in the leverage ratio framework. In particular, we recommend that the Basel

Committee adopt the hedge recognition criteria described in the Associations' comment letters, which reflect real world exposure-reducing practices.

D. Clearing: The Leverage Ratio Framework Should Facilitate Clearing and Recognize the Exposure-Reducing Effects of Collateral and Netting Arrangements

Although the Proposal does not expressly address the treatment of cleared transactions (including futures, listed options and cleared swaps), we believe that the Basel Committee should expressly recognize exemptions from the Exposure Measure for customer clearing transactions. We believe that the leverage ratio should complement and support other elements of the emerging regulatory regime, including mandatory clearing determinations for certain derivatives and efforts to incentivize voluntary clearing for other derivatives.

Accordingly, we recommend that the Basel Committee revise the Proposal to exclude banking organizations' customer clearing positions from the Exposure Measure. When a bank faces a CCP on behalf of a customer, the bank acts as an agent for the customer, and the bank has no liability to the customer in the event of CCP default. In addition, although the bank guarantees the performance of customer positions to the CCP, the bank has no market risk on these positions, as it is acting as a pass-through of such market risk between the CCP and the customer. To the extent the bank has credit risk to its customer, the bank-customer relationship is subject to a rigorous regulatory regime that requires collateralization of customer positions, including through initial and variation margin requirements, segregation of customer assets and restrictions on the use of customer collateral. We fully support the comments of the Futures Industry Association seeking an exclusion for customer-cleared positions from the leverage ratio framework.

Alternatively, if the Basel Committee rejects our proposed exclusion for customer cleared positions, we believe that, at a minimum, the Exposure Measure should be modified to (i) exclude the bank-CCP leg of customer-cleared transactions and (ii) reflect collateral and netting arrangements when measuring exposure on the bank-customer leg of these transactions. As noted in the preceding paragraph, when a bank clears positions in an agency capacity on behalf of a customer, the bank has no liability to the customer in the event of CCP default; the bank therefore has no "exposure" to include in the Exposure Measure on this leg of the transaction. As for the bank-customer leg of the transaction, as noted above, these arrangements are subject to rigorous collateral and segregation requirements under applicable regulatory regimes. Given that regulatory frameworks require collateralization and segregation on the theory that such arrangements reduce a bank's exposure to its customers, it would be illogical to disregard these arrangements in the leverage ratio framework.

E. Central Bank Reserves: Exclude from the Exposure Measure

Morgan Stanley believes that reserves maintained by a banking organization at a central bank should be excluded from the Exposure Measure of the Basel III leverage ratio. Central bank reserves are among the safest and most liquid assets on a bank's balance sheet. Significantly, central bank reserves are not a source of leverage for the bank. They also qualify as HQLAs under the LCR. Accordingly, excluding central bank reserves from the Exposure Measure would be a step in the right direction in terms of reducing the tension between the LCR and the Basel III leverage ratio framework. Finally, central banks in certain jurisdictions rely on reserve requirements as a tool for implementing monetary policy.[15] Therefore, the inclusion of central bank reserves in the Exposure Measure could have unintended consequences for the effective implementation of monetary policy in those jurisdictions.

F. Minority Interests: Fully Recognize All Available Capital in the Numerator of the Basel III Leverage Ratio

Morgan Stanley supports the general principle expressed by the Basel Committee that the "Exposure Measure (the denominator of the leverage ratio) should be measured consistently with capital (the numerator of the leverage ratio)."[16] Since the Basel Committee is proposing that the denominator of the leverage ratio *fully* reflect exposures of entities within the scope of regulatory or accounting consolidation, it would be consistent with the above-mentioned principle to *fully* include the entire capital resources of such consolidated entities in the numerator of the leverage ratio. This should be the case even where the entity in question (*e.g.*, a joint venture entity) has issued regulatory capital instruments to third parties and such minority interests would normally receive limited (*i.e.*, less than full) recognition in the consolidated regulatory capital of the parent under the Basel III minority interest rules.

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[15] For example, the interest rate for excess reserve balances is determined by the Federal Reserve and is an additional tool for the conduct of monetary policy. Federal Reserve, *Reserve Maintenance Manual* 27 (June 2013), *available at* http://www.federalreserve.gov/monetarypolicy/rmm/june-2013/pdf/RMM_final_june2013.pdf.

[16] Basel Committee, *Revised Basel III leverage ratio framework and disclosure requirements* at ¶ 10.

Morgan Stanley appreciates the opportunity to provide comments to the Basel Committee. Please do not hesitate to contact us if you have any questions.

Yours sincerely,

Ruth Porat

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