

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

Group Chief Accountant's
Level 12
280 Bishopsgate
London EC2M 4RB

Telephone: 020 7672 0202
Facsimile: 020 7672 1424

www.rbs.com

20 September 2013

Dear Sirs

Revised Basel III leverage ratio framework and disclosure requirements

I enclose The Royal Bank of Scotland Group's ('RBS') response to the above consultation paper and welcome the opportunity to comment. RBS has been an active participant in the preparation of the response from GFMA.

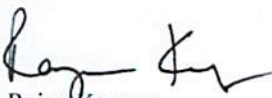
RBS supports the Basel Committee on Banking Supervision's ('the Committee') objectives in creating a simple and globally consistent framework for a leverage ratio. We are however concerned that the lack of recognition of netting and collateral dis-incentivises firms to comply with other good behaviours that the Committee is seeking to promote. Amongst other things, the proposals dis-incentivise firms to clear through central counterparties or to margin derivative or financing transactions. Without netting and collateral recognition, there is a risk that leverage ratio will become the dominant driver of capital adequacy rather than acting as the back-stop it was designed to be.

We are also concerned that there may be a number of unintended consequences for the real economy. The proposals will reduce the liquidity of the securities financing market thereby increasing the cost to sovereigns and businesses of issuing debt. Furthermore there is a risk that the proposals promote a shift towards banks holding riskier assets and incentivise firms to hold the smallest liquidity buffer.

Given these concerns, RBS would urge the Committee to recognise netting and collateral in the calculation and to exclude assets held for liquidity purposes. If, however, the Committee is minded to proceed, RBS would urge the Committee to undertake a Quantitative Impact Study ('QIS') first, the results of which should be published.

These concerns are described and illustrated in more detail in the Appendices to this letter. We would be happy to elaborate further on any of the points made in this response and look forward to engaging with you on this topic. In the first instance, please address any enquiries to myself.

Yours faithfully



Rajan Kapoor
Group Chief Accountant

Principal comments

The objective of the leverage ratio is to avoid the excessive build up of on and off balance sheet leverage in the banking system. More specifically the stated objective of the leverage ratio is to:

- Constrain leverage in the banking sector, thus helping to mitigate the risk of the destabilising deleveraging processes which can damage the financial system and the economy;
- Introduce additional safeguards against model risk and measurement error by supplementing the risk-based measure with a simple, transparent, independent measure of risk; and
- Reinforce the risk based requirements with a simple, non-risk based “backstop” measure.

Given the lack of recognition of netting and collateral within the calculations, there is a risk that the proposed calculations will be more constraining than the risk sensitive regulatory capital ratio. As a result, there is a risk of the leverage ratio becoming the predominant minimum capital requirement ratio rather than the back-stop ratio it was designed to be.

The imposition of a leverage ratio that becomes predominant as the minimum capital requirement ratio would provide incentives for firms which conflict with the Committee’s major objectives in other areas of prudential regulation, in that it:

- Penalises the posting of collateral in support of Payment systems;
- Creates a disincentive to clear against CCPs;
- Penalises good margin behaviour for OTC derivatives;
- Penalises margin behaviour for lending, in particular SFTs;
- Encourages a shift towards riskier assets by penalising high quality assets;
- Penalises holding of assets held for the LCR and prudent liquidity management; and

Such behaviour contradicts the intended objectives of the Committee. The factors driving these concerns are described in more detail in the sections below.

1. Gross Security Financing (‘SFT’) Measure

The Basel CP proposes use of “Gross SFT assets recognised for accounting purposes”, with no recognition of netting. RBS considers that there are a number of possible unintended consequences from this. These include:

- As noted above, the leverage ratio risks becoming the dominant capital measure and as such, it will increase capital requirements thereby increasing the cost and significantly reducing activity.
- Since there is a close relationship between refinancing rates and issuer yields, any factor increasing repo rates is expected to be passed onto issuers, both sovereign and corporate, and ultimately onto consumers.
- Any reduction in liquidity in the government paper market may lead banks to utilising more cash in liquidity buffers, thus perpetuating the reduced liquidity for government paper.
- A limited SFT market would limit the ability of pension funds, money market funds & insurance companies to raise extra yield through securities lending, driving up premiums and pension fund deficits. It would also limit the ability of insurance companies to realise cash quickly to cover unexpected obligations thus depressing asset prices through forced sales.

RBS recognises that reliance upon accounting netting standards may result in an inconsistent standard across jurisdictions. RBS would urge the Committee to adopt the same standards for netting as it has already sanctioned for default risk capital.

It should also be noted that the prohibition on netting for SFTs is inconsistent with the leverage treatment for derivatives.

2. Disincentive to Clear

The Basel Central Counterparty ('CCP') default risk requirement rules published in July 2012 provided incentives for firm's to clear trades as opposed to trading bi-laterally with other counterparties. This was provided exactly because the arrangements of a CCP (e.g. mandatory contributions to default funds on top of mandatory margining arrangements) act to reduce the counterparty default and liquidity risks associated with derivative and SFT trading. If similar concessions are not included in the leverage ratio, the incentives to trade through CCPs that is will be significantly diluted, and in certain circumstances will become redundant.

Further details on the impact of the leverage ratio on centrally cleared SFTs are set out in Appendix 3.

3. Exclusion of collateral for Derivatives

CSA¹s used for collateralisation of derivatives are a fundamental part of a legal framework designed to avoid a recurrence of significant losses on uncollateralised derivatives that occurred during the economic crisis, while at the same time maintaining liquidity in derivative markets. For this reason, such agreements are recognised within the counterparty risk capital requirement rules, provided certain criteria are met.

Not permitting offset of collateral against derivative exposures for the purpose of the leverage ratio has the following effects:

- It undermines wider objectives of regulatory developments to encourage firms to make use of legally effective and enforceable collateral agreements for all derivative trading;
- It undermines the Committee's stated objective that the leverage ratio should be a "backstop" measure, given that the leverage ratio calculation for a bank that fully collateralises all derivative trading will always be a more punitive measure for those derivatives; and
- It creates major inconsistencies in the Exposure Measure calculation for this purpose, given that netting of derivatives is permitted but offset of collateral is not.

As such, RBS would support inclusion of collateral in the leverage exposure measure based upon the same criteria that are applied in the counterparty risk capital framework.

Further details on the impact of the leverage ratio on collateralised derivatives are set out in Appendix 4.

4. Penalising High Quality Assets

In the past 5 years, banks have been restructuring their balance sheets to de-risk and de-lever. The leverage ratio does not recognise and incentivise such de-risking since the measure does not incorporate a risk element. The "benefits" of reduced leverage could come with the unintended consequences of riskier balance sheets.

A balance sheet comprised principally of low risk assets, such as mortgages secured on residential property with an LTV below 80%, will have a low capital requirement, but this will not necessarily lead to a low leverage ratio calculation under these proposals. The suggestion from industry groups to scale in some way, for example, by using adjusted exposure weights for qualifying SME lending, is supported.

¹ Credit Support Annex

Basel III states that only 100% and 10% CCFs should be used for leverage ratio purposes². The proposal recognises these are a source of potential significant leverage and stays with the original Basel III text stating that the calculation should only include 100% and 10% Credit Conversion Factors ('CCFs'), an exception only available for cancellable facilities. This is inconsistent with the credit conversion factors for capital and the LCR rules³,

RBS would urge the Committee to consider other products for a reduced CCF. For example, Trade financing is one such example where the Committee should consider a different ratio, given that these instruments being underpin the movement of goods and services globally. Regulation should not impede the flow of financing to importers and exporters - particularly in emerging markets - by creating perverse incentives for banks to shun low risk trade finance activity. Therefore RBS supports the proposal made by industry groups to scale such off balance sheet commitments.

In response to the concerns noted above, as part of the final CRD4 regulation, the EU included a 20% and 50% CCF for certain specific trade finance exposures when calculating the leverage ratio exposure measure. To ease pressures put on lending to vulnerable parts of the economy, and to help ensure global consistency of application of leverage ratio requirements, RBS would like to ask again that the Committee consider inclusion of similar CCFs.

5. Impact on Liquidity

Similarly, since the leverage ratio does not distinguish between highly liquid and low risk assets, it weakens banks' incentives to hold a stock of cash and other HQLA above the minimum level required for the LCR, as to do so would result in economically unprofitable returns on capital (which is not the case on a risk-adjusted basis). The result of this could be a banking sector LCR which is both publically and privately sub-optimal and would lead to cliff risk after the 30 day LCR survival horizon as there would be a disincentive to banks to hold liquidity to cover liquidity risks beyond 30 days. To address this, RBS believes the proposal should fully exclude cash and other HQLA from the exposure measure.

Banks have to be able to demonstrate that HQLA are liquid by way of repo and / or outright sale⁴. As noted above, a consequence of the leverage ratio might be that repo markets are reduced. In times of stress a bank may be less able to repo its assets to other banks because those counterparties might be constrained by the leverage ratio. The consequential reliance on central banks or the shadow banking sector contradict the recent FSB paper regarding that sector.⁵

RBS recommends full exclusion, not risk-weighting, to support a simple and complementary ratio to the risk-based capital framework. This is preferred to risk-weighting the exposure measure, as the leverage ratio is a backstop to the subjectivity and modelling involved in the calculation of the capital requirement.

² Paragraph 40 and 41 states that off balance sheet items include "commitments (including liquidity facilities), unconditionally cancellable commitments, direct credit substitutes, acceptances, standby letters of credit, trade letters of credit, failed transactions and unsettled securities".

³ BCBS 238, January 2013, "Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, paragraph 131

⁴ BCBS 238 paragraph 25

⁵ FSB paper on shadow banking sector

Additional comments

Capital Measure

The measure to be published, being the arithmetic average of the three month ends within the quarter, is reasonable. RBS does not consider that publication of the individual monthly data is necessary.

Scope of Consolidation

The Basel CP provides details of the approach required to be used for the purpose of establishing the consolidated position for leverage ratio purposes; however there is no discussion around application at the solo regulated entity level. Under EU legislation, firms are obliged to calculate at both a solo and consolidated level. The paper suggests the view of the Committee remains that the leverage ratio should only be required to be calculated for the consolidated group. To help ensure global consistency we would ask the Committee to emphasise this in final communications of this Basel standard.

New detail is included in the consultation⁶ starting with the accounting consolidation basis but with certain items removed, though underlying assets of any securitisation within the scope of regulatory consolidation or accounting consolidation must be included. This proposed approach may impact upon the scope of entities and assets currently included in the leverage ratio calculation.

General measurement principles

A bank's total Exposure Measure is the sum of the following exposures: (a) on-balance sheet exposures, (b) derivative exposures, (c) securities financing transaction exposures, and (d) other off-balance sheet exposures. The treatment for these four main exposure categories is a mixture of bases. For example, on-balance sheet exposures follow the accounting basis whereas derivative transactions look to a counterparty risk which is permitted only some netting (not that which would be applied in a close-out situation) together with a measure of potential future exposure.

RBS considers that the leverage calculation would be better served with a single clear definition of leverage, to be applied consistently for each asset class rather than this blended approach.

Derivative exposures

Use of non-IMM approach for exposure measure

RBS supports the ongoing work regarding NIMM which is being developed as replacement for the Current Exposure Method for counterparty risk capital purposes. A separate response on the NIMM consultation will be sent to the Committee in due course.

If the Committee is minded to use NIMM in the leverage ratio, this should be subject to an additional QIS.

Gross up of collateral provided

The Committee does explain what the treatment should be in relation to bankruptcy remote collateral provided. RBS would propose that when including collateral posted in the leverage exposure measure, this should be included as part of the CEM calculation as follows:

Exposure = (greater of (0, MTM + collateral posted)] + add-on

Transitional arrangements

RBS notes that the European CRD4 implementation commences with a point in time measure prior to moving to an average. This is simpler to implement.

⁶ paragraph 12

Proposed leverage ratio calculations for SFTs

The below illustrations show the comparisons of:

1. Accounting entries;
2. Basel III EAD calculations for RWA purposes;
3. Basel III leverage ratio exposure measure calculation; and
4. Basel CP proposed leverage ratio exposure measure calculation.

Bank X trade 4 repos, A to D, with the same counterparty, that may be subject to netting under a master netting agreement for EAD purposes, as follows:

Trade	Type	Cash leg	Sec leg	Margin	Trade Haircut		Regulatory Haircut	
A	Repo	-50.35	53.0	0.0	5.0%	2.65	6.0%	3.18
B	Rev Repo	29.44	-32.0	0.0	8.0%	-2.56	8.0%	2.56
C	Repo	-39.99	43.0	0.0	7.0%	3.01	6.0%	2.58
D	Rev Repo	49.50	-55.0	0.0	10.0%	-5.50	10.0%	5.5
Total		-11.4	9			-2.40		13.82

BEFORE execution of trades A to D, assume that Bank A has cash at bank of 150m and stock of securities of 96m. The comparison of accounting entries and regulatory calculations is as follows:

	1		2	3	4
	Assets	Liabilities	Basel III EAD (non modelled)	Basel III Leverage Ratio Exposure calc	Basel CP Leverage Ratio Exposure calc
Cash	150	0	150	150	150
Securities	96	0	96	96	96
SFTs	0	0	0	0	0
Total	246	0	246	246	246

AFTER execution of trades A to D the comparison of accounting entries and regulatory calculations when executing with a non-CCP is as follows:

	IFRS accounting balance sheet				Basel CP Leverage Ratio Exposure calc		
	Assets	Liabilities	Basel III EAD (non modelled)	Basel III Leverage Ratio Exposure calc	Gross BS assets	SFT [E-C] net regulatory Calc (no-haircut)	Total
Cash	161.4	0	161.4	161.4	161.4	N/A	161.4
Securities	96	0	96	96	96	N/A	96
SFTs	78.94	-90.34	11.42	0	78.94	0.0	78.94
	336.34	-90.34	268.82	257.4	336.34	0	336.34

Asset change	90.34	Leverage ratio change	90.34
Diff	0		

AFTER execution of trades A to D the comparison of accounting entries and regulatory calculations when executing with a CCP is as follows:

	IFRS accounting balance sheet				Basel CP Leverage Ratio Exposure calc		
	Assets	Liabilities	Basel III EAD (non modelled)	Basel III Leverage Ratio Exposure calc	Gross BS assets	SFT [E-C] net regulatory Calc (no-haircut)	Total
Cash	161.40	0	161.4	161.4	161.4	N/A	161.4
Securities	96	0	96	96	96	N/A	96
SFTs	0	-11.4	11.42	0	78.94	0.0	78.94
	257.4	-11.4	268.82	257.4	336.34	0	336.34

Asset change	11.4	Leverage ratio change	90.34
Diff	78.94		

In the CCP scenario the change in the leverage ratio calculation suggests that there has been an increase in total balance sheet funding whereas the accounting balance sheet would suggest this is not the case. As a consequence, the Basel CP creates a leverage ratio exposure value that dilutes or potential entirely erodes pillar 1 capital incentives to centrally clear.

If netting of on balance sheet SFT assets and liabilities were permitted, the calculation would result in a figure that is far more relevant to the total additional funding required for the SFT portfolio as a whole, and this double count of required funding would, to a great extent, be avoided.

Although the impacts are obviously more severe in relation to CCP trading, RBS would still endorse the application of netting for non-CCP SFTs where there is a master netting agreement to ensure incentives in both the RWA capital regime and leverage ratio regime are appropriate and aligned (i.e. there is an incentive to ensure that on an ongoing basis there is legal right of offset of trades and collateral).

Proposed leverage ratio CEM calculation for derivatives

Three illustrative examples of leverage ratio calculations of derivative trades are included below.

Example 1 – Posting collateral against a derivative negative MTM

Taking the following FX derivative trade as an example:

Notional	MTM	P&L since last call	Collateral Posted (Securities)	Residual Maturity	PFE	
200	-400	-40	360	More than 5 yrs	7.5%	15

The following regulatory calculations arise:

Description	CCR EAD calc	Basel Leverage Exposure Measure
On-BS Securities	360	360
Replacement cost	0*	0
PFE	15	15
Collateral posted	0*	0**
Derivative total	15	15
Total	375	375

Leverage Ratio Tier 1 capital at 3% min ratio

11.25

* For EAD purposes collateral posted is incorporated into the replacement cost calculation i.e. replacement cost = greater of (zero) or (MTM + collateral posted).

** For leverage ratio purposes only required to include collateral posted if it also reduces on-balance sheet assets for accounting. In this instance we assume this is not the case. If it were the increased EAD from the derivative calculation would be offset by a matching decrease in the On-BS Securities value.

For the pillar 1 RWA requirement to exceed the minimum leverage ratio back-stop requirement of 11.25m the counterparty to these trades would need to be subject to a risk weight in excess of 37.5%.

Example 2 – Receiving collateral against derivative positive MTM

Taking the same FX derivative trade as an example, but this time with a positive MTM:

Notional	MTM	P&L since last call	Collateral received (Securities)	Maturity	PFE	
200	400	40	360	More than 5 yrs	7.5%	15

The following regulatory calculations arise:

Description	CCR EAD calc	Basel Measure	Leverage Exposure
On-BS Securities	0	0	
Replacement cost	400	400	
PFE	15	15	
Collateral received*	360	0	
Derivative total	55	415	
Total	55	415	

Leverage Ratio Tier 1 capital at 3% min ratio

12.45

** Collateral received can be offset for EAD purposes assuming the eligibility requirements are met*

For the pillar 1 RWA requirement to exceed the minimum leverage ratio back-stop requirement of 12.45m the counterparty to the trade would need to be subject to a risk weight in excess of 283%.

The impact for an individual counterparty would be very much dependent on the risk weight applied for pillar purposes but we would certainly expect to find many counterparties with risk weightings well below the backstop of 283% per above.

In particular, the impacts are extremely severe for trading with Qualifying Central Counterparties (QCCPs) trading, where a risk weights of:

- 2% or 4% would be used for house trades; and
- 0% would be used for QCCP exposures in relation to client clearing services, assuming that the bank is not obligated to reimburse the client for any losses suffered due to changes in the value of transactions in the event of default.

The comparison of the risk weights for CCPs with the 283% risk weight from the illustrative example demonstrates that incentives to clear that are apparent in the RWA calculation for CCPs are significantly undermined when the leverage ratio calculation is introduced.

For all counterparties, there is no benefit of collateralisation of derivatives under the leverage ratio calculation. As such, incentives to collateralise that are embedded in the EAD calculation for RWA purposes are always weakened (regardless of the nature of the counterparty) when the leverage ratio calculation is introduced.