POSITION PAPER

WSBI-ESBG common response to the Basel Committee on Banking Supervision Consultation on the Revised Basel III Leverage Ratio Framework and Disclosure Requirements

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WSBI-ESBG Register ID 8765978796-80

September 2013

WSBI ESBG

Basel Committee on Banking Supervision Consultation on the Revised Basel III Leverage Ratio Framework and Disclosure Requirements

The European Savings Banks Group (WSBI-ESBG) welcomes the opportunity to share its views on the Revised Basel III Leverage Ratio Framework and Disclosure Requirements.

General observations:

In principle, WSBI-ESBG has strong reservations over the leverage ratio. This is due to the limited information it provides with regard to the leverage and stability of banks. Hence, we feel that a further specification of the rules for calculating the leverage ratio is not very helpful when it comes to increasing the meaningfulness of the leverage ratio *per se*. Notwithstanding the foregoing, before addressing the language of the framework made available for consultation, WSBI-ESBG would like to preface more specific comments by a number of general remarks.

First and foremost, WSBI-ESBG believes that the present proposal for a revised definition of the leverage ratio will lead to an increase in the exposure measure (the denominator of the leverage ratio). This would result in a considerable capital requirement within the international financial system that entirely ignores the economic risk inherent in the various on-balance sheet transactions and off-balance sheet transactions conducted. We want to point out that the proposed amendment on requirements for leverage ratio would lead to the disproportionate importance of the leverage ratio which was initially implemented within the Basel III rulebook as a simple backstop. We see the leverage as an additional capital measure which should be easily understood and create comparability through the global banking industry. From our point of view the legal capital ratios, in particular CET1 ratio, should remain as the most important capital measure as, in contrast to the leverage ratio, the CET1 ratio is based on a risk-sensitive approach. As the leverage ratio is not risk-related we feel that an increase of importance of this back-stop ratio is not in line with the prudent approach linked to the capital situation of an institution or group of institutions.

Unlike the Liikanen Report, we reject demands for a higher general leverage ratio. The leverage ratio is always unspecific and places low-risk assets at a disadvantage.
Indeed we consider that leverage should be limited at a maximum of 3% and applied only on a group consolidated level; leverage ratio should constitute only a backstop; if the leverage ratio is higher than 3% or applied at the entity level, the leverage ratio will become the main driver of banks' solvency: this would have dangerous and unintended consequences as this tool is too simplistic to adequately govern banks' solvency.

Compared to the provisions under Basel III dating back to the year 2010, the present Consultation Document proposes a considerable tightening of a number of rules, for example in regards to netting in the context of credit derivatives and other derivatives as well as SFT (in particular repo transactions). In essence, we hold the view that these tightened rules are both inappropriate and inacceptable. Our objection relates to the fact that the current proposals fail to accept (at least not without considerable restrictions) the tested and tried supervisory netting rules applied at an international level in a consistent

and legally enforceable manner. There are no objective reasons why the netting impact would have to be treated any differently compared to the treatment for the purposes of calculating the capital requirements under Basel III. This differentiation merely leads to perverse incentives, cost inflation, additional, unnecessary complexity and ties up additional resources in a needless manner.

Moreover, the Basel Committee seeks to develop a definition of the leverage ratio which is not being influenced or distorted by the application of a specific accounting standard – be it IFRS, US GAAP or any other national GAAP. We welcome this objective. However, the definition of the leverage ratio continues to depend upon the applicable accounting standards and this relationship is not altered even when considering the proposed changes concerning e.g. the *qua definitionem* treatment of derivatives and securities financing transactions (SFT). For instance, this becomes evident given that - in its capacity as a residual parameter and as the numerator in the definitions of the leverage ratio - the "equity ratio" shall directly depend upon each and any carrying and valuation rule of the respective accounting standard. It is also evidenced by the requirement under paragraph 35 (Gross-SFT assets recognised for accounting purposes which refers to accounting netting). Consequently the differences between IFRS and US-GAAP will impact the resultant leverage ratio dependent on what accounting standards an entity applies.

Lastly, European banks tend to be at a disadvantage due to the structural differences (extent of the credit supply through the banking systems) between Europe and the US; to date, this structural difference is not reflected in the calibration of the leverage ratio.

As a conclusion, WSBI-ESBG believes that migrating the leverage ratio to Pillar I is not the right direction to follow as maintaining it as a Pillar II instrument would avoid unintended consequences such as the false incentive to switch to riskier business given the same capital base or to penalize particularly low-risk business models.

II. Specific Comments

Concerning the amendments submitted in the form of the present Consultation Document, we would furthermore like to address the following specific items.

Definition and minimum requirement (Paragraph 6-7)

WSBI-ESBG would like to highlight that the technical and operational requirements for calculating each month-end leverage ratio are significant. According to the current consultation the average of the monthly leverage ratio over the quarter is used to calculate the average quarter-end leverage ratio. This requirement causes a regulatory divergence at European level as the reporting requirement for the purposes of regulatory reporting (CoRep) and financial reporting obligations (FinRep) exclusively arise at the end of the quarter.

During the implementation of the initial Basel III requirements at a European level and upon request, the competent authorities are entitled to exempt individual banks from the monthly calculation meaning that these banks will only have to calculate and report a leverage ratio at the quarter-end.

However, it remains unclear whether the implementation costs are justified by the putative information advantage inherent in an average three-month ratio. In terms of data quality, one further reason why we hold the view that the calculation of monthly ratios is counterproductive lies in the overall rationale of establishing a transparent and simple leverage ratio. Carrying out both the calculation and the reporting at the end of the quarter will achieve consistency with the overall regulatory reporting framework (CoRep).

Scope of consolidation (Paragraph 10-15)

Nr. 11 – Extension of the scope of consolidation

We would welcome a clarification concerning those "investees" who are merely inside the scope of accounting consolidation that are included under the Tier 1 capital. We recommend a corresponding specification, should this translate into a need to include all investees which have to be taken into account according to the regulatory or accounting consolidation scopes. The current wording is open to misunderstandings and fails to explain why a correlation is created between regulatory capital on the one hand and regulatory or accounting consolidation scopes, on the other hand.

Nr. 12 – Extension of the consolidation scope (examples)

Under the provisions of paragraph 12, where an entity is not included in the regulatory consolidation but included within the scope of accounting consolidation, its exposure has to be included in the calculation of the leverage ratio. As a consequence, when it comes to the leverage ratio, the regulatory consolidation scope rules are thus being suspended. Accordingly, banks would have to define a divergent consolidation scope specifically for the purposes of the leverage ratio. In our view, the rationale given for this proposal ("because the investment in the commercial investee remains included in the capital of the bank") is not applicable at this point. Whilst it may be correct that - *de lege lata* - the book value of the investment shall not be deducted from capital, entities that are not included under the regulatory consolidation scope (or, moreover, their *pro rata* contribution to the provisions) will not be included in the calculation of the capital. Hence, we do not see any reason for any further regulatory consolidation rules that are specifically designed solely for the calculation of the leverage ratio. Furthermore, we should like to reiterate that we see an absolute need for avoiding that the definition of the leverage ratio is affected by differences in accounting standards worldwide.). Due to the fact that the proposed extension of the consolidation scope for the leverage ratio from a mere regulatory consolidation scope to an accounting consolidation scope is at odds with this fundamental principle, we explicitly object to this proposal.

Nr 15 – "*Pro rata* offsetting"

Whenever exposures within a unit shall be excluded on a "*pro rata*" basis, an equivalent *pro rata* exclusion within other banks will usually be impossible. Whilst the benefits obtained in terms of added precision will remain moderate, this approach would tie up considerable resources. Hence, we feel it would be appropriate to drop the *pro rata* requirement whilst ensuring 100% recognition of any offsetting effects.

On-balance sheet exposures (Paragraph 19 -21)

During the determination of the Liquidity Coverage Ratio (LCR), the interdependency between the definition of the leverage ratio and the treatment of High Quality Liquid Assets (HQLA) is still not

taken into account sufficiently. The LCR requires banks to keep substantial volumes of highly liquid assets in place. This requirement is considerably obstructed by the fact that such assets were not excluded from the calculation of the leverage ratio. We still perceive an urgent need for this exclusion and we would appreciate an adequate consideration of this interdependency.

WSBI-ESBG is of the opinion that HQLA that banks are required to hold because of the LCR and insurance exposures should be exempted from the leverage ratio calculation; this will ensure consistency between the requirements of the various ratios.

Banks are required by regulators to hold HQLA to meet the LCR requirements. HQLA consist of cash or assets that can be converted into cash at little or no loss of value in private markets. In order to prevent inconsistencies between the LCR that force banks to hold HLQA and the leverage ratio that make the holding of those assets very costly, HQLA should be exempted from the leverage ratio calculation.
Insurance exposures should also be exempted from the leverage ratio calculation. Indeed the leverage ratio is tied to banking activities and should be limited to a prudential scope. A calculation on an accounting scope (or on a prudential scope retreated, e.g. for insurance activities) should not be conceptually right and should result in an asymmetrical treatment between denominator and numerator. For example, we consider that insurance activities do not contribute to a leverage effect, notably because they are secured by some technical and mathematical provisions (not deducted of assets) and are covered by a lot of regulatory rules. Including insurance assets should result in an undue increase of expositions. Moreover, including assets should give to an asymmetrical treatment because insurance capital is not taking account as in a conglomerate approach. Consequently, we consider that the carrying amount of the investee (after regulatory adjustments) should be only required.

On principle, we welcome the clarification that fiduciary loans which have been accounted for as an on-balance sheet item under national GAAP may remain excluded during the calculation of the total exposure level. At the European level, this derogation was already implemented under the provisions of Article 429(11) CRR. However, footnote 11 of the Consultation Document points out quite rightly that, to this end, the IAS 39 criteria for de-recognition and, where applicable, the IFRS 10 criteria for deconsolidation have to be met. At this point, a clarification is lacking as to the treatment of on-balance sheet items which are accounted for under the respective national accounting principles but which are not simultaneously subject to the IFRS rules. Hence, in order to subsequently assess whether the specified de-recognition criteria or, moreover, deconsolidation criteria have been met (for instance when it comes to items accounted for under local GAAP), only a hypothetical IFRS accounting can be assumed. Yet, this can only ever be a hypothetical assessment. After all, under IFRS, items which meet these de-recognition and deconsolidation criteria from the outset will generally not be accounted for as on-balance sheet items in the first case. Hence, in this regard we would welcome a clarification concerning the required policy.

Under the provisions of Article 429(11) CRR, particularly loans under promotional schemes shall only be excluded from the leverage ratio if and when the loans constitute fiduciary assets. However, at present, the majority of loans from promotional schemes fails to meet this criterion and is thus not eligible for preferential treatment. This is inconsistent with the national promotion of, for instance, renewable energies. Hence, the current proposals should clarify in an unambiguous manner that also

loans from promotional schemes shall be clearly excluded from the calculation of the total exposure measure.

Furthermore, it is worth noting that, under the Consultation Document's current proposals, collateral shall not be allowed to reduce on-balance sheet or off-balance sheet exposures. Particularly in the event of cash collateral, we see this as a distorted treatment of on-balance sheet and off-balance sheet exposures. This is of major relevance particularly as regards derivative items which are usually collateralised by means of cash collateral. For a more detailed discussion of the collateralisation of derivatives please see the following paragraphs.

Treatment of derivatives (Paragraph 22-29)

Under paragraph 24, the derivative exposure is determined on the basis of the current exposure method (CEM). At the same time, the Basel Committee is holding consultations concerning a newly developed and more precise method for determining the exposure, i.e. the NIMM. This method should be used as early as possible also for determining the leverage ratio (under the *proviso* that the IMM - which would be the ideal approach – will be rejected).

Whether or not netting is permitted under the bank's operative accounting or risk-based framework and notwithstanding whether such an approach is fit for purpose, under the provisions of paragraph 27, collateral received may not be netted against derivatives exposures. Allegedly, this is due to the fact that collateral received would not be able to reduce the economic leverage arising from a given derivative position. Thus, whilst the Consultation Document recognises the risk mitigating impact of the collateral for counterparty risk, it refers to the potential leverage due to the re-use of the collateral. To us, the rationale for this is not immediately obvious. Banks do not use the collateral received in order to "lever[age]" their balance sheet; instead, they use it in order to hedge their P&L. If a P&L impact is not visible, this shows the effectiveness of the hedging. It is also an indication that, to this effect, the recognition of the netting effect is useful for the purposes of the leverage ratio. The current proposals also disincentivise collateralised transactions. This effect is incompatible with the objective of stronger collateralisation which is not only pursued by regulatory initiatives such as EMIR but which is also in the broader regulatory interest of supervisors. Also, this is bound to have a negative knock-on effect on the liquidity of derivatives markets. As a result, there will be inflation in the corporate costs for hedging against market risks. In this regard, we object to curtailing the netting options motivated by the mere possibility of re-using the collateral. By way of analogy, the same applies to collateral provided.

One simple regulatory choice the BCBS might wish to consider as an alternative to the prohibition of netting would be allowing banks to exclude from the calculation of the leverage ratio any collateral received which they have recognised on the asset side according to the applicable accounting rules. This will cover any cash collateral received by way of a full legal rights transfer. For the receiver of the collateral this results in a stretching of balance sheet as the bank has to capitalise the received cash collateral as an exposure to the account-maintaining bank. At the same time, it has to post in the liabilities section of the balance sheet a liability (subject to call) to the provider of the collateral asset for repayment of the cash collateral. Apart from the cash collateral received, under the provisions of the current exposure method, the bank also has to show the exposure from the derivative on the asset side of the balance sheet – as a result of this, the aggregate assets almost see a 100% increase. The fact that

the capitalisation of the cash collateral received is inappropriate is illustrated by virtue of a comparison with the security collateral received; according to generally accepted accounting rules, this does not stretch the balance sheet on the part of the collateral receiver (namely even if and when the securities ownership is transferred to the collateral receiver): given that all risks and opportunities deriving from the securities provided as collateral have to be assigned to the collateral provider (in their capacity as the economic beneficiary, they are entitled to each and any interest income) these securities have to be shown on the asset side of the collateral provider's balance sheet. However, the treatment for accounting purposes should not lead to a differential treatment of collateral during the calculation of the leverage ratio. This is especially true in cases where - in line with paragraph 27 - the assumption is that cash collateral and non-cash collateral will have an identical impact on the balance sheet leverage. At this juncture, it would be more appropriate to put cash collateral on an equal footing with securities collateral meaning that the collateral received would be de-recognised in each and every case.

Furthermore, in our preliminary understanding, the language under paragraph 28 is unclear because it does not stipulate any unambiguous policy for treating off-balance sheet collateral. We therefore suggest a clarification stating that the off-balance sheet collateral provided (e.g. from lending transactions) will not increase the exposure, either.

Additional treatment for written derivatives (Paragraph 30-33)

For credit derivatives, an additional, notional exposure to the reference entity is assumed. This leads to a considerable increase in the volumes meaning that this, too, constitutes a clear tightening of the rules. However, there are no reasons why credit derivatives should receive different treatment to other derivatives.

Under the provisions of paragraph 31, netting such transactions will only be an option in the event of a perfect hedge (the remaining maturity of the purchased credit derivative has to be equal to or greater than the remaining maturity of the written credit derivatives). In our view, the netting options are not far-reaching enough. We therefore suggest applying the requirements set out under paragraph 80, 143, 204 of the Basel Framework. Under said provisions, it is permissible to net purchased credit derivatives with a minimum term to maturity of one year against corresponding written credit derivatives. A one-year-timeline is sufficiently long in order to adopt measures for the purposes of e.g. a "rollover of the purchased hedge".

Securities financing transaction (SFT) exposures (Paragraph 34-39)

Under the provisions of paragraph 35, SFT exposures shall be calculated as the sum total of:

1. Gross SFT assets recognised for accounting purposes (i.e. no recognition of accounting netting)
2. The current exposure as a measure of counterparty default exposure.

In our view, the gross SFT value exaggerates the transaction's exposure, especially as it should be the latter which ought to be relevant for the leverage ratio. Hence we believe that there is a lack of economic assessment. Using the gross figure also means that netting between the cash leg and the securities leg is not allowed. Both legs are characteristic for these transactions and they allow the bank to gain access to a secure source of short-term funding. We have difficulties in comprehending the

rationale for the refusal to recognise collateral – even cash collateral. *De facto,* the use of the gross figure leads to a double counting of such transactions which seems to lack any economic motivation. The transactions are subject to master netting agreements (MNA). As a result, merely the net value will be subject to a counterparty default and should thus be treated as the exposure value which can be compared to regular lending operations, i.e. the key measure relevant for defining the leverage ratio.

The reference to the respective accounting standard in calculating the gross SFT value may furthermore lead to a renewed violation of the international level playing field. Whilst not limited to, this especially applies to scenarios where certain standards require recognition of the transactions whilst other standards remain silent on this issue. A departure from the provision of a level playing field should be avoided.

Should the gross SFT value remain relevant as an exposure measure for the leverage ratio, adding a further exposure ratio for recognition of the counterparty exposure is unjustified from the point of view of risks. The gross ratio is the highest possible exposure (in the event of a counterparty default).
The approach described in this Consultation Document incurs a number of unintended yet serious negative side effects which means the rules would cause considerable market stress (particularly for the repo market and for the government bond market) and which will lower financial stability:

- The netting of reverse repos should be authorised in the leverage ratio calculation as a gross approach for reverse repos would disproportionately increase the capital requirements for this activity; this would dislocate interbank funding markets and dramatically reduce the liquidity of bond markets; more specifically sovereigns.
- For the purposes of the leverage ratio definition, compared to collateralised transactions, uncollateralised transactions generally feature a lower exposure (or, at most, an identical exposure). This results in disadvantages for collateralised securities lending / repo transactions compared to uncollateralised transactions thus creating a massive incentive for uncollateralised transactions. Given the fact that - compared to the reverse repo - the risk inherent in an uncollateralised credit exposure is clearly higher, this approach is unjustified. From a supervisory and macro-prudential point of view, these incentives for uncollateralised transactions will have negative repercussions for the financial stability. Given the fact that the repo market is an important monetary transmission mechanism which assists central banks in verifying the effectiveness of their decisions, the current proposals will also have negative repercussions on monetary policy.
- The current proposals will result in less deep repo markets. In combination with the associated inflation in liquidity premiums, repo rates both for banks and also for companies will see an increase. In the context of the LCR rules, the Basel Committee explicitly mentions active repo markets as a fundamental criterion for HQLA. However, the rules proposed in the present Consultation Document will have a rather detrimental effect upon these markets. Given that the liquidity is mostly based on repo transactions, there is bound to be a less liquid market for government bonds.
- More likely than not, there will also be a spill-over of the aforementioned effects upon corporate borrowing in the form of bonds. Banks ensure the liquidity of primary markets by means of SFTs in the secondary markets. We hold the view that the new definition of the leverage ratio will tremendously burden this SFT function thus resulting in less liquid funds being made available by the SFTs; this will seriously impair the financial options available to larger corporations.

Hence, we are of the opinion that the extreme overstatement of the exposures inherent in such transactions should be remedied and we recommend preserving the existing Basel III rules which date back to the year 2010. Due to the fact that this method is sufficiently conservative, an alternative regulatory choice that the BCBS might wish to consider consists in the use of supervisory haircuts for the leverage ratio.

Concerning the treatment of agent transactions in SFTs set out under paragraph 37, the treatment of agent transactions in derivatives remains unclear. Banks generally act exclusively as financial intermediaries ("in its own name and on behalf of its customers"). As a consequence, when it comes to the underlying transactions they do not participate in risks or benefits, nor do these transactions have to be shown on the balance sheet. Hence, we hold the view that these transactions do not have to be included in the exposure calculation of the leverage ratio and we would welcome a corresponding clarification.

Other off-balance-sheet-exposures (Paragraph 40-42)

We recommend deleting the second sentence under paragraph 40. The reference in footnote 24 to Annex I is sufficient and avoids inconsistencies between the regulatory text and Annex I. Furthermore, we would appreciate a clarification as to why there is a reference to "failed transactions and unsettled securities“; they are not referred to under Annex I.

With the exception of unconditionally cancellable commitments, banks should include off-balance sheet exposure items in the calculation of their aggregate exposure position by applying a 100% credit conversion factor (CCF). Under the provisions of the Consultation Document, unconditionally cancellable commitments shall keep their 10 % weight. On the other hand, the credit conversion factor for calculating the risk weighted assets when determining the regulatory capital requirements for credit commitments that are unconditionally cancellable amounts to zero percent whilst any other credit lines are usually subject to 75% (instead of the 100% proposed for the purposes of the leverage ratio in the present Consultation Document).

Whilst the Basel Committee’s endeavours to establish a 100% risk weight for off-balance sheet items in order to take account of the increased risks which have materialised in the past is essentially understandable, when it comes to said credit commitments it is worth noting that banks featuring a major volume of highly diversified retail business along with local roots as well as real estate financing would suffer a clear discrimination if credit commitments were to receive a 10% or, moreover, 100% weighting. Furthermore, the actual exposure will see a material exaggeration. In this respect, we hold the view that using the conservative CCFs of the credit risk standard approach will also be appropriate for the purposes of defining the leverage ratio and we recommend a corresponding definition.

For trade and export finance, a 100% CCF shall remain applicable according to the current consultation. We recommend adopting the provisions set out under of the European Capital Requirements Regulation (CRR) which envisages a 20% CCR. Given the importance of trade and export finance for the real economy we hold the view that such relief is called for and objectively feasible. A 100% CCF would inflate transaction costs and/or reduce the availability of finance which would be detrimental to economic growth. Furthermore, the 20% CCF takes account of the average

cancellation patterns in this area which means that a 20% CCF is fit for purpose when it comes to transforming the off-balance-sheet exposure items into an equivalent on-balance-sheet exposure.

Disclosure Requirements

In our opinion, the requested quarterly disclosure of the leverage ratio is clearly excessive. In line with the disclosure requirements for the Pillar 3 reports, we suggest an annual disclosure interval. Furthermore, we are of the opinion that the disclosure in the annual financial statements proposed in the present Consultation Document is inappropriate. We suggest a disclosure in combination with the supervisory ratios in the Pillar 3 reports (this approach is also envisaged under the CRR). The Consultation Document refers to the possibility of incorporating a Pillar 3 reference in the financial statement. In our view, this is neither effective, efficient, nor feasible. Hence, this requirement should be deleted.

Paragraph 44 sets out specific disclosure requirements with regard to balance sheet items as well as different components of the leverage ratio. At this point, it is first and foremost questionable whether the additionally incurred considerable costs will be justified by the benefit gained. The technical and operational costs incurred especially by smaller banks might lead to considerable competitive distortion. Hence, the rationale provided under paragraph 44 merits a critical review.

About WSBI-ESBG

WSBI-ESBG – The Global Voice of Savings and Retail Banking

WSBI (World Savings and Retail Banking Institute) is one of the largest international banking associations and the only global representative of savings and retail banking. Founded in 1924, it represents savings and retail banks and associations thereof in close to 90 countries (Asia-Pacific, the Americas, Africa and Europe). It works closely with international financial institutions and donor agencies and promotes access to financial services worldwide in both developing and developed regions. At the end of 2011, assets of member banks amounted to more than $15,600 billion, non-bank loans to more than $7,400 billion and non-bank deposits to more than $9,600 billion. Together, member banks conducted operations through more than 227,000 outlets.

ESBG (European Savings and Retail Banking Group) is an international banking association that represents one of the largest European retail banking networks, with total assets of more than €7,6 billion, non-bank deposits of €4,500 billion and non-bank loans of €4,200 billion (31 December 2011). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates, and manages high quality cross-border banking projects.

WSBI and ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. WSBI and ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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Published by the WSBI-ESBG, September 2013