

A response by the British Bankers' Association to the Basel Committee on Banking Supervision's consultative document on:

Revisions to the Basel III leverage ratio framework

July 2016

The BBA is the leading association for UK banking and financial services representing members on the full range of UK and international banking issues. We have over 200 banking members active in the UK, which are headquartered in 50 countries and have operations in 180 countries worldwide. Eighty per cent of global systemically important banks are members of the BBA, so as the representative of the world's largest international banking cluster the BBA is the voice of UK banking.

All the major banking groups in the UK are members of our association as are large international EU banks, US and Canadian banks operating in the UK, as well as a range of other banks from Asia, including China, the Middle East, Africa and South America. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum from deposit taking and other more conventional forms of retail and commercial banking to products and services as diverse as trade and infrastructure finance, primary and secondary securities trading, insurance, investment banking and wealth management.

Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses.

Introduction

The BBA is pleased to respond to the Basel Committee's consultation paper 365 proposing revisions to the leverage ratio framework¹.

This response represents the views of all our members, each one of which will be impacted by the introduction of a leverage ratio. In our response, we outline some key messages before providing more granular observations on the consultation paper.

Key messages

A holistic view is needed

The BBA and its members broadly support a properly calibrated leverage ratio as a simple ancillary supervisory metric to supplement risk based capital measures that should remain the focus of capital adequacy assessment.

We strongly encourage the Committee to consider comprehensively and holistically the impact of the wide range of prudential capital regulatory measures that are under review at present, including

¹ <http://www.bis.org/bcbs/publ/d365.pdf>

revised standardised approaches to operational and credit risk as well as the more constrained use of credit modelling on the global banking system and the fundamental review of the trading book. This would ensure the Committee's objective that there should be no significant increase in the amount of capital in the global banking system is met.

Careful consideration of the results of the Quantitative Impact Study (QIS), which has recently been completed by some of our largest members, will be a most important source of information in ensuring this capital objective is met and we encourage the Committee to share the results of the QIS publically as soon as is practical. We note that the impact of the leverage ratio was not included in the most recent QIS so care will have to be given to interpret, and where necessary update the results of the 2015 leverage ratio QIS appropriately.

The leverage ratio as a backstop

We support the Committee's visualisation of the leverage ratio as a backstop measure, but are concerned the proposals in CP 365 will overstate the Exposure Measure denominator of the ratio.

Many of our members are fully engaged in completing the QIS. We look forward to a better understanding of the likely impact of the revised proposals relating to credit risk and leverage on overall levels of bank capital and how these might differ between regions, so that the Committee's stated objective of ensuring that the aggregate level of capital held against credit risk does not increase is met and to highlight the possibility that increases in one region might be offset by decreases in others.

It will be important that the Committee shares the results of the QIS with industry at an early stage and we would appreciate confirmation from the Committee that this is its intention.

Keep it simple

The relative simplicity of the Basel III leverage framework is generally regarded as one of its main benefits as it facilitates straight forward comparisons to be made against minimum required ratio levels. The BBA supports a simple, accountancy-standard neutral leverage ratio acting as a non-risk based complement to the much improved risk weighted minimum capital adequacy framework, which, in our view, should remain the most appropriate way of ensuring that banks hold sufficient capital against the risks to which they are exposed.

We comment below on the consultation paper's more specific proposals.

Credit Conversion Factors (CCFs) for off-balance sheet (OBS) items

We agree with the Committee's proposal to incorporate into the leverage ratio the final CCFs currently under review as part of the revisions to the standardised approach for credit risk. This is a sensible linkage consistent with the approach currently undertaken and supports the Committee's objective in keeping the leverage ratio simple and transparent. As highlighted in our response to the Committee's second consultative document 'Revisions to the Standardised Approach for credit risk', we disagree with the proposed calibration of those CCFs. We suggested some key revisions to those CCFs without which significant and disproportionate effects would be observed for key areas of the economy such as small and medium-sized entities (SME) lending and for the trade finance sector.

Securities financing transactions

Also, the consultative document on the leverage ratio proposes that the new standardised credit risk OBS items should be used for the purposes of determining the exposure amount for the leverage ratio. So there will be a similar penal impact on banks' leverage ratios unless significant revisions are made to the CCFs under the risk-based framework. Consequently, the concerns that we expressed to the Committee as part of our response to that consultation document are relevant here and, once again, we hope that the current calibration is revisited.

The new requirement that a 100% credit conversion factor is applied to the posting of securities as collateral is unnecessarily punitive, and risks double counting of exposure.

Firstly, the Committee's proposals should make clear that where collateral is posted as part of a structured financial transaction (SFT) and is already appropriately properly reflected under the SFT component of the leverage calculation, to also include it as a 100% off balance sheet item would double-count the collateral. Secondly, where collateral is transferred to secure a liability such as a borrowing, the exposure to the collateral receiver is only the net amount, not the gross amount (provided appropriate legal arrangements are in place). This is specifically recognised in the leverage rules relating to SFTs and this principle should be further applied to other collateralised transactions to create consistency.

Modifying the standardised approach to Counterparty Credit Risk (SA-CCR)

We are supportive of the Committee's introduction of the SA-CCR approach for counterparty credit risk, however, we do not agree with the departures for the leverage ratio from Basel's proposed SA-CCR framework. We believe that neither the collateral, nor the netting achieved under normal derivative contractual practice is properly recognised.

Firstly, under the capital requirements framework, the SA-CCR recognises the over-collateralisation in derivative netting sets by reducing the PFE via the multiplier. The Committee's proposal that this element of the SA-CCR framework be excluded from the leverage exposure measure does not encourage proper transaction management so there is no advantage for a secured trade compared to an unsecured one. Indeed, the only collateral recognised is that for variation margin and its offset of the replacement cost or mark to market component of the exposure. This ignores the prudent over-collateralisation covering both replacement cost and PFE in the form of net positive Initial Margin (IM). There has been a historical concern with the practice of re-hypothecation of such IM and the opportunity that this provides for increased leverage. However, the proposals are too broad, and do not reflect the various safeguards used for IM, such as segregation with a third-party depositary

Importantly, any concerns as to the additional leverage that a bank could generate through re-hypothecation are already addressed by other non-prudential regulation, for example, those set out in the Committee's paper: *'Margin requirements for non-centrally cleared derivatives'*.

Additionally, we believe that the Committee's proposals to fix the PFE multiplier at 1 are not cognisant of exercises to appropriately calibrate the SA-CCR. This ignores the recognition that derivative transaction which is currently out-of-the-money is less likely to go in-the-money in future than one that is currently in the money. The SA-CCR multiplier for RWA measurement does reflect this and importantly, is already subject to a prudent floor.

As such, we strongly suggest that the PFE multiplier used under the SA-CCR approach be used consistently across the leverage and RWA frameworks, reducing unnecessary variation across the overall prudential framework.

We note that an alpha of 1.4 for derivative exposures is applicable under the SA-CCR framework. This alpha was intended to reflect both concentration risk and wrong-way risk within portfolios and also to offset model and estimation error. Given that these are all risk concepts, we are unsure as to the purpose of the alpha in the leverage ratio framework. This alpha will result in derivative exposure values being significantly overstated for leverage purposes. This seems to mean an unnecessary cost that will ultimately lead to fewer avenues for risk management and hedging open to corporate clients.

Central clearing

We note that the Committee's proposals do not encourage central clearing and settlement. This appears contrary to the desire to create a transparent, liquid, and stable financial market for derivatives. Indeed, banks, as clearing members (CM) provide essential intermediary services for commercial clients, providing access to central clearing activities. Where banks provide a back-to-back transaction for a centrally cleared product between a commercial client and a Central Counterparty (CCP), it is in reality acting as an intermediary of a transaction between the commercial client and the CCP as a commercial client has no other route, other than through a CM, to this CCP. The proposal does not reflect this and is punitive to the positive service that CM's provide in terms of wider access to central clearing.

We would also suggest that the Committee recognise that there is potential for inconsistency under the current proposal given the use differing use of agency and principal-to-principal models for central clearing in different jurisdictions. Depending on the requirement of CCP's for CM's to provide guarantees for commercial clients, banks using the agency model would be required to hold significantly less leverage capital although the service provided is essentially the same.

Written credit derivatives

We note that the Committee's proposal that the leverage exposure for a written credit derivatives is driven materially by reflecting effectively the replacement cost plus 100% of the notional value of the instrument. We believe that this represents a significant and unnecessary departure from the SA-CCR approach used for measuring RWAs.

For IFRS purposes, credit derivatives are reflected on the statutory balance sheet at a marked-to-market basis and subject to cash variation margin and the fair value factors in the markets perception as to the credit worthiness of the reference entity. The SA-CCR approach takes this a step further by factoring in the future volatility using the PFE measure. These volatility metrics just as readily reflect a credit deterioration of a reference entity as an improvement. Thus, we believe that using SA-CCR methodology is sufficient to quantify the leverage exposure of written credit derivatives. Moreover, should the Committee wish to continue with the notional add-on for sold protection, and indeed to widen its application to credit options, we would strongly urge SA-CCR to be used in its unmodified form. That is, any notional for the options should be a delta weighted notional, using the supervisory deltas used in the SA-CCR. In addition, we would support use of these delta weighted notionals when considering offsets between bought and sold options of different strikes as opposed to the method currently proposed, which sees strike price used to determine whether an offset of the sold protection add-on can be permitted.

Currency of settlement

We do not support the Committee's proposals that, where the currency of the cash variation margin does not match the termination currency of the netting set, an FX haircut should be applied. This introduces an inappropriate degree of risk adjustment into the explicitly non risk sensitive leverage ratio. Further, contracts subject to periodic variation margin are not, in reality, exposed to any real risk of mismatch between the currency of collateral and the currency of termination. This is because periodic re-valuation of collateral versus the underlying derivative transactions, including for the underlying currencies removes this as a relevant risk.

Treatment of regular way purchases and sales of financial assets

We are pleased that the Committee has recognised that the treatment of security settlement balances within the Leverage Ratio differs because of the differing accounting frameworks across the globe. Banks using settlement date accounting, an option under IFRS, will not record settlement balances in the leverage ratio on balance sheet, as the security will only be recognised or de-recognised at the point the transaction completes.

Dealer banks under US GAAP applying trade-date accounting to regular-way security trades are able to net their settlement balances down to a single net number, with no restrictions or conditions on the ability to net the balances. In contrast, if an IFRS bank applies trade date accounting to such trades, the resulting settlement balances would generally be presented gross. IAS 32 allows very limited netting of balances; offsetting will only occur when, and only when, an entity: (a) currently has a legally enforceable right to set off the recognised amounts; and (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously (IAS 32, par. 42).

Therefore banks that are using trade date accounting under IFRS will record significantly higher balances than US banks operating under the unsettled regular way trade accounting treatment by way of the fact that both the cash and the security will appear on balance sheet, when in reality the bank will only ever hold one or the other; never both simultaneously.

We therefore support option B proposal which effectively aligns the treatment with the unsettled regular way trades treatment under US GAAP. Harmonisation of treatment to address accounting difference is desirable, as it enables supervisors and other stakeholders to make more accurate comparisons between firms within a jurisdiction and across jurisdictions to international peers. We note however that it is proposed this treatment should be limited only to those banks that are market-makers. As we do not believe the efficacy of offsetting is affected by whether or not a bank is a market maker, we request that the scope of this helpful proposal in relation to unsettled balance is extended to all banks.

Cash pooling

We do not support the proposal that notional cash pooling balances should be grossed up for the purposes of calculation of the leverage ratio and suggest that an approach driven by legal right to set-off, supplemented in some cases by cross guarantees and operational controls. Moreover, in line with the BBA's overall view that the leverage framework should be accounting-standard neutral, achieving a single unit of account in under accounting standards should not be a condition to allow for netting. Differences in accounting standards across major jurisdictions mean that this is

considerably easier to achieve in some jurisdictions and therefore such a policy could have a competitive impact.

Notional cash pool is pre-funded and self-funded by corporate clients. Bank lines may not be required. It is a popular cash management tool used by corporates to efficiently manage intra-group liquidity and minimise reliance on bank borrowings. It is a solution which leads to operationally strong client relationships providing the benefit of account balances which are more 'sticky' creating greater resilience in the event of a stress.

We propose that that notional cash pooling balances be reported on a net basis for Leverage Ratio purposes, if the conditions stated below are met;

- a) For single entity structures - a right of setoff, which is backed by well-informed legal opinions which confirm a reasonable expectation of legal enforceability.
- b) For multi entity structures - cross guarantees and right of setoff (or equivalent) from all entities participating in the notional cash pooling structure. Cross guarantees and right of setoff should be backed by well-informed legal opinions which confirm a reasonable expectation of legal enforceability.
- c) All accounts participating in a particular notional cash pooling structure must be located in the same legal jurisdiction.
- d) As is currently the case, the cash notional pooling provider must have operational control of the pool.

Securitisation

We welcome the statement that the Committee is working on the further clarification of the treatment of traditional securitisations for leverage ratio purposes.

We recommend that all traditional securitisation structures that achieve de-recognition from the regulatory scope of consolidation should be excluded from the calculation of the Leverage Ratio; such securitisations do not offer the investor any recourse to the bank. The assets held at the SPV should not therefore be classified as assets of the bank although, for accounting purposes they remain on balance sheet because of the difficulty of achieving accounting deconsolidation for such SPVs.

Treatment of Provisions

We support the proposed treatment of general and specific provisions but note that the introduction of IFRS 9, which will be operationally intensive for our members, may require a re-examination of the proposed approach.

Additional requirements for G-SIBs

G-SIBs have more diversified business mixes which ensures that they are less exposed to the risks of excessive leverage. Other measures are already being implemented to address "too big to fail" challenges identified by regulators, such as designated capital buffers and structural reforms (ring-fencing, recovery and resolution, and total loss absorbency capacity (TLAC) proposals, etc.).

So we would suggest that an additional Basel III leverage ratio requirements should apply to G-SIBs only in the event that the Committee publishes robust evidence supporting the view that G-SIBs are more exposed to the risk of excessive leverage than other banks and therefore validating the need for an additional leverage backstop for G-SIBs and bearing in mind the need to maintain a level global playing field.

If, however, the Committee decides to implement an additional requirement, this should be set in the form of a buffer (consistent with the risk based capital framework), based on a scaling of the higher loss absorbency requirement for systemic importance. In particular, it is of crucial importance that firms can use the buffer without automatic consequence as to do so would create unnecessary uncertainty, particularly in times of stress.

Furthermore, any Committee proposal to create a G-SIB leverage ratio buffer structure must avoid any unnecessary complexity and supplement the risk-based measure with a simple non-risk based “backstop” leverage ratio buffer.

An approach for setting leverage buffers that the Committee should consider is to try and preserve the relative roles of the risk-based ratio and the leverage ratio within the regulatory capital framework. Although this was the approach adopted in the UK by the Bank of England, we recognise that this goes against the objective of the leverage ratio being a simple and independent metric.

We are of the opinion that any additional leverage ratio requirement should be independent of RWAs in its formulation/composition and that the size of any additional leverage ratio buffer requirement above the 3% minimum should be derived following an independent calibration, resulting from a quantitative impact study and stress testing exercises.

Ultimately, the design and calibration of any internationally agreed additional leverage ratio requirements should be clearly defined with a view to be consistently applied across jurisdictions.

Below you will find our response to the Committee’s questions on the various characteristics that would need to be specified for any additional G-SIB requirement.

Question: Should there be a limit on Additional Tier 1 (‘AT1’) capital that may be used to satisfy an additional requirement?

There should not be a limit on the amount of AT1 that can be used to meet a leverage requirement. The Basel III framework has enhanced the loss absorbency capacity of non-common equity capital instruments and as such, these securities should be viewed as valid capital instruments for the purpose of calculating the leverage ratio. However, it could be appropriate to consider a CET1 trigger ratio before such instruments can be recognised.

In the UK, for example, banks are required to use a trigger of at least 7% CET1 before an AT1 capital instrument can be counted as tier 1 capital for leverage ratio purposes. Additionally, banks are required to meet additional leverage buffer requirements with CET1 capital. We would urge the Committee to consider this to ensure that a harmonised international leverage ratio framework is implemented and that there is a level-playing field across jurisdictions.

Question: Should an additional requirement be fixed and applied uniformly to all G-SIBs or should it vary based on a scaling of the G-SIB's higher loss absorbency requirement as applicable under the risk-based framework?

If the Committee decides to implement additional leverage requirements for G-SIBs, then in the interests of harmonising the rules in this area internationally and to ensure a level playing field, any additional G-SIB requirement should vary based on a scaling of the G-SIB's higher loss absorbency requirement, as applicable under the risk-based framework. The UK's scaling approach of 35%, derived by the overall minimum leverage requirement of 3% divided by the overall Tier 1 requirement of 8.5%, is something to be considered in this respect.

Question: Should an additional requirement be in the form of a higher minimum requirement or a buffer requirement with or without implications on MDA?

If the outcome is an additional leverage ratio requirement then, in the interests of creating a level playing field internationally, and to preserve a proportionate relationship with the risk-based capital buffers regime, we strongly request that it be in the form of a buffer. We also recommend that it should be the responsibility of the national competent authority to decide the appropriate supervisory response if a firm's leverage ratio were to fall within any additional buffer requirements, rather than setting pre-determined consequences such as automatic restrictions on capital distributions, as this would be disproportionate and increase complexity.

Other key considerations

Cash balances held at central banks

Although the Committee is not addressing the issue of cash balances held at central banks in the current leverage ratio consultation, we strongly request that they reconsider this approach and, as a result, exclude them from the leverage exposure measure in the final framework, given the nature of these balances and the fact they are not redeployable for other asset purchases and so cannot be used to generate or increase leverage. We consider that there is a strong financial stability rationale for excluding cash balances at central banks from the leverage ratio denominator. This has been recognised by the Bank of England's Financial Policy Committee, which in its [July 2016 Financial Stability Review](#) (p40) expressed strong reservations about the inclusion of central bank cash balances in the leverage ratio exposure measure.

We consider it necessary to make a specific, limited, exclusion for central bank cash balances only in order to offer a "safety valve" in the system. Healthy banks may, in times of stress, receive large inflows of deposits from a wide range of market counterparties and retail depositors. Without the safety valve of excluding central bank cash deposits, this leaves banks exposed to volatility in their leverage exposure which they have no power to control. As a result, banks may – regrettably – be forced to refuse new deposit inflows; for example, from customers of other, distressed banks, or from customers seeking to liquidate other, riskier, assets.

This could prompt retail depositors to access central bank liabilities directly, in the form of banknotes; and could lead wholesale counterparties to hoard the central bank liquidity that they do have, causing dysfunction in the payment system. These issues are core financial stability and we politely but firmly request the Basel Committee to reconsider its position on this.

Further, we would note that excluding central bank cash balances would be entirely in line with the objectives of the leverage framework because by definition central bank cash deposit balances cannot be associated with maturity transformation or with credit intermediation, because they are by definition the most liquid and safest asset in the banking system. Holding central bank cash balances is necessary for the orderly functioning of the payment system: as the FPC says, as the ultimate settlement asset they are unique. We consider there to be no micro- or macro-prudential rationale for requiring capital to be held against them.

We would note that we are not requesting that any other asset (e.g. government securities or other HQLA) should be carved out of the leverage exposure, because we recognise legitimate concerns around potential arbitrage possibilities and the fact they do potentially contribute to leverage in the system. We would be happy to engage in a dialogue with the Committee to help it find a formulation which would provide for the central bank cash deposit safety valve without undermining any other aspect of its leverage framework.

Impact of IFRS 16 – Leases

The new IFRS accounting standard for lease, IFRS 16, will require lessees to recognise assets and liabilities for most leases on-balance sheet. A lessee will be required to account for a leased asset as a right-of-use (RoU) asset, representing its right to use the underlying leased asset and a lease liability, representing its obligation to make lease payments.

If this change in the accounting for leases were to flow through to the leverage ratio then the lease commitments would also be included as an on-balance sheet exposure since the lessee would be required to recognise its future lease commitments on the balance sheet as an asset. However, we would consider it unacceptable were the leverage ratio to be penalised as a result of an increase in balance sheet asset value driven by what essentially would be just a formal change in the accounting for leases without any corresponding economic change.

For this reason, to avoid any unintended and penal effects on banks' leverage ratios, we strongly believe that on-balance sheet RoU assets should be included net of the related lease liability for the purposes of the leverage ratio framework.

Other high quality liquid assets (HQLA)

We strongly request that a similar exemption for other HQLA, to the extent required by the liquidity coverage ratio ('LCR'), be considered by the Committee.

The LCR was proposed to improve the banking sector's ability to absorb shocks arising from financial and economic stress, reducing the spill over from the financial sector to the real economy. It is clear that holding sufficient balances of HQLA in times of stress is a priority for both banks and the Committee. It is counterintuitive to this objective to apply a penal treatment to such low risk and low yielding assets under leverage. During times of stress, banks should be incentivised to increase balances of HQLA, as this is the time that banks' leverage ratios will be most constrained due to the inflow of deposits from corporate and retail depositors, in search of a safe haven.

In addition, HQLA provide the easiest avenue to quickly reduce leverage exposure (assuming LCR can still be met) when banks are constrained by leverage, and this could provide short term incentives for banks to reduce those holdings of HQLA in order to meet short term leverage ratio

requirements. This would have significant implications for the real economy, counter to the Committee's objectives of promoting prudential liquidity management and preventing spill overs.

We therefore have the opinion that assets meeting the definition of level 1 HQLA should be exempt from the leverage ratio exposure measure. This would better align the leverage framework with the liquidity rules and should provide sufficient incentives for banks to hold HQLA to promote financial stability in stressful periods.

Responsible executive

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