

EAPB Position Paper on Basel Committee for Banking Supervision's Revisions Proposed to the Basel III Leverage Ratio Framework

06 July 2016

On 6 April 2016 the Basel Committee on Banking Supervision (BCBS) published a consultation paper on the revision of the Basel Leverage Ratio Framework. The European Association of Public Banks (EAPB) welcomes the consultation and would like to use this opportunity to comment on it.

1. General comments

Being a risk-insensitive measure, the leverage ratio (LR) may cause inconsistencies between the risk-weighted capital framework and LR capital requirements. The purpose of banking supervision – namely guaranteeing the solvency of a bank – can be achieved if risk is appropriately accounted for when determining capital requirements. Therefore, regulatory capital requirements with no reference to risk of default may not be sufficient for ensuring solvency.

Consequently, EAPB believes that the leverage ratio as proposed by BCBS is not sufficient as a binding supervisory minimum capital ratio. It is neither able to limit the risk of excessive leverage nor does it offer any protection from measurement errors and modelling risks. Additionally, the LR does not represent a second safety net as add-on to the risk-weighted framework, but is another approach for calculating capital requirements. Similarly, the aim of creating a level playing field will not be achieved, since the measurement of on-balance sheet assets is carried out in accordance with accounting rules without any adjustments.

In the LR framework, the treatment of derivatives, securities financing transactions and off-balance sheet items is complex and dependant on on-balance sheet items and their valuation making the LR less reliable in view of the different accounting rules. The BCBS consultation paper contains various new approaches for determining the value of balance sheet items, in particular in the general provisions in Sections 10 – 12 and the specific provisions for normal purchase/sale of financial instruments (Section 16 and Annex Section 9) and for cash pooling (Section 17). However, such provisions may even contribute to the inconsistency between the LR and the risk-based framework and may introduce unnecessary complexity in Pillar 1.

Therefore, EAPB would recommend that with respect to the LR exposure measure definition (apart from the differences in definition existing between leverage ratio and the risk-based framework), the LR and the risk-based framework should be synchronised. In example, the following has been implemented at European level: pursuant to Article 429 (5) of the European Union Capital Requirements Regulation (CRR) the LR exposure value of certain on-

balance sheet items must be calculated using the credit risk standardised approach (CRSA) values. Such a link would reduce the complexity in Pillar 1 but has unfortunately to date been lacking in the Basel III framework. EAPB would thus require that a principle-based definition of the LR exposure measure is retained, which should be linked to the risk-based approach. Moreover, the number of specific LR requirements (as for floating rate transactions and cash pooling transactions) should be kept as low as possible.

With respect to an enhanced comparability of the assessment base in the solvency and leverage ratio framework, EAPB would argue in favour of a consistent introduction of the standardised approach for counterparty credit risk exposures (SA-CCR) if the market valuation method should be replaced. In the case of SA-CCR, the industry is currently expecting an increase in exposure compared to the market valuation method (in particular due to alpha equal to 1.4). However, the fixed multiplier of 1 as proposed by the BCBS goes against the logics of the SA-CCR of "taking into consideration" an analogous over-collateralisation and may lead to a further increase in the risk position value. An introduction of the SA-CRR would have the advantage that one existing provision would consistently apply to two frameworks avoiding additional operational costs, which would be significantly higher if the proposed modified approaches were used.

2. Detailed comments

2.1 Minimum requirement and additional requirements

The risk of excessive leverage, which the LR measure is supposed to limit, is evidenced by the fact that banks can be forced by virtue of losses and refinancing bottlenecks to sell bonds or securities on a massive scale or to reduce lending. This could lead to decreasing asset prices and devaluation. Even banks which have suffered no losses could therefore be forced to fire sale. Arguments of this nature must be countered by stating that, in contrast to risk-insensitive capital measures, risk-based capital requirements are very well suited to prevent destabilising deleveraging processes. The volume of bonds or securities, which must be sold, in order to compensate for losses in risk-weighted capital, is indeed higher the lower the risk-weighting is. However, the volume does not depend on the level of the risk-insensitive capital ratio, but on the level of the institute's risk-weighted capital ratio. It is the risk-insensitive LR which causes that banks holding predominantly low-risk assets – such as public and promotional banks – might have to sell bonds or securities on a large scale in order to meet the LR capital requirements. In the case of such low-risk public and promotional banks with stable refinancing methods, it is the devaluation process and the accounting rules on which devaluation is based which trigger the reasons for deleveraging. A risk-insensitive leverage ratio is therefore not required in order to limit the risk of system-destabilising deleveraging processes. Therefore, it can be claimed that from there is no technical base for imposing a 3% minimum leverage ratio requirement. On the contrary, there should be no such additional charge in order to avoid that this "backstop measure"

becomes a "front stop" measure for the majority of credit institutions. The impact studies undertaken on Basel III have revealed that even a LR of 3% becomes a binding measure for most of the cases, i.e. it has an effect not as a back-stop, but as a front-stop. In this respect it would be necessary to reconsider whether a LR level of 3% does not infringe the original intention of establishing a back-stop measure on leverage. In addition, results from the European Central Bank's (ECB) Comprehensive Assessment 2014 showed that on average, the LR entails a higher capital requirement than the risk-based framework for a vast majority of European banks within the Single Supervisory Mechanism (SSM). Therefore, EAPB believes that the BCBS should not exceed a minimum leverage ratio requirement of 3% and refrain from additional requirements.

2.2 Capital measure

The EAPB welcomes the Group of Central Bank Governors and Heads of Supervision (GHOS) decision of January 2016 to use Tier 1 capital as the LR capital measure. Given the characteristics of AT1 capital as going concern capital, it is not considered that further restrictions on the AT1 capital in the context of satisfying the leverage ratio are required.

2.3 Exposure measure

2.3.1 On-balance sheet exposures

2.3.1.1 Treatment of regular-way purchases and sales of financial assets

In principle, the BCBS proposal to standardise the calculation of exposure for regular-way purchases and sales of financial instruments is understandable and for reasons of comparability, EAPB would support such an approach. However, EAPB would like to point out that the proposed options are not justified when indebtedness and risk aspects are taken into account and would therefore reject the proposed options A and B.

The BCBS consultation paper provides that in the case of settlement date accounting for common market sales of financial instruments, the sales of floating-rate securities on the reporting date must be accounted for in their entirety in the exposure measure (apart from specific exceptions in option B). EAPB does not regard this approach as justified, neither in terms of indebtedness, nor of risk. The reasoning for this is as follows:

Against the background of credit risk, EAPB would like to point out that these transactions are mostly delivery-versus-payment transactions. If the security purchased is not deposited as envisaged, there is no payment in the institute's accounts. Consequently, the risk cannot be measured with the full purchase price, but must be measured with replacement costs, which here equal the difference between the purchase price and the current market value of the security. Even if all delivery-versus-payment transactions were cancelled on a given value date, the actual credit default risk does not equal the amount to be accounted for in the overall risk position as suggested in this BCBS consultation paper.

Although a securities purchase does contribute to leverage since the purchase amount (assuming constant level of cash) must be refinanced at the latest by the value date and the overall risk position would increase, this approach is however far-fetched because it only takes account of the securities purchase while securities sales are completely disregarded. Against the background, a risk of excessive leverage cannot be justified. By the given value date, only the difference between purchases and sales of securities must be refinanced. Consequently, when measuring leverage, too high capital requirements result if only securities purchases are to be considered. Such an approach would only be justified in the unlikely case that floating rate securities purchases would still be prevalent after the reporting date. Therefore, it would only be justified to consider the (positive) difference resulting from all delivery-versus-payment floating rate purchases and sales for the leverage framework. The high amount that has to be accounted for following the BCBS consultation paper proposals would only be valid if transactions were not subject to delivery-versus-payment but to advance performance risks. Moreover, the proposals in option B set up conditions which only allow a small amount of the sales figures to be set off against each other and which consequently results in an overestimation of the underlying risk.

A possible solution would be to account for receivables from floating rate transactions, which are discharged delivery-versus-payment, in accordance with the provisions from the risk-based capital framework for such transactions (in line with Basel II BCBS 128, Annex 3) irrespective of the selected accounting rules. Should the BCBS be opposed to this kind of standardisation, EAPB would argue in favour of option B. Here, EAPB would only consider the requirement of fulfilling delivery-versus-payment (DVP) as relevant. A restriction to market-makers or trading book transactions would favour only major market participants and could result in unnecessary implementation and monitoring burden for the sole purpose of calculating the LR exposure measure. For these reasons, EAPB proposes that the general treatment of delivery-versus-payment transactions should be facilitated.

2.3.1.2 Treatment of “prudent valuation adjustments” (PVA)

The BCBS consultation paper departs from the assumption that PVAs are only created for low-liquidity assets. In European Union legislation however it is requested to take various scenarios into account (market price uncertainty, model risk, unearned credit spreads, investing and funding costs etc.; see Commission Delegated Regulation 2016/101). The guidelines for determining PVAs allow, inter alia, that assets and liabilities are netted to determine the relevant values and that the PVAs are calculated predominantly on the basis of aggregated risk positions and not on the basis of individual assets or liabilities. An allocation of PVAs to asset and liability is accordingly only possible to a very restricted extent and the requirement that only PVAs on assets should be considered can therefore only be implemented with limited scope.

Furthermore, it should be highlighted that in the case of derivatives (PFE) and securities financing transactions (SFT) (counterparty risk components), transactions with negative market values and liabilities are also included in the LR exposure measure calculation. Since the predominant proportion of the PVAs applies to derivatives and SFTs, it is not appropriate to restrict the reduction possibility of the PVAs to balance sheet assets. EAPB would therefore suggest that the requirement that PVAs must apply to on-balance sheet assets should be deleted, so that all PVAs, which have reduced the Tier 1 capital, may be cancelled from the exposure measure.

2.3.1.3 Treatment of traditional securitisations

Taking into consideration the proposed options for conventional securitisations, in which the risk transfer is discharged in accordance with the regulations in the securitisation framework, but not under the conditions for a balance reduction or deconsolidation, EAPB would favour option 1. The proof of risk transfer as a prerequisite for not requiring that the securitised receivables are taken into account for the purposes of determining regulatory capital is regulated and subject to an approval requirement and right of appeal. This detailed and closely supervised process is appropriate in order to disregard the securitised receivables in the leverage ratio framework

2.3.2 Derivatives Exposures

Impact on the client clearing business model

The BCBS LR framework should recognise the exposure-reducing effect and segregated initial margin (IM). Capital levels should be appropriate to the level of risk of a given financial activity, in order to ensure that potential exposures arising from such activities are properly aligned and calibrated with the capital supporting them. However, the leverage ratio requirements are not appropriate for cleared client transactions as they ignore the risk mitigating impact of segregated margin. This acts as a significant disincentive to central clearing. The rules will constrict the ability of smaller market participants to secure clearing arrangement, forcing some to stop using derivatives, thus increasing risk in the system and reducing liquidity in hedging instruments. The LR should be amended to recognise the exposure reducing effect of segregated margin. It is not clear how the IM will be treated in the BCBS framework. The IM should be recognised in the LR exposure measure to ensure a consistent implementation of the SA-CCR. Furthermore this would reduce administrative burden since only one calculation would be necessary.

Treatment of cash variation margin (CVM)

EAPB would like to propose to account for partially secured derivative exposure in the CVM treatment if these exposures are set within credit support annexes (CSA) and if they allow not cash only, but also the provision of securities in form of bonds. This would enhance flexibility in collateral management and increase market liquidity in stress scenarios. EAPB therefore supports the consistent implementation of the SA-CCR and thus, the implementation of the relevant provisions for securities to be also taken into account for the

LR. Such an approach would allow limiting diverging treatments and could imply a simplification on the operational level rendering implementation significantly less complex.

Additional treatment for written credit derivatives

EAPB perceives the BCBS comments on the purchase of hedging on a pool of reference issuers as unclear and would therefore request clarification as to which constellation is meant here (n-t-default?) and an illustrative example (see Annex, Subsection 33, Clause 3 et seq.)

EAPB would like to seek clarification on whether the provisions for the valuation of opposing credit derivatives (see Annex, Subsection 34) are only relevant for cases, in which the valuation of written credit derivatives is not considered in national accounting standards. Consequently, EAPB would like to clarify whether these provisions could thus be viewed as irrelevant for IFRS purpose as written credit derivatives have to be measured at fair value in the IFRS framework anyways.

As regards the proposals in Subsection 35 of the Annex, EAPB believes that they would not be workable requiring multiple calculations of the add-on. Generally, the determination of the net long position in credit derivatives is undertaken at a later point in time and requires re-calculation of the add-on based on the results obtained for the net long position. EAPB would therefore propose that the calculation of an add-on for written credit derivatives should be waived.

2.3.3 SFT exposures

In accordance with Recital 7 of the European Union Commission Delegated Regulation 2015/62 (amending Commission Regulation (EU) No. 575/2013) on the leverage ratio framework, "Repurchase transactions that can be terminated at any day subject to an agreed recall notice period should be considered equivalent to having an explicit maturity equal to the recall notice period [...]" Therefore, it does not seem evident why the BCBS diverges from this approach in Section 37(i) (a) of its consultative documents as this treatment strikes EAPB as an economically viable approach. The differentiated treatment of these very similar items may consequently lead to distortions. Ultimately, repo transactions without fixed notice periods have a mutual notice option. This option allows either party – as in transactions with a one-day term – to close the transaction at any time.

Furthermore, EAPB would recommend that the current treatment of SFTs in the LR framework should be reconsidered, since the risk position value can exceed the maximum possible indebtedness and default. This can be explained with the following example:

A reverse repo consists of an outstanding debt of 100 EUR. The borrowed securities have a market value of 95 EUR. In accordance with the current provisions, an amount of 105 EUR (100 EUR plus counterparty credit risk 5 Euros) must be added to the overall risk position,

although the maximum possible risk position amounts to 100 EUR (in the case of complete financial loss of the outstanding debt without taking into account possible compensation from the assets held). An overall amount of 105 EUR is consequently not justified. Therefore, the overall risk position should be limited to the maximum amount (100 EUR as stated in the example above). This could for instance be implemented by reducing the risk position value arising from the cash receivable (in the example 100 EUR) by the (positive) risk position value from the counterparty credit risk (in the example 5 EUR). The example above gives a result of an overall amount of 100 EUR arising from the risk position value from the cash receivable (95 Euros) and the risk position value arising from the counterparty credit risk (5 EUR).

2.3.4 Off-balance-sheet (OBS) items

2.3.4.1 Treatment of provisions for OBS items

EAPB would welcome the BCBS proposal for taking into account the valuation adjustments of off-balance transactions when calculating the LR exposure measure. It is also considered as appropriate to use the credit conversion factors (CCF) from the credit risk standardised approach (without any methodological variations). Further, EAPB would welcome the proposal to deduct the valuation adjustments from the LR exposure measured in accordance with the CCF weighting. However, this should be implemented consistently for every case following the requirements as laid down in the latest BCBS proposals on the credit risk standardised approach.

2.3.4.2 Revisions to the CCFs for OBS items

In the consultative document, the BCBS proposes to use the conversion factors, which have been significantly increased within the credit risk standardised approach framework, for the scope of the LR calculations. EAPB would have reservations with regards to this proposal since the conversion factors as currently already in force are sufficiently restrictive and since no value-added would occur from a further tightening of the conversion factors. An increase in the conversion factors could even have a negative impact on the banks' readiness to lend, in particular to small- and medium-sized enterprises. Such a tightening could even trigger stricter contractual conditions. Therefore, EAPB is sceptical towards this proposal. Moreover, the determination of the relevant credit conversion factors seems considerably more complex under the new BCBS proposals in which a 0% treatment is no longer provided for. This is particularly critical given that for the case of the LR framework, a lower limit of 10% exists already for low-risk OBS transactions.

The credit conversion factors for undrawn credit approvals in corporate lending are unfavourable and would also affect corporate SMEs which may have a negative impact on the availability of financial means for companies and the real economy. EAPB would therefore propose to differentiate between retail and corporate businesses also for the scope of the LR framework.

3. About EAPB

The European Association of Public Banks (EAPB) gathers member organizations (financial institutions, funding agencies, public banks, associations of public banks and banks with similar interests) from 17 European Member States and countries, representing directly and indirectly the interests of over 90 financial institutions towards the EU and other European stakeholders. With a combined balance sheet total of about EUR 3,500 billion and a market share of around 15%, EAPB members constitute an essential part of the European financial sector.