

Morgan Stanley

July 6, 2016

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

Re: Revisions to the Basel III leverage ratio framework

Ladies and Gentlemen:

Morgan Stanley appreciates the opportunity to provide comments to the Basel Committee on Banking Supervision (the “**Basel Committee**”) regarding its April 2016 consultative document entitled *Revisions to the Basel III leverage ratio framework* (the “**Proposal**”).

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

We believe the most critical issue raised in the Proposal is whether a bank may recognize an offset between cash receivables and cash payables in regular-way purchases or sales of financial assets.¹ We strongly believe that recognizing offsets between receivables and payables, as contemplated by Option B in the Proposal, would best advance the Basel Committee’s underlying policy goals. Failure to recognize an offset, as contemplated by Option A in the Proposal, would dilute the foundational exposure-based principles of the leverage ratio and introduce significant capital penalties for banks that support market making and client trading activities, severely impairing liquidity across securities markets and weakening global capital markets. In addition, Option B would harmonize the treatment of securities settlement transactions globally, appropriately resolving any differences in accounting frameworks.

In addition to this central issue, the Proposal also raises a number of related questions around how best to calibrate the leverage ratio exposure measure in specific technical areas, including exposure measurement principles for derivatives, credit conversion factors (“**CCFs**”) for off-balance sheet exposures, and client clearing transactions. We address these additional technical issues in Part II of this letter.

¹ Proposal, Section II.2; Proposal Annex, ¶ 16.

We support comments submitted on the Proposal by the Global Financial Markets Association, the International Swaps and Derivatives Association, the Institute of International Finance, The Clearing House and the Japan Financial Markets Council as well as comments submitted by the Futures Industry Association (the “**Associations’ Letters**”). The Associations’ Letters contain appropriate, practical recommendations for ensuring that the leverage ratio is an effective tool in the prudential framework without unnecessarily weakening economic growth and job creation.

I. The treatment of regular-way purchases and sales of financial assets

Banks play a critical role in facilitating liquidity, depth and efficient pricing in global securities markets. Investors seeking to purchase or sell securities in major jurisdictions will typically transact with a broker-dealer, which agrees to execute with the investor on the “trade date,” followed shortly thereafter by the “settlement date” on which the transaction is operationally completed. In regular-way purchases and sales of financial assets, there is generally a small period of time (e.g., 1-3 days) between the trade date and the settlement date.

In its current form, the leverage ratio exposure measure begins with a bank’s accounting balance sheet before applying add-ons related to derivatives and other off-balance sheet exposures; accordingly, regular-way purchases and sales of financial assets are included in the leverage ratio consistent with accounting standards applicable to each bank. Accounting frameworks diverge by requiring (or permitting) banks to include securities in their balance sheets as of trade date or as of settlement date and by permitting (or prohibiting) banks to net receivables and payables arising from purchases or sales of securities pending settlement. To the extent that an accounting framework derecognizes the netting of payables and receivables, the bank’s balance sheet assets may include a “double count” of both the security and cash positions, even though in substance the bank has either a security or cash position as a result of the pending transaction but never both.

In response to these accounting differences, the Basel Committee has proposed two potential options for measuring regular-way purchases and sales of financial assets in the leverage ratio during the period between trade date and settlement date. Option A would, in essence, derecognize banks’ ability to offset payables and receivables during a normal course securities settlement period. Option B, by contrast, would permit banks to offset such payables and receivables if certain criteria are met, the most important being that the transactions settle on a delivery-versus-payment (“**DvP**”) basis. DvP settlement mechanisms emerged in response to concerns that one party in a securities transaction might perform its obligations at settlement date without performance by its counterparty, resulting in the performing party suffering a total loss. DvP arrangements solve for this problem by making the performance of each party contingent on the performance of its counterparty, ensuring that neither party is exposed to the unilateral loss of the securities or cash it delivers at settlement.²

For the reasons explained below, we strongly support Option B. We believe that Option A is fundamentally inconsistent with leverage ratio exposure measurement principles and would weaken global capital markets and impair liquidity. We also believe that any concerns with the comparatively

² See generally Bank for International Settlements, *Delivery Versus Payment in Securities Settlement Systems* (1992).

minor risks presented by securities settlement practices are more appropriately addressed in the risk-based capital framework.

A. Option B results in the correct measurement of a bank's exposure

Option B is based on the same exposure measurement principles that otherwise serve as the foundation of the leverage ratio.³ By requiring DvP settlement practices, Option B reflects the reality that a bank is exposed to only securities or cash at any moment during the settlement process. If the bank's counterparty fails to perform at settlement, the bank remains exposed to the original asset (securities or cash) that it owned before the settlement date.

Option A, by contrast, is not based on exposure measurement principles. As noted in the Proposal, the Basel Committee is concerned that a bank faces "the risk" that the value of its payable or receivable may change between the trade date and the settlement date and that the counterparty will fail to perform at the settlement date, leaving the bank with losses.⁴ This concern, however, is focused on risks in securities settlement practices, which are already addressed through risk-weighted asset penalties on failed settlements.⁵

Even if it were appropriate to address securities settlement risks in the non-risk-based leverage ratio, Option A massively overstates and mismeasures those risks. While risks are inherent in securities settlement practices, these risks are relatively minor and well-contained. By relying on a "double count" gross-up methodology, Option A lacks even basic risk sensitivity.

B. Option A would weaken global capital markets and increase systemic risk

Option A would lead to significant increases in the leverage exposure measures of banks that facilitate clients' sales and purchases of securities by, in effect, "double counting" both sides of sales and purchases. We believe that Option A, by overstating banks' exposure, would fundamentally alter the economics of normal course securities transactions, including for equity agency execution businesses and sovereign debt market making. These capital penalties, and resulting lower return on equity, would provide strong incentives for banks to withdraw support from the capital markets, thereby impairing market access for clients and reducing market liquidity.

Although the exact amounts will vary by firm and over time, we believe that Option A would result in significant increases in a bank's leverage ratio exposure, which could drive banks to shrink

³ See, e.g., Basel Committee, *Basel III leverage ratio framework and disclosure requirements* (January 2014), ¶ 2 (describing the leverage ratio as "a simple, transparent, non-risk based" framework grounded in exposure principles); Remarks by Mr Stefan Ingves, Chairman of the Basel Committee on Banking Supervision and Governor of the Sveriges Riksbank to the 8th Meeting of the Regional Consultative Group for Europe, Berlin, May 5, 2015 (noting that the leverage ratio is "not risk sensitive").

⁴ Proposal, Section II.2.

⁵ See Basel Committee, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework Comprehensive Version* (June 2006), ¶¶ 88-89 and Annex 3; see also Basel Committee, *Basel III: A global regulatory framework for more resilient banks and banking systems* (June 2011), ¶ 162 (cross-referencing ¶¶ 88-89 of the June 2006 framework).

their equity agency execution businesses because the capital costs would become unsustainable. For example, the leverage ratio exposure amount attributable to a bank's equity agency execution business could increase by 10 times or more, significantly increasing capital requirements. Beyond being an inaccurate measure of leverage exposure, Option A would result in prudentially regulated banks withdrawing support from equity agency execution businesses, severely impacting the foundation of global capital markets.

Option A would also impair market liquidity, and increase systemic risk, in stress periods. A bank seeking to maintain a high leverage ratio to appear strong in a crisis would be incentivized to cease executing securities transactions with clients, including those related to equity agency execution businesses and sovereign debt trading, since that would directly remove the leverage exposure "double count" resulting from Option A. Such a pullback in support for client trading and investing would compound existing illiquidity in markets, removing banks as a source of strength and increasing systemic risk.

Finally, Option A would also create major and unjustified discrepancies between the capital requirements of bank-affiliated broker-dealers and independent broker-dealers. Securities settlements, agency execution and sovereign debt market making are conducted through broker-dealers in all major jurisdictions, and we are unaware of any similar "double count" that applies in broker-dealer capital rules for facilitating such activities.⁶ While Basel Committee-based standards generally result in heightened capital requirements for bank-affiliated broker-dealers relative to independent broker-dealers, the size of capital charges under Option A, and the fact that facilitating securities settlements is a core function of broker-dealers, would in combination create significant regulatory inequalities that would drive market activity out of regulated banking groups into lesser capitalized entities.

C. Option B appropriately resolves any differences in accounting frameworks

The Proposal notes that major accounting frameworks rely on different approaches for measuring a bank's assets between trade date and settlement date, with some banks measuring assets as of trade date or as of settlement date, and inconsistent netting standards apply across trade date and settlement date accounting regimes.⁷ We agree with the Committee that the leverage ratio should be based on harmonized measurement principles, a goal which would be achieved by Option B.

Option B resolves leverage ratio exposure measurement differences between banks that rely on either trade date or settlement date accounting by permitting the netting of payables and receivables in either case under the same uniform criteria, which include DvP settlement. Accordingly, Option B relies on conceptually clear, non-risk-based exposure measurement principles to create a consistent global standard that can be applied without reference to differences in local accounting standards.

⁶ See, e.g., U.S. broker-dealer net capital requirements contained in 17 C.F.R. § 240.15c3-1.

⁷ Proposal, Section II.2.

II. Other technical issues

We support comments in the Associations' Letters regarding other technical issues in the Proposal. In this section, we highlight a few issues of particular concern to Morgan Stanley and our clients.

A. Incorporation of SA-CCR in the leverage ratio

We support the incorporation of the standardized approach for measuring counterparty credit risk exposures ("SA-CCR") into the leverage ratio.⁸ However, we believe that, for purposes of the leverage ratio, the 1.4 multiplier should not apply to the Replacement Cost ("RC") component of the SA-CCR calculation.

In its current form, the leverage ratio relies on the current exposure method ("CEM") to calculate the potential future exposure ("PFE") of a bank's derivatives transactions. As noted by the Basel Committee, the CEM methodology has many significant weaknesses, including that it does not differentiate between margined and unmargined transactions, that the supervisory add-on factor does not sufficiently capture the level of volatilities as observed over recent stress periods, and that recognition of netting benefits is too simplistic and not reflective of economically meaningful relationships between derivatives positions.⁹ The Basel Committee developed SA-CCR specifically to remediate these known shortcomings in CEM.

The application of the 1.4 multiplier to RC, however, is inconsistent with leverage ratio exposure measure principles. As noted above, the leverage ratio relies on simple, non-risk-based measurement principles. Because RC is based on the balance sheet value of a bank's derivatives positions, a 1.0 multiplier best reflects the actual economic exposure of a bank, as opposed to a risk-adjusted view that is artificially increased by 40 percent and was originally developed in connection with models-driven risk-based capital requirements.¹⁰ Moreover, the leverage ratio already incorporates risk-related add-ons for derivatives transactions through the PFE calculation, which is not based on balance sheet assets or other exposure principles.

B. Credit conversion factors for off-balance sheet exposures

The Proposal indicates that the Basel Committee intends to incorporate into the leverage ratio revised credit conversion factors ("CCFs") that are currently under development as part of new credit risk standards in the risk-based capital framework (the "Credit Risk Proposal").¹¹

We have two concerns with this approach. First, the CCFs described in the Credit Risk Proposal are significantly higher than U.S. banks' historical experiences with drawdown rates on

⁸ Basel Committee, *The standardised approach for measuring counterparty credit risk exposures* (April 2014) ("BCBS SA-CCR").

⁹ BCBS SA-CCR, Section I.A.

¹⁰ BCBS SA-CCR, Section I.B (noting that the 1.4 multiplier is "carried over" from the Internal Model Method).

¹¹ Proposal, Section III.1; see also Basel Committee, *Revisions to the Standardised Approach for credit risk - second consultative document* (December 2015).

commitments, resulting in potentially punitive capital requirements for these products. Mechanically adopting identical CCFs into the leverage ratio would exacerbate the problem further.

Second, we are concerned that we cannot comment meaningfully on the full impact of the potential incorporation of new CCFs into the leverage ratio since the Credit Risk Proposal specified a range of treatments rather than a specific calibration. There are fundamental differences in the risk-based and leverage frameworks, and the Basel Committee itself has modified the existing CCFs that otherwise apply in the risk-based rules to create special treatments in the leverage ratio.¹² In addition, the risk-based capital rules apply CCFs against the risk-weight of specific counterparty exposures, whereas the leverage ratio applies CCFs uniformly across all counterparty categories, without regard to risk profile. Accordingly, we believe that, after finalization of the Credit Risk Proposal CCFs, the Basel Committee should invite comment on whether such CCFs are appropriate for incorporation into the leverage ratio, taking into account its specific policy goals and unique design.

C. Treatment of client clearing

The Proposal notes that banks have raised concerns with the Basel Committee about the treatment in the leverage ratio of initial margin received from clients in client clearing transactions. In particular, client clearing firms have expressed concerns that initial margin received from clients does not reduce a bank's leverage ratio PFE and, in some circumstances, initial margin received actually increases a bank's leverage exposure measure if the margin is recorded as a balance sheet asset.¹³ We appreciate the Committee's indication that it is considering these concerns, and reiterate our support for an appropriately designed leverage ratio that recognizes the exposure-reducing features of initial margin received from clients.

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¹² See Basel Committee, *Basel III leverage ratio framework and disclosure requirements* (January 2014), Annex, ¶ 15 (applying a 10 percent minimum CCF on unconditionally cancelable commitments).

¹³ Proposal, Section II.1.2.

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

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Jonathan Pruzan', with a long, sweeping horizontal stroke extending to the right.

Jonathan Pruzan
Executive Vice President and Chief Financial Officer