

Revisions to the Basel III leverage ratio framework

Joint response PMT/PME/MN



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Revisions to the Basel III leverage ratio framework - consultative document

Background

Last year the Pension fund for Metalworking and Mechanical Engineering (PMT), the Pension fund for the Metal and Electrical Engineering Industries (PME) and their service provider MN, submitted a joint position paper to the European Commission (EC) on the European Market Infrastructure Regulation (EMIR) (<http://www.mn.nl/media/1370/pmt-pme-and-mn-position-paper-on-emir.pdf>). In this paper we support the initiative for a more robust financial market infrastructure, but also express our concerns for substantially increased liquidity requirements end-users will face. Moreover, we also put forward possible unintended consequences (such as a limited number of clearing members) which impede proper functioning of the clearing market.

At the beginning of 2016, Insight Investment Management, APG, PGGM, and MN also expressed their combined concerns to Commissioner Lord Hill of Oareford in an open letter. In the letter our worries were presented, specifically regarding Basel III legislation on the Leverage Ratio (LR) and the Net Stable Funding Ratio (NSFR). The current proposals from Basel Committee on Banking Supervision (BCBS) for these measures heavily incentivise banks to require end-users (pension funds) to post Variation Margin (VM) on OTC derivatives transactions in cash. As a consequence, disallowing to post High Quality Liquid Assets (HQLA) as currently end users do.

On 25 April 2016 the BCBS published a consultative document on Revisions to the Basel III leverage ratio framework. The Basel III leverage ratio framework introduces a risk measure for banks to act as a credible supplementary measure to the risk-based capital requirements. The Basel Committee is of the view that a credible leverage ratio should ensure a broad and adequate capture of both the on- and off balance sheet sources of banks' leverage.

The consultative document sets out the BCBS's proposed revisions to the design and calibration of the Basel III leverage ratio framework. The proposed changes have been informed by the monitoring process in the parallel run period since 2013, by feedback from market participants and stakeholders and by the frequently asked questions process since the January 2014 release of the standard Basel III leverage ratio framework and disclosure requirements. The final design and calibration of the proposals will be informed by a comprehensive quantitative impact study.

Introduction

This response to the consultative document Revisions to the Basel III leverage ratio framework is a joint response of the Pension fund for Metalworking and Mechanical Engineering (PMT), the Pension fund for the Metal and Electrical Engineering Industries (PME) and their service provider MN.

Key messages

PMT, PME and MN want to stress key messages based on the consultative document:

- High Quality Liquid Assets (HQLA) should be permitted to offset Replacement Cost (RC) similar to Cash Variation Margin (CVM) in both a cleared and non cleared OTC derivatives exposure calculation.
- Initial Margin (IM) should be incorporated into the Potential Future Exposure (PFE) calculation for both cleared and non-cleared OTC derivatives.
- The impact of the proposed Leverage Ratio Framework needs to be closely looked at for the financial market and the functioning of the clearing market in particular.
- Inflation should be explicitly mentioned and treated as being within the same class as interest rates.
- Repurchase agreement (repo) markets should not be disproportionately affected by the Leverage Ratio Framework rules, because repo's are increasingly important for pension funds to be able to meet higher liquidity requirements.

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High Quality Liquid Assets should be permitted to reduce Replacement Costs

In the proposed Basel III Leverage Ratio Framework only received Variation Margin (VM) in cash reduces the Replacements Costs (RC). However, HQLA subject to appropriate haircuts can also suffice the criteria mentioned in the Leverage Ratio framework.

Unfortunately, there is currently no recognition of HQLA as VM to reduce the RC of OTC derivatives. Therefore banks already put pressure on end users to post cash VM when trading OTC derivatives bilaterally. Many banks have also restricted OTC derivatives trades to those that are collateralised with cash VM only, while previously they would have accepted high quality government bonds as VM. We expect this trend to continue in the market as the leverage ratio and the net stable funding ratio (NSFR) rules are fully implemented. Adjusting the leverage ratio framework to recognize HQLA to reduce the RC would help curb this trend.

Furthermore, another negative “side effect” of not recognizing HQLA as VM is a strong discouragement for developing a solution to the higher liquidity requirements in the derivatives market for pension funds. This discouragement is very unfortunate bearing in mind that the European Securities and Markets Authority (ESMA) has given the market (not only banks) the task to find a clearing solution for pension funds. A viable solution would most likely involve, indirectly or directly, high quality bonds being posted for VM or cash.

Another worrisome “side effect” is an increased chance of a financial liquidity crisis. We believe the preferential treatment of cash VM over HQLA VM will greatly increase the demand for cash, especially in times of stress. This is likely to substantially increase liquidity risk and exacerbate downward pressure on falling asset prices as market participants probably will sell “physical” assets in order to meet cash VM calls. This increases pro-cyclicality risk and reduces financial stability.

We urge the Basel Committee on Banking Supervision to modify the leverage ratio framework to allow High Quality Liquid Assets posted as VM to reduce Replacement Costs

Initial Margin should be incorporated into the Potential Future Exposure calculation

In the current central clearing setup under the EMIR pension funds will post Initial Margin (IM) collateral based on their cleared OTC derivatives. This IM collateral is meant to cover losses in a crisis scenario as defined by a CCP (e.g. London Clearing House). Many (simulated) crisis scenarios are also used to determine the Potential Future Exposure (PFE) under the SA-CCR methodology within the proposed Leverage Ratio Framework. Therefore, not recognizing IM collateral to reduce the PFE would disproportionately overstate OTC derivatives exposures in this context. Especially, in case of European pension fund portfolios, which hold long-term interest rate swaps and have a very directional “net” exposure.

Also, in the bilateral OTC derivatives market, it is envisaged to post IM in the future. The reasoning mentioned for cleared OTC derivatives will be similarly applicable at that time. Furthermore, IM collateral posted by pension funds in the cleared and bilateral market cannot be re-used and therefore it cannot be leveraged by a bank to take on more risk.

We recommend the Basel Committee on Banking Supervision to incorporate IM into the Potential Future Exposure calculation for (non) cleared OTC derivatives exposure.

The impact of the proposed Leverage Ratio Framework needs to be closely looked at

While the SA-CCR methodology is widely reported to be better for banks because of its netting benefits, it seems to disproportionately penalise European pension funds’ one-directional long term derivatives portfolios. The impact of SA-CCR should be fully calibrated to portfolios of all derivative users including pension funds and other end-users.

As already mentioned, while European pension funds typically have one-directional portfolios, we believe they should not be overly penalised as a result of banking regulation intended for risky and leveraged institutions. Pension fund’s derivatives portfolios generally offset risks that are naturally inherent to pension funds.

Moreover, the current bank capital rules that affect central clearing are causing banks to exit the clearing broker business. Pension funds and other end users are therefore left with a small and decreasing number of (big) banks willing to provide sound clearing broker services.

This trend of less and less clearing members combined with mandatory clearing is likely to significantly increase clients’ concentration risk on (banking) counterparties. Also, the shrinking market for clearing members puts into question whether porting can really work in either stressed market conditions. The ability to port to an alternate clearing member is very important in a stressed market environment.

We believe that the impact of the proposed Leverage Ratio Framework has a negative effect on end users in the financial market and more specifically competition in the clearing market.

Inflation should be explicitly mentioned

The rules regarding inflation are not explicit in terms of where inflation sits as a class, such as interest rates. We would expect inflation to be treated within the same class as interest rates given their strong economic link. In this context, one should be reminded that the nominal interest rate (often referred to simply as interest rate) is build up of the real interest rate and inflation rate.

We request the Basel Committee on Banking Supervision to explicitly state that inflation should be within the same asset class as interest rates for the SA-CCR calculation.

Repurchase agreement (Repo) markets should not be disproportionately affected

The Repo market in which high quality government bonds are used to generate cash plays a crucial role in the functioning and smooth running of financial markets. The cash obtained can, for example, be used as collateral for posting Variation Margin. The importance of this market will grow significantly as demand for cash increases substantially once the central clearing obligation is fully in force throughout Europe and the current proposed legislation on the Leverage Ratio Framework (LR) and Net Stable Funding Ratio (NSFR) is not modified.

The legislation on LR and NSFR is expected to significantly increase the demand for cash and simultaneously shrink the repo market. We are concerned the combination of these two will reduce financial stability and cause a possible liquidity crisis in the future. The consequence of a dysfunctional repo market must not be underestimated. If market participants are unable to transform high quality securities collateral into cash quickly, cash VM calls on cleared and non-cleared trades may not be met, which could lead to market participants, such as pension funds, defaulting on their contracts or result in the forced unwinding of positions at times of market stress.

We advise the Basel Committee on Banking Supervision to address our concerns on the repo markets and treat high quality government bonds, with appropriate haircuts, similar to cash and allow netting between cash and high quality government bonds.