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Secretariat of the Basel Committee
on Banking Supervision

Bank for International Settlements
CH-4002 Basel
Switzerland

Zurich, 6 July 2016

Dear Sir/Madam

UBS would like to thank the Basel Committee on Banking Supervision (BCBS) for the opportunity to respond to the consultative document on the "Revisions to the Basel III leverage ratio framework".

Our response should be considered complementary to the Joint Associations' response¹ to which UBS contributed and which UBS supports. With this letter, we would like to highlight our main on the calculation of the leverage ratio denominator concerns in order of significance, followed by comments on the overall leverage ratio (LR) capital requirements.

Our main concern is related to the proposed treatment for measuring regular-way purchases and sales of financial assets:

- We are **concerned that Option A would substantially overstate a banks' actual economic exposure** in delivery-versus-payment transactions as it would **produce an artificial and volatile "ballooning"** of the bank's leverage ratio exposures even though the risk of failed transactions is extremely low and already captured in accounting and capital standards. Initial estimates of an industry QIS exercise show that Option A would lead to a significant increase of the leverage ratio denominator across the industry.
- We are further concerned that Option A would have an adverse impact on **market liquidity and increase systemic risks** as it would create yet another **disincentive for firms to engage in securities trading activities** which is already a relatively low margin business.
- We therefore **strongly urge the Committee to adopt Option B, with certain modifications to the proposed conditions** and to its application to banks using settlement date accounting.
- In particular, the BCBS should **simplify Option B for banks using settlement date accounting**. We believe that it would be **extremely burdensome** for such a bank to build

¹ Joint Association response by the Global Financial Markets Association (GFMA), the Institute of International Finance (IIF), and the International Swap and Derivatives Association (ISDA)

the systems necessary to be able to calculate the offsetting of positions as if it were a bank using trade date accounting in addition to the systems it uses for settlement date accounting.

- It is also **unnecessary since the calculation of the LR exposure using existing settlement date accounting would nearly always produce a similar result** as that proposed in Option B. Therefore, we suggest that banks using **settlement date accounting qualifying to use Option B be allowed to continue to follow the accounting treatment of such trades for LR purposes should the Committee adopt Option B.**
- We note that in its 2016 Financial Stability Report, the Bank of England is also supportive of "an internationally agreed leverage ratio standard permitting banks to net cash receivables relating to unsettled sales against cash payables relating to unsettled purchases, where trades are settled through a delivery versus payment or equivalent settlement system".

We do not consider the application of an alpha factor of 1.4x to SA-CCR under the leverage ratio to be economically justified.

- Whilst we support the introduction of SA-CCR in the leverage ratio framework, we believe **the modified version of SA-CCR**, with restrictions on the recognition of collateral, already **adds a significant layer of conservatism** to SA-CCR relative to its application in the risk based framework. To apply the alpha multiplier to the exposure measure as well would, in our view, be unjustifiably conservative.
- Furthermore, applying the alpha multiplier to replacement cost (RC) effectively **calls into question the accuracy of derivative valuations on firms' balance sheets**. We do not consider this appropriate as there is no inherent reason to believe that the valuation of derivative assets is less reliable than the valuation of other assets. **We therefore do not support any alpha factor being applied to the leverage ratio exposure measure.**

We believe that the BCBS should re-consider the treatment of IM for centrally cleared trades:

- We strongly believe that, in the context of bank exposure created by a cleared derivatives transaction, the leverage ratio should **recognize the exposure-reducing effect of a margin that is segregated**. Failure to recognise the exposure-reducing effect of segregated IM will likely result in an increase in the cost of clearing for end derivative users and a reduction in the availability of client clearing services, which runs in direct contrast to the G20 mandate that OTC derivatives be centrally cleared where appropriate.
- We are **concerned that the capital requirements for client clearing** under the leverage ratio **will reduce liquidity in the market for cleared derivatives and make clearing members reluctant to acquire customer positions from a failed clearing member**, thus reducing the potential for porting. Furthermore, as CCP margin requirements increase in times of stress, leverage ratio capital requirements would increase materially in stressed periods and consequently constrain the provision of liquidity which would further increase systemic risk.
- **We therefore believe the leverage ratio framework should be amended to recognise segregated initial margins as an offset to clearing members' PFE for client cleared derivatives transactions.**
- In this regard, the Bank of England's Financial Policy Committee also highlighted in its 2016 Financial Stability Report "that there would be merits allowing IM posted to reduce banks' potential exposures to a default of those clients in centrally cleared derivative transactions".

We also believe the treatment of IM for non-cleared trades should be re-assessed by the BCBS:

- The lack of a specific treatment to address IM in respect of bilateral OTC derivatives trades overstates leverage on a system wide basis because only one party can ever be in-the-money on a derivatives contract. There **is no derivative exposure mitigation from the IM received under the proposed framework as the PFE multiplier is set to 1, thereby not recognising any collateral posted by the counterparty** (or any negative net market value of the derivative position). Crucially, due to the segregation requirements in the BCBS / ISOCO

framework for margin requirements for non-centrally cleared derivatives, banks cannot use IM received to leverage themselves.

- **We therefore believe the BCBS should re-consider the interaction of the BCBS / IOSCO margin requirements for non-centrally cleared derivatives and the BCBS leverage ratio framework to ensure the appropriate capital incentives for effective risk management are embedded in the Basel framework.**

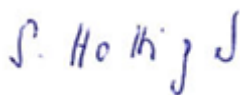
Finally, we do not see a need to increase the current LR requirement or to apply specific G-SIB buffers:

- We strongly agree that **the BCBS should set reasonable minimum standards** that are appropriate for all major markets. The recently adopted FSB TLAC standards already include LR requirements and clearly exceed the current Basel III minimum which was used as reference point for the calibration of the FSB TLAC LR minimum. Furthermore, any adjustments at this stage **could put the credibility of the just recently implemented standards in question.**
- In case the BCBS identifies the need to raise the LR requirement – which in our view is unnecessary – it is crucial that **any G-SIB leverage buffer is a genuine buffer** and not an increase in the hard minimum LR requirement.
- We further share the industry view that the **entry into a CET1 leverage ratio buffer does not have automatic consequences as this would add unnecessary and counter-productive complexity** into the framework. This would lead to a pro-cyclical increase in the “uncertainty premium” particularly where a firm enters a period of stress and would run directly contrary the leverage regime’s objectives.

Please find below our detailed response to the consultation, where we also include comments relating the currency of settlement criterion associated with the eligible cash variation margin, written credit derivatives, the revisions to the credit conversion factors for off-balance sheet items and traditional securitisations.

We would be happy to discuss with you in further detail any comments you may have. Please do not hesitate to contact us if you have any questions.

With best regards



Steve Hottiger
Group Governmental Affairs



Basil Ackermann
Capital Management and Planning

II.1.1 Adoption of a modified version of the standardised approach for measuring counterparty credit risk exposures (SA-CCR)

Application of alpha factor

The BCBS consultation proposes that derivative exposures be measured as RC+PFE multiplied by an alpha factor of 1.4x, following the SA-CCR framework from the Basel risk based capital framework.

We do not consider the application of an alpha factor to the use of SA-CCR in the leverage ratio to be economically justified and do not support any alpha factor being applied. In our view, there is no justification for applying an alpha factor to RC as to do so effectively calls into question the validity of derivative valuations on firms' balance sheets. However, there is no inherent reason to believe that the valuation of derivative assets is less reliable than the valuation of other assets on the balance sheet. Derivative valuations are subject to stringent independent price verification controls and procedures. They are also subject to independent third party audit, just like all other asset and liability values on the balance sheet.

There is arguably more justification for an alpha factor to be applied to a future exposure that is uncertain (i.e. PFE), but even for PFE, we don't think it is justified given that the modified SA-CCR used for the leverage ratio is already more conservative than the SA-CCR used in the risk based framework given the restrictions imposed on the recognition of collateral. This conservatism in the modified SA-CCR already makes the approach sufficiently prudent without the need for an alpha factor.

Applying the 1.4x alpha factor to RC will particularly penalize derivatives transacted with uncollateralized counterparties, mainly corporates and sovereigns, given that positive present value (PV) will be particularly significant in these cases as it cannot be offset with any collateral. In addition, the alpha factor will magnify the effect of market volatility in PV in the leverage ratio exposure.

We also highlight that the PFE multiplier is set to 1 for any amount of IM exchanged which means there will be no derivative exposure mitigation from any IM received. This adds a further layer of conservatism to the leverage ratio.

SA-CCR treatment of FX forwards

SA-CCR only allows netting within a specific currency pair, without allowing triangulation. So, for example, if a client is long 100mio EUR/USD, long 100mio USD/JPY and short 100mio EUR/JPY, the economic risk is 0, however SA-CCR will "gross-up" the notionals (i.e. to 3x). Whilst this is an issue with SA-CCR itself, the impact is even greater under the leverage ratio framework than the risk based framework given that IM / excess collateral cannot be used as an offset. If the BCBS is concerned about options and implied correlations, we believe a more appropriate and risk sensitive way to address the issue would be to allow triangulation and to have a Gross Vega add-on, that can only be netted within a currency pair (but not across).

II.1.2 Impact assessment on the client clearing business model

Treatment of IM for centrally cleared trades

We strongly believe that, in the context of a bank exposure created by a cleared derivatives transaction, the leverage ratio should recognize the exposure-reducing effect of margin that is segregated, because segregated margin cannot be used to increase the bank's leverage. In this regard, the Bank of England's Financial Policy Committee highlighted in its 2016 Financial Stability Report "that there would be merit in any internationally agreed leverage ratio standard allowing initial margin posted by clients to reduce banks' potential exposures to a default of

those clients in centrally cleared derivative transactions, provided appropriate safeguards are in place”.

We are concerned that the leverage ratio currently fails to recognise the exposure-reducing effect of segregated margin in the context of centrally cleared derivatives transactions (whether executed over-the-counter or through an exchange). Margin that is segregated (as is very often the case for cleared derivatives transactions) may not be leveraged by a bank. As a result, such segregated margin is solely exposure-reducing with respect to a bank’s cleared derivatives exposure, and accordingly, we strongly believe that the leverage ratio’s total leverage exposure ought to recognize that reduction. A failure to recognize the exposure-reducing effect of segregated margin will have materially adverse consequences on cleared derivatives markets, end users, and market participants.

Moreover, the leverage ratio’s inappropriate treatment of segregated margin in cleared transactions is compounded where such margin is posted in the form of cash, rather than securities, as is often the case. The accounting rules of some jurisdictions require such segregated cash margin to be treated as an on-balance sheet asset of the receiving bank, and as such, the segregated cash is included as a separate leverage exposure in the denominator of the bank’s leverage ratio. In these circumstances, the bank is subject to a double leverage ratio penalty: (i) the segregated cash margin received may not be used to reduce a cleared derivatives exposure in the denominator of the bank’s leverage ratio, and (ii) because such segregated cash margin is treated as an on-balance sheet asset, it must be separately added as an exposure to that denominator as well.

We believe the failure to recognize the exposure-reducing effect of segregated margin for leverage ratio purposes will substantially and unnecessarily increase the amount of required capital that will need to be allocated to clearing activity.

Such a significant increase in required capital will also significantly increase costs for end users that rely on derivatives for risk management purposes. Further, banks may be less likely to take on new clients for derivatives clearing. As a result, some market participants may not gain access to clearing services and not be in a position to hedge their underlying risks.

In addition, the liquidity and portability of cleared derivatives markets could be significantly impaired, which would substantially increase systemic risk. That is, in times of market stress, when banks’ capital may decline to levels that make the leverage ratio a truly binding limit, the ability of such banks to purchase portfolios of cleared derivatives from other banks will be severely constrained.

Treatment of IM for non-centrally cleared trades

As well as re-considering the treatment of IM for centrally cleared trades, we believe the treatment of IM for non-cleared trades should also be re-assessed by the BCBS. The BCBS / IOSCO standards for the margining of non-centrally cleared OTC derivatives require two way of exchange of IM which must be fully segregated with very limited scope for re-hypothecation (in some jurisdictions, including the EU, there is no scope for re-hypothecation). Consequently, the mandatory IM requirements have the effect of grossing up the balance sheet and increasing the leverage ratio exposure through either the cash IM posted to the counterparty (which will be a receivable) or through the additional securities inventory that must be held to meet requirements. Meanwhile, there will be limited derivative exposures mitigation from the IM received under the proposed framework, as the PFE multiplier is being set to 1 for any amount of margin exchanged.

The lack of a specific treatment to address IM in respect of bilateral OTC derivatives trades overstates leverage on a system wide basis because only one party can ever be in-the-money on

a derivatives contract. Since non-centrally cleared OTC margin derivatives rules require two-way exchange of margin, there will always be a surplus of IM relative to default risk. Furthermore, due to the segregation requirements, banks cannot use IM received to leverage themselves. We therefore believe the BCBS should give further consideration to the coherence between the non-centrally cleared OTC derivatives margin rules and the leverage ratio framework.

Specifically, we propose that IM received should be allowed to offset PFE. We note that VM is permitted to offset RC so we believe it would be consistent to permit IM to offset PFE.

Calculation of effective notional amount

We have the following concerns with the Paragraph 31 criteria relating to "same material terms" and "connected or correlated counterparties".

"Same Material terms": In order to reduce the effective notional amount of a written credit derivative by the effective notional amount of a purchased credit derivative on the same reference name, Paragraph 31, bullet 4 states that:

"the credit protection purchased through credit derivatives is otherwise subject to the same material terms as those in the corresponding written credit derivative;"

We are concerned that the term "same material terms" is not sufficiently precise and could be interpreted inappropriately widely by supervisors and could lead to different interpretations in different jurisdictions, thus creating an un-level global playing field. We consider the other conditions for offsetting that are set out in Paragraph 31 are sufficient to ensure that the purchased credit derivative provides effective protection against the written credit derivative meaning the "same material terms" criterion is not necessary and should be deleted.

"Connected or correlated counterparties": In order to reduce the effective notional amount of a written credit derivative by the effective notional amount of a purchased credit derivative on the same reference name, Paragraph 31, bullet 5, states that:

"the credit protection purchased through credit derivatives is not purchased from a counterparty connected with the reference name as defined in Section II.E of the standard Supervisory framework for measuring and controlling large exposures or from a counterparty whose credit quality is highly correlated with the value of the reference obligation in the sense specified in paragraph 101 of the Basel III framework;"

We understand that the BCBS is concerned about banks recognizing purchased protection where there is a high degree of correlation between the underlying and the counterparty. We fully agree that wrong way risk is an important concern that should be appropriately addressed, but we believe the use of the connected counterparty concept of the large exposure framework within the leverage ratio is not appropriate given that the large exposure framework has a very different focus and purpose compared to the leverage ratio. We believe that in order to avoid inappropriate restrictions being placed on the eligibility of credit protection, the connected and correlated counterparty criteria should be strictly limited to pairs of issuers and counterparties considered as affiliates for accounting purposes.

II.1.3 Clarification on the currency of settlement criterion associated with the eligible cash variation margin

The BCBS notes that the term "currency of settlement" in the criteria for eligible CVM in paragraph 25 (iii) in the January 2014 version of the Basel III leverage ratio framework has been cited as unclear in the context of multicurrency derivative contracts (e.g. foreign exchange

swaps) and derivative contracts that are governed by master netting agreements (MNAs) and credit support annexes (CSAs), or by rules prescribed by CCPs. However, the BCBS has chosen to retain the wording "currency of settlement" to specify the eligibility of the currency in which CVM payments are made and notes that with specific reference to issues arising from foreign exchange risk, the Committee proposes that CVM be subject to an FX haircut where the currency of the CVM does not match the termination currency of the netting set (i.e. the currency in which the bank would submit its claim upon a counterparty default).

We disagree with the proposal to apply an FX haircut where the currency of the CVM does not match the termination currency of the netting set. We believe it is appropriate to limit the recognition of VM as exposure reducing to cases when the payments are made in the currency or currencies identified in the collateral agreement, for example the Credit Support Annex (CSA) to the Master Netting Agreement (MNA). Provided this is the case, we do not consider it necessary or appropriate to apply an FX haircut where the currency of the CVM does not match the termination currency of the netting set.

This is justified on the basis that other risk mitigation techniques currently applied to CVM are sufficient for effective risk management. Currently the market practice is to make a single net cash VM payment in an agreed transport currency. To the extent FX risk arises due to differences between the currency of VM received and the other contract settlement currencies, it is relatively small, given it is limited to short-term timing differences (e.g. if FX rates move one day, additional collateral will be called the next day). Such timing differences are risk managed to a minimum through requirements for frequency of margin transfer, low thresholds for transfer, low minimum transfer amounts and initial margin.

II.1.4 Revisions to the specific treatment for written credit derivatives

Offsetting of credit protection

The proposal suggests that credit protection sold via options shall be considered "written credit derivatives".

Further, it states that the effective notional of such options shall only be offset against the effective notional of credit protection purchased via options provided further conditions are met (general notional offsetting criteria for credit derivatives, strike price of the option where credit protection is purchased is equal or lower than the strike price of the option where credit protection is sold).

Consequently the proposal does not allow offsetting the effective notional of a written CDS with the effective notional of an option where credit protection is purchased on the same underlying CDS, or vice versa, it would not allow offsetting of the effective notional of an option where credit protection is sold with the effective notional of a purchased CDS.

We agree that options may create an exposure to the underlying reference entity or index and that options may provide protection on the underlying reference entity or index. However, limiting the scope of offsetting only to options is not justified. Economically, the exposure from an option where credit protection is sold may be offset by credit protection purchased through a CDS; equally, the exposure from protection sold through a CDS may be offset by an option where credit protection is purchased.

With the pre-requisite that the general notional offsetting criteria for credit derivatives must be fulfilled, we therefore suggest to allow for notional offsetting irrespective of the product under which credit protection is sold or purchased. If credit protection is sold or purchased through a non-linear product such as options, as an additional requirement the effective notional should

be delta-weighted, in order to reflect the economic exposure written credit derivatives through options where credit protection is sold as well as the economic effectiveness of offsetting any exposure from any written credit derivative using options where credit protection is purchased.

Limits on the use of credit options

The BCBS has proposed that in order to use credit options via which a bank has the right to purchase credit protection as an eligible hedge, the strike price of the purchased protection must be less than or equal to the strike price of the written protection in order for the hedge to be recognised.

We are concerned that these restrictions will result in banks having to overstate the level of credit exposure they have, thereby penalizing prudent risk management practices by disconnecting hedges from true underlying risk.

The proposed restriction on strike price is, in our view, inappropriate for short-term market making positions. Market makers facilitate client demand and therefore provide liquidity to the credit index market, rather than to take directional positions. Therefore, market makers portfolios of credit indices and credit index options typically consist of a large number of client-driven positions and associated hedges. Little aggregate net risk exists because these positions offset each other, as measured by a variety of risk metrics. They are actively risk managed on an intraday basis and are subject to multiple risk limits. These aspects of credit options make them inappropriate for the restrictions around strike price. Furthermore, the proposed restrictions on strike price would be difficult to operationalize and implement because it is divorced from banks' own risk management.

Restricting the ability to achieve hedge recognition through the additional requirements on strike price may significantly impact liquidity in the credit markets because banks will find it more difficult to act as market makers. Credit options provide banks with an important tool to efficiently hedge the risks generated by their market making activity. Limiting the recognition of credit options as an effective risk mitigation tool will limit banks' ability to hedge their risks, thereby having to either pass on costs, reduce market making activity, or both.

In order to align hedge recognition with prudent risk management, we believe it is more effective to use a delta-based exposure. A delta-based exposure would be consistent with the Market Risk Rules and standard risk management practices. Delta is widely used as a measure of trading book exposures and hedge effectiveness. Each instrument's delta is a function of a variety of risk factors at a point in time, including maturity, volatility, and strike price. As such, deltas yield a more appropriate measure of exposure that is not limited to just strike price and would correspond with the way that banks risk manage and assess regulatory capital for their market making activities.

We recognize that the use of delta would incorporate a risk metric into the non-risk based leverage ratio. However, the BCBS has introduced a measure of risk through the strike price and we ask that a more appropriate measure of risk be used. Furthermore, the BCBS has already integrated the use of deltas into the leverage ratio through the use of SA-CCR.

Treatment of written credit protection

In addition to our proposal regarding credit options, we wish to address the treatment of written credit protection in the leverage ratio framework. We believe the current formulation, which requires notional-based leverage ratio exposure for net sold positions analogous to a long bond position, is logical, but includes a shortcoming in the netting treatment for bought and sold CDS positions. The concern relates to paragraph 30, third bullet point, which limits nettable bought positions to those with a remaining maturity "equal to or greater than the remaining maturity of the written credit derivative." We believe that full disallowance of bought positions

as offsets against longer dated sold positions does not reflect the economic risk of such positions and therefore should be reconsidered.

To understand this, it is useful to consider the impact of a CDS trigger event on respective bought and sold positions. Upon activation of a "hard" trigger, such as bankruptcy and failure to pay, bought and sold CDS positions are netted by CDS holders across their portfolios of trades. An auction of the defaulted reference obligations is conducted to determine the market-agreed CDS recovery price. Net sellers make, and net buyers receive, a settlement payment based on (1-recovery price) net notional. CDS contract maturity is irrelevant in this determination; all debt and CDS contracts are treated the same.

Standard CDS for North American reference entities are designated as No Restructuring ("NR") contracts, incorporating only bankruptcy and failure-to-pay trigger events. We believe the netting of bought protection against written protection for NR contracts should be expanded to include bought credit protection that has a remaining maturity at least equal to the lower of (i) the remaining maturity of the written credit derivative and (ii) one year. The one-year floor applies to written credit derivatives with remaining maturity greater than one year, and is included as a conservative measure reflecting the one-year time horizon used for risk-based capital.

Maturity comes in to play for CDS against European reference entities. These CDS include the above "hard" triggers and a debt restructuring-based trigger: modified-modified restructuring ("MMR"). Additionally, European bank CDS include an additional provision to cover government interventions in bank debt that lead to restructuring of a bank's obligations. Restructuring triggers introduce a maturity-based dimension to determination of the market recovery amount. When protection buyers trigger CDS upon a Restructuring Event, multiple auctions are held to determine market recovery values for multiple maturity buckets: 2.5y, 5y, 7.5y, 10y, 12.5y, 15y, 20y, 30y. As a practical matter, given that CDS rarely trade past 10 years, there would be up to four auctions. CDS buyers can either settle at the auction price for the appropriate maturity bucket or deliver bonds of maturity no longer than that of the relevant maturity bucket. We believe it prudent to address this by limiting netting of bought positions to sell positions of the same maturity bucket or shorter.

Given the above, we propose amending paragraph 30 by replacing the third bullet point with the following provisions:

~~the remaining maturity of the credit protection purchased through credit derivatives is equal to or greater than the remaining maturity of the written credit derivative.~~

- The remaining maturity of the credit protection purchased is no shorter than the lower of (i) the remaining maturity of the written credit derivative and (ii) one year; and
- In the case of credit derivatives that include restructuring event triggers, purchased credit protection may only be netted against sold credit protection falling into the same auction maturity bucket or a shorter maturity bucket.

II.2 The treatment of regular-way purchases and sales of financial assets

The Committee proposes to clarify the calculation of regular-way purchases and sales of financial assets for purposes of the Basel III leverage ratio exposure measure to ensure that differences in accounting frameworks do not affect the calculation among comparably situated banks. The committee is considering two possible options.

While Option A would essentially require all banks to recognise in the leverage ratio denominator the purchases and sales of financial assets trade at date but without any recognition of an offsetting reduction of the cash receivables for sales of such assets by the cash payable for purchases of such assets until the settlement date, Option B would recognize this offsetting. We are therefore concerned that Option A would substantially overstate banks' actual economic exposure in delivery-versus payment transaction and have adverse impact on market liquidity and increase systemic risks. In addition, an initial QIS shows that Option A as proposed would lead to a significant increase of the leverage ratio denominator for banks using settlement date accounting.

For the reasons discussed below, we strongly urge the Committee to adopt Option B, with certain modifications to Option B's proposed conditions and to its application to banks using settlement date accounting.

Overstatement of Banks' actual economic exposure in Delivery-Versus Payment Transactions

Delivery-versus-payment ("DvP") settlement ensures that, at all times during the life of a trade, a bank has either the security or the cash associated with buying or selling that security; as a result, there should be no reason to artificially inflate the amount of the leverage exposure beyond the value of either the security or the associated cash. As a consequence, a bank will never have both the security and the cash associated with buying or selling that security at the same time, and it will never have neither the security nor the cash – it will always have one or the other. Therefore, Option A would at times require the bank to maintain leverage ratio capital against both the security and the cash associated with buying or selling the security, as though the bank were exposed to losses on both the security and the cash at the same time.

Option A would produce an artificial "ballooning" of the bank's balance leverage ratio exposures and therefore a substantial overstatement of actual economic exposure during the period between trade and settlement. Further, under Option A there would be large day-to-day swings in the leverage exposure for any bank that engages in a substantial amount of securities trading activities, since the bank's leverage exposure would change significantly over the life of particular trades.

Option B solves this problem by allowing banks using trade date accounting to offset the cash payable attributable to pending securities purchases against cash receivables attributable to pending securities sales. Option B would also allow banks using settlement date accounting to replicate the effect of this treatment for banks using trade date accounting. In this regard, the Bank of England's Financial Policy Committee highlighted in its 2016 Financial Stability Report "that there would be merit in any internationally agreed leverage ratio standard permitting banks to net cash receivables relating to unsettled sales against cash payables relating to unsettled purchases, where trades are settled through a delivery versus payment or equivalent settlement system".

The offset permitted in Option B reflects the economic reality of how the bank's balance sheet looks before the trades and how it looks after pending trade settle, and therefore prevents the substantial overstatement of exposure that is produced under Option A.

Impact on market liquidity and increase of systemic risk

By artificially ballooning a trading bank's leverage exposure, Option A would create yet another significant disincentive for firms to engage in securities trading activities. As an example, if a bank were required to gross up its leverage exposure measure by \$100 billion under Option A, an additional \$3–5 billion of Tier 1 capital would be required (assuming a 3–5 percent binding LR requirement), which would require an additional \$300–500 million of post-tax income (more in pre-tax earnings) for the bank to meet a 10 percent return-on-equity hurdle. Regular-way securities dealing is a relatively low margin business. The marginal returns of additional trades would not cover the increase in cost of capital, and as a result, the bank would be

disincentivised to trade. At a time when there are clearly concerns about the adequacy of market liquidity, such a disincentive needlessly runs the risk of aggravating liquidity concerns, thereby increasing risk to the system.

The risk of failed transactions is extremely low and already captured in accounting and capital standards

One of the concerns cited by the Committee for proposing Option A is that, once a commitment is made to buy or sell a security, exposure to loss increases based on the possibility that the bank's counterparty will not perform, resulting in a "failed" transaction that could in turn lead to a loss arising from a decline in value of the security at issue. There are a number of reasons why this concern is misplaced:

- The LR exposure measure under Option B already includes an exposure to cover fully the risk of loss from a decline in value of the purchased or sold security.
- Under the operative accounting frameworks in jurisdictions permitting an offset for receivables and payables associated with unsettled trades, should a failed trade occur, the bank would no longer be permitted to offset cash payables against the cash receivables associated with that particular trade but would be required to unwind on its books any offsetting of cash receivables associated with the trade, which has the effect of "grossing up" the bank's unsettled assets for the failed trade until the trade settles or the bank enters into a new trade.
- The proportion of securities transactions that result in "fails" is extremely low. As a result, even if a "fail" did result in increased risk to the bank, the probability of such an event occurring is extremely low relative to total trading volume and certainly would not justify the substantial and grossly disproportionate increase in the leverage exposure measure that would result from the over-counting under Option A.
- Any concern about loss in market value of a security due to failed transactions is a risk-based concept, not a LR concept.

Inconsistency with the key stated rationale for the leverage ratio

Treating both the security and the cash receivable in an unsettled asset sale as distinct LR exposures, as Option A would do, assumes that there are two distinct pools of economic resources available to the bank to "leverage" during the period pending settlement. That is not so, however. Neither cash receivables attributed to unsettled financial asset sales nor the securities associated with financial asset purchases can be "leveraged" in the same manner as other forms of collateral. That is, banks cannot and do not pledge or otherwise re-hypothecate trade date receivables to meet their other obligations. As a result, it would not be appropriate to require an artificial overstatement of leverage exposure to account for an unsettled purchase or sale of a financial asset.

For all of these reasons, we strongly oppose Option A's approach of effectively adopting trade date accounting without permitting an offset of cash payables against cash receivables, and instead strongly prefer Option B – subject to the modifications we suggest below and outlined in detail in the overall industry response.

- The market-maker condition is unnecessary and overly restrictive as this condition could lead to a concentration of trading activities at banks that clearly satisfy the market-maker condition and would create competitive imbalances.
- The trading book condition is unnecessary and would create a significant compliance burden.

The BCBS should simplify Option B for banks using settlement date accounting.

As proposed, Option B appears to require a settlement date accounting bank to increase its LR exposure by treating unsettled financial asset purchases as off-balance sheet items subject to a 100 percent CCF, while then permitting the bank to offset that increase in whole or in part to

achieve the “equivalent effect” of the offset that Option B permits for banks that use trade date accounting.

It would be extremely burdensome for a settlement date bank to build the systems necessary to calculate the offset as if it were a trade date accounting bank in addition to the systems it uses for settlement accounting – and fundamentally unnecessary since the calculation of the LR exposure using existing settlement date accounting would nearly always produce a similar result as that proposed in Option B.

Therefore, we suggest that settlement date banks qualifying to use Option B be allowed to continue to follow the accounting treatment of such trades for LR purposes should the Committee adopt Option B. We propose the following changes in to the text regarding Option B:

“Option B

- *For such exposures, banks using trade date accounting must reverse out any offsetting between cash receivables for unsettled sales and cash payables for unsettled purchases of financial assets that may be recognised under the applicable accounting framework, but may offset between those cash receivables and cash payables (regardless of whether such offsetting is recognised under the applicable accounting framework) if the following conditions are met:*
 - *the bank is serving as a market-making entity. ~~for the financial assets;~~*
 - *the financial assets bought and sold that are associated with cash payables and receivables are fair valued. ~~through income and included in the bank’s regulatory trading book as specified by paragraphs 8 to 20 of the market risk framework;~~*
 - *the transactions of the financial assets are settled on a delivery-versus-payment (DVP) basis.]*
- *Banks using settlement date accounting will be subject to the treatment set out in paragraphs 43 to 45 and paragraph 9 of the Annex.”*

9. A 100% CCF will be applied to the following items: . . .

Option B

- *The exposure amount associated with unsettled financial asset purchases (ie the commitment to pay) where regular-way unsettled trades are accounted for at settlement date **unless**. ~~Banks may offset commitments to pay for unsettled purchases and cash to be received for unsettled sales provided that the following conditions are met: (i) the bank is serving as a market-maker for the financial assets; (ii) the financial assets bought and sold that are associated with cash payables and receivables are fair valued through income and included in the bank’s regulatory trading book as specified by paragraphs 8 to 20 of the market risk framework; and (iii) the transactions of the financial assets are settled on a DVP basis.”~~*

II.3 Revisions to the treatment of provisions

We support the Committee's proposal to allow the deduction of general and specific provisions from the leverage ratio exposure. In addition, we also believe finance lease liabilities should be deducted from the leverage exposure and offset against finance lease assets (particularly as changes to lease accounting under IFRS 16 and ASU 2016-02 would require firms to recognise operating leases on BS).

II.4 Additional requirements for G-SIBs

The consultation seeks views on the characteristics for an additional GSIB requirement in order to propose a minimum global standard for leverage, comparable to the risk-based GSIB capital framework. We agree with the view expressed in the response of AFME/IIF that there is no necessity to increase the current LR minimum requirement as a result of the higher risk-based capital requirement also in light of the (implemented or proposed) TLAC standards in major financial centres which include LR requirements that clearly exceed the current Basel III minimum. From a stability point of view there is thus no need to increase the international minimum requirement. Also the BCBS should be mindful that its minimum LR requirement was used as a reference point for the calibration of the FSB TLAC LR minimum and therefore there is a risk that an increase of its minimum LR requirement could result in what we believe unfounded discussions to increase the FSB minimum which in turn could put the just recently implemented standards in questions.

We also strongly agree that the BCBS should continue setting reasonable minimum standards that are appropriate for all major markets. In case the BCBS identifies the need to raise the LR requirement – which in our view is unnecessary - it is crucial that any G-SIB leverage buffer is a genuine buffer, not an increase in the hard minimum LR requirement for G-SIBs. In setting such buffers, the BCBS should take into account divergent regional financing structures and bank balance sheet compositions and only apply G-SIB LR buffers if the QIS data indicates that the LR does not perform its role as a meaningful backstop across jurisdictions and if such buffers can be applied without significant damage to broader markets and availability of key financing products.

We further share the view of IIF / AFME that the entry into a CET1 leverage buffer does not have automatic consequences. Introducing automatic consequences for breaching G-SIB leverage buffers would add unnecessary and counter-productive complexity into the framework, and an increase in the “uncertainty premium” particularly where a firm enters a period of stress. This would run directly contrary to the leverage regime’s objectives, and could be pro-cyclical. A more appropriate response to any use of the LR GSIB buffer would be for supervisors to be expected to take timely and appropriate action to ensure that the use of the LR GSIB buffer is temporary.

III.1 Revisions to the credit conversion factors for off-balance sheet items

We recognize the need for simplicity and that therefore the treatment of CCFs in the LR should in principle be aligned with changes into the SA in the credit risk framework. However, we would like to point to the UBS response and in the GFMA, IIF, ISDA and IACPM response² to the second consultative document on revisions to the standardized approach for credit risk response where we noted that the current proposals are in some cases disproportionate and would lead into significant increase in capital requirements. We strongly recommend that BCBS’s Task Force for Standardised Approach takes into account industry concerns and recommendations. Furthermore, we suggest that appropriateness of the final SA CCFs in the context of LR are carefully considered, bearing in mind its objectives.

We would like to reiterate that as noted in our response to the SA CR, “the proposed CCF treatment for general commitments (50-75%) is considered unduly punitive compared to historical default experiences and external studies. This punitive treatment will most likely lead to one of the following outcomes for financial institutions: increase in the spread charged to clients for the unutilised part of facility and/or reduction of the general commitments (limits) for new

2 <http://www.gfma.org/Initiatives/Basel-III/GFMA,-IIF,-ISDA-and-IACPM-Comments-to-Basel-on-the-Second-Consultative-Documents-on-Revisions-to-the-Standardized-Approach-for-Credit-Risk/>

facilities or those under renegotiation – both leading to an actual reduction in the availability of credit with negative effects on economic growth.”

III.2. Incorporation of responses to frequently asked questions

We do not provide comment to this section.

III.3. Treatment of cash pooling transactions

Please refer to the overall industry response.

III.4 Treatment of traditional securitisations

The BCBS notes that it is possible to interpret the exclusion of traditional securitisations that achieve Significant Risk Transfer (SRT) under the regulatory framework from the calculation of RWAs to mean either: (i) the securitised assets are excluded from the regulatory scope of consolidation and therefore should also be excluded from the Basel III leverage ratio exposure measure; or (ii) the securitised assets are included within the regulatory scope of consolidation, and therefore should be included in the Basel III leverage ratio exposure measure, but receive a 0% risk weight under the risk-based framework. The BCBS notes that while the two interpretations produce the same results for risk-based capital purposes (i.e. no associated RWAs), their respective impacts on the Basel III leverage ratio exposure measure can differ significantly.

We fully agree that the different interpretations produce very different results. Our view is aligned with the outcome described in (i) above as we believe assets that are transferred to third parties via securitisations that achieve SRT should be excluded from the leverage ratio denominator. This is appropriate as achieving SRT demonstrates that the risk of the assets has been effectively transferred off the balance sheet of the originating bank to a third party.

An effective way of excluding such transferred assets from the leverage ratio in cases where SRT is achieved would be to remove assets from the leverage ratio in an amount equal to the notional value of tranches sold to third party investors.

III.5. Treatment of securities financing transactions (SFTs)

The existing BCBS LR framework has a double counting anomaly for SFT exposures, which is not remediated in the consultation paper: For SFT transactions for which an on-balance sheet receivable is recognized (for example reverse repo and security borrowing transactions) and that are under-collateralized from the bank's perspective (i.e. the fair value of the collateral received is smaller than the cash provided), an SFT CCR exposure is added to the on-balance sheet receivable. This creates an anomaly in terms of the LR exposure compared to real economic leverage as uncollateralized loans have a smaller exposure than under-collateralized reverse repos. While this issue is not directly consulted upon, we highly recommend that the BCBS takes this opportunity to amend the rules so that such double counts can be removed from the exposure measure.

III.6. Disclosure requirements

We would like to refer to the industry response to the BCBS consultation on Pillar 3 Disclosure requirements submitted by the Institute of International Finance (IIF), the International Swap and Derivatives Association (ISDA), and the Global Financial Market Association (GFMA). In addition, we would like to reiterate that some relatively minor adjustments of the frequency and timing of disclosures would ease reporting burdens and create greater coherence in overall reporting and data requirements.

Conclusion

Against the aspects outlined above, we urge the BCBS to consider carefully the appropriateness and calibration of the proposed revisions to exposure calculations. In addition, we call on the BCBS to include the results of the ongoing industry wide QIS in the final calibration of the leverage ratio.

In UBS's view the BCBS should also follow its stated objectives of implementing a leverage ratio that is not materially impacted by any particular accounting standard. Improving the consistency and comparability of the capital framework also includes a single, consistent measure of the leverage ratio in all jurisdictions, as well homogeneous disclosures by banks which increase a level playing field.

We are convinced that the current capital framework strikes the right balance between risk sensitivity, simplicity and comparability. Risk sensitivity must remain at the core of the capital adequacy framework. To a large extent, the current capital framework based on risk sensitivity complemented by a backstop leverage ratio strikes the right balance. The proposed measures outlined in the LR consultation would have significant impact and increase the stringency of the leverage ratio and lead to a more binding leverage ratio. These proposals could undermine the benefits of the risk-based approach.

Finally, we strongly encourage the BCBS to consider comprehensively and holistically the impact of the wide range of prudential capital measures that are under review at present, including the 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, in order to ensure that the Committee's objective that there should be no significant increase in the amount of capital in the global banking system is met.