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Frequently asked questions on the Basel III leverage ratio framework

Introduction

In January 2014, the Basel Committee on Banking Supervision (“the Committee”) published the Basel III leverage ratio framework¹ together with the public disclosure requirements applicable as of 1 January 2015. To promote consistent global implementation of those requirements, the Committee has agreed to periodically review frequently asked questions (FAQs) and publish answers along with any technical elaboration of the standards text and interpretative guidance that may be necessary.

Since publication, the Committee has received numerous questions on the published standards text. This document sets out the third set of FAQs that relate to the Basel III leverage ratio framework, inclusive of FAQs that were published previously, in October 2014 and July 2015. The questions and answers are grouped according to relevant areas: (i) criteria for the recognition of cash variation margin associated with derivative exposures; (ii) centrally cleared client derivative exposures; (iii) exposures and netting of securities financing transactions (SFTs); (iv) the treatment of netting of SFTs and derivatives under a cross-product netting agreement; (v) the exposure measure under the additional treatment for credit derivatives; (vi) the treatment of long settlement transactions and failed trades; (vii) on-balance sheet exposures; (viii) general treatment of derivative exposures; (ix) specific treatment of written credit derivatives; (x) off-balance sheet items; and (xi) scope of consolidation and disclosure. FAQs that have been added since the publication of the previous version of this document in July 2015 are shaded yellow.

1. On-balance sheet exposures

1.1 Cash pooling positions

Q1. Are notional and physical cash pooling positions (ie whereby corporate groups combine the credit and debit positions of their various accounts into one account) required to be treated on a gross basis?

Relevant provisions: Paragraphs 12 and 13 of the Basel III leverage ratio framework.

Answer: The Basel III leverage ratio exposure measure treatment of assets that are subject to cash pooling positions (ie whereby corporate groups combine the credit and debit positions of various accounts into one account) must be determined in accordance with the first sentence of paragraph 12 of the Basel III leverage ratio framework. On this basis, the starting point is the exposure value as identified in the applicable accounting framework subject to the additional criteria of the second bullet of paragraph 12 and of paragraph 13 of the Basel III leverage ratio framework. Hence, the Basel III leverage ratio exposure measure must not be reduced through recognition of collateralisation, guarantees or risk mitigation purchased. Also, possible effects arising from netting of loans and deposits must be reversed, leading to an un-netted (gross) recognition of these exposures in the Basel III leverage ratio exposure measure.

“Netting” should, however, be distinguished from physical “settlement”, with the latter referencing the transfer of credit and debit balances into a single account, with the result that these balances are extinguished and transformed into a single balance (ie a single claim on or a single liability to a single legal entity on the basis of a single account). In contrast to “netting”, the criteria of the second bullet of paragraph 12 and of paragraph 13 of the Basel III leverage ratio framework do not require the reversal of the effects of physical “settlement”. The resulting single balance as the consequence of physical

settlement constitutes the new starting point for establishing the Basel III leverage ratio exposure measure. Note, however, that the condition of “extinguished and transformed into a single balance” is not met when the bank could potentially be held liable for the non-performance of one or multiple participants in the cash pool.

To the extent that physical settlement does not extinguish all of the credit and/or debit balances of the participants in the cash pool, in addition to the balance amount in the master account after settlement, banks must include in their Basel III leverage ratio exposure measure any remaining credit balances (i.e., the “unswept” amounts owed to the institution) in the cash pool on a gross basis.

In addition, any off-balance sheet exposures arising from cash pooling products (both notional and physical) must be included in the Basel III leverage ratio exposure measure in accordance with paragraphs 38 and 39 of the Basel III leverage ratio framework.

2. Derivative exposures

2.1 Interpretation of the currency of settlement requirement

Q1. Under paragraph 25 (iii), cash variation margin received must be in the same currency as the currency of settlement of the derivative contract. What does currency of settlement mean?

Relevant provisions: Paragraph 25 (iii) of the Basel III leverage ratio framework.

Answer: For purposes of paragraph 25 (iii) of the Basel III leverage ratio framework, currency of settlement means any currency of settlement specified in the derivative contract, governing qualifying master netting agreement (MNA), or the credit support annex (CSA) to the qualifying MNA. The above answer should be considered an interim response. The Committee will undertake a more detailed analysis of this interpretation and the consequences of paragraph 25 (iii) of the Basel III leverage ratio framework, including issues arising from foreign exchange risk due to currency mismatches between the market value of the derivatives and the associated cash variation margins.

2.2 Legal enforceability and effectiveness of an MNA

Q2. What standards are banks expected to meet for MNAs to be legally enforceable and effective?

Relevant provisions: Paragraph 25 (v) of the Basel III leverage ratio framework.

Answer: An MNA is deemed to meet this criterion if it satisfies the conditions in paragraphs 8 (c) and 9 of the Annex to the Basel III leverage ratio framework and disclosure requirements.

2.3 Daily calculation and exchange of cash variation margin

Q3. The condition that cash variation margin must be calculated and exchanged on a daily basis may not be met for certain types of cleared derivatives (e.g., energy derivatives). Will any exception for the daily calculation/exchange requirement be permitted for these types of transactions?

To the extent that the criteria in this paragraph include the term “master netting agreement,” this term should be read as including any netting agreement that provides legally enforceable rights of offsets. This is to take account of the fact that, for netting agreements employed by central counterparties (CCPs), no standardisation has currently emerged that would be comparable with respect to over-the-counter netting agreements for bilateral trading.
**Relevant provisions:** Paragraph 25 (ii) of the Basel III leverage ratio framework.

**Answer:** To meet this criterion, derivative positions must be valued daily and cash variation margin must be transferred daily to the counterparty or to the counterparty’s account, as appropriate.

### 2.4 Exchange of cash variation margin on the subsequent morning

**Q4.** In the case where cash variation margin is exchanged the next morning to meet end-of-day market values, would the requirement of paragraph 25 (iv) still be met?

**Relevant provisions:** Paragraph 25 (iv) together with paragraph 25 (ii) of the Basel III leverage ratio framework.

**Answer:** Cash variation margin exchanged on the morning of the subsequent trading day based on the previous, end-of-day market values would meet this criterion, provided that the variation margin exchanged is the full amount that would be necessary to fully extinguish the mark-to-market exposure of the derivative subject to applicable threshold and minimum transfer amounts.

### 2.5 Non-segregation of cash variation margin

**Q5.** What is meant in paragraph 25 where it states that the cash received by the recipient counterparty is not segregated?

**Relevant provisions:** Paragraph 25 (i) of the Basel III leverage ratio framework.

**Answer:** Cash variation margin would satisfy the non-segregation criterion if the recipient counterparty has no restrictions on the ability to use the cash received (ie the cash variation margin received is used as its own cash).

**Q6.** Where a bank provides cash variation margin, it would not necessarily have any knowledge of whether its counterparty has segregated the cash or not. What standard would need to be met to fulfil this criterion?

**Relevant provisions:** Paragraph 25 (i) of the Basel III leverage ratio framework.

**Answer:** This criterion would be met if the cash received by the recipient counterparty is not required to be segregated by law, regulation or any agreement with the counterparty.

### 2.6 Calculation of the net-to-gross ratio (NGR)

**Q7.** Paragraph 26 mentions that cash variation margin may not be used in the calculation of the NGR. Is this also the case when the conditions of paragraph 25 are met?

**Relevant provisions:** Paragraphs 25 and 26 of the Basel III leverage ratio framework together with paragraph 10 of the Annex to the Basel III leverage ratio framework.

**Answer:** Cash variation margin may not be used to reduce the NGR, even if the conditions in paragraph 25 are fully met. Specifically, in the calculation of the NGR, cash variation margin may not reduce the net replacement cost (ie the numerator of the NGR) nor the gross replacement cost (ie the denominator of the NGR).
2.7 Client clearing of affiliated entities’ trade exposures

Q8. Can an entity affiliated to the bank acting as a clearing member be considered a client in the sense and for the purposes of paragraph 27?

Relevant provisions: Paragraph 27 of the Basel III leverage ratio framework.

**Answer:** An entity affiliated to the bank acting as a clearing member (CM) may be considered a client for the purposes of paragraph 27 of the Basel III leverage ratio framework if it is outside the relevant scope of regulatory consolidation at the level at which the Basel III leverage ratio is applied. In contrast, if an affiliate entity falls within the regulatory scope of consolidation, the trade between the affiliate entity and the CM is eliminated in the course of consolidation, but the CM still has a trade exposure to the qualifying central counterparty, which will be considered proprietary and the exemption in the said paragraph 27 no longer applies.

2.8 Treatment of written options

Q9. Since banks will not encounter counterparty credit risk with written options under the risk-based capital framework, please clarify whether these kinds of transactions should be included in the Basel III leverage ratio exposure measure.

Relevant provisions: Paragraph 18 of the Basel III leverage ratio framework.

**Answer:** As written options create an exposure, they must be included in the Basel III leverage ratio exposure measure.

2.9 Potential future exposure (PFE) add-on factors for credit derivatives under the Current Exposure Method (CEM)

Q10. Single-name credit derivatives have their own add-on factors, as specified in paragraph 3 of the Annex to the Basel III leverage ratio framework. Should an index credit default swap (CDS) be treated the same or would it be in a different category?

Relevant provisions: Paragraph 3 of the Annex to the Basel III leverage ratio framework.

**Answer:** For index CDS, banks must use the same PFE add-on factors specified under the CEM as they would use for single-name CDS under the risk-based capital framework.

3. Specific treatment of written credit derivatives

3.1 Meaning of a “negative change in fair value”

Q1. What is meant by “negative change in fair value” in paragraph 30 of the Basel III leverage ratio framework?

Relevant provisions: Paragraph 30 of the Basel III leverage ratio framework.

**Answer:** A “negative change in fair value” is meant to refer to a negative fair value of a credit derivative that is recognised in Tier 1 capital. This treatment is consistent with the Committee’s communicated rationale that the effective notional amounts included in the exposure measure may be capped at the level of the maximum potential loss, which means that the maximum potential loss at the reporting date is the
notional amount of the credit derivative minus any negative fair value that has already reduced Tier 1 capital.

For example, if a written credit derivative had a positive fair value of 20 on one date and has a negative fair value of 10 on a subsequent reporting date, the effective notional amount of the credit derivative may be reduced by 10. The effective notional amount cannot be reduced by 30. However, if at the subsequent reporting date the credit derivative has a positive fair value of 5, the effective notional amount cannot be reduced at all.

3.2 Scope of written credit derivatives

Q2. Does the term “written credit derivative” as used in paragraph 30 apply exclusively to written credit default swaps (CDS) and total return swaps?

Answer: For the purposes of paragraph 30 of the Basel III leverage ratio framework, the term “written credit derivative” refers to a broad range of credit derivatives through which a bank effectively provides credit protection and is not limited solely to CDS and total return swaps.

3.3 Reduction of the effective notional amount of written credit derivatives due to changes in fair value

Q3. Please confirm the following interpretations of the first half of footnote 15 of the Basel III leverage ratio framework: for the purposes of offsetting, (a) when a purchased credit derivative transaction exists, the effective notional amount of the written credit derivative may be reduced by any negative change in fair value reflected in Tier 1 capital provided that the effective notional amount of the offsetting purchased credit derivative is also reduced by any resulting positive change in fair value reflected in Tier 1 capital; and (b) when a purchased credit derivative transaction exists, and the effective notional amount of the purchased credit derivative has not been reduced by any resulting positive change in fair value reflected in Tier 1 capital, then the effective notional amount of the written credit derivative may only be offset if the effective notional amount of that written credit derivative has not been reduced by any negative change in fair value reflected in Tier 1 capital.

Answer: The interpretations in the question are correct.

3.4 Eligibility criteria for offsetting written credit derivatives

Q4. Would tranched junior position hedges through credit derivatives that meet the following criteria be eligible for offsetting: (i) the junior and senior tranches are on the same pool of reference entities; (ii) the level of seniority of the debt of each of the reference entities in the portfolio is the same; (iii) the designated credit events for the credit protection sold on the senior tranche and purchased on the junior tranche, are the same; and (iv) the anticipated economic recovery on the junior tranched protection purchased is equal to or greater than the anticipated economic loss on the senior tranched protection sold?

Answer: No. As described in footnote 14, credit protection purchased through a credit derivative on a pool of reference assets cannot offset a written credit derivative unless both instruments reference the same pool of reference assets and the level of subordination of both transactions is identical.
3.5 Application of credit derivative offsetting criteria to cleared trades

Q5. If a bank writes credit protection through a credit derivative for a client and enters into a back-to-back trade with a central counterparty (CCP) whereby it purchases credit protection through a credit derivative on the same name, may that purchased credit protection be used to offset the written protection for the purposes of the Basel III leverage ratio?

Relevant provisions: Paragraph 30 of the Basel III leverage ratio framework.

Answer: Yes. A bank may offset the effective notional amount of a written credit derivative sold to a client by means of a credit derivative on the same underlying name purchased from a CCP provided that the criteria in paragraph 30 are met.

3.6 Potential future exposure (PFE) treatment of written credit derivatives included at their full effective notional amount

Q6. What does the phrase “which is not offset according to paragraph 30” in paragraph 31 of the Basel III leverage ratio framework mean? Does it refer to the case where neither of the two deductions in the effective notional amount from an offsetting purchased credit derivative, detailed in paragraph 30, is included?

Relevant provisions: Paragraphs 30 and 31 of the Basel III leverage ratio framework.

Answer: The condition in paragraph 31 regarding the removal of a PFE add-on associated with a written credit derivative from the Basel III leverage ratio exposure measure refers only to the offset by credit protection purchased through a credit derivative according to paragraph 30 of the Basel III leverage ratio framework and not to the reduction of the effective notional amount as a result of the negative change in fair value that has reduced Tier 1 capital.

4. Securities financing transaction (SFT) exposures

4.1 Eligibility criteria for measuring cash payables and cash receivables on a net basis

Q1 (a). Paragraph 33 (i) (c) requires that the linkages to collateral flows between a reverse repo and repo settled on the same day not result in the unwinding of net cash settlement. What is meant by this requirement and what is the standard for meeting it?

Q1 (b). How should one interpret footnote 22? Could you provide further clarity on this point, and examples of settlement system facilities that would be acceptable to qualify for netting and any that would not?

Q1 (c). Can the Basel Committee define in more detail what is meant by “net settlement” as described in paragraph 33 (i) (c)? More specifically, does a transaction that has “failed” impact the ability of that transaction to be netted?

Relevant provisions: Paragraph 33 (i) (c) and footnote 22 of the Basel III leverage ratio framework.

Answer: Paragraph 33 (i) (c) and footnote 22 set out necessary requirements for settlement mechanisms which are used to settle cash payables and cash receivables in SFTs with the same counterparty in order to offset the cash payables against the cash receivables. Subject to the criteria of paragraphs 33 (i) (a) and 33 (i) (b) also being met, the requirements are that the transactions are subject to a settlement mechanism that results in the functional equivalence of net settlement, ie the cash flows of the transactions are
equivalent, in effect, to a single net amount on the settlement date. To achieve such equivalence, all transactions must be settled through the same settlement mechanism. The failure of any single securities transaction in the settlement mechanism should delay settlement of only the matching cash leg or create an obligation to the settlement mechanism, supported by an associated credit facility.

Further to the requirements set out in paragraph 33 (i) (c) and footnote 22, if there is a failure of the securities leg of a transaction in such a mechanism at the end of the window for settlement in the settlement mechanism, then this transaction and its matching cash leg must be split out from the netting set and treated gross for the purposes of the Basel III leverage ratio exposure measure.

Specifically, the criteria in paragraph 33 (i) (c) and footnote 22 are not intended to preclude a delivery-versus-payment settlement mechanism or other type of settlement mechanism, provided that the settlement mechanism meets the functional requirements set out in paragraph 33 (i) (c). For example, a settlement mechanism may meet these functional requirements if any failed transaction (that is, the securities that failed to transfer and the related cash receivable or payable) can be re-entered in the settlement mechanism until they are settled.

Q2. How should SFTs with no explicit end date but which can be unwound at any time by any counterparty be treated?

Relevant provisions: Paragraph 33 (i) (a) of the Basel III leverage ratio framework.

**Answer:** An SFT with no explicit end date but which can be unwound at any time by any counterparty (eg open repos) is not eligible for Basel III leverage ratio netting of SFTs, as it does not meet the condition set out in paragraph 33 (i) (a). This condition requires that, for Basel III leverage ratio netting, transactions must have the same explicit final settlement date.

Q3. The Basel III leverage ratio framework refers to the “final contractual exposure” as a replacement for “gross SFT assets recognised for accounting purposes” for SFT assets cleared through qualifying central counterparties (QCCPs). Could you please define “final contractual exposure”?

Relevant provisions: Paragraph 33 (i) and footnote 19 of the Basel III leverage ratio framework.

**Answer:** “Final contractual exposure” as set out in footnote 19 of the Basel III leverage ratio framework refers to the exposure to the QCCP after the process of novation has been applied. However, banks can only net cash receivables and cash payables with a QCCP if the criteria in paragraph 33 (i) are met. Any other netting permitted by the QCCP is not permitted for the purposes of the Basel III leverage ratio.

Q4. Please clarify whether paragraph 33 (i) (b) refers to the default, insolvency and bankruptcy of the counterparty or also of the reporting entity.

Relevant provisions: Paragraph 33 of the Basel III leverage ratio framework.

**Answer:** Paragraph 33 (i) (b) of the Basel III leverage ratio framework provides that, for the purpose of measuring SFT assets on a net basis, “the right to set off the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable both currently in the normal course of business and in the event of: (i) default; (ii) insolvency; and (iii) bankruptcy”. The references to the events of default, insolvency and bankruptcy apply to such events occurring at the counterparty, not at the reporting entity.

4.2 Securities deposited at triparty repo agents

Q5. When banks enter into repo transactions with customers, must the securities that banks deposit at triparty repo agents as collateral be considered as “securities lent to a counterparty” and therefore be included in the exposure (E) under paragraph 33 (ii)?

Relevant provisions: Paragraph 33 (ii) of the Basel III leverage ratio framework.
**Answer:** For the purposes of paragraph 33 (ii) of the Basel III leverage ratio framework, the term “counterparty” includes not only the counterparty of bilateral repo transactions but also triparty repo agents that receive collateral in deposit and manage the collateral in the case of triparty repo transactions. Therefore, securities deposited at triparty repo agents are included in “total value of securities and cash lent to a counterparty” (E) under paragraph 33 (ii), up to the amount effectively lent to the counterparty in a repo transaction. However, excess collateral that has been deposited at triparty repo agents but has not yet been lent out in specific repo transactions should be excluded.

### 4.3 Bank acting as agent

**Q6.** Paragraph 35 states that a bank agent generally provides indemnity or guarantee to only one of the two parties involved. Does this mean that the treatments as set out in paragraphs 36 and 37 apply only to this case? If so, what is the treatment for the case where the bank agent provides guarantee to both parties?

**Relevant provisions:** Paragraphs 33 and 35 to 37 of the Basel III leverage ratio framework.

**Answer:** Paragraphs 35 to 37 of the Basel III leverage ratio framework explain the treatment of SFTs where a bank acts as an agent between two parties of the transaction. It is assumed that an agent bank generally provides an indemnity or guarantee to only one party of the transaction and only for the difference between the cash/securities lent and the collateral borrowed.

If an agent bank provides an indemnity or guarantee to both parties involved in an SFT (ie securities lender and securities borrower), it must calculate its Basel III leverage ratio exposure measure in accordance with paragraphs 35 to 37 separately for each party involved in that transaction.

**Q7.** Please clarify the application of footnote 25 of the Basel III leverage ratio framework to omnibus accounts that are used by agent lenders to hold segregated client collateral.

**Relevant provisions:** Paragraph 37 and footnote 25 of the Basel III leverage ratio framework.

**Answer:** Under the condition that the bank calculates the exposure on a client by client basis, for the purposes of the Basel III leverage ratio exposure measure it does not matter how the bank elects to categorise its client collateral provided that client collateral is segregated from the bank’s proprietary assets and other relevant criteria, as described in paragraphs 36 and 37 of the framework, are met. Under those circumstances, footnote 25 of the Basel III leverage ratio framework does not apply to omnibus accounts that are used by agent lenders to hold and manage client collateral segregated from the agent bank’s own assets.

### 5. Cross-product netting agreements for derivative exposures and securities financing transactions (SFTs)

**Q1.** How should banks perform netting under the leverage ratio for derivatives and SFTs that are included in a cross-product netting agreement?

**Relevant provisions:** Footnote 7 of the Basel III leverage ratio framework.

**Answer:** Consistent with footnote 7 of the Basel III leverage ratio framework, netting across product categories (ie derivatives and SFTs) is not permitted for the purpose of determining the Basel III leverage ratio exposure measure. However, where a bank has a cross-product netting agreement in place that meets the eligibility criteria of paragraphs 8 and 9 of the Annex to the Basel III leverage ratio framework, it may choose to perform netting separately in each product category provided that all other conditions for netting in this product category that are applicable to the Basel III leverage ratio are met.
6. Treatment of long settlement transactions and failed trades

Q1. How should long settlement transactions (LSTs) and failed trades be treated in the Basel III leverage ratio?

Relevant provisions: Paragraph 12 of the Basel III leverage ratio framework.

Answer: “Long settlement transactions” (LSTs) and “failed trades” are terms that are in use in the Basel II capital framework. For the purposes of the Basel III leverage ratio framework, such transactions have to be treated according to their accounting classification. For example, if an LST is classified as a derivative according to the applicable accounting standards, the Basel III leverage ratio exposure measure has to be calculated according to paragraphs 18 to 28 on “derivative exposures”. Similarly, if a failed trade is classified as a receivable according to the applicable accounting standards, the exposure measure has to be calculated according to paragraphs 15 to 17 related to “on-balance sheet exposures”. Securities financing transactions that have failed to settle are excluded from the described treatment and their exposure measure must be calculated according to paragraphs 32 to 37 on “securities financing transaction (SFT) exposures”.

7. Off-balance sheet items

7.1 Treatment of forward assets

Q1. What is the treatment of forward forward deposits, deliverable bond futures and equity forward purchases under the Basel III leverage ratio framework?

Relevant provisions: Paragraphs 38 and 39 and paragraphs 14 to 22 of the Annex to the Basel III leverage ratio framework.

Answer: Paragraphs 38 and 39 of the Basel III leverage ratio framework provide that off-balance sheet items are included in the Basel III leverage ratio exposure measure using the credit conversion factors (CCFs) as set out in paragraphs 14 to 22 of the Annex, subject to the 10% CCF floor. Paragraph 17 of the Annex provides that forward asset purchases, forward forward deposits and partly paid shares and securities, which represent commitments with certain drawdown, will receive a CCF of 100%.

The commitment to place or accept forward forward deposits under the Basel III leverage ratio framework must be treated consistently with the treatment for these commitments under the risk-based capital framework. Specifically, the commitment to place forward forward deposits is subject to a 100% CCF, as provided in paragraph 17 of the Annex, while the commitment to accept forward forward deposits is treated as an interest rate derivative. In addition, deliverable bond futures and over-the-counter equity forward purchases must be treated as derivatives.

8. Scope of consolidation and disclosure

8.1 Proportionate consolidation

Q1. Should entities subject to proportionate consolidation be included in line item 2 of Table 1 – “Summary comparison of accounting assets vs leverage ratio exposure measure”?

Relevant provisions: Paragraphs 8 and 9, and line item 2 of Table 1 of paragraph 52 of the Basel III leverage ratio framework and disclosure requirements.
Answer: The reconciliation in Table 1 uses as its starting point total assets within the accounting scope of consolidation. To the extent that entities subject to proportionate consolidation in the regulatory scope of consolidation (and, therefore, measured as such for purposes of the leverage ratio exposure measure) are captured differently within the accounting scope of consolidation, the resulting difference must be reflected in line item 2 of Table 1.

8.2 Retention period of past disclosures

Q2. What is the retention period for past disclosures that banks are required to make publicly available?

Answer: Paragraph 6 of the standard Revised Pillar 3 disclosure requirements leaves the determination of the suitable retention period for Pillar 3 reports to the relevant supervisor. Since disclosure information on the Basel III leverage ratio is typically included in the same Pillar 3 report as all other information required under the Pillar 3 framework, the retention period for the purposes of Basel III leverage ratio disclosures must be the same as the general retention period for Pillar 3 reports as determined by the relevant supervisor.

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3 Basel Committee on Banking Supervision, Revised Pillar 3 disclosure requirements, January 2015, http://www.bis.org/bcbs/publ/d309.pdf.