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Basel III leverage ratio framework – Executive summary

The Basel Committee on Banking Supervision (BCBS) introduced a leverage ratio in the 2010 Basel III package of reforms. Basel III leverage ratio framework and disclosure requirements followed in January 2014 with detailed specification of the leverage ratio framework (the "framework"). This Executive Summary provides an overview of the framework and its main components.

Why is there a leverage ratio in Basel III?

An underlying cause of the Great Financial Crisis was the build-up of excessive on- and off-balance sheet leverage in the banking system. In many cases, banks built up excessive leverage while maintaining seemingly strong risk-based capital ratios. The ensuing deleveraging process at the height of the crisis created a vicious circle of losses and reduced availability of credit in the real economy.

The BCBS introduced a leverage ratio in Basel III to reduce the risk of such periods of deleveraging in the future and the damage they inflict on the broader financial system and economy. The leverage ratio is also intended to reinforce the risk-based capital requirements with a simple, non-risk-based "backstop".

Main features of the framework

The framework is designed to capture leverage associated with both on- and off-balance sheet exposures. It also aims to make use of accounting measures to the greatest extent possible, while at the same time addressing concerns that (i) different accounting frameworks across jurisdictions raise level playing field issues and (ii) a framework based exclusively on accounting measures may not capture all risks.

The leverage ratio is defined as the capital measure divided by the exposure measure, expressed as a percentage:

$$\textbf{Leverage Ratio} = \frac{\textbf{Capital measure}}{\textbf{Exposure measure}}$$

The minimum requirement is set at 3%, where it will remain until the BCBS finalises the calibration and makes any necessary adjustments to the definition of the exposure measure, with a view to migrating to Pillar 1 treatment on 1 January 2018. The related public disclosure requirements have been in effect since 1 January 2015.

Capital measure

The capital measure is Tier 1 capital as defined for the purposes of the Basel III risk-based capital framework but after taking account of the corresponding transitional arrangements. In other words, the capital measure for the leverage ratio at a particular point in time is the applicable Tier 1 capital measure at that time under the risk-based framework.

Exposure measure – main elements

The exposure measure includes both on-balance sheet exposures and off-balance sheet (OBS) items. On-balance sheet exposures are generally included at their accounting value, although exposures arising from derivatives transactions and securities financing transactions (SFTs) are subject to separate treatment (in essence, amounts owed to a bank are excluded while any on-balance sheet collateral related to such transactions are included).

Except where a different treatment is specified, no offset is allowed for physical or financial collateral held, guarantees in favour of the bank or other credit risk mitigation techniques. Balance sheet assets that are deducted from Tier 1 capital may also be deducted from the exposure measure.

Off-balance sheet items

OBS items arise from such transactions as credit and liquidity commitments, guarantees and standby letters of credit. The amount that is included in the exposure measure is determined by multiplying the notional amount of an OBS item by the relevant credit conversion factor from the Basel II standardised approach for credit risk, subject to a floor of 10%.

Derivative transactions

The basis for the framework's treatment of derivative transactions is a modified version of Basel II's Current Exposure Method. It captures both the exposure arising from the underlying of the derivative contract and the related counterparty credit risk (CCR). The exposure measure amount is generally equal to the sum of the replacement cost (the mark-to-market value of contracts with positive value) and an add-on representing the transaction's potential future exposure. Eligible bilateral netting contracts can reduce the exposure amount, but collateral received generally cannot. In some cases, the posting of collateral increases the exposure amount. There are specific rules governing the treatment of cash variation margin, clearing services and written credit derivatives.

Securities financing transactions

Secured lending and borrowing in the form of SFTs is an important source of leverage. How the framework measures exposure from SFTs depends on whether the bank is acting as a principal or agent. For principal banks, the exposure measure is equal to the sum of gross SFT assets (gross receivables related to SFTs, with some adjustments) and an amount representing the CCR. When acting as an agent, depending on the structure of the SFT, a bank may be able to ignore the collateral involved and reflect only the CCR component, or it may have to include both. The framework also includes specific rules for SFTs that qualify for sale treatment under the operative accounting regime.

Scope of consolidation

The framework applies to all internationally active banks on a consolidated basis, following the scope of regulatory consolidation used in the risk-based capital requirements (see Part I: Scope of Application of Basel II). Where a banking, financial, insurance or commercial entity is outside the scope of regulatory consolidation, only the investment in the capital of such entities (that is, only the carrying value of the investment, as opposed to the underlying assets and other exposures of the investee) is included in the exposure measure. However, any such investments that are deducted from Tier 1 capital may be excluded from the exposure measure.

Proposed revisions

In April 2016, the BCBS released for consultation a proposed set of changes to the exposure measure. The paper also proposes an additional leverage ratio requirement for global systemically important banks. The BCBS expects to finalise the framework at the same time as it finalises other Basel III reforms currently under consideration.

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