

Comments on the Basel Committee on Banking Supervision's consultative document on revisions to the Basel III leverage ratio framework

Register of Interest Representatives

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Contact:

Dr Uwe Gaumert

Telephone: +49 30 1663-2150

E-mail: uwe.gaumert@bdb.de

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

Coordinator:

Association of German Banks

Burgstraße 28 | 10178 Berlin | Germany

Telephone: +49 30 1663-0

Telefax: +49 30 1663-1399

www.die-deutsche-kreditwirtschaft.de

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Dear Madam/Sir,

On 6 April 2016, the Basel Committee on Banking Supervision issued a consultative document on revisions to the Basel leverage ratio framework. We welcome the opportunity to comment on this document.

1. General remarks

The leverage ratio is a non-risk-based regulatory measure which will create a number of perverse incentives. It will also lead to inconsistencies between risk-weighted capital requirements and the leverage ratio. The introduction of a non-risk-based ratio will reverse a decades-old trend towards greater risk sensitivity in the capital requirements regime. This trend has been based on recognition of the fact that the regulatory objective of ensuring a bank's solvency with a high degree of probability can only be achieved if no risk exposure is overlooked when determining capital requirements. Major categories of risk such as market risk, operational risk and derivatives exposures can only be adequately captured by moving away from a balance-sheet approach and focusing instead on the associated risk. Regulatory capital requirements which have no relationship with the exposure to loss are not a suitable means of ensuring solvency. On the contrary, they are counterproductive since they create incentives to engage in regulatory arbitrage, which actively undermines financial stability.

We take the well-founded view that a leverage ratio in the form of a binding regulatory minimum capital ratio will serve no useful purpose. It will neither be able to limit the risk of excessive levels of debt, nor will it guard against measuring errors and model risk. Nor can the leverage ratio act as second safety net which is independent of risk-weighted capital requirements: it is merely another way of calculating them. It will also be unable to establish a level playing field because assets are measured on the basis of accounting standards without any adjustments for differences between accounting regimes.

The leverage ratio is no simple, transparent and credible measure, moreover. The rules for measuring derivatives, securities financing transactions and off-balance-sheet items are sometimes highly complex. And basing the value of assets closely on accounting valuations makes the leverage ratio vulnerable to the exploitation of recognition and measurement options.

The consultative document sets out various new approaches to determining exposure values, especially the general requirements in paras 10-12 and the specific requirements for regular-way purchases or sales of financial assets (para 16 and Annex, para 9) and for cash pooling (para 17). In the process, the definition of the leverage ratio diverges increasingly from the risk-based requirements, introducing unnecessary complexity to Pillar 1.

We therefore recommend that – except for differences between leverage ratio and risk-based rules which are intrinsic to the nature of the leverage ratio, such as those relating to credit risk mitigation techniques, netting or the use of internal models – a close link should be established in the definition of the exposure measure between leverage ratio and risk-based requirements. This has been the approach adopted at European level, for instance: under Article 429(5) of the Capital Requirements Regulation (CRR), the leverage ratio exposure measure is basically calculated on the basis of balance sheet assets valued using the standardised approach to credit risk (without credit risk mitigation techniques, netting or internal models). A link of this kind, which would reduce complexity in Pillar 1, is missing from the Basel

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framework as things stand. We consequently call on the Basel Committee to retain a principles-based definition of the exposure measure, to link this as closely as possible with the risk-based requirements and to keep the number of specific leverage ratio rules (such as those for unsettled trades and cash-pooling transactions) to an absolute minimum.

In the interests of a comparable measurement basis for the solvency regime and the leverage ratio, we would recommend a consistent application of the SA-CCR. This would have the advantage of establishing a single, clear set of rules for two key metrics and would save operating costs, which will be much higher if the proposed modified version of the approach is adopted. The banking industry currently anticipates an increase in the exposure measure under the SA-CRR compared to that under the CEM, particularly as a result of the alpha set at 1.4. The proposed multiplier fixed at one (in the context of the add-on) flies in the face of the basic rationale of the SA-CCR, namely to “take account” of corresponding over-collateralisation, and will lead to a further increase in exposure values.

2. Detailed comments

2.1 Minimum requirement and additional requirements for G-SIBs

The risk seen as associated with excessive leveraging, and which a leverage ratio is supposed to counter, is that banks may be forced to sell assets or cut back on lending on a large scale as a result of losses and funding difficulties. This would depress asset prices, triggering further write-downs even at banks which had not initially experienced any losses. These banks would then also get into difficulties and be forced into fire sales.

An objection to this line of reasoning is that, unlike risk-insensitive capital ratios, risk-based capital requirements are most certainly capable of preventing destabilising deleveraging processes. Admittedly, the lower the risk weight on the assets, the more assets will need to be sold to compensate for the impact of losses on a risk-weighted capital ratio. But the volume depends on the level of the bank's risk-weighted, not on its non-risk-weighted, capital ratio. Only capital requirements based on a risk-insensitive leverage ratio will lead to banks holding mainly low-risk assets having to sell off assets on a large scale (cf. section 4.1 of the GBIC expert opinion)¹.

Banks with stable funding will only need to sell assets as a result of the impairment requirements of their accounting standards and the rigid minimum capital requirements tied to them. Capital buffers, which can be drawn on in the event of losses without compromising the bank's future, and the going-concern approach set out under Pillar 2, which requires minimum capital requirements to be met even when an unusual loss has occurred, are effective ways of preventing destabilising deleveraging processes.

There is consequently no need for a risk-insensitive capital ratio in order to contain the threat of a deleveraging process which might destabilise the financial system. It also follows that there are no valid grounds for imposing add-ons to the 3% minimum leverage ratio requirement. On no account should there be add-ons of this kind, otherwise the supposed backstop will become a "frontstop" measure for most banks. The impact studies on Basel III indicate that even a leverage ratio of 3% becomes a binding capital requirement in many cases – in other words acts not as a backstop, but as a frontstop ratio. The real question to consider is therefore whether even the 3% figure is in breach of banking supervisors' commitment to the strictly backstop nature of the leverage ratio.

Deutsche Bundesbank's Basel III monitoring exercise found that the leverage ratio requires the German banks included in the study to hold higher levels of capital on average than do risk-based capital requirements. The ECB's 2014 Comprehensive Assessment of a large number of banks in other major economies of the SSM came to similar conclusions (cf. section 7.3 of the GBIC expert opinion).

For these reasons, we are opposed to additional requirements in general and thus also to any additional requirements for G-SIBs. In particular, we believe that additional requirements should on no account be imposed on domestic systemically important banks.

¹ The full text of the expert opinion can be downloaded here:
<https://die-dk.de/themen/pressemitteilungen/new-gbic-expert-opinion-leverage-ratio-sets-serious-perverse-incentives/>

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Should the Basel Committee nevertheless decide to set additional requirements for G-SIBs, these add-ons should be designed in the same way as the corresponding risk-based requirements and should take the form of a buffer, not a minimum requirement. Failure to meet the requirement should not automatically trigger sanctions or a restriction on dividend payments and should be tolerated on a medium-term basis in periods of stress.

2.2 Capital measure

We welcome the decision by the GHOS in January 2016 to use Tier 1 capital as the capital measure for the leverage ratio. Given that AT1 capital qualifies as going concern capital, we do not consider it necessary to place further restrictions on the use of AT1 capital for the purpose of meeting the leverage ratio requirement.

2.3 Exposure measure

2.3.1 On-balance-sheet exposures

2.3.1.1 Treatment of regular-way purchases and sales of financial assets

We understand the Committee's wish to standardise the method of measuring regular-way purchases and sales of financial instruments and support standardisation in the interests of enhancing comparability. We would nevertheless like to point out that neither of the proposed options would be justified from a leverage or a risk perspective. In consequence, we oppose options A and B.

The consultative document proposes that banks using settlement day accounting should fully include in the calculation of their exposure measure all regular-way purchases of assets which are unsettled transactions on the reporting date (apart from certain exceptions in Option B). We consider this approach unwarranted from both a leverage and a risk perspective for the reasons set out below.

These purchases are normally delivery-versus-payment (DVP) transactions. If the purchased asset is not delivered to the bank on the agreed value date, no payment will be made from the bank's account. In consequence, the exposure cannot be measured as the full purchase price, but only as the replacement risk arising from the difference between the purchase price and the current market value of the asset. Even if all delivery-versus-payment transactions defaulted on a given value date, the actual credit risk would be nowhere near the amount which the consultative document proposes should be added to the total exposure measure. Nor would such an amount be justified on the grounds of countering excessive leverage. Admittedly, the purchase of a financial asset contributes to leverage because the purchase price (assuming a constant cash amount) needs to be refinanced by the value date at the latest, which increases the bank's overall exposure. But this view is extremely one-sided because it focuses exclusively on asset purchases and totally ignores sales. In the real world, the bank only has to refinance the difference between its purchases and sales of assets by the value date. The proposed treatment will consequently normally result in far too great an amount being added to the exposure measure except in the highly unlikely event that only purchases of financial assets remained unsettled after the reporting date. To counter the risk of excessive leverage, therefore, *at most any (positive) difference* between unsettled delivery-versus-payment purchases and sales should be included in the exposure measure.

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The amount for inclusion proposed in the consultative document would only be justified if the transactions were not settled on a delivery-versus-payment basis and carried pre-settlement risk.

Though Option B allows offsetting, it makes it subject to strict conditions so that it would only be possible to offset a small proportion of transactions. As a result, this option also significantly overstates the actual risk.

We would suggest that, regardless of the accounting treatment used, exposures arising from unsettled delivery-versus-payment transactions should be calculated using the rules for determining exposures for the risk-based capital requirements for these transactions (i.e. the treatment set out in the Basel II framework, BCBS 128, Annex 3). Given, in particular, that the settlement time for these transactions in Germany is normally extremely short, normally two working days at most, we believe the approach we propose is appropriate, consistent with the risk-based treatment, and would ensure a treatment independent of the accounting system used.

Should the Basel Committee decide against standardising the treatment, our preference would then be for Option B. In this case, however, we believe the only sensible precondition for allowing offsetting is delivery-versus-payment settlement. Restricting Option B to market-makers or trading book transactions would only benefit a limited number of big market participants and generate unnecessary implementation and monitoring costs simply for the purposes of calculating the leverage ratio exposure measure. For these reasons, we recommend permitting blanket offsetting of DVP transactions.

In its QIS based on data as at 31 December 2015, the Basel Committee collected gross figures (cf. leverage ratio template, table K, row 206 and ad-hoc QIS, table F, row 55). It is not possible to accurately assess the impact of a change in the rules using the collected data since nowhere in the monitoring exercise is there a request for the balance after offsetting. The Basel Committee is evidently assuming when assessing the impact that any possible accounting offsetting has already been reversed in the regular monitoring exercise (leverage ratio template; row 19; columns J vs. K). In our view, this is not certain based on the current rules and the instructions on completing the monitoring worksheet. We therefore assume that banks will not normally have reported this impact on a gross basis so a robust assessment of the impact of a corresponding rule change is not possible. If the Basel Committee's objective is to determine the impact on the basis of offsetting currently undertaken, it would make good sense to ask for the balance after offsetting in row 55 instead of gross figures as at present.

2.3.1.2 Treatment of prudent valuation adjustments (PVAs)

The consultative document assumes that PVAs are applied only to less liquid assets. In the EU, however, this requirement has been implemented far more broadly and obliges banks to take various different factors into account (market price uncertainty, model risk, unearned credit spreads, investing and funding costs, etc.; cf. Delegated Regulation (EU) 2016/101). The rules for calculating PVAs allow assets and liabilities to be netted and calculations to be largely based on aggregated exposures, not individual assets or liabilities. As a result, a breakdown of PVAs by assets and liabilities is possible only to a very limited extent. It will therefore be very difficult to comply with a requirement to take account only of PVAs for assets.

We would also like to point out that, for derivatives exposures (PFE) and exposures to SFTs (counterparty risk components), transactions with negative market values are included in calculating the leverage ratio

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exposure measure. Since the vast majority of PVAs relate to derivatives and SFTs, it is not appropriate to restrict the ability to deduct PVAs to on-balance-sheet assets only. We would urge the Basel Committee to permit all PVAs which are deducted from Tier 1 capital to be deducted from the exposure measure as well.

2.3.1.3 Treatment of traditional securitisations

Of the proposed options for the treatment of traditional securitisations in cases where the requirements for the recognition of risk transfer under the securitisation framework are met, but not the conditions for accounting derecognition/deconsolidation, we support option (i).

The criteria for the recognition of risk transference – a prerequisite for excluding the securitised exposures from the calculation of risk-weighted assets – are extremely strict and recognition is subject to the approval of supervisors. This detailed, closely monitored process for justifying capital relief for the securitised assets is also an appropriate basis for permitting the securitised assets to be excluded from the calculation of the leverage ratio.

2.3.2 Derivative exposures

Impact on the client clearing business model

The leverage ratio should recognise the exposure-reducing effect of segregated margin. Capital requirements should be appropriate to the level of the risk associated with the financial activity involved to ensure potential exposures arising from the activity are properly aligned with the capital supporting them. The leverage ratio requirement for cleared client transactions is not appropriate as it ignores the risk-mitigating impact of segregated margin. This acts as a strong disincentive to central clearing. The rules will restrict the ability of smaller market participants to secure clearing arrangements, forcing some to stop using derivatives, thus increasing the risk in the system and reducing liquidity in hedging instruments. The leverage ratio requirement should be amended to take account of the exposure-reducing effect of segregated margin.

It is not clear how initial margin will be treated under the Basel framework. Initial margin should be recognised in the leverage ratio exposure measure to ensure a consistent implementation of the SA-CCR. Furthermore, this would reduce the administrative burden since only one calculation would be necessary.

Treatment of cash variation margin

We would suggest also recognising on a pro rata basis derivative exposures which are partially collateralised by CVM posted under CSAs that permit collateral to be posted in the form of both cash and securities. This would do much to make collateral management more flexible and increase market liquidity, especially in periods of stress. We advocate a consistent implementation of the SA-CCR, including the requirements for recognising collateral for the purposes of the leverage ratio exposure measure. This approach would avoid the need for two different treatments, thus facilitating operational processes. On top of that, significantly more complex implementation would be avoided.

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Additional treatment for written credit derivatives

The explanation concerning the purchase of credit protection on a pool of reference names is not entirely clear to us. We would ask the Committee to clarify exactly what type of derivatives are meant (nth-to-default?) and provide an illustrative example (cf. Annex, para 33, sentence 3 ff.).

We would appreciate confirmation that the requirement concerning net income from offsetting credit derivatives (cf. Annex, para 34) only applies to cases in which valuations of written credit derivatives are not necessary under national GAAP and is not relevant to IFRS users, which have to measure all derivatives at fair value.

The proposed requirement in para 35 of the Annex is not practicable and would involve multiple counting of the add-on. The net long exposure in credit derivatives is normally determined at a later date and requires a new calculation of the add-on on the basis of the result of the net long exposure determination. We would therefore suggest dropping the requirement to calculate an add-on for written credit derivatives altogether.

2.3.3 SFT exposures

Under recital 7 of Delegated Regulation (EU) 2015/62 (amending Regulation (EU) No 575/2013) “Repurchase transactions that can be terminated at any day subject to an agreed recall notice period should be considered equivalent to having an explicit maturity equal to the recall notice period.” We do not understand why, in para 37(i)(a) of the Annex, the Basel Committee deviates from this (in our view) economically sensible approach. Subjecting these highly similar products to different treatment will give rise to distortion. Repos without an explicit termination period give both parties the option of giving notice. As a result of this option both parties are able to terminate the transaction at any time, along the lines of a transaction with a maturity of one day.

In addition, we would suggest reviewing the current treatment of SFTs in the leverage ratio calculation because the exposure measure of the SFT can sometimes exceed the maximum possible leverage and loss amount. Take the following example:

A reverse repo involving a loan of 100 euros has been entered into. The borrowed securities currently have a market value of 95 euros. Under the current rules, an amount of 105 euros has to be added to the total exposure measure (exposure value of 100 euros + 5 euro counterparty credit risk add-on) despite the fact that the maximum possible loss is 100 euros (in the event of a total default on the loan and without taking into account possible compensation from realising the assets received). Furthermore, the actual leverage resulting from this transaction is also 100 euros since the loan – assuming a constant cash amount – has to be refinanced. There is consequently no justification for adding an amount of 105 euros to the total exposure measure.

The amount to be added to the exposure measure should be limited to the maximum possible amount of loss (100 euros in the above example). One way of achieving this would be to reduce the amount of the exposure to the cash loan (100 euros in the example) by the (positive) amount of exposure as a result of the counterparty credit risk (5 euros in the example). In the above example, the exposure to the cash loan (95 euros) plus the exposure to counterparty credit risk (5 euros) produce a total of 100 euros to be added to the total exposure measure.

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2.3.4 OBS items

2.3.4.1 Treatment of provisions for OBS items

We welcome the proposal to take account of provisions for OBS items when calculating the exposure measure. The consistent use of CCFs from the standardised approach (without methodological deviations) is also appropriate, in our view. And we welcome the proposed deduction from the exposure measure of provisions after the application of the relevant CCF. It is vital, however, that implementation is consistent with the new standardised approach for credit risk (d347).

2.3.4.2 Revisions to the CCFs for OBS items

The Basel Committee wishes to use the significantly higher conversion factors proposed in its revisions to the standardised approach for credit risk for the purposes of the calculating the leverage ratio as well. As explained in GBIC's comments on the proposed new SA to credit risk, we have serious reservations about the proposed new factors:²

Based on model results at banks using the advanced IRB approach, we assume that the currently applicable conversion factors are already sufficiently conservative. There are no valid grounds, in our view, for the more stringent requirements now proposed.

Most off-balance-sheet items are associated with lending to retail clients and SMEs. Increasing CCFs will therefore have an adverse effect on the readiness to lend or will lead to a tightening of the terms and conditions for fixed-term credit facilities. We are particularly critical of the fact that the new method of determining the relevant CCF is much more complex than at present and that there is no longer any provision whatsoever for applying a 0% factor. For the purposes of calculating the leverage ratio, a floor of 10% already exists for low-risk OBS transactions.

The CCFs for undrawn credit facilities granted to corporates remain excessively high. Corporate SMEs would also be affected. The proposed CCFs would have a particularly adverse effect on capital requirements for credit facilities valid until further notice. These currently receive a 0% CCF and would in the future be assigned an as yet undefined factor of between 50% and 75%. It is absolutely essential to reduce the CCF for facilities valid until further notice. Otherwise, banks will have no alternative but to significantly curtail existing credit lines or charge companies for the associated cost of capital. A combined scenario is the most likely outcome. This would have a negative impact on the ability of firms in the real economy to access funds swiftly.

With this in mind, we would suggest making a distinction between retail and corporate clients. A 5% CCF should be applied to facilities for retail clients, and a 10% CCF to facilities for corporates since these companies, owing to the close relationship they have with their bank, are especially dependent on inexpensive credit lines valid until further notice. This would still represent a significant – though more manageable – increase in the CCF.

There would be no rationale for applying a more favourable CCF only to unconditionally cancellable retail commitments. Lower CCFs should be applied to all exposure classes. As far as we are aware, banks using

² https://die-dk.de/media/files/2016-03-11_DK-Stn-Ga-BCBS_rev_KSA_EN_final.pdf

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the advanced IRB approach have detected no significant differences during their annual review of CCFs between the way retail and corporate clients draw on credit facilities.

Yours sincerely,
on behalf of the German Banking Industry Committee,
Association of German Banks



Dirk Jäger
Member of the Management Board



Dr Uwe Gaumert
Director