

German Banking Industry Committee and Austrian Economic Chamber – Division Bank and Insurance

Position paper on the implementation of the leverage ratio in Europe – comments on the analysis commissioned under Article 511 of the CRR

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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.

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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, as we will demonstrate in detail below. 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 its capital requirements are determined without overlooking any risk exposures. 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 do not consider 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 the 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 the differences in accounting regimes. The leverage 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 contradictory. And basing the value of assets closely on accounting valuations makes the leverage ratio vulnerable to the exploitation of recognition and measurement options.

What is more, the leverage ratio has a number of negative side effects, which we will also go explore in detail. For these reasons, we strongly recommend using the leverage ratio as a Pillar 2 instrument, not a Pillar 1 limit. This will allow greater flexibility and avoid eroding the positive incentives set by risk-based capital requirements. In our view, European implementation should not follow the approach adopted by the Basel Committee and endorsed by the GHOS in January 2016, which envisages introducing the leverage ratio as a Pillar 1 measure.

The following section looks at individual aspects of the leverage ratio whose analysis is required under Article 511 of the CRR. Our comments are intended to supplement and summarise the views set out in the expert opinion on the leverage ratio prepared for the German Banking Industry Committee (GBIC) by Professor Thomas Hartmann-Wendels. The Austrian Economic Chamber (WKO) and GBIC support the key findings of this independent opinion.

The full text of the expert opinion can be downloaded from the following website:

<https://die-dk.de/themen/pressemitteilungen/new-gbic-expert-opinion-leverage-ratio-sets-serious-perverse-incentives/>

2. Detailed comments (Article 511 of the CRR)

2.1 Eliminating the risk of “excessive leverage” (Article 511(3)(a) to (d) and (i), (j) and (l))

The risk seen as associated with excessive leveraging 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 with mainly low-risk assets having to sell off assets on a large scale (cf. section 4.1 of the expert opinion).

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 to contain the danger of a deleveraging process which might destabilise the financial system.

It also follows that there are **no** valid grounds, in our view, for imposing an add-on at European level to the 3% leverage ratio requirement (Basel Committee calibration). On no account should there be add-ons of this kind or 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% will in many cases become a binding capital requirement – in other words act 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 expert opinion).

2.2 Original exposure method (Article 511(3)(e))

The current exposure method (CEM) is to be replaced at Basel Committee level by the revised standardised approach for measuring counterparty credit risk exposures (SA-CCR), which will probably also be implemented in European law. We would recommend retaining the original exposure method (OEM) at European level for small banks. The new standardised approach is more risk sensitive than the

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CEM, but also significantly more complex. Small banks should therefore be permitted to continue using the OEM for the purposes of calculating the leverage ratio. The OEM is simple, not very risk sensitive and normally clearly overstates counterparty credit risk. In consequence, supervisors should have no concerns about applying the principle of proportionality and allowing small banks to use this simpler alternative. In any event, counterparty credit risk is normally only a minor issue for small banks, so any material divergence between the SA-CCR and OEM can also be disregarded.

2.3 Capital measure (Article 511(3)(f))

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.

2.4 Conversion factors (Article 511(3)(g))

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 under discussion by the Basel Committee for the standardised approach to credit and the leverage ratio. They should not be replicated at European level (either in general or for the leverage ratio in particular).

Most off-balance-sheet items are associated with lending to retail clients and SMEs. Increasing the credit conversion factor (CCF) 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 CCFs is much more complex than at present and that there is no longer any provision for applying a 0% factor.

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% risk weight and would in the future be assigned an as yet undefined weight 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

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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.

2.5 Frequency and format of disclosure (Article 511(3)(h))

The scope of Part 8 of the CRR, with the exception of Article 450, should be confined to publicly traded¹ companies. Non-publicly traded companies would then be exempt from disclosing the leverage ratio.

The disclosure requirements agreed at international level by the Basel Committee were designed with international, publicly traded companies in mind. But these requirements have been implemented in European law on an "as is" basis for all banks. We believe this is inappropriate. The disclosure requirements are particularly, and excessively, burdensome for small banks, which – considered individually – have no bearing on financial stability. The review of the Basel framework currently under way will result in the requirements being expanded further. At the same time, the benefit of disclosure seems questionable. Pillar 3 reports are viewed only very rarely on banks' websites. Nor is there much demand for the disclosed information, which suggests a general lack of interest. The relevant stakeholders probably use other sources of information instead (e.g. annual financial statements, regulatory reporting). The aim of Pillar 3, namely to strengthen market discipline, is consequently not achieved at banks that are not active in the capital markets.

2.6 Changes needed to the definition of the leverage ratio (Article 511(3)(k))

ECA-covered export finance: We believe it would be appropriate to exclude ECA-covered export finance from the leverage ratio so that the product remains attractive from a bank perspective and can continue to be offered to European exporters.

Development loans are an important instrument for the long-term funding of the economy. They are granted for non-competitive purposes and on a not-for-profit basis to support public good objectives of the European Union, or of a central government or local authority of a member state. Given the likely implications of the leverage ratio for development loan programmes operated for the public benefit, we expect to see a negative impact on the real economy and the funding of the public sector.

At present, development loans are only excluded from the calculation of the leverage ratio if the loans represent on-balance-sheet fiduciary assets and meet the criteria for non-recognition and non-consolidation set out in Article 429(11) of the CRR. Most development loans in Germany do not meet these conditions, however. In Germany, development loans are normally granted using a commercial bank as an intermediary. The funds are not extended by the originating development bank to the borrower direct; instead, commercial banks are involved in the process. To take account of this type of development loan in the context of the bank levy, Article 5(1)(f) of Commission Delegated Regulation (EU) 2015/63 excludes from the calculation of contributions the liabilities of the intermediary institution and of the original development bank towards its funding parties as long as the amount of the liabilities is

¹ Publicly traded within the meaning of Section 264d of the German Commercial Code (HGB): making use of a regulated market within the meaning of the German Securities Trading Act (WpHG) by issuing securities or applying for permission to trade such securities on a regulated market.

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matched by a development loan. Development loans excluded under Article 5(1)(f) of Commission Delegated Regulation (EU) 2015/63 should also be excluded from the calculation of the total exposure measure of the leverage ratio.

LCR assets: see our comments in section 2.8

Client clearing: The clearing member uses back-to-back transactions to enter into a derivative transaction with the CCP and a “mirror” transaction of identical economic substance with its client. It is this chain of transactions that gives the client access to the CCP and allows it to comply with its clearing obligation under EMIR.

The two derivatives transactions that arise for the clearing member, and that it enters into as a service for its client, have to be included by the clearing member in the calculation of the leverage ratio denominator without any deductions. Owing to the large volume and high market value of derivative transactions originating in client clearing, the regulatory capital of many banks that wish to offer this service is often insufficient to comply with the required leverage ratio. In consequence, banks are withdrawing from client clearing, leaving this business to a small number of large market participants with a corresponding increase in systemic risk. Many small and medium-sized businesses that wish to enter into derivative transactions can no longer find a provider offering indirect access to CCP clearing. This is likely to result in further concentration of the market for derivative transactions, along with a decline in hedging transactions despite their importance to the real economy.

It is vital, against this background, to exclude derivative transactions originated solely for the purpose of client CCP clearing from the calculation of the leverage ratio.

Lease accounting: see our comments in section 2.9

Securities financing transactions (SFTs): We recommend reviewing the current treatment of SFTs in the leverage ratio calculation because the exposure value of the SFT can sometimes exceed the maximum possible exposure 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, the exposure value of the transaction is 105 euros (book 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 exposure 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 an exposure value calculated at 105 euros. The exposure value to be used for the purpose of calculating the leverage ratio should be limited to the maximum possible amount of loss (100 euros in the above example).

2.7 Impact of introducing the leverage ratio (Article 511(4)(a))

Higher capital requirements can only fail to have an impact on banks’ business policies if the average cost of capital is independent of the capital structure. Claims by some academics that this is the case overlook the fact that the funding of banks cannot be equated to that of non-banks. For banks, deposit-taking business is not only a funding source but above all a part of value creation. Banks offer their clients liquid

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and secure savings products. Regulatory capital is necessary to ensure the safety of deposits. But if banks are required to maintain capital ratios beyond that which is needed for this, their ability to create value will be adversely effected. This causes the average cost of capital to rise, as a number of empirical studies have confirmed. A higher average cost of capital translates into more expensive banking products. The leverage ratio would have a particularly noticeable impact on assets assigned a low risk weight and assets exempt from risk-based capital requirements (cf. section 6 of the expert opinion).

Items (i) and (ii) of point 4(a) – financial markets (e.g. derivatives) and the robustness of institutions

The leverage ratio sets perverse incentives. Since it captures only default risk but not market risk, the use of derivatives to hedge market risk will result in a higher capital requirement, thus discouraging banks from hedging and risk diversification. There will be a similar effect on the use of repos to hedge loans. Thanks to the leverage ratio, this will result in a higher capital requirement than that for an unsecured loan. A shift towards assets with higher risk weights will lead to risk-based capital requirements moving closer to the leverage ratio requirement. Though the objective of establishing a backstop ratio will be achieved, it will not make the financial sector more robust, but will encourage banks to assume more risk.

Item (iii) – low-risk areas of business

The leverage ratio has an extremely adverse effect on low-risk areas of business. A decline in lending and/or rise in the cost of credit will be particularly noticeable in these areas and, indeed, can already be observed as banks take anticipatory action (see also comments on item (ix)).

Item (iv) – migration to shadow banks

Demand for credit which cannot be satisfied by the banking sector owing to excessive leverage ratio requirements will be met by alternative, mostly unregulated, market participants (shadow banks). The next financial crisis may therefore be triggered by a regulatory burden imposed only on the “traditional” banking industry.

Item (vi) – risk-taking behaviour

A leverage ratio which becomes a binding capital requirement will inevitably have an effect on banks’ business policies. Advocates of a leverage ratio normally overlook this point. To earn the higher cost of capital, there will be a shift towards less low-risk, but higher-yield, assets.

Item (vii) – clearing, settlement and custody

Some clearing brokers have already stopped offering client clearing services. Those remaining are amending their fee structure, increasing the price for clearing a portfolio between three and ten-fold. Clearing is therefore becoming economically unattractive to clients, forcing them to decide whether to use less perfect hedges (e.g. via futures) or not to hedge their risk at all.

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 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.

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Item (ix) – bank lending

Especially detrimental effects on the supply of funding and funding costs are likely – or already in evidence – in the following areas:

- government-backed export finance
- trade finance
- lending to central and local governments
- mortgage lending
- development loans (see also section 2.6)
- lending to SMEs

2.8 Interaction with liquidity requirements (Article 511(4)(b))

The leverage ratio is not compatible with other regulatory requirements. Take the liquidity coverage ratio (LCR), which requires banks to hold a liquidity buffer made up of assets that are highly liquid and of high credit quality. The rationale for this requirement is that, even in times of bank-specific or market-wide stress, these assets can be liquidated at any time without loss to offset unexpected liquidity outflows. The leverage ratio, by contrast, effectively penalises low-risk assets on the grounds that they could only be sold at a substantial markdown in the event of a crisis. To establish consistency between the leverage ratio and the LCR, assets in the liquidity buffer should not be included in the calculation of the leverage ratio.

2.9 Impact of differences in accounting regimes (Article 511(4)(c))

The Basel Committee has made strenuous efforts to define the leverage ratio in such a way that differences between accounting regimes will have as little impact as possible. Admittedly, however, the focus has primarily been on the differences between the treatment of derivatives and SFTs under IFRS and US GAAP. Success in neutralising these differences has nevertheless come at the price of a considerable increase in the complexity of the definition.

By contrast, the Committee has not succeeded – since the problem was not addressed at all – in eliminating the differences in the treatment under IFRS, US GAAP and national GAAP of “straightforward” balance-sheet assets, such as loans and securities. Yet for the vast majority of banks, these assets account for the bulk of the exposure measure. The impact of the accounting regime is largely due to the fact that the accounting “capital measure” – as the residual value and major determinant of the numerator of the leverage ratio (Tier 1 capital) – depends indirectly on all the recognition and measurement requirements of the accounting standards applied by the bank. Without harmonisation of international and national accounting standards, therefore, it is impossible to define the leverage ratio in a way that will not distort competition. This means that, as things stand, the definition of the leverage ratio will give rise to unacceptable competitive distortion.

New differences as a result of different accounting regimes will arise for users of IFRS and German GAAP, for instance, when the new lease accounting standard IFRS 16 takes effect. While nothing will change for banks using German GAAP, IFRS users will see their balance sheet assets (and corresponding liabilities) rise. To avoid further divergence of exposure measures, banks should be permitted to set off lease assets

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against the corresponding liabilities for the purpose of calculating the leverage ratio. An exception to the general ban on balance-sheet netting is both appropriate and necessary in this case.