

POSITION PAPER



WSBI-ESBG response to the BCBS consultation on Revisions to the Basel III leverage ratio framework

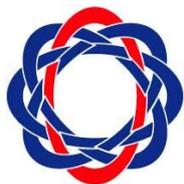
WSBI (World Savings and Retail Banking Group)

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ESBG Transparency Register ID: 8765978796-80

06 July 2016



WSBI



ESBG



Dear Sir/Madam,

Thank you for the opportunity to comment on the Basel Committee on Banking Supervision (BCBS) Consultation on revisions to the Basel III leverage ratio framework (LRF). Leverage ratio is a key issue to our members greatly impacting each of them. With this in mind WSBI-ESBG members would like to express their gratitude for the work done so far but to also point out a number of the concerns that they have with the framework.

General comments

Our members believe that the leverage ratio discourages the investment in low-risk exposures unless the yield can be increased as the lack of differentiated risk weights in the leverage ratio calculation will increase the capital required for these exposures. A higher leverage ratio in Europe would counteract the general objective of strengthening a heterogeneous and diversified banking market structure in Europe and disturb the transfer of credits to the real economy, particularly to well-performing small and medium-sized enterprises.

The leverage ratio favours higher-risk investments that yield a comparatively higher return. For many of our members, a leverage ratio above 3% would become the primary binding capital measure unless they opt for a change in the risk profile of their portfolios towards higher-risk, higher-yield instruments, e.g. by reducing their lending to low-risk customers. Due to its lack of risk weights, the leverage ratio must remain a backstop measure in order for these customers not to be unduly punished by increased costs and/or a reduced supply of credit in the market.

A widely used rationale for the Leverage Ratio is that it should serve as a simple, transparent measure offering protection against model risks and uncertainties in risk measurement. During the course of the revision of the leverage ratio, the regulations for determining the exposure measure have become ever larger and complex. This moved away from the objective of creating a metric that was easy to calculate and easily grasped by anyone. The now considerable complexity is due on the one hand to the objective of evening out differences in the accounting rules, but on the other hand also to the realisation that substantial risks can arise not just from on-balance-sheet assets but also from off-balance-sheet positions. Adequate consideration of these portfolios of mostly complex financial instruments requires complex rules. Besides for on-balance-sheet positions there have been considerable changes which have led to the regulations becoming much more complex. Summing up, it must be noted that simplicity is not a meaningful objective in and of itself and that this objective cannot even be met by the now relatively complex rules for determining the leverage ratio.

Comments on the Revisions

Treatment of the derivative exposures

WSBI-ESBG members support the BCBS's introduction of the SA-CCR as the methodology for calculating the exposure measure for derivative exposures and aiming to replace the Current Exposure Method (CEM) as SA-CCR provide better recognition of collateral for legal netting agreements. However, the Committee's revision to the SA-CCR limiting the application of the collateral for the leverage ratio has not met with member approval. The reasoning behind taking collateral into account as risk mitigating under the risk weighted approach but not under the leverage ratio approach is not



clear. For derivatives used for hedging purposes the position taken should be looked upon as risk reducing. When collateral is received, the risk is even further reduced, both for hedging positions and other positions. We are of the view that it is crucial to consider the non-cash collaterals as counterparties tend to post more collateral and some of them do not have access to cash collaterals thus posting non-cash collateral instead. Also, ESBG is of the opinion that the alpha factor used in the modified version of SA-CCR was initially introduced to produce loan-equivalent EAD for the purpose of calculating credit risk RWAs for derivative transactions. The application of an alpha multiplier is inconsistent with the underlying principle that the on-balance sheet assets, and not a risk-based measure, should be the basis for the LR, thus implying that the alpha factor shouldn't be applied to reflect derivative exposures. Furthermore, we believe that this modified version of the SA-CCR is penalising the overcollateralization thus reducing the incentives for overcollateralization and in its turn leading to increased risk in the case of derivative deals. It is also our view that all HQLA assets should be accepted as collateral, not only cash collateral.

As regards to the proposed revision and conducting an impact assessment with respect to the Initial Margin (IM) posted by clients to the clearing members it is important to align the proposed revisions to the central clearing regulation (EMIR) and to also consider IM for OTC derivatives. We strongly believe that it is important to provide the possibility to deduct the IM when calculating the exposure measure for derivative transactions as this would otherwise reduce the ability to provide clearing services to clients and consequently substantially increasing the cost for clearing banks. This would in its turn lead to the reduction of clearing services in the market. In the consultative paper, the Committee aims to clarify that the currencies listed in the CSA of MNA can be eligible for derivative exposures, this has received support from WSBI-ESBG members. However, with respect the proposed haircut of the Cash Variation Margin (CVM) where the currency does not match the termination currency of the netting set, we believe that this would lead to unwanted operational burdens as well as risk sensitivity in the LRF. Moreover, with respect to the specific treatment of credit derivatives, we believe that there is clearly a definition issue of 'written credit derivatives' which needs to be clarified more in detail. We are of the view that the Committee is aiming to capture only credit protection sold thus the scope of credit derivatives that contributes for their nominal amount to the leverage exposure measure should be consistent with the credit derivatives that qualify as credit protection from a regulatory perspective.

Additional requirements for G-SIBs

The main regulatory purpose of the LR is to address the excessive leverage as well as risk modelling. Given the current regulatory alterations to overlook the institution's internal models which underpin the importance of the risk-based capital ratio we believe that introduction of additional LR requirements for G-SIBs are punitive and that the LR loses its purpose of being a "back-stop" measure and instead superseding the risk-based measures. The leverage ratio is not intended to be binding and its requirements are to be homogenous amongst institutions, moreover and in particular for the larger banks, we would like to point out that a buffer is always added to the minimum prudential requirements by the market.

As regards to whether there should be a limit on additional Tier 1 capital that may be used to satisfy an additional requirement, we would find it reasonable that such a limit would allow banks using at least the same proportion of AT1 capital as is allowed for satisfying the minimum requirement of Tier 1 capital. As the minimum requirement on Tier 1 capital is 6.0% of RWA, and as AT1 capital amounting



to 1.5% of RWA may contribute towards satisfying the requirement, the limit on AT1 capital that may be used to satisfy an additional requirement should thus be at least $1.5\%/6.0\% = 25\%$. However, quantitatively we would support that the additional LR requirement should vary based on scaling factor of the G-SIBs' higher loss absorbency requirement as applicable under risk-based framework.

With regards to whether an additional requirement should be in the form of a higher minimum requirement or a buffer requirement, members have suggested a buffer requirement, by analogy with the higher loss absorbency requirement for G-SIBs as applicable under the risk-based framework. Moreover, a buffer requirement should operate as a buffer whereby supervisors would be expected to take action in the event of a breach, rather than having automatic restrictions on capital distributions. The reason for that is that the leverage ratio measure is intended to constitute a "backstop" measure. Breaches of an additional leverage ratio requirement should thus lead to supervisory attention and action. The bank's supervisor should discuss with the bank the response to a breach on a case-by-case basis; the most appropriate response might not be restrictions on capital distributions, it might very well be reductions of certain exposures or issuance of AT1 capital, for instance.

Credit conversion factors for off-balance sheet items (OBS)

The Committee proposes to incorporate into the Basel III leverage ratio framework revisions to the Credit Conversion Factors (CCFs) for OBS items upon their finalisation and implementation into the revised standardised approach for credit risk. The treatment of CCFs should be further considered as the current levels are too high. The current proposals are in some cases disproportionate and will lead to significant increase in capital requirements under the credit risk framework, and similarly in the context of the leverage ratio. As has been stated in WSBI-ESBG comments on BCBS consultation on *revisions to the Standardised Approach for credit risk (second consultative document)* we have significant concerns on this point.

Members are concerned that commitments to corporates are given the same risk weight regardless of the commitment being unconditionally cancellable (UCC) or cancellable with conditions, as this does not acknowledge the inherently different nature of these two types of commitments. This is because in the former case, the contracts are carefully studied by legal services in order to guarantee their enforceability.

In fact, in some of these contracts every disposable amount is previously approved, eliminating de facto the free availability of disposable amounts. We consider this should be recognised in the CCF by giving it the value of 0%. WSBI-ESBG does not agree with the hypothesis that, in practice, these commitments are not UCC.

Apart from this, the above mentioned BCBS consultative document imposes a 10% or 20% CCF to be applied to retail commitments that are unconditionally cancellable at any time by the bank without prior notice. This charge would lead to an important increase compared with the current 0% CCF for these exposures. In our view, this is not justified with respect to certain credit cards.

In WSBI-ESBG's opinion, the BCBS could better take into account the operative differences across jurisdictions regarding the use of credit cards. For example, in some countries credit card debt balances are normally fully paid at the end of the month, while in other countries the use of revolving credit cards is much more extended, increasing the riskiness of the disposable credit balances. In our view, this is an



important element that should be included in the new framework in order to not penalise banks incorporated in jurisdictions where the use of revolving credit cards is not widespread. We therefore propose to introduce a distinguishing factor based on the existence of an interest rate charge on the client account related to the credit card. If the credit card debt is fully paid at the end of the month, a 0% CCF could then be applied.

In respect of cash commitments, irrespective of whether they are UCC or not, WSBI-ESBG would like to add that the CCF is an estimate of the amount of the cash commitment that would be used in the event of a default. Normally, the use of the loan facilities is the highest immediately before a default, and we assume that this has been the BCBS's hypothesis. Nevertheless, we would like to highlight that this assumption could not be correct for certain types of commitments, particularly those related to large corporations. For these, the level of drawdown is especially influenced by business volumes that enable a company to obtain more funding for increased sales and trade volumes. In other words, drawdowns depend on the client's business cycle rather than on its proximity to default. A remarkable example in this connection can be found in cash pooling agreements with large corporates or insurance companies (high credit quality corporations) in order to have enough liquidity in peak months/days. Normally these agreements are structured with large disposable amounts or authorised overdraft facilities that have a very low frequency of use and, when used, are regularised overnight or in the next weekday. We believe these kinds of disposable amounts, whether UCC or not, have historically demonstrated their very low use, being only a facility to treasury management and should be assigned a CCF of 0% in order to not limit this liquidity management tool of larger corporations.

The proposal to assign a 100% risk weight to unsettled securities transactions might have a significant impact and should be further assessed as a part of the Quantitative Impact Study (QIS).

Treatment of traditional securitization

The Committee's planned effort with respect to further clarification of the treatment of traditional securitization in the LRF is supported by WSBI-ESBG. Regarding the treatment of securitizations there has been a view put forward by members that tranches sold to third parties, and thus not retained by the originating bank, should be excluded from the leverage ratio (providing that the securitization meets the criteria of Significant Risk Transfer). As regards to the options prescribed in the consultative paper regarding the interpretation of operational requirements for recognition of risk transfer in the risk based framework as set out in paragraph 24 of the securitization framework, we believe that Option 2 would mean that LR is far beyond any possible losses for the entity, while the LR should be linked to the maximum amount of loss, which is the nominal value of holdings and not the whole securitization portfolio. Risk-weights are specially designed to address risk of the underlying assets. Finally, when comparing the EU with the US, although US banks have to comply with minimum requirements of 6% LR, the US securitizations will not be subject to LR calculation at all.

Regarding the treatment of securities financing transactions (SFTs) members have voiced their opinion that open repos transactions should be treated as overnight repos in order to allow the netting of cash payables to, and cash receivables from the same counterparty.



Other requirements

The Committee, in this consultative paper, states that banks may use more frequent calculations, for instance daily or monthly averaging, as long as they do so consistently. We believe that opening up the discussion for potentially higher frequency of calculations, in particular daily averaging, will lead to implementation and operational burdens resulting in level playing field issues. On the back of this reasoning we would urge the Committee to consider all aspects before providing the possibility for higher frequency of calculating the LR.

Regarding the treatment of regular-way purchases and sales of financial assets members have expressed the view that for “trade date accounting” Option B should be recommended. However, if the infrastructure for settlements is based upon delivery versus payment and a net settlement approach, members suggest that netting of settlements should always be allowed for leverage ratio measurement both under Option A and Option B. It has been proposed by members that, regarding the treatment of cash pooling transactions, both virtual and physical cash pooling arrangements within a Master Netting Agreement should be recognized for leverage ratio measurement purposes. In view of the disclosure requirements, members support the removal of the requirements from this standard and transferring them to the Pillar 3 standard. We welcome the decision to use Tier 1 capital as the capital measure for the leverage ratio.

Conclusion

Please let us conclude by again thanking you for this opportunity to comment and reiterating our position that any developments in this area require caution as the leverage ratio discourages the investment in low-risk exposures unless the yield can be increased as the lack of differentiated risk weights in the leverage ratio calculation will increase the capital required for these exposures. We are convinced that the above comments will be a valuable addition to the responses received and are more than willing to answer any queries that you may have.



About WSBI (World Savings and Retail Banking Institute)

WSBI brings together savings and retail banks in all continents and represents the interest of circa 6,000 financial institutions with total assets of USD 14 trillion and serving some 1 billion customers in 80 countries worldwide (2013 figures). As a global institution, WSBI focuses on international regulatory issues that affect the savings and retail banking industry. It supports the aims of the G20 in achieving sustainable, inclusive and balanced growth and job creation around the world, whether in industrialised or less developed countries. WSBI favours an inclusive form of globalization that is just and fair, supporting international efforts to advance financial access and financial usage for everyone. It supports a diversified range of financial services that meet customers' transaction, savings and borrowing needs responsibly. To these ends, WSBI recognizes that there are always lessons to be learned from savings and retail banks from different environments and economic circumstances. It therefore fosters the exchange of experience and best practices among its members and supports their advancement as sound, well-governed and inclusive financial institutions.



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About ESBG (European Savings and Retail Banking Group)

ESBG – The Voice of Savings and Retail Banking in Europe

ESBG brings together nearly 1000 savings and retail banks in 20 European countries that believe in a common identity for European policies. ESBG members represent one of the largest European retail banking networks, comprising one-third of the retail banking market in Europe, with 190 million customers, more than 60,000 outlets, total assets of €7.1 trillion, non-bank deposits of €3.5 trillion, and non-bank loans of €3.7 trillion. ESBG members come together to agree on and promote common positions on relevant regulatory or supervisory matters.



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Published by WSBI-ESBG. March 2016.