Leverage Ratio

The leverage ratio (LR) has been introduced as a non-risk based approach to the measurement of leverage which the BCBS is seeking to limit to 3% of Tier 1 capital. It is intended that the new ratio should therefore act as a ‘backstop’ and thereby mitigate the regulatory and other model uncertainties that can arise from risk-based approaches. In its current form, however, the ratio appears unsuited to application across different types of firm and it provides counter-intuitive risk management incentives.

1. Why it matters

1.1 While it is acknowledged that BCBS is seeking a non-risk based measure of leverage it is not possible to apply the same limit to different types of firms. In particular as it stands, studies have shown how the ratio can constrain commercial banking more than investment banking, its counter-intuitive impact in terms of hedging and the disincentive it presents to holding additional liquid assets. There are also remaining questions as to the extent of netting permitted.

2. Summary of AFME Position

2.1 The leverage ratio is considered only one measure of leverage risk, which should be assessed on a comprehensive and risk-focussed basis under the Pillar 2 framework. Disclosure of the new ratio on a firm specific basis should not occur until the completion of the parallel run and full implementation.

3. Regulatory Context

3.1 Excessive leverage by banks is widely believed to have contributed to the global financial crisis. The BCBS is therefore introducing a leverage ratio to contain the build up of excessive leverage in the banking system and provide an extra layer of protection against model risk and measurement error.

3.2 While some countries had implemented leverage ratios prior to the global financial crisis, notably the US, it is unclear whether such a ratio can constrain leverage and therefore help banks to avoid the next crisis or to mitigate its effects.

4. Overview of the LR

a LR Calculation

4.1 At its highest level, the leverage ratio can be summarised as a measure of capital as a proportion of total adjusted assets. More specifically, it has been defined as the average of the monthly leverage ratio over the quarter based on Tier 1 capital (the capital measure) and total exposure (the exposure measure). The minimum ratio is currently calibrated at 3%.
b  Capital Measure

4.2 Capital is calculated using the new definition of Tier 1. This comprises essentially common share capital, share premium, retained earnings and other comprehensive income. To qualify as Tier 1, capital has to be subordinated, perpetual in nature, loss bearing and fully paid up with no funding having come from the bank. Where, for capital measurement, items are deducted or entities (non) consolidated, the same treatment is applied in the exposure measurement for consistency.

c  Exposure Measure

General Measurement Principles

4.3 The financial accounting balance sheet is used as the starting point for exposure measurement. Specific provisions and valuation adjustments may be netted against the exposure to which they relate. Loans and deposits may not be netted (unlike under Basel II where legally enforceable netting with the same counterparty is permitted). As a general principle, collateral, guarantees and purchased credit risk mitigation may not be netted against exposures – however, see below for specific provisions for SFTs and derivatives.

On balance sheet items

4.4 Repurchase agreements and securities finance (SFTs) are included using the accounting measure of exposure, to which are applied the regulatory netting rules based on the Basel II framework, except for the rules on cross product netting. But while Basel II netting provisions permit securities to be included in the netting calculation, it appears that for leverage purposes only the cash legs may be netted.

4.5 Derivatives are measured using the accounting measure of exposure (broadly a present value reflecting the fair value of the contract), plus an add on for potential future exposure using the Current Exposure Method (CEM) of the Basel II Framework, to ensure all derivatives are converted to a loan equivalent amount in a consistent manner. The regulatory netting rules from Basel II are also applied, except the rules on cross product netting.

Off balance sheet items

4.6 These include commitments, letters of credit, failed transactions and unsettled securities. A uniform 100% credit conversion factor (CCF) is used for all of these. The only exception is that any commitments that are unconditionally cancellable by the bank at any time without prior notice may have a CCF of 10% applied.
5. Issues and commentary

5.1 Below is a link to the Table of Issues that AFME has sent to BCBS on behalf of its members.

Table of Issues

5.2 Our main concerns can be summarised as follows.

Pillar 1 vs Pillar 2

5.3 The BCBS’ single measure of leverage risk is not risk based and has a disproportionate impact on trade finance. It is to be introduced as a Pillar 2 measure within the Basel III framework but later transitioned to Pillar 1 as a binding minimum requirement. We support the transitional arrangements BCBS has put in place to assess the currently proposed design and calibration in reference to the full business cycle and different business models, but AFME is of the view that the LR should remain a Pillar 2 measure and should not be transitioned to Pillar 1.

5.4 A Pillar 2 approach to leverage risk will allow supervisors a greater opportunity to assess a bank’s approach to measuring and managing its leverage risk. We therefore welcome indications that under CRD 4 there might be greater flexibility to the assessment of leverage with the Basel III LR forming only one possible measure of this risk.

Disclosure

5.5 Our members are also concerned that as currently drafted the Basel III package requires disclosure of the LR before the parallel run is complete (disclosure is to start on 1 Jan 2015 and the parallel run finishes on 1 Jan 2017). AFME and its members are concerned that any changes in a bank’s leverage ratio associated with changes in the design and / or calibration, or indeed changes in bank specificities, introduced over the parallel run, may not be well understood by the market and other stakeholders. In practice, disclosure may also have the effect of restricting the capacity to make any changes considered to be necessary given lessons learnt in the parallel run: this would clearly be undesirable.

6. Transitional Regime

6.1 BCBS has put in place transitional arrangements to assess the current design and calibration of the LR in reference to the full business cycle and different business models. It is intended that 2011-2012 will serve as a monitoring period; 2013-2016 as a parallel run before full implementation in 2018. As mentioned above, disclosure is scheduled to commence from 2015.

7. Case Studies

7.1 AFME has developed a case study on the LR that examines the outcomes the LCR produces for a universal bank and a broker dealer based on a proforma
balance sheet. The case study highlights that in its current form the ratio provides counter-intuitive risk management incentives and presents a greater constraint for a universal bank than a broker dealer.

7.2 AFME has also developed a case study which examines the interplay of the LCR, NSFR and LR using a stylised balance sheet. The study highlights that:

- The ratios must be managed together, but their design makes steering difficult;

- The cures associated with a breach in one of the ratios may result in responses that cannot effectively address the underlying 'capital or liquidity issues';

- A breach in, for example, the NSFR can result in a cure that has the bank raising capital in response to a funding problem that cannot be addressed by longer term funding invested in high quality liquid assets owing to constraints presented by the leverage ratio.

Leverage Ratio Case Study

Interplay Case Study