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Finance for Europe

Association for Financial Markets in Europe

AFME Position Paper

CRD 5: Leverage ratio

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A non-risk based backstop

AFME is supportive of the introduction of the leverage ratio into the European prudential framework as a simple, transparent and non-risk-based backstop to the risk-based requirements and in a manner which is as consistent as possible with the BCBS's agreed leverage framework.

It is important to note that, according to the EBA, nearly 43% of Group 1 banks[1] and G-SIBs/O-SIIs in Europe are already constrained by the leverage ratio when compared to the Tier 1 risk-based minimum requirement and the conservation and G-SIB/O-SII buffers. If the comparison is restricted to only the risk-based minimum requirement without the buffers, this portion increases to 75% for both Group 1 banks and G-SIBs/O-SIIs. To avoid fundamentally changing the way banks allocate capital, careful consideration must be given to ensuring the leverage ratio effectively fulfils this backstop role rather than becoming banks' main regulatory constraint throughout an economic cycle. Divorcing capital requirements from underlying risk levels leads to suboptimal capital allocation to the real economy by creating incentives for banks to invest in higher yielding and riskier assets for a given level of capital.

Given the "remarkable constraint power" of the leverage ratio[2], reflection is required as to whether an additional leverage ratio buffer is effectively needed for G-SIBs (or domestic equivalents). Drivers of leverage, such as TLAC requirements which are also to be required from G-SIBs, should be taken into account when making this determination. Moreover, any additional buffer also clearly needs to be differentiated from the "hard" leverage ratio requirement. In other words, a breach of the buffer should not trigger automatic distribution restrictions but result in capital planning discussions between the firm and its supervisor to the restore the buffer in a timely manner.

Intragroup exposure exemptions should be extended to include all intragroup exposures and not only those within a single EU Member State

Global banking organisations centralise risk management to manage market risks, maximise netting and efficiently allocate capital, liquidity and balance sheet capacity. Intragroup trades are thus used to pass risk from one entity to another to consolidate the risks in one place. The CRD4/CRR currently allows intragroup exposures in a single EU Member State to be deducted from the leverage ratio exposure measure but requires inclusion of cross border intergroup exposures. In our view, there is no justification for this approach which implies that intragroup transactions within a single Member State do not create leverage, whereas intragroup transactions across borders do. As it stands, this rule increases the cost of cross-border financial intermediation without any underlying increase of leverage. We therefore recommend that the exemption for intragroup transactions be extended to group entities which are established in another Member State as well as in other jurisdictions which apply prudential supervision equivalent to the CRR.

[1] CRD4-CRR/Basel III Monitoring Exercise - EBA QIS Data (based on 31 December 2015 data), Group 1 banks are banks with Tier 1 capital in excess of EUR 3 billion and that are internationally active.

[2] Idem, page 21

The rest of this paper sets out the remaining issues that need to be addressed by the Basel Committee. The EU should support these issues being resolved within the BCBS and should ensure that EU implementation of the leverage ratio is flexible enough to accommodate any ensuing developments.

Cash and unencumbered cash equivalents should be excluded from the leverage exposure measure to ensure the smooth functioning of markets

Cash and high quality government bonds are used as collateral by most market participants for central clearing and other financing transactions, and as liquidity reserves by banks of all sizes, as well as by investment funds and corporates. Moreover, they are required to be held for LCR purposes. They play a critical role in the smooth functioning of financial markets. If market participants' ability to generate liquidity through these assets is impaired due to constraints on banks' balance sheet capacity, particularly during stress periods, it will have ramifications for the functioning of financial markets. Moreover, as has recently been noted by the UK's Financial Policy Committee, "there is no direct benefit to funding holdings of reserves with capital". The inclusion of central bank cash balances in the leverage exposure affects the ability of the banking system to cushion shocks and to draw on central bank liquidity facilities as necessary to maintain the supply of credit and support for market functioning.

The accounting treatment of regular-way purchases or sales should not lead to artificial inflation of the leverage ratio exposure measure

The method for recognising regular-way[3] purchases or sales of financial assets that have not been settled differs across accounting frameworks. For purposes of inclusion in the leverage exposure measure, a netted approach under trade-date accounting should be applied in order to ensure a level playing field. Relying on the IFRS grossing up approach will otherwise artificially balloon a bank's balance sheet, increase volatility in the exposure measure and constrain banks' ability to execute client orders. This would be an undesired outcome with a significant impact on broader market liquidity, while not addressing a real leverage concern. Moreover, delivery-versus-payment settlement ensures that, at all times, the bank has either the security or the cash associated with buying or selling that security.

Adjustments to the leverage ratio are necessary to allow the appropriate functioning of the securitisation market in line with EU objectives

Where a bank securitises assets in a traditional securitisation by placing tranches of that securitisation with unaffiliated third party investors, without recourse to or where there is no repurchase obligation by the bank, the bank should be permitted to not consolidate the SPV in the regulatory consolidation perimeter, and for the purpose of calculating its LR it would include only those tranches which it retains. This would also ensure consistency with the definition of the regulatory consolidation perimeter in the risk-based framework when significant risk transfer has been achieved for securitisations.

Notional cash pooling treated as a single unit of account should be dealt with net in the exposure measure

Notional cash pooling arrangements are treated as a single unit of account for accounting purposes across various accounting standards whereby a single amount is owed to or from the client entity (or the group of affiliated client entities) subject to the Pooling Agreement. The leverage ratio treatment should follow the accounting treatment in these situations to avoid gross presentation of pooled accounts, which would overstate the bank's leverage. This could significantly damage banks' ability to provide these important cash management products to their clients.

[3] A "regular-way" purchase/sale is the purchase/sale of a financial asset under a contract which requires delivery of the asset within an established time frame

The inclusion of off balance sheet exposures into the exposure measure should continue by reference to the current CRR framework rather than the untested Basel proposals which are not yet finalised

The leverage ratio exposure measure includes both on and off-balance sheet exposures, with off-balance sheet exposures determined by reference to conversion factors set out in the CRR's Standardised Approach for Credit Risk (Art 111.1) and subject to a 10% floor. The BCBS's current proposals to review the SA for Credit Risk include significant increases to the levels of these conversion factors which are not in line with industry data. Undrawn credit lines, back up liquidity lines for commercial paper issuance, stand-by letters of credit, cash management facilities and a variety of other banking facilities needed to support corporates' commercial activities will be significantly affected if these as yet untested changes are incorporated into the EU leverage ratio at this stage.

For the purposes of the leverage ratio, derivative exposures should be measured using the new SA-CCR without the alpha multiplier applied to the replacement cost

AFME is supportive of the new Standardised Approach for Counterparty Credit Risk (SA-CCR) being introduced into CRD5/CRR2 for purposes of calculating exposure measures for derivatives under the leverage ratio. This being said, the SA-CRR should not be implemented in a way that creates artificial exposures as is currently proposed by the BCBS. In particular, the alpha factor should not be applied to the replacement cost as it introduces risk based components into the leverage framework compromising consistency with accounting valuation without clear justification. While risk based capital is determined on a portfolio-based level and requires consideration of correlation or diversification, the replacement cost component of the leverage ratio exposure is a simple sum of balance sheet exposures. We therefore do not believe that the alpha factor should be applied to replacement cost in the leverage framework.

The exposure reducing effect of initial margin should be recognised for both cleared and uncleared derivatives to avoid overstating leverage on a system-wide basis

In order to avoid reducing the availability of client clearing services which are otherwise being promoted by policymakers to mitigate systemic risk in derivative markets, the exposure reducing effect of initial margin (IM) posted by clients to banks serving on their behalf as clearing members should be recognised in the leverage ratio framework. This should also be extended to non-centrally cleared derivatives that are bilaterally collateralised as IM cannot be used by banks to leverage themselves. Moreover, not recognising IM would be contradictory to promoting a robust prudential framework for non-cleared OTC derivatives which requires they be subject to either margin or capital requirements (but not both). Finally, the lack of recognition of IM requirements artificially overstates leverage on a system wide basis because only one party can ever be in-the-money on a derivatives contract and since non-centrally cleared OTC derivatives rules require two-way margin there will always be a surplus of IM relative to default risk.

AFME contact

Jouni Aaltonen, jouni.aaltonen@afme.eu +44 (0)20 38282671

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