

## CRD IV

4 May 2012

# Leverage Ratio as Pillar 2 vs. Pillar 1

## The Issue

At the Basel level, the leverage ratio (LR) has been introduced as a Pillar 2 measure to begin with. We support the observation period which has been put in place to assess the currently proposed design and calibration in reference to the full business cycle and different business models. However, AFME is of the view that the LR should remain as a Pillar 2 measure applied at group level and should not be transitioned to Pillar 1. 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 believe that LR is only one possible measure of such risk. The LR presents a greater constraint for a universal bank than for a broker-dealer. Additionally, we have determined that the insensitive nature of the LR results in counter-intuitive results when both hedged and unhedged transactions are introduced into the equation. The LR is not a risk-based measure and also, as currently calibrated, has a disproportionate impact on trade finance.

## Potential Impacts and Consequences

The LR can be viewed as a simplistic, non-risk sensitive limit imposing unreasonable constraints where some of the impacts and consequences include the following:

- Co-existing RWA and leverage constraints provide misaligned incentives
- LR obligations can encourage substitution with riskier, higher yielding assets
- Disclosure of LR can distort firms' risk profiles
- Off-balance sheet commitments and guarantees included in LR at 100% will reduce credit supply
- Comparability of LR difficult due to differences in accounting treatment
- Impact of LR on investment firms' business models may be higher, due to perverse hedging treatment

Additionally, LR levels appear unrelated to bank failure/weakness - for example, banks that failed, were acquired, or needed significant government intervention (e.g., Lehman Brothers, Bear Stearns) showed leverage ratios ranging from high to low. Other banks with similar leverage did not face the same issue. Also, operating LR regimes do not demonstrably deliver fewer bank failures (i.e., the LR constraint implemented in the US did not prevent large numbers of bank failures).

## Amendment proposed by AFME

AFME has serious concerns about the consequences for the European economy which might occur if the LR does not remain in Pillar 2. As there is a large degree of variability in how the LR is calculated across jurisdictions globally, it is essential that the EBA monitor the LR during the observation period in order to reduce any detrimental effects and ensure that any calculation differences with other parts of the world would not jeopardise the European economy. AFME is proposing to keep open the possibility of the LR appropriately staying as a Pillar 2 requirement. Additionally, AFME is seeking a delay in the application of the LR until the report of the Commission into the LR's impact and effectiveness, including consideration of it remaining under Pillar 2, has been considered.