afme/ Finance for Europe

ISDA Safe, Efficient Markets

12 September 2014

Vicky Saporta
Bank of England
Threadneedle Street
London, EC2R 8AH

The Financial Policy Committee's review of the leverage ratio

Dear Ms Saporta,

Enclosed please find our response to the consultation paper 'The Financial Policy Committee's review of the leverage ratio' published on 10 July 2014.

Yours faithfully

Michael Lever
Managing Director, Prudential Regulation
AFME

Mark Gheerbrant
Head of Risk and Capital
ISDA

Association for Financial Markets in Europe
London Office: St. Michael's House, 1 George Yard, London EC3V 9DH T: +44 (0)20 7743 9300 F: +44 (0)20 7743 9301
Brussels Office: Square de Meeûs 38-40, 1000 Brussels, Belgium T: +32 (0)2 401 8724 F: +32 (0)2 401 6868
Company Registration No: 6996678 Registered Office: St. Michael's House, 1 George Yard, London EC3V 9DH
www.afme.eu

afme/ Finance for Europe

ISDA Safe, Efficient Markets

Consultation response

The Financial Policy Committee's review of the leverage ratio

12 September 2014

The Association for Financial Markets in Europe (AFME)[1] and International Swaps and Derivatives Association (ISDA)[2] welcome the opportunity to comment on the consultation paper of the Financial Policy Committee's review of the leverage ratio (LR).

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Executive Summary

Bank of England has sufficient leverage ratio powers to manage financial stability

The industry is supportive of the objective to introduce macro prudential tools to limit the build-up of risks at system-wide level instead of relying only on micro prudential regulation and supervision. However, we do not believe that a more complex, time varying and bank specific LR framework meets this macro prudential objective as it is not risk sensitive by design and therefore isn't the appropriate tool to target risks that other tools, for example the risk based countercyclical buffer, were designed to target. A complex local bank specific LR framework will only apply to regulated entities and also reduces the transparency and comparability of the leverage measure across the sector.

In our view, the Bank of England already has considerable powers over the application of a leverage ratio in the UK. The FPC can make recommendations to the PRA in respect of the leverage ratio, and the PRA can set the leverage ratio, both for individual firms and for the system as a whole. We believe that these powers are more than sufficient to address any potential financial stability concerns that the FPC may want to address prior to the implementation of the CRD IV leverage ratio. We believe that while the FPC's review has not provided clear evidence on why additional leverage buffers ahead of the international timeline would contribute to greater

[1] AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. For more information please visit the AFME website, www.afme.eu.

[2] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

financial stability in the UK, the proposed framework outlined in the consultation paper has the potential to undermine the FPC's other statutory objective, to support the growth and employment objectives of the Government due to the impact on the provision of services and credit to the economy.

Secondly, the industry notes that the FPC's proposal for a new LR framework is not aligned with the BCBS's objectives to introduce LR as a simple, transparent, non-risk based measure to complement the risk based framework. Considering that the Basel FAQ process is still ongoing, the CRR delegated act is yet to be completed and the EBA is still to review how the LR should be applied to different business models, we do not believe that this is the best time to propose material changes to the UK's LR framework. We urge the FPC to focus its work towards an outcome that achieves consistent global implementation, particularly across the EU, and a global level playing field.

Thirdly, the industry is concerned that in the FPC's opinion the discussion on backstops and frontstops is unhelpful. We acknowledge the role of the leverage ratio as a complement to the existing risk-weighted capital framework. However, in GFMA's recent study in relation to Basel's earlier consultation on the LR, AFME and our sister organisations SIFMA and ASIFMA highlighted that the changes to the exposure measure will make LR the binding constraint to a large number of firms on a business as usual basis, especially in Europe. We also highlighted the consequences - a binding LR would change the way firms allocate capital to their business lines. We concluded that if the majority of firms become constrained by a measure of capital adequacy that does not differentiate between low and high risk assets, it will fundamentally change the pricing and availability of products that are vital to the functioning of the capital markets. Furthermore, if regulated firms have to comply with materially higher non risk based capital requirements; it will exacerbate the problem of "barbelling" bank portfolios into high risk and liquid asset buffer investments.

A systemic change in risk measurement, pricing of low risk products and further deleveraging of bank balance sheets will shrink the size of the capital markets and increase reliance on the shadow banking sector for provision of liquidity and credit. As Andy Haldane noted in his article on 5th August in the Central Banking journal, this type of transfer of risks into the unregulated sector may mean more and deeper economic cycles in the future that "*could in turn be transmitted to, and mirrored, in greater cyclical instabilities in the wider economy*".

Scope and level of application of leverage buffers

The application of any additional leverage measures by the FPC across international groups, and inconsistently with global standards, needs to be carefully judged. The UK is a global financial centre with a diverse population of institutions that may be affected in different ways depending on their business model, risk profile and international footprint. We believe that FPC should focus on the financial stability of the UK and should not define leverage ratio requirements which could be considered extraterritorial.

We recognize and support the Bank of England's efforts to agree standards at the international level including, for example, the Basel Committee agreement on a common definition of the leverage ratio. We recommend that Bank of England continues these efforts with respect to the scope of application. The introduction of UK leverage ratio requirements that are inconsistent with global standards contribute to an uneven playing field. This will create undesirable incentives for regulatory arbitrage. Therefore we would strongly recommend that introduction of changes to the UK leverage ratio requirements should only be introduced in line with, and at pace with, changes to global level ratio standards.

The need for another tool to address weaknesses in the risk based framework

The FPC notes that the LR is particularly helpful in safeguarding the system from modelling errors and from unforeseeable events. In our view these concerns should be dealt with in the appropriate risk based framework

rather than indirectly via a supplementary LR measure. The risk-based framework is better able to identify, target and adjust for these issues. In contrast, the capital impact of a Leverage Ratio is determined significantly by the business mix of a bank rather than the level of model risk to which it is exposed, and as such the Leverage Ratio is a rather inappropriate tool for addressing model risk. The Basel Trading Book Group is working to improve the allocation of capital, transparency and supervisory information to control for model risks. The FRTB proposes to introduce rules for non modellable risk factors, standardised floors and model independent risk measures that substantially limit modelling freedom to avoid misallocating risk capital during economic cycles.

Similarly, competent authorities have introduced floors or restrictions on the parameters that firms may use in internal model approaches in the banking book. Some of these floors may be applied across all firms whilst other floors may be applied on a firm-by-firm basis. We have recommended to the EBA, whose work on benchmarking exercises is supported by the industry, to control for differences in supervisory approaches applied to achieve greater comparability and transparency.

Currently, as a result of differences between accounting standards applicable in the EU and other jurisdictions, significant differences may arise in the leverage ratio (for example trade date vs. settlement date accounting). These differences should be addressed as part of the work currently undertaken by Basel and the EBA.

With all this work in progress, we believe that the FPC should allow it to be completed before concluding that there is a need for additional floors and firm specific capital add-ons. The joint industry groups have submitted numerous papers to the Basel Committee and EBA regarding the risk based frameworks that we would be happy to discuss further with the FPC in order to align the work streams and to reduce duplication.

We strongly believe that a binding business-as-usual leverage measure would create wide ranging changes in the market structures, thus creating unforeseeable events when banks start managing their businesses to non risk based capital requirements that make certain capital markets intermediation businesses unviable. Some of these changes are already filtering through to the availability and pricing of products as banks are withdrawing capacity from for example the repo market. It is also worth noting that if despite the divergences in bank business models and risk appetites the capital allocated to similar exposures is the same across the sector, the likely consequence is that the whole banking system becomes more homogenous and less competitive, which would not benefit financial stability.

Questions

Question 1: Do you agree that the leverage ratio plays a complementary role to risk-weighted ratios and stress tests in assessing capital?

The industry agrees with the objectives of BCBS 270, published in January 2014 that a simple, transparent, non-risk based leverage ratio can act as a credible supplementary measure to the risk-based capital requirements. However, the FPC's consideration of a more complex LR partially contradicts these objectives and introduces two new dimensions that the framework is trying to achieve, to guard against risks arising from modelling errors and from unforeseeable events.

We see this departure from Basel's original objectives as destabilizing. It introduces more complexity to the LR framework while in all likelihood making the LR the binding business-as-usual capital measure to most large firms at most times (a frontstop). If the FPC is concerned about modelling errors and under allocation of capital due to unforeseeable events, we believe that such issues should be considered in the appropriate global risk

based frameworks - rather than by burdening a locally adopted LR with undue complexity. In particular, the capital impact of a Leverage Ratio is determined significantly by the business mix of a bank rather than the level of model risk to which it is exposed, and as such the Leverage Ratio is a rather inappropriate tool for addressing model risk.

On the other hand, once the LR becomes a widely used metric for assessing and stressing bank capital levels, the risks that leverage ratio captures are likely to migrate elsewhere in the financial system.

Question 2: Do you agree with the considerations regarding potential alternatives to the leverage ratio?

The industry recognizes that there is a need for increased and more harmonized supervisory review of models and additional disclosures, such as planned by the BCBS on how to improve Risk Weighted Assets ("RWA") models in a manner that is more consistent and comparable across jurisdictions. Indeed, divergent RWAs have contributed to a loss of credibility, leading both in the official and private sector to an increased focus on simplicity, comparability and transparency. In addition to reducing divergences in internal modeling practices, the industry suggests an approach, which (i) recognizes the public interest in comparability and transparency and (ii) focuses on the target of disclosure and optimizes its quality.

However, we do not agree with asset class-specific risk weight floors. Retaining the risk sensitivity of the capital framework is not only important for ensuring that capital is commensurate with risk, in individual banks as well as the system as a whole, but also to maintain incentives for banks to continue to improve their risk measurement and management systems. We believe that implementing additional one-size-fits-all floors could not fulfill this goal, and would not lead to additional simplicity or comparability of risk metrics. There is additional danger that such floors could drive bank portfolios, resulting in a reduction in diversity of bank business models. In our opinion, to some degree the supervisory floors already exist and the FRTB, the benchmarking exercises and the Basel IRRBB are likely to further limit modelling freedom, as discussed in the summary section.

Question 3: Do you agree with the advantages and disadvantages of symmetry between the leverage ratio framework and the risk-weighted ratio?

We consider it fundamental to retain the principle that the Leverage Ratio should be a simple non-risk based backstop measure as introduced by BCBS. A move away from that to a framework that is symmetrical with the risk-based ratio framework does not align with BCBS's principle.

The implication of the leverage ratio as more than a backstop is that it would be a binding constraint for a significant number of banks. Banks that are most of the time bound by the Leverage Ratio would have an incentive to take more risk in their portfolios in order to increase returns. They could continue to do that until they reach the point whereby their Risk Weighted Asset minimum is equal to the Leverage Ratio minimum. The impact of such restructuring would be to increase the overall level of risk and reduce the diversity of business models across the industry, and is not likely, therefore, to be in the interests of financial stability.

More generally we are also concerned that insufficient consideration has been given to the linkages between the leverage ratio and the liquidity framework. We believe that the leverage ratio can reduce incentives for banks to hold cash and other High Quality Liquid Assets above the minimum level required for the Liquidity Coverage Ratio ("LCR"). The result of this could be a banking sector LCR which is both publicly and privately sub-optimal. On the other hand, if the depth and liquidity of repo markets continues to decrease, it may become

more difficult to demonstrate that any security is sufficiently liquid to be included in the liquid asset buffer, unless central bank liquidity is a sufficient requirement.

In particular as they relate to:

- ***including a minimum requirement and buffers analogous to the risk-weighted framework;***

  The industry is not in favour of implementing numerous buffers that are analogous to the risk weighted framework, however, if the concept of the Leverage Ratio as a backstop measure were to be retained then a framework containing a basic regulatory minimum and a single regulatory buffer may be sensible. It is worth noting, though, that a bank is likely to want to operate with a management buffer over the minimum requirement. The regulatory buffer would be an additional buffer to the management buffer not a replacement or partial replacement for it. Extending the single buffer approach to a system of different regulatory buffers would depart from the BCBS principle of simplicity which we would consider outweighs any advantages of having multiple buffers. A simple measure and associated regulatory requirements facilitate a straight-forward and easy comparison between banks.

- ***Establishing a leverage conservation buffer in proportion to the risk-weighted buffer;***

  Whereas the risk-based ratio framework tends to be procyclical in nature driven by movements in the risk weights of assets, the same observation of procyclicality is not clearly evidenced in the case of leverage.

  Firstly, in a period of economic stress, a bank's risk based capital ratio will deteriorate both as a result of its capital resources being depleted by impairment provisioning and value adjustments as well as a result of its minimum capital requirements increasing through increased risk weights and RWAs. As the risk-based ratios and leverage ratio are not likely to move symmetrically in a stress it would not be appropriate for the size of any leverage conservation buffer to be the same proportion of the leverage minimum requirement as for the risk-weighted requirements. The appropriate calibration of a leverage conservation buffer will, therefore, need to be investigated.

  Secondly, the leverage ratio is already a countercyclical measure. When the economy is strong the bank's balance sheet grows with the result that the leverage ratio requirement increases, serving as a brake upon excessive growth. It is not necessary, therefore, to introduce a leverage countercyclical buffer (Please refer to the answer to questions eight and nine for further details).

- ***Eligible capital;***

  We recognize and support the FPC's aim to ensure that the capital framework is underpinned by loss absorbing capital. However, the leverage ratio and the risk based capital framework, whilst complementary, are not the same and therefore should not necessarily have the same measure of eligible capital. The exposure measure that is used in the leverage ratio is not a representative measure of the losses that would be incurred in the event of a firm failure and therefore the capital measure does not need to be the highest quality loss absorbing capital. The leverage ratio's primary aim is to constrain individual firm and system-wide leverage, and we believe that this aim can be achieved by using the internationally agreed measure of eligible capital, Tier 1. Using a narrower definition of eligible capital than the international standards is not warranted.

Within the UK, the PRA already require eligible AT1 capital instruments to contain a conversion / write-down trigger at a level that would be prior to the point of non-viability. A 7% CET1 trigger has become the norm. Consequently we can see no reason to require the leverage ratio minimum to be covered entirely by CET1 capital as AT1 instruments would be expected to convert before the bank reaches the point of non-viability.

Requiring the minimum leverage ratio component to be met by at least 75% CET1 would be a symmetrical approach to the risk-based ratio requirements but would be another departure from the simplicity principle. We believe that the additional capital required to meet any incremental buffers could be met with capital or debt instruments which have demonstrable loss absorbing capacity. The eligible capital should as a minimum be consistent with the EBA's review of the EU framework that is due in 2017.

- ***The level of application; and***

As stated in the FPC paper, capital requirements at the consolidated level determine how much capital needs to be held against a group's balance sheet – which we note aligns with the objective of the leverage ratio – whereas individual entity level capital requirements affect the allocation of capital to specific parts of a group.

The argument provided in the FPC paper in favour of applying entity level LR requirements is that FPC's objective in applying a time-varying leverage ratio may otherwise be undermined. We do not believe that this is sufficient justification to apply onerous entity level requirements. Particularly, given that there are a number of other practical and conceptual issues which will undermine the effectiveness of the time-varying leverage ratio (some of these issues are discussed in Q8 & Q9).

The application of any additional leverage measures by the FPC across international groups needs to be carefully judged. The UK is a global financial centre with a diverse population of institutions that may be affected in different ways depending on their business model, risk profile and international footprint. We believe that FPC should focus on the financial stability of the UK and should not define leverage ratio requirements which could be considered extraterritorial.

We recognize and support the Bank of England's efforts to agree standards at the international level including, for example, the Basel Committee agreement on a common definition of the leverage ratio. We recommend that Bank of England continues these efforts with respect to the scope of application. The introduction of UK leverage ratio requirements that are inconsistent with global standards contribute to an uneven playing field. This will create undesirable incentives for regulatory arbitrage. Therefore we would strongly recommend that introduction of changes to the UK leverage ratio requirements should only be introduced in line with, and at pace with, changes to global level ratio standards.

The application of leverage requirements to granular levels within a group would be another significant departure from the principle of simplicity and may result in the mobility of capital and transfer of risk within the group structure being constrained. One of the clear advantages of a group structure is the ability to use group shared resources in a flexible way and to manage risk efficiently. The most efficient approach is to hold the capital surplus above the required minima at the group level, and for risk it is most efficient to house similar offsetting risks centrally. If a framework of regulatory leverage buffers is introduced at the individual entity level within the group then that will constrain the free flow of surplus capital and the efficiency of centralized risk management. The industry believes that the result,

trapping capital in smaller pockets within the group structure, will lead to increasing the risk of failure occurring somewhere within the group.

We note that the scope and level of application is also affected by the measure of exposure used in the leverage ratio denominator. Whilst we acknowledge that FPC will use the CRR definition of exposure we believe that this needs to be amended to ensure it is a fair and accurate measure of leverage for the global financial institutions that operate in the UK.

The European Commission Delegated Act on the leverage ratio, amending article 429 of CRR, recognizes concerns about the impact of including intra-group transactions in the exposure measure of the leverage ratio. The Commission Delegated Act cites that these concerns include the impact on internal refinancing operations between a parent company and its affiliates; derivatives operations between the group's investment bank and other entities of the group; and financial guarantees.

To rectify this issue the Delegated Act proposes to exclude certain intra-group transactions - as long as the intra-group exposure is to an entity within the same Member State. The industry believes all intra-group transactions should be excluded from the leverage ratio, provided the solo-entity and its related counterparties are part of a group that is covered by equivalent supervision on a consolidated basis, and subject to the permission of the National Competent Authority.

There should be consistent treatment of all intra-group transactions, without distinguishing between entities in the same group but established in different jurisdictions. The principle remains the same for all intra-group transactions, and banks should not be discriminated against on the basis of their place of domicile or funding structure. We understand that this is a change that would require an amendment to the Commission Delegated Act before it is adopted.

- ***The scope to which the framework is applied.***

  The issue of scope overlaps with the issue of calibration and the design of the leverage ratio as a back stop measure. With a minimum of 3% and in the absence of any regulatory buffers as suggested by BCBS, the application uniformly to all banks and building societies makes sense as the leverage ratio is designed to be non risk-based and so it would be inappropriate for the calibration to vary with the level of risk in a firm. The leverage ratio would then genuinely serve as a simple non risk-based back-stop measure.

  With a higher combination of minimum and buffers the ratio is likely to depart from being a genuine back-stop and impact a higher proportion of firms in particular those with low risk profiles. The range of firms to which this framework would be applied and timing of implementation would need careful consideration given the potential impact on affected firms business models. We note that the impact of the Leverage Ratio on low risk business models is an area the Basel Committee and the EU will be reviewing prior to implementation of their ultimate Leverage Ratio frameworks.

Question 4: What are your views on the remaining design elements discussed in Chapter 3, in particular regarding the interaction between Pillar 2 and the leverage ratio, including for pension risks, and transitional arrangements, including coverage of only the large UK banks and building societies?

Pillar 2 should not be used to increase capital charges for additional risks because the leverage ratio is intended to be a simple, non-risk based measure. For example, it would be inappropriate to make a non-risk based Pillar 2 adjustment to the leverage ratio for pension risk, differentiating between a bank with a defined benefit

pension scheme and identical bank without a defined benefit pension scheme but which has higher remuneration levels.

Supervisory discretion may be appropriate, however, to adjust for non-risk based factors outside a bank's control. For example, a bank may have a sudden and temporary influx of customer deposits during times of market stress, which increases the balance sheet and places pressure on the leverage ratio constraint. Because these customer deposits are temporary, the bank places them at central banks or in other highly liquid, low-risk assets as a matter of prudent liquidity management. Banks should not be penalized by the leverage ratio for such sudden deposit influxes due to factors outside of their control or for placing these customer deposits in a prudent way.

We welcome the transitional arrangements, which we recommend should follow the international timeframe and developments. The transition should allow the FPC to better evaluate the effects of the leverage ratio on bank behavior.

Question 5: What are your views on the impact on different business models of a "baseline" requirement in a steady state?

We believe it is very important to preserve diversity and specialization in the financial system. As the FPC recognised, banks bound by the leverage ratio tend to shift into higher-risk, higher-yielding assets. While some banks diversify among lower-risk assets and higher-risk assets, others focus almost exclusively on lower-risk assets. Some banks focus on capital market activities such as client intermediation and repo. Still other banks are driven by services/liabilities and not assets at all, such as custody, payment, and settlement banks. The leverage ratio could cause some of these business models to be challenging and compel significant business model changes. The impact of this would be a reduction in diversity in the financial system, with associated increases in systemic risks.

To balance these divergences in business models and risk appetites with the FPC's concerns about tail risk, model risk, and complexity, the leverage ratio should be calibrated to preserve the diversity and specialization in the financial system. We believe that it is important to understand the impacts of supplementary leverage buffers to particular types of business models and what the wider market impacts are likely to be. In this context, we understand that the EBA is investigating the extent to which the leverage ratio calibration should vary according to business model.

Custody banks

As an example of such activity, custody, payment, and settlement banks hold a high proportion of cash at central banks. Customers use these banks for their custody, payment, and settlement services, and leave cash deposits with the bank to facilitate these services. Banks typically place these customer deposits at central banks to manage intraday liquidity and to prevent payments bottlenecks. Thus, these banks' balance sheets grow because of customer deposits that are a by-product of the services they provide, not because of asset growth or "leverage."

This low risk asset-liability management strategy is prudent because cash at central banks is the most basic, riskless asset a bank can hold. Cash deposits are not subject to tail risk, credit risk, interest rate risk, and if held in local currency, foreign exchange risk. Cash deposits are not modelled using complex formulas or netted, nor can cash deposits at central banks be re-hypothecated or re-used. Nonetheless, this cash is subject to the same leverage capital charge as assets with much higher yields. The leverage ratio thus could make a low risk, highly liquid business model particularly challenging. These custody

banks may be forced to seek more credit risk assets to manage capital and ROI to the leverage ratio, causing them to change their risk management approach and/or adjust their business model, putting pressure on their risk appetite.

Broker dealers

We are concerned that a significantly higher leverage constraint is particularly harmful for broker dealers. A typical broker dealer holds a significant proportion of their assets in cash and cash equivalents in order to settle transactions, meet daily obligations and to manage liquidity risk. A higher leverage ratio would have an impact on most business lines as liquidity and margin management costs would increase substantially. Similarly, other broker dealer balance sheet categories (SFTs, receivables) that mainly relate to client intermediation, financing, trade execution and clearing activities would be significantly impacted by higher LR requirements. In our view, higher leverage ratio requirement run counter to the regulatory imperative of central clearing and would disincentivise the provision of lower risk fee-based clearing services; significantly increase end-user clearing costs (in particular pension funds and insurance companies); and promote increased systemic risk by reducing the likelihood of portability, especially in a stressed scenario. A higher LR requirement would directly reduce incentives for banks to provide clearing and execution services and it would increase the end-user pricing of these important products. The increase in capital requirements for fair value assets and SFTs (for example from a risk based 1 -20 bps to > 300 bps based on LR on a government repo) is also likely to reduce the capacity and increase costs of primary issuance and secondary market making, increasing market volatility (especially during stressed conditions) and bid/offer spreads. Such an outcome would have unprecedented impacts on financial markets and liquidity of all securities.

Bearing this in mind, we can already see that large investment and wholesale banks are retreating from the multitrillion dollar repo market that the short term liquidity of the financial markets depends on. This is a direct consequence of the leverage rules and the impacts on the overall volatility of the market can be drastic, especially when the exceptional central bank facilities are wound down and interest rates start rising. We also anticipate that if inter-bank dealers reduce their collateralized financing capacity, central banks' repo facilities will become permanently necessary components for the functioning of the capital markets.

These are just broad examples of the potentially unintended effects of the leverage ratio on different business models, if leverage buffers are applied universally. Banks cannot adapt business models overnight without significant disruption to the provision of credit and services to the economy. On a systemic level, we are concerned that a shift from risk based capital ratios to a non risk based measure would lead to greater homogeneity in bank asset bases and further to more similar business models across the wider banking system.

Therefore, we would strongly recommend that there is a sufficient transitional phase – referred to in the FPC paper – which would allow bank business models to adapt to the new normal. To the extent that any buffers are included, we would recommend that buffers are not applied before 2018 when the internationally binding leverage ratio requirements are expected to come into force and it will be clear how the rules are implemented to different business models in Europe. It would seem counter-intuitive from a macro economic perspective for the MPC to keep interest rates low due to headwinds that are facing the UK economy whilst the FPC hampers the provision of credit and services to the economy by requiring banks to comply with LR rules on an accelerated timeline.

We urge the FPC to further analyze the impact of a leverage ratio on different business models and the resulting impact on the financial system and we would be willing to review the assumptions within the FPC's modelling of the interaction between these drivers.

Question 6: Do you agree with the considerations regarding a supplementary leverage ratio component for G-SIBs and RFBs?

As mentioned earlier in our response, we would prefer that the FPC allows the EBA to complete its analysis of LR requirements for different business models before concluding that additional buffers relating to particular types of banks are required. We would also argue that the effect of leverage on the system does not become worse because of the size or nature of the entity which generates it. . Adding a buffer for G-SIBs and RFBs would create additional cost, because of the higher capital requirement. This effectively represents a further tax on size for G-SIBs, or on business model for RFBs. In this way, the buffer approach for GSIBs would create a competitive disadvantage.

We recognise the US application of a GSIB supplementary leverage ratio is in train and that this may be a consideration for the FPC. We would strongly recommend that any such proposal with potentially far reaching international consequences should be thoroughly considered in the appropriate international fora. Moreover, consideration should be given to whether supplementary buffers should be applied to entities whose UK business is already captured by similar buffers in other regimes.

Differences in opportunities available to banks to improve their ratios need to be taken into account. EU based GSIB balance sheets (and likely RFB too) hold significant volumes of low risk mortgage assets which cannot easily be reduced, whereas US banks can to a significant extent use securitisation by the US Agencies to reduce exposures. We note and support the recent efforts by the Bank of England and ECB to decide how to develop and rebuild a viable securitisation infrastructure in Europe. Such liquidity backstopped EU securitisation agency or process should be fully operational before higher levels of leverage constraint could be safely contemplated for either GSIBs or RFBs.

Some banks may have an incentive to reduce average risk weights in the absence of a leverage ratio and whereas some, like the RFBs, have lower average risk weights because they have conservative business models, and a lower risk portfolio. The application of a supplementary leverage ratio would disproportionally penalise RFBs which by their nature and design are more conservative and have a lower risk profile. A higher supplementary leverage ratio for RFBs could also create adverse incentives to increase their riskiness.

RFBs are also intended to be simpler business models, and will therefore be subject to less model risk. Supervisory reviews of risk-weighted models and stress tests of RFB portfolios will provide sufficient reassurance that the risk weighted requirements were suitable and would enable a targeted approach to addressing specific instances of model risk.

In the consultation paper there is a strong presumption that GSIBs are not holding sufficient capital and therefore should always be bound by the leverage ratio. Without any calibration, it is very difficult to conclude that GSIBs would be subject to less onerous requirements than non-systemic firms if the leverage ratio isn't symmetrically increased. GSIBs will be subject to significantly higher capital requirements under the risk weighted regime, especially if Pillar II requirements are included in the calculation.

Question 7: Do you agree that it would be desirable to scale up the leverage ratio in proportion to the supplementary risk-weighted buffer for G-SIBs and RFBs, with a presumption of symmetry?

We do not agree that the leverage ratio should be scaled up for systemic firms or for those which have a different business models, such as RFBs. We believe that the entire structure proposed represents a sea change, from the use of leverage as a "back stop" or even secondary "lens" to a driving and governing variable.

If applied as proposed, it would recalibrate the consumption of capital by firms and, if it were to be the driving factor (as is clearly anticipated through the scaling approach), assets with little risk would be penalised and those with high risk would be treated too softly.

The approach also implies that different assets should be more expensive and give a lower return for larger or ring fenced banks than for others. This would not only create level playing field issues, but also price fragmentation for even the simplest assets - with those constrained by higher leverage pricing quite differently from those with lower requirements.

We note that the leverage ratio is described as addressing model risks and tail events, neither of which are more relevant to RFBs or GSIBs than to any other types of banks. The historical evidence from banking crises indicates that often the crisis starts from smaller and narrow-scope banks and subsequently spreads into larger and more diversified banks. Therefore, for the purposes of financial stability, comparability and simplicity, a simple leverage ratio alone should apply in a consistent manner across all firms.

If a leverage ratio is introduced for globally systemic banks in the UK, it is essential that this is aligned with international developments. We would urge the FPC to ensure that any measures with international reach such as this are discussed and universal standards promulgated before application. We note that although it breaches this principle, the US unilateral introduction of a supplementary ratio for GSIBs does not come into force until 2018. We would also strongly recommend that the FPC does not "front-run" the internationally agreed timeline, which allows for a period of observation, prior to a binding requirement entering into force.

Question 8: Do you agree with the desirability of being able to vary the leverage ratio requirement in the same way as risk-weighted requirements can be varied through the countercyclical buffer?

AFME does not agree with varying of the leverage ratio requirements in the same way the countercyclical buffer is applied to the risk-weighted framework. We believe there are fundamental conceptual and practical issues which will undermine its effectiveness as a macro-prudential tool.

One of the principle advantages of the leverage ratio is its simplicity. A time-varying ratio would erode much of that advantage and impact market confidence. As the leverage ratio is set in proportion to exposures regardless of their risk it is not suitable for targeting risks. It would replace one type of model risk - arising from banks' internal models - with another i.e. macro-prudential modelling, which we believe that the FPC would acknowledge is still at a very early stage of development. We are therefore concerned that the market impact of a time varying ratio is not well understood, perhaps risking unintended feedback as participants adjust leverage in response to policy.

The Bank of England's discussion paper on instruments of macro-prudential policy[3] sets out the rationale for the risk weighted countercyclical buffer: "*Countercyclical capital buffers are intended to build resilience in the upswing, which should help to moderate the economic cycle. When credit growth and excessive leverage are judged to be endangering resilience looking ahead, the FPC would gradually increase capital requirements across the banking system as a whole, or part of it, to enhance resilience. That would provide incentives for banks to move back towards prudent lending and reduce leverage.*" This is elaborated in the FPC's policy statement[4], which states that a countercyclical buffer *"provides incentives for banks to rein in excessive or underpriced exposures, which might reduce the extent of losses when boom turns to bust."*

[3] Instruments of macro-prudential policy (Dec 2011) http://www.bankofengland.co.uk/publications/Documents/other/financialstability/discussionpaper111220.pdf
[4] The Financial Policy Committee's powers to supplement capital requirements (Jan 2014), http://www.bankofengland.co.uk/financialstability/Documents/fpc/policystatement140113.pdf

The leverage ratio is already a countercyclical measure. When the economy is strong the bank's balance sheet grows with the result that the leverage ratio requirement increases serving as a brake upon excessive growth. It is not necessary, therefore, to introduce a leverage countercyclical buffer.

We are also concerned that a countercyclical leverage buffer would produce undesirable incentives. As a bank's leverage ratio could be improved by increasing capital or by reducing the size of the balance sheet, given that capital raising takes time, banks are more likely to reduce leverage by offloading or reducing assets. If a counter-cyclical buffer was applied across the industry, all firms would be seeking to reduce assets at the same time. For assets which cannot be readily packaged and sold, such as loans, this means banks would be incentivized to stop lending to the economy. This is the intended outcome of a countercyclical buffer but - unlike a risk-based countercyclical buffer - a leverage countercyclical buffer perversely incentives firms to stop lending to "good" low-risk obligors and to increase lending to higher risk obligors. This is because both types of borrowers have the same impact of the leverage ratio but lending to higher risk borrowers would generate higher returns on capital. We are concerned that the functioning of a leverage ratio countercyclical buffer will not *provide incentives for banks to move back towards prudent lending and reduce leverage,* which the FPC expects a countercyclical buffer to do. It will undermine the performance of the real economy by artificially incentivising banks to constrain lending to lower risk obligors. This is another reason why the leverage ratio is not suitable for targeting risks.

We also believe there may be practical challenges to the application of a countercyclical buffer. Under the UK's implementation of CRD IV, the FPC does not have power to set a counter-cyclical buffer in the risk based framework for an EEA state, or exposures located in an EEA state, other than the UK. (FPC may, however, recognize a buffer set by another EEA State.)[5] If the FPC was to vary the leverage ratio requirement in the same way as risk-weighted requirements through a countercyclical buffer it is unclear what powers FPC would have to impose leverage ratio requirements on 1) banks of other EEA member states lending to UK borrowers via branches or 2) UK banks' exposures in other EEA member states. With these limitations a countercyclical buffer would simply be a tax on UK banks lending to UK customers.

Question 9: Do you agree that, as a guiding principle, the leverage ratio should vary in proportion to the risk-weighted countercyclical buffer?

The industry does not support the proposition that the leverage ratio should, as a guiding principle, vary in proportion to the risk-weighted counter-cyclical buffer. A correctly calibrated baseline leverage ratio should act as an automatic counterbalance to the pro-cyclicality inherent in risk-weighting models. As risk weights decline in an upswing, the leverage ratio would become more of a constraint, reversing as risk weights rise in a downturn.

We see a significant risk in linking and varying the leverage ratio in proportion to the risk-weighted countercyclical buffer.

While international guidance states that the credit-to-GDP gap should be the leading indicator when setting the risk based countercyclical buffer, we note that the FPC has raised concerns with the performance of this indicator[6] and the consequences of placing too much reliance on it. The FPC Policy papers states that: *"the measure may […], be a poor indicator of the possible need to reduce the CCB in the face of deteriorating credit*

[5] FSMA 2014 No. 894, The Capital Requirements Regulations 2014 (Capital Buffers and Macro-prudential Measures), Part 3, Chapter 1-3, http://www.legislation.gov.uk/uksi/2014/894/pdfs/uksi_20140894_en.pdf

[6] The Financial Policy Committee's powers to supplement capital requirements (Jan 2014), http://www.bankofengland.co.uk/financialstability/Documents/fpc/policystatement140113.pdf

conditions as it typically continues to increase at the onset of a crisis. In particular, while GDP might decline rapidly, the stock of credit can be slow to fall, especially if companies draw on credit lines previously provided by financial institutions", furthermore, FPC states that *"the indicator may also be sensitive to the way the trend is computed which could limit its reliability."*

As stated in the sections above, we believe that the countercyclical leverage ratio buffer is a flawed concept. However, if the FPC chose to proceed with implementing such buffers to the LR measure, we would strongly advise against linking it to the risk based countercyclical buffer due to the aforementioned impacts on the wider market capacity and availability of products that are key components of a healthy and liquid financial market. We believe that while there is uncertainty on the implementation and economic effects of the risk based countercyclical buffer – in part due to the potentially misleading or unreliable nature of the chosen indicators - it would be misguided to link the countercyclical leverage ratio to the risk based measure. FPC should collect data on the internationally agreed definition of the leverage ratio, which has yet to be finalized, and compare to a range of indicators before determining how a countercyclical leverage ratio buffer should be calibrated and applied to products and business lines.

The asymmetrical nature of the FPC's countercyclical tools, and the problems with identifying the peak of the cycle, would also lead us to recommend that a link between the leverage ratio and the risk-weighted countercyclical capital buffer should not be established.

Question 10: Do you have any views on the cost-benefit analysis considerations?

In our view, so far the regulatory community has not assessed or quantified the impacts of much more binding LRs and how the market structures, including product pricing and availability, may change as a consequence if banks significantly withdraw capacity from product segments and restructure their balance sheets.

We also believe that given the still ongoing regulatory overhaul and the changes that are already in the pipeline, it is difficult to assess what the incremental benefits are from using the Leverage Ratio framework to address modelling errors and unforeseeable events.

We note that the reforms introduced (broader increase in risk-weighted capital, improvements to liquidity, structural measures) have already claimed large benefits arising from reductions in the probability and severity of banking crises. Any assessment on the benefits of additional leverage ratio requirements needs to rigorously assess the incremental benefits[7]. We note that the BCBS paper (2010) cited in the consultation finds that, assuming moderate permanent effects and an improvement in liquidity, the net benefits of incremental capital are modest beyond a 10% tangible common equity to risk-weighted assets ratio and diminish beyond 13%. We would therefore urge that care must be taken not to overstate the benefits.

[7] There has been a distressing tendency in official sector cost-benefit analyses to ascribe the estimated benefits of the entire post-2008 FSB reform agenda to each individual measure in turn, while only measuring the specific costs of that measure.

afme/
Finance for Europe

ISDA. Safe, Efficient Markets

AFME contacts

Jouni Aaltonen, jouni.aaltonen@afme.eu +44 (0)20 7743 9325

ISDA Contacts

Panagiotis Dionysopoulos, pdionysopoulos@isda.org +44 (0)20 3088 3515

Published:

12 September 2014