Position Paper

CRD 5: Leverage ratio

May 2018

1. Overview

AFME and ISDA (the Industry) continue to support introducing the leverage ratio 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 Basel Committee on Banking Supervision's (BCBS) agreed leverage framework. While many areas of the framework are well understood and complete, the BCBS has yet to finalise its revisions to some aspects of the framework. These revisions could impact the leverage based capital requirements for G-SIBs and how the exposure measure is calculated for certain exposures.

The main objectives of the revisions to the exposure measure are to reduce variance between banks' by harmonising the calculation where accounting assets diverge between different standards. In some areas the Commission's proposal, anticipates outcomes from the international discussions and in others it does not address important issues that can be detrimental to functioning of the financial markets or add unnecessary costs to end-users.

We welcome the sensible provisions to reduce variance between accounting standards and enhance the framework on areas such as exposures on unsettled trades, recognition of significant risk transfer for sold securitisations and recognition of initial margin for cleared derivatives. These changes benefit the end-users by lowering transaction costs as well as by improving the functioning of the EU capital markets without sacrificing safety and soundness. We make further recommendations below that are aligned with the industry views on the BCBS consultation and where the BCBS standard should be improved or recalibrated before implementation.

In addition, there are EU specific considerations relating to the nature of the European financial structures that need to be considered in the calibration of the leverage ratio and in the way the requirements are applied on a legal entity rather than on the consolidated level for which the BCBS rules are designed.

Finally, there is an inconsistent reference in the article three implementation date. While the revisions to the exposure measure and scope come into force two years after the final CRR is published, the new article three, would result in LR implementation in January 2019. Our key policy priority areas are set out below, with additional priority issues and technical amendments in the main body and in the annex:

1. Central bank deposits should be excluded from the exposure measure to avoid unnecessarily trapping capital that could be deployed to financing the economy;
2. The scope of intra-group transactions should be expanded to reflect supervisory and resolvability consolidations;
3. We support a 3% LR Tier1 calibration for all banks, with a G-SII buffer aligned with the final BCBS standards, applied in 2022. This buffer should be set at the highest EU consolidation of the banking group;
4. We oppose including an O-SII capital buffers without an impact assessment. Such buffers are not aligned with the BCBS standard and would create an un-level playing field;
5. We oppose introducing countercyclical capital buffers for leverage ratio;
6. Variation Margin – Allow the recognition of cash and Level 1 HQLA variation margin as collateral for purposes of calculating the LR's replacement cost; and
7. The RC of derivative exposures including the alpha factor should be excluded from the exposure measure.

2. Scope: Leverage ratio, macro-prudential concerns and EU application

New regulation was essential to address key contributors to the financial crisis such as overreliance on short term wholesale funding, excessive leverage in the financial system and inadequate capital levels. Banks and the broader financial system are significantly safer and sounder today as a result of reforms implemented in the wake of the crisis, including the leverage and funding rules.

However, the incentives created by the regulation have significant implications for capital markets activity and the leverage ratio and NSFR in particular weigh heavily on low-risk assets like cash and government securities. These assets are used as collateral for central clearing and other financing transactions by market participants and as liquidity reserves by small and large banks. Thus, they play a critical role in the smooth functioning of financial markets. If market participants' ability to generate liquidity through these assets is impaired, or they cannot deposit cash with a bank that is constrained by the LR, particularly during stress periods, it will have negative ramifications to the functioning of financial markets.

Similarly, we are concerned that the cumulative impact of regulation on capital markets intermediation by wholesale banks will further reduce end-users' ability to transact, particularly during stressed market conditions. In many markets, banks remain central to wholesale transactions, and restrictions on their intermediation capacity will necessarily affect their clients' ability to execute trades. Lower liquidity and lack of immediacy facilitated by wholesale banks can result in sharper price dislocations.

To address these issues, we make two recommendations that should be adopted in the BCBS as well as EU LR rules. Additionally, to improve the flow of capital across the Single Market, we make a further recommendation regarding the EU specific legal entity level leverage ratio requirements.

Central bank deposits should be excluded from the leverage exposure measure to ensure the smooth functioning of markets

The LR is an important component of the post-crisis regulatory regime. However, two technical revisions are warranted in the international framework, firstly in the form of exclusions for central bank deposits as there is no direct benefit to allocating capital towards them. They cannot contribute to leverage at a bank or system-wide level because central bank deposits, as the ultimate settlement asset and unit in which banking assets and liabilities are denominated, are by definition (assuming no currency mismatch) entirely risk-free from both capital and liquidity perspectives. The inclusion of central bank cash balances in the leverage exposure affects the ability of the banking system to cushion shocks, take on client deposits and to draw on central bank liquidity facilities as necessary to maintain the supply of credit and support for market functioning, including in times of stress. Moreover, the effectiveness of monetary policy could be reduced if central banks' transactions with banks attract significant capital charges.

Intra-group exposure exemptions should be extended to include all intra-group 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. Intra-group trades are thus used to pass risk from one entity to another to consolidate the risks in one place; they cannot contribute to system-wide leverage. The CRR proposal would allow supervisors to permit intra-group exposures in a single EU Member State to be deducted from the leverage ratio exposure measure but would, conversely, require the mandatory inclusion of cross border intragroup exposures in that measure.

In the industry's view, there is no justification for an 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 financing without any underlying increase of leverage.

The CRR proposal recognises the interaction between internal TLAC and MREL and the prudential framework by providing for a blanket exemption for all own funds and eligible liabilities items from any large exposures limits that may otherwise apply without supervisory discretion. A symmetrical approach should be taken for the leverage (and risk-based) exposure measure, in which all internal TLAC and MREL items provided are exempted automatically. We also recommend that there be, at a minimum, a possibility to exempt other intra-group exposures to entities in other Member States as well as in other jurisdictions which apply prudential supervision equivalent to the CRR.

3. Calibration: Leverage ratio in the EU

Calibration: alignment with the global rules

Generally, AFME and ISDA support the objectives behind and the changes proposed by the BCBS. It is important that banks operating under different accounting standards have the same LR exposures for prudential purposes and that the LR exposure measure reflects true leverage rather than artificially inflated exposures pertinent to other than prudential objectives in the accounting standards. However, there are a few areas where we do not agree with the proposals made by the BCBS and what has been similarly put forward by the Commission.

We support a 3% LR Tier 1 calibration for all banks, with a G-SII buffer aligned with the final BCBS standards, applied in 2022. This buffer should be set at the highest EU consolidation of the banking group

We do not support deviating from the global BCBS standard and the risk-based framework, limiting the range of capital structures that can be used to meet the ratio. Allowing only CET1 capital in the denominator could lead to much more binding capital ratios for banks that have ownership models that make it difficult to issue equity capital and who rely more on AT1 instruments.

Additionally, we strongly support aligning the introduction of the G-SIB buffer with the Basel timeline and at the highest EU consolidation of the banking group. This is to avoid negative impacts at legal entity level, whereby some low risk but high-volume activities (such as clearing) would be unduly penalised.

For the purposes of the leverage ratio, the replacement cost of derivative exposures should not be subject to the alpha factor as currently carried across from the new SA-CCR

Although the leverage ratio is a non-risk based and balance sheet aligned backstop measure the measurement of exposure for derivatives has always included an element of risk based calculation to reflect the volatility in fair values (PFE). AFME and ISDA support this principle in general, and specifically support maintaining the alignment between credit risk and leverage calculation for PFE by using the new SA-CCR.

Conversely, the current fair value, or replacement cost (RC) element of derivative exposures is already captured in the balance sheet as a mark to market (MtM) receivable. The treatment in the existing CRR to adjust for inconsistencies in accounting standards by recognising legally enforceable netting and variation margin is prudent and in line with both the design principles of the leverage ratio and economic reality. The treatment in CRD5/CRR2 to further adjust RC by applying an alpha factor of 1.4x is not, and creates a situation whereby a balance sheet receivable is not included at balance sheet value without a good reason.

Inflating the balance sheet exposure for derivatives in this way will increase cost of hedging for end users in the real economy, notably corporates, pension funds and sovereigns who are less likely to margin their hedging positions. The industry therefore believes that the alpha factor should not apply to the RC element of leverage exposure on derivatives. RC should rather reflect the on-balance sheet exposure, consistent with the treatment of loans, overdrafts, securities or any other balance sheet exposure.

The RC of derivative exposures should be excluded from the new SA-CCR. A new measure should be based on the accounting treatment of on balance sheet items before any netting (so called gross positions) and adjusted with the appropriate netting rules allowing an even playing field, whatever is the firm specific accounting framework (e.g. IFRS vs US GAAP).

Recognise high quality liquid assets (HQLAs) as eligible variation margin (VM)
Banks' inability to offset the replacement cost in OTC derivatives exposures with HQLAs received as VM incentivises banks to request cash VM from their counterparties, including those clients who would typically post HQLA as VM. Without changes to the way these cash equivalent assets are treated in the LR exposure measure, pension funds and other end-users that rely on the ability to post securities as collateral, will instead post cash as VM, or be shut out of the derivatives market. This goes against the policy objective reached by European policymakers for EMIR and CRR under which corporates and pension funds should not be forced to post cash margin, and the non-centrally cleared derivatives markets should remain workable for them to continue to hedge at an acceptable cost.

For example, pension funds do not generally have access to or hold the necessary levels of cash, meaning their derivatives exposures will either be unmargined, or they pay to borrow cash through a repo transaction which also attracts higher costs due to the leverage ratio requirements on repos with banks. This will ultimately increase the cost of services they provide to investors, or leave them exposed to additional risks.

<u>Other key areas where revisions would enhance the LR standard:</u>

Open repo transactions that meet relevant criteria should be treated as having a specific maturity
We propose that Recital 7 of the Delegated Act should be maintained. SFT transactions that can be terminated at any day subject to an agreed recall notice period should be considered equivalent to having an explicit maturity equal to the recall notice period and the 'same explicit final settlement date' should be deemed to be met so that such transactions are eligible for the netting of cash receivables and payables of repurchase transactions and reverse repurchase transactions with the same counterparty.

Treatment of Cash Pooling arrangements
Banks offer a variety of cash pooling arrangements and we appreciate that the treatment of cash pooling arrangements has now been included in the Leverage Ratio rules. Divergences in accounting treatment have led to different views on Leverage Ratio treatment within Europe as well as globally. Hence the main intention of the rules should be to create a global level playing field. We welcome the proposal to treat the balances arising from certain cash pooling arrangements on a netted basis rather than gross. We would however suggest to add some clarifications to the wording to further refine the proposal.

Firstly, there are cases where a client does not want the balances on the accounts to be zero but another pre-agreed target balance. This is based on client specific requirements to fit their organisational policies that should not be penalised by a regulatory outcome that is beneficial from a cost perspective only if the client sets the target balance to zero.

Also, it's common that the resulting balance after 'zero-balancing' all participating accounts is not transferred to a separate, single account as mentioned in the proposal but rather stays with the target account which is usually owned by the parent company. We suggest clarifying that the end balance will be transferred to 'one account'.

Although in most cases, balances are transferred daily, there may be customers who prefer for example a weekly transfer. Therefore, the proposal should be amended to instead of "daily" to use "regularly" to avoid undue complications for bank clients that are managing their cash with set operational and business practices.

Treatment of optionality on credit derivatives

Pursuant to Art. 429d(2) written protection may be offset against purchased protection where the purchased protection, amongst others, is subject to the same or more conservative material terms as those of the written credit derivative. Material terms means any characteristic that is relevant for the valuation of the credit default swap (CDS) and, amongst others, includes optionality.

Where protection is bought, or sold through options on CDS, additional guidance on the determination of the effective notional is required. In this respect the industry proposes to use the methodology for SA-CCR purposes i.e. to use the product of the Adjusted Notional and the supervisory delta. Using the notional of the underlying CDS – without the supervisory delta - would significantly overstate the leverage exposure.

The industry is also of the view that protection bought through options may be used to offset against both protection sold via options as well as protection sold directly and independent of whether the options have been exercised. In case of off-set of option against option the strike of the purchased protection must be lower than or equal that of the sold protection, and the maturity of the bought protection option must be equal to or longer than the maturity of the sold protection option

4. Deviations from the BCBS rules

Treatment of undrawn commitments

The Article 429 (5a) states that any derivative instrument that is considered off-balance sheet item but is treated as derivative in accordance with the applicable accounting framework, shall be subject to treatment as set out in Article 429(b), i.e. as derivative exposure.

It is not clear what is meant by “derivative instrument that is considered off-balance sheet item”, and no further definition or clarification has been provided. As a results our members expect difficulties in implementing the new rule.

While we generally support alignment with the accounting in determination of the leverage exposure, it is important that the rules remain GAAP neutral and do not create un-level playing field for reporters under different accounting frameworks. For example, certain off-balance sheet loan commitments held for trading may be treated as derivatives under IFRS. However, under other local accounting frameworks (for example, US GAAP) these are generally reported as off-balance sheet commitments in accordance the legal form. Given diversity in accounting treatment for certain off-balance sheet items, the new provisions under Article 429(5) may be more punitive for IFRS reporters and we do not believe this was the intention of the commission.

We would like to have more clarity on what type of derivatives that are also considered off-balance sheet items the new rules were intended to address. If the accounting treatment for such items is different between various accounting framework, we would recommend to remove the Article to maintain a level playing field for reporters under IFRS and other local GAAP.

In addition, we would not expect loan commitments or other similar off-BS items to be subject to SA-CCR and such treatment may be extremely difficult to implement.

Contacts

AFME London:
Jouni Aaltonen, jouni.aaltonen@afme.eu
+44 (0)20 3828 2671

AFME Brussels:
Stefano Mazzocchi, stefano.mazzocchi@afme.eu
+32 (0)2 788 3972

Contacts

ISDA London:
Olivier Miart, omiart@isda.org
+44 (0)20 3808 9735

ISDA Brussels:
Roger Cogan, rcogan@isda.org
+32 (0) 2 4018760

About AFME

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

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 66 countries. These members comprise a broad range of 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, such as exchanges, intermediaries, clearing houses 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 website: www.isda.org.