



EBF response to the BCBS consultation on the revision to the Basel III leverage ratio framework

1- General comments

The European Banking Federation welcomes the opportunity to respond to the BCBS consultative document on the revisions to the Basel III leverage ratio framework.

Overall, European banks are supportive of the division of the risk-based framework that has been in place for over 25 years. The leverage ratio had its rationale in the “good old days” but its effect and value today is relatively modest and could not pretend to be an accurate reflection or test of the leverage level of the economy. Unfortunately, in light of certain conceptual flaws in the leverage ratio, very few demonstrations have been convincingly made of its ability to maintain the leverage of the economy within a range compatible with financial stability, in particular in jurisdictions where it has been in force for many years (including pre-crisis) such as the US. Consequently, we consider that the leverage ratio must remain a backstop measure.

The usage and application of the leverage ratio should always take into account the banking business mix, the structure of the financial markets concerned, the level of intermediation and the existence of actors absorbing part of banks’ off-balance sheets. It needs therefore to be carefully interpreted by local regulators and supervisors, as well as by the Basel Committee in conjunction with other indicators before any conclusion can be drawn and the constituent parts of the test agreed.

For this reason we believe that the “crude and neutral” proposed definition that has been proposed should only be conceived as an ultimate safety net as, unless it is read in conjunction with other key risk indicators, it can be misinterpreted and in the end be completely misleading for the market. Taming excessive leverage may be legitimate in certain circumstances but cannot be achieved solely through a single banking ratio. Such a leverage ratio could be harmful when combined with the already agreed solvency and liquidity ratios as it will create conflicting pressures to reduce balance sheets (especially in relation to inter-bank money markets and repos which combine high volumes and low risks). It also risks generating a counterproductive pressure that would lower lending capacity and may therefore be harmful to the real economy, especially if a leverage ratio of more than 3% was to be proposed by the Basel Committee.

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2- Detailed comments on the proposed revisions

Revisions to the treatment of derivative exposures

Introduction of the SA-CCR

The EBF was supportive of the adoption by the Basel Committee of a new non-internal model method for measuring counterparty credit risk exposures, which aims to replace the Current Exposure Method. The main intention of the new SA-CCR was specifically to benefit from a better recognition of collateral that better reflects the actual legal effect of netting arrangements.

We also understand that the Basel Committee's intention was to rely on a non-internal model method that could also be used with respect to (i) the leverage ratio, (ii) the large exposures regime as well as (iii) exposures to central counterparties (CCPs), and that this is the stated aim of the SA-CCR. Consequently, the EBF does not understand the Basel Committee's rationale in revising the SA-CCR by (i) limiting the recognition of collateral in the leverage ratio; (ii) applying a 1.4 coefficient to the total risky exposure (Replacement Cost (RC) + Potential Future Exposure (PFE)) for which we do have no rationale for a non-risk based exposure context (Leverage context); (iii) limiting the recognition of Initial Margins Received for the leverage ratio (induced by a multiplier fixed at 1).

Against this backdrop, the EBF recommends:

- The removal of the 1.4 alpha to be applied to the RC ;
- The downsizing of PFE add-on, thanks to a lower multiplier which should not be floored at 1. It should rather be aligned with the SA-CCR multiplier, which ranges from [0.05; 1].
- The recognition of all type of collateral received in the RC, not only eligible Cash Variation Margin (CVM), but also all non-cash collateral received, including at least HQLA securities.

European banks would like to stress in this respect the importance of taking into account non-cash collateral, as more and more counterparties will increasingly have to post collateral and some of these counterparties can only rely on non-cash collateral (e.g. pension funds that don't have cash). As such, we therefore ask the Basel Committee to take account of non-cash collateral and to give effect to HQLA securities at the very least, as these non-cash collateral items do not represent any liquidity risk.

Possible inclusion of initial margins received for client clearing activity

The EBF fully supports the need to conduct an impact assessment on the treatment of initial margin (IM) posted by clients to banks serving as clearing members. It has to be clearly endorsed by the Committee, otherwise there will be (and we are already observing the same) a massive exodus of client clearing actors even though in the European Union the central clearing regulation (namely EMIR) already requires generalisation of central clearing via QCCPs. This could increase the systemic risk on some very large clearing

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members. On this topic, it is the EBF's position that, for the sake of consistency with EMIR, IM should also be taken into account for OTC deals.

Additionally, the computation of the exposure value for derivatives transactions without the deduction of the IM could reduce the ability to provide clearing services to banks' clients, as the cost of those services will face a substantial increase, acting as a source for the reduction of the supply across the market.

Currency of settlement associated with the eligible CVM

The EBF is also supportive of the Basel Committee's clarification in its 2014 FAQ that currencies listed in the CSA of a MNA can be eligible CVM for derivative exposures.

Nevertheless, the EBF is not in favour of the CVM haircut proposed by the Basel Committee where the currency of the CVM does not match the termination currency of the netting set. This could introduce undue operational complexity and also a risk sensitivity in the leverage ratio framework, which is obviously not the objective of the leverage ratio.

Specific treatment for credit derivatives

There is clearly a definitional problem in relation to the definition "written credit derivatives", which needs to be more specific. We believe that the purpose of the Basel Committee is not to capture all credit derivatives but to capture only the situation where "a bank sells protection using a credit derivative". So the scope of credit derivatives whose nominal amount contributes to the leverage exposure should be consistent with credit derivatives that qualify as a credit protection from a prudential standpoint. In particular, such credit derivatives should meet the Basel provisions laid down in paragraphs 191 to 193. We firmly believe that such an alignment is meaningful and necessary as it would both achieve the Committee's stated goals and ensure a consistent implementation between credit institutions.

Treatment of regular-way purchases and sales of financial assets

Option B is the preferred option for EU banks:

To ensure a level playing field among jurisdictions (notably to cancel the accounting differences between those that apply IFRS and those under US GAAPs), it is essential to retain option B, i.e. trade dates with cash netting permission.

Revision to the treatment of provisions

Given the overall objective of the leverage ratio, to mitigate the procyclical effect of the regulatory measures on bank's activity, we consider it of the utmost importance that on and off-balance sheet items must be accounted for in the leverage ratio at their net value (i.e. after provisions).

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Additional requirements for G-SIBs

The leverage ratio should remain a backstop measure:

The regulatory purpose of the leverage ratio is to address the risk of excessive leverage and model risk. Considering ongoing regulatory reforms, which aim to address excessive RWA variability between institutions using internal model approaches for regulatory risk assessment, the EBF believes the leverage ratio contributes significantly to the reinforcement of the effect of the risk-based capital ratio and therefore the EBF does not support the introduction of additional requirements for G-SIBs.

We believe that a 3% leverage ratio is already a binding and efficient backstop. If calibrated at too high a level, the leverage ratio will cease to be a complementary “backstop” measure and instead will over-ride the risk-based measures. In addition, we would remind the Basel Committee that a buffer is always added by the market to the minimum prudential constraints, especially for the largest banks. For the leverage ratio, we estimate this ‘market buffer’ to be at least 0.5%.

However to account for the Basel Committee’s concern regarding G-SIBs, we propose that local regulators be permitted to design a range for that jurisdiction within which such regulator could decide on possible additional requirements according to the level of banking intermediation / disintermediation of that particular jurisdiction. This is of the utmost importance to protect against unduly penalising the EU banking sector in light of the EU economy being, currently, predominantly intermediated.

Regarding the instrument that could be used to satisfy such an additional requirement, the EBF recommends that AT1 should be allowed without specific limits, subject to sufficient quality to convert AT1 into CET1 on a going concern basis.

Besides, we believe that there should be no automatic consequences, such as the application of a maximum distributable amount (MDA) or the conversion of AT1 instruments into CET1, for breaching G-SIB additional requirement.

From a quantitative perspective, we would favour the second option for an additional requirement contemplated in the consultative document, i.e. that the additional requirement should vary based on a scaling of the G-SIB’s higher loss absorbency requirement as applicable under the risk-based framework. This additional requirement could be calculated easily with a scaling factor of the G-SIB buffer.

With regards to whether an additional requirement should be in the form of a higher minimum requirement or a buffer requirement, the EBF finds a buffer requirement preferable, by analogy with the higher loss absorbency requirement for G-SIBs as applicable under the risk-based framework. Moreover, a buffer requirement should operate as a buffer whereby supervisors would be expected to take action in the event of a breach, rather than having automatic restrictions on capital distributions. The reason for that is that the leverage ratio measure is intended to constitute a “backstop” measure. Breaches of an additional leverage ratio requirement should thus lead to supervisory attention and action. The bank’s supervisor should discuss with the bank the response to a breach on a case-by-case basis and the most appropriate response might not be restrictions on capital distributions, it might very well be reductions of certain exposures or issuance of AT1 capital, for instance.

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Revisions to the Credit Conversion Factor (CCF) for off-balance sheet items

European banks (and the EBF on their behalf) have already transmitted to the Basel Committee their comments on the proposed revisions with respect to the consultation on the revision of the standardised approach for credit risk.

The requirement that a Credit Conversion Factor (CCF) must be greater than 0% regardless of the exposure type is overly conservative. We also believe this does not achieve the goal of correctly quantifying the risk associated with the lending product. Likewise, the removal of the 0% CCF for uncommitted facilities is viewed as a very conservative solution as these are just uncommitted engagements.

For retail unconditionally cancellable commitments (UCC), the increase in CCF from 10% to 20% contemplated in the second draft of the Basel Committee's proposal does not reflect the significantly lower underlying default risk and provides an unduly increased risk weighting on those individuals who utilise little or none of their credit limit.

We also believe that the range of 50 – 75% for non-retail UCC is overly conservative as it does not reflect the actual usage ratios of these credit lines and would adversely affect lending and economic growth. Furthermore, the introduction of this approach would mean that there is little to no difference in capital requirements between the cancellable and non-cancellable commitments and a bank will accordingly receive very little capital relief from making a commitment cancellable. We would argue that there are good reasons why a commitment is judged to be unconditionally cancellable as it puts the bank in a better position to manage its risks, which should be recognised in reduced capital requirements.

We re-iterate the proposal previously made in the EBF response to the BCBS consultation on IRB: the concept of unconditional cancellable commitment (UCC) needs to be examined and defined. There should be guidelines to identify the UCC that should keep the 0% risk weight. In particular, it should be made clear that risk limits and unadvised facilities are not commitments. At last, accounting standards should remain the reference of the calculation of RWA.

For product types that truly allow the bank to cancel uncommitted facilities at any time in practice, we believe that it is reasonable to apply the lower CCF proposed for retail UCC to non-retail exposures where there are demonstrated controls and legal rights, monitored with robust internal bank governance processes.

Please also refer to the [EBF's response](#) to the 2nd BCBS consultation on the revision of the Credit Risk Standardised Approach for the complete EBF's position on the Credit Conversion Factors for off-balance sheet items. In addition, we believe that a 0% CCF should be applied to Export Credits covered by an official ECA.

Treatment of cash pooling transactions

The proposed treatment of cash pooling transactions clarified by the Basel Committee will have harmful consequences on the ability of treasurers at small and medium sized enterprises and corporate to combine the credit and debit positions of various accounts into one account.

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The EBF believes that, to the extent that there is a Master Netting Agreement with daily cut-off between two counterparties, virtual cash pooling and physical cash pooling should be recognized as equivalent.

Additionally, we believe both virtual and physical cash pooling arrangements within a Master Netting Agreement should be recognized for leverage ratio measurement purposes.

Treatment of traditional securitisations

We welcome that the Basel Committee is working on further clarification regarding the treatment of traditional securitisations in the leverage ratio. Nevertheless, European banks would like to stress the following concerns:

- European banks believe that all traditional securitisation tranches sold to investors should reduce the leverage ratio since investors have no recourse to the originator bank, and thus these tranches should not be classified as bank liabilities for purposes of the leverage ratio calculation.
- Indeed, the business case to sell securitisations to investors is significantly weakened if they cannot subsequently be excluded from the calculation of the leverage ratio such that a failure to exclude such securitisations will have a deleterious effect on both the securitisation industry in general (which it has been acknowledged has an important role to play in stimulating growth in the real economy in Europe) and European banks in particular.
- To the extent that the Basel Committee chooses not to adopt the approach outlined above, the EBF considers that, at the very least, all securitisations that achieve Significant Risk Transfer (SRT) for regulatory purposes should be excluded from the calculation of the leverage ratio, even though for accounting purposes they might remain on balance sheet. In this case the originator would only recognise for leverage ratio calculation purposes the nominal value of any retained tranches.
- This is of particular importance to European banks using the IFRS accounting standard. Under IFRS, the control tests required for accounting de-consolidation are exceedingly difficult to meet, resulting in the fact that the vast majority of European securitisations remain consolidated on the originator's balance sheet, despite the fact that investors have no recourse to the originator bank.
- Option 2 which suggests that "the securitised assets are included within the regulatory scope of consolidation, and therefore should be included in the Basel

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III leverage ratio exposure measure, but receive a 0% risk weight under the risk-based framework”, is not correct in our opinion for the following reasons:

- There exist detailed regulations governing the calculation of risk weights of securitisations which depend upon and differ according to the asset class, whether the assets are standardised or advanced IRB, and whether any positions are retained by the originating bank. It is doubtful that such detailed regulations would be overridden were the Basel Committee to exclude securitisations achieving SRT from the leverage ratio as we have proposed above.
- Option 2 ignores the non-recourse substance of a securitisation sold to investors as described above, and in doing so would divorce the calculation of the leverage ratio from reality and distort the ratio for no beneficial prudential purpose.

Treatment of Securities Financing Transactions (SFTs)

The EBF is particularly concerned at the Basel Committee’s position that open repos cannot be eligible for netting because they do not meet the condition of featuring an explicit settlement date.

It is not acceptable to reconsider the treatment of open repos that was accepted by European regulators in the 2014 EU delegated act relating to the leverage ratio (open repos are a European specificity). This approach considerably reduces operational risk and some jurisdictions intend on using such instruments.

Frequency of calculation

Paragraph 5 of the Annex provides that banks may, subject to supervisory approval, use more frequent calculations (e.g. daily or monthly averaging) as long as they do so consistently.

This provision raises particular concerns on implementation and will create an uneven playing field, especially if a more frequent than quarterly calculation is established. Specifically in this regard, the Basel Committee will recognise that European regulations on capital require that losses are recognized immediately in a Bank’s P&L whereas profits can only be recognized after an accountant audit (i.e. an external auditing certification). Conversely the US regulations on capital allow profits to be taken into account when they occur (even on a daily basis) without external validation.

Disclosure requirements

The EBF fully supports the removal of the disclosure requirements from this framework and their transferal to the pillar 3 standard.

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