Comments

on the Leverage Ratio in follow-up to the lcr-lr-hearing of the EU-Commission on 10 March 2014

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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We welcome the opportunity to give a written opinion in follow-up to the EU Commission hearing on the issues of Leverage Ratio and Liquidity Coverage Ratio and herewith submit the position of the German Banking Industry Committee on the Leverage Ratio.

Preliminary remarks

Because of its limited meaningfulness in relation to the indebtedness and stability of financial institutions we continue to be basically negatively disposed to the leverage ratio. In this regard, even further specification of the rules to calculate the leverage ratio seem little suited to enhance its meaningfulness.

The final Basel paper includes a number of stringent tightening up measures compared with the position of Basel III in 2010, e.g. with regard to taking into account the netting of credit derivatives and SFTs (particularly repo transactions), which we reject.

The tried and tested, internationally uniformly applied and legally enforceable regulatory netting rules are now simply to be accepted with considerable restrictions. There are no factual reasons why the effect of netting would have to be treated differently here than for the purposes of calculating capital adequacy under CRR. This differentiation leads to misdirected incentives, additional costs, increased complexity and unnecessary additional work. We therefore advocate maintaining the current netting rules in the CCR. In view of the restrictive conditions for application, also the final Basel rules for offsetting cash variation margins and the exemption of derivative clearing appear to us to be difficult in practice. It is, for example, thus not compatible with the conventional Master Netting Agreements to include Cash Variation Margins in the same settlement currency.

The EBA's own-initiative report published at the beginning of March on the effects of the different definitions of the Basel requirements and European regulations on the leverage ratio is purportedly based on a data basis characterised by estimates and assumptions. In our opinion, adequate data quality is essential for the discussion on which regulations are appropriate at a European level too. The EBA report, furthermore, is not clear on which assumptions the ratio survey was based. We believe that the transposition of international regulations into European law will require a differentiated approach that takes into account the particularities of the European banking system. While BCBS 270 the Basel Committee rightly bases the calculation of the ratio on the regulatory scope of consolidation and thus corrects a material structural error of the leverage ratio, the requirements for dealing with the SFTs, in particular, result in a significant increase of the measure of exposure (denominator of the leverage ratio) and thus, under otherwise similar conditions, to a considerable capital requirement.

- **<u>Securities financing transactions (SFTs)</u>**

We reject the application of the much restricted netting possibilities of the final Basel paper; we would rather see the current CRR rules maintained. By not taking into account the full netting possibilities in SFTs, a number of serious unintended side effects will manifest themselves:

- By applying this rule, the additional inclusion of counterparty default risks and the negligible netting effect established as part of the Basel III monitoring mean that unsecured transactions generally show a lower exposure (maximum equal exposure) for the leverage ratio definition than secured transactions. Secured securities lending/repo transactions are thus at a disadvantage vis à vis unsecured transactions and a considerable incentive for unsecured deals is thereby created. This is not justifiable by the significantly higher risk inherent in an unsecured credit receivable in comparison with a reverse repo. These incentives to unsecured transactions will, from a regulatory and macro-prudential viewpoint, have negative consequences for financial stability.

- A less liquid market for sovereign bonds is to be expected because liquidity will centre predominantly on repo transactions.
- A spreading of the aforementioned effect to the debt financing of corporates with bonds/debentures is to be expected. The liquidity of the primary market will be ensured by banks through SFTs in the secondary markets. Because of the reduction in liquid funds provided by SFTs the considerable burdens of the new leverage ratio definition for this SFT role will, in our estimation, lead to a serious undermining of the financial possibilities of large corporates.

For the calculation of the add-on we recommend a calculation in line with the Basel paper, i.e. without taking into account the haircuts in offsetting the value of collateral and the application of netting at individual transaction levels for deals without a Master Netting Agreement. Here, without plausible reason, the CRR uses the stricter Basel rules. It is not explicitly explained when the comprehensive method and when the simple method for deducting collateral to reduce exposure is to be applied.

- **<u>Netting of derivatives</u>**

We welcome the ruling introduced in BCBS 270 that allows the offsetting of collateral for transactions with “daily margining”. In the final Basel regulations there remains nonetheless the principle that a netting of collateral received to reduce exposure is not possible, even when such netting is permitted as part of the banking regulatory or accounting regulations, and is appropriate too. This is justified by the Basel Committee by the fact that collateral received cannot reduce economic leverage inherent in a derivative position. However, banks do not use collateral to “leverage” their balance sheets, but for the purpose of securing/hedging their P+Ls. Insofar as there is no effect evident on the P+L this shows that the collateral security is effective and that the taking into account of the netting effect in this respect makes sense for leverage ratio purposes too. Also, a negative effect on the liquidity of the derivative markets can be expected, which will, for example, increase companies’ costs of hedging against market risks. In this regard, we reject the restriction of netting possibilities which result from the very possibility of reusing the collateral. By analogy the same applies to collateral given.

- **<u>Cash Varation Margins</u>**

A condition in note 25 of the Basel regulation on deducting the “variation margin” stipulates that the cash collateral received must be in the same currency as that of the derivative contract. In its present form this condition is hardly workable in practice, since a unique allocation of cash collateral received/given for a transaction within the netting set is not possible.

Within a netting set with one counterparty there are mostly several transactions in various currencies. Collateral in the form of a variation margin is given/received after offsetting and/or netting all transactions and mostly only in one specified currency. As illustrated in the example below, an unambiguous allocation of the cash collateral given/received for a derivative contract is not possible.

Assume there is a Master Netting Agreement with counterparty X. There are three transactions with the counterparty and it is specified in the Credit Support Annex that cash collateral must be given in EUR:

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Derivative A:	+ 1,392	USD	=	+ 1,000	EUR
Derivative B:	+ 2,590	CHY	=	+ 300	EUR
Derivative C:	- 418	GBP	=	- 500	EUR
Derivative D:	- 1,000	EUR	=	- 1,000	EUR
Derivative E:	+ 141,368	JPY	=	+ 1,000	EUR
Derivative F:	+ 500	EUR	=	+ 500	EUR
Net claims			=	800	EUR
Collateral received in EUR			=	800	EUR

From this list it can be seen that the positive surplus for the one cash collateral received cannot be allocated specifically to one transaction. Thus, to start with, the same-currency condition is basically not fulfilled. The bank would now have two theoretical possibilities to achieve an allocation:

1. Pro rata reallocation of received cash collateral on the EUR contract. An appropriate reallocation is not possible, since there arises no claim from contracts D and E, and thus for these contracts no cash collateral would be received.
2. Offsetting the EUR collateral received with the EUR contracts which represent a claim as a separate netting set.
   Netting set 1 (EUR)
   Derivative E – collateral given = 500 EUR – 800 EUR = 0 EUR (Cap at zero).
   Netting set 2 (other currencies)
   Derivative A - E = 300 EUR

This method is conceivable in principle, but works only if claims/receivables exist in the currency of the collateral and it is assumed that the collateral is given exclusively for EUR contracts. This assumption is not appropriate, however, since it can not be unambiguously determined from which currency the net claim on the total netting set level originates.

A more exact explanation is therefore required as to how such an allocation of collateral received/given to the individual contracts within a netting set should be made. On the whole, this approach is hardly realisable and/or economically understandable. We therefore recommend deleting, as part of the CRR implementation, the criterion that provides for the same currency between collateral given/received and the individual contracts.

- **<u>Scope of consolidation</u>**

We believe that the regulatory scope of consolidation should also apply to the calculation of the leverage ratio. Enterprises for regulatory purposes not included in the feeder reports for the consolidated capital coefficient should not be pushed into a regulatory reporting regime, including the related regulatory valuation procedures, as part of the leverage ratio either, as is the case according to the current provisions in Art. 429 para. 4 S. 2 CRR. Adherence to the CRR rules would significantly limit comparison possibilities of groups of institutions after the disclosure obligation takes effect on 1 January 2015, since differences in accounting standards can lead to considerable differences in the exposure figures in the leverage ratios. We specifically welcome the final Basel regulation in BCBS 270. A material "structural error" has been rectified. The scope of consolidation for the leverage ratio is now consistent with the scope of consolidation of the risk-weighted capital adequacy ratio. We therefore call for the implementation of the Basel regulations in the scope of consolidation at EU level. Against this background, the reporting of regulatory exposure values of subsidiaries which are outside the regulatory scope of consolidation (positions in COREP reporting form C 45.00/LRCalc, lines 130, 140 and C 46.00/ LR6) should be waived in the short term at European level too - analogous to Basel III monitoring (ideally already for the first report due as of 31 March 2014).

- **On-balance sheet exposures**

There is still not enough attention being paid to the independence between the definition of the leverage ratio and the treatment of HQLA in the LCR calculation. The LCR requires banks to hold substantial volumes of highly liquid assets. This requirement is being crucially hampered by the fact that such assets are not excluded from the calculation of the leverage ratio. We continue to see this as an urgent necessity and request that this interdependence be duly taken into account.

We expressly welcome the concretisation that fiduciary assets/loans on a trust basis (for third-party accounts), which in line with the principles of orderly accounting at respective national levels are included in the balance sheet (e.g. in accordance with the German accounting standards for credit institutes), can be omitted from the calculation of the overall risk position. This exemption was already implemented at European level in Art. 429 para. 11 CRR. However, for this, as explained in footnote 4 too, the derecognition criteria according to IAS 39 and/or the deconsolidation criteria pursuant to IFRS 10 have to be met. What is lacking here is a concretisation of how to deal with positions that according to national generally accepted accounting principles are recognised in the balance sheet, but are not additionally subject to IFRS rules. With national GAAP-recognised balance sheet items it is thus possible to assume only a fictitious IFRS balance sheet recognition in order to then check whether the aforementioned non-recognition and/or non-consolidation criteria have been met. This can be only a fictitious view, as items which from the start fulfil these non-recognition and non-consolidation criteria are generally not even recognition candidates in the first place under IFRS. In this respect we request clarification regarding the required procedure.
Apart from the special treatment of fiduciary assets other specific transactions continue to receive no special consideration. As a result, banks which have specialised in less risky business areas such as construction finance, commercial real estate or housing loans or mortgage bond business will be significantly disadvantaged. Development-programme loans in particular, e.g. from KfW or the state regional development banks, will be exempt from a leverage ratio calculation pursuant to Art. 429 para. 11 CRR if they constitute fiduciary assets. The majority of development-programme loans does not currently meet this condition, however, and is thus not favoured. Thereby also in the case of a direct passing on of development funds/subsidies via the local bank to the end borrower the development funds/subsidies are reflected not only on the institution’s assets side but also as liabilities to credit institutions (development bank) on its liabilities side. The same applies to pass-though transactions, in which loans in one’s own name are approved for the account of a third party, the claims from the loan and collateral contracts, however, pass directly to the contracting party. This stands in contradiction to state promotion of, for example, renewable energy. Development-programme loans should therefore be exempted from the calculation of the overall risk position.

Should a tightening of the Basel regulations be applied on a one-to-one basis at EU level, then they must definitely be taken into consideration in the future calibration of the leverage ratio. In connection with this it must be ensured as part of the calibration process that the leverage ratio does in fact remain exclusively a “backstop key ratio” as intended. Neither the “equal footing” of the leverage ratio nor the domination of the risk-based norms (leverage ratio as front stop) complies with the decision basis of the

Basel Committee. This should not be counteracted by a considerably more stringent definition of the leverage ratio.

Yours sincerely,
on behalf of the German Banking Industry Committee
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i. V.

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