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Die Deutsche Kreditwirtschaft

Comments

On the Consultation Document “Revised Basel III leverage ratio framework and disclosure requirements“ Published by the Basel Committee for Banking Supervision

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Berlin, 20. September 2013

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On 26 June 2013, the Basel Committee for Banking Supervision published its Consultation Document entitled “Revised Basel III leverage ratio framework and disclosure requirements“. We appreciate the present opportunity to share our comments.

I. General Comments

In principle, we have strong reservations over the leverage ratio. This is due to the limited information it provides with regard to the leverage and stability of banks. Hence, we feel that a further specification of the rules for calculating the leverage ratio is not very helpful when it comes to increasing the meaningfulness of the leverage ratio *per se.* Notwithstanding the foregoing, before addressing the language of the framework made available for consultation under Part II of our present comment letter, we should like to preface our more specific comments by a number of general remarks.

First and foremost, the present proposal for a revised definition of the leverage ratio leads to a clear increase in the exposure measure(denominator of the leverage ratio). As a consequence, in the presence of identical conditions, this leads to a considerable additional capital requirement within the international financial system that entirely ignores the economic risk inherent in the various on-balance and off-balance sheet transactions conducted. What is more, the Basel Committee chooses a non-risked based calculation method for [regulatory] capital requirements which, in our view, is highly problematic.

The Basel III risk-based framework contains inherent incentives to allocate low capital requirements to low risks and to allocate high capital requirements to high risks. The application of one and the same percentage ratio (ie three percent) across all exposure classes unduly restricts these incentives. Furthermore, a bank which fine-tunes the measurements of its risks will, on principle, be able to mitigate its regulatory capital burden; this principle, too, is being eroded. As a consequence, if the leverage ratio were to be modelled on the current proposals, the actually binding capital requirements for comparably low-risk but high-volume business models featuring lower margins would be based on the leverage ratio and not on a risk-weighted approach. This leads to inappropriate incentives. As a consequence, low risk transactions featuring, however, high volumes would be reduced whilst transactions featuring a higher risks but a lower volume would be expanded. Given the fact that the scope for passing on the higher costs is extremely limited, the “one-size-fits-all” capital requirements (ie requirements that would apply to all transactions) would incur profitability losses in rather low margin business lines.

Above and beyond this, European banks tend to be at a disadvantage anyway: This is due to the structural differences (extent of the credit supply through the banking systems) eg between Europe and the US; to date, this structural difference is not reflected during the calibration of the leverage ratio.

Compared to the provisions under Basel III dating back to the year 2010, the present Consultation Document proposes a considerable tightening for a number of rules; whilst not limited to, this concerns eg netting in the context of credit derivatives and other derivatives as well as SFT (particularly repo transactions). In essence, we hold the view that these tightened rules are both inappropriate and inacceptable. Our objection is owed to the fact that the current proposals fail to accept (at least not without considerable restrictions) the legally enforceable supervisory netting rules applied on an international level in a consistent manner. There are no objective reasons why the netting impact would have to be treated any differently compared to the treatment for the purposes of calculating the capital requirements under Basel III. This differentiation merely leads to perverse incentives, cost inflation, additional, unnecessary complexity and ties up additional resources in a needless manner.

Due to the fact that the proposed rules will render an achievement of the target (three percent) clearly more difficult, it is indispensable that the future calibration of the leverage ratio take into account these proposed tightened rules. Otherwise, the proposed change will result in considerable additional capital requirements which banks could not reflect during their planning process.

In line with the framework adopted by the Basel Committee, in this context, the calibration process needs to ensure that the function of the leverage ratio as a backstop ratio be preserved. Neither the equal footing of the risk-based standards with the leverage ratio, nor the domination of the risk-based standards (leverage ratio as a front stop) is consistent with the framework adopted by the Basel Committee. This should not be foil by a considerable tightening of the leverage ratio definition.

Based on the reasons mentioned above, the GBIC would like to reiterate its reservations over migrating from a Pillar II treatment to a Pillar I treatment of the leverage ratio.

The Basel Committee seeks to develop a definition of the leverage ratio which is not being influenced or, moreover, distorted by the application of a specific accounting standard – be it IFRS, US GAAP or any other national GAAP. We welcome this objective. However, in essence, the definition of the leverage ratio continues to depend upon the applicable accounting standards and this relationship is not altered even when considering the proposed changes concerning eg the *qua definitionem* treatment of derivatives and securities financing transactions (SFT). For instance, this becomes evident given that - in its capacity as a residual parameter and as the numerator in the definitions of the leverage ratio - the “equity volume” shall directly depend upon each and any carrying and valuation rule of the respective accounting standard Furthermore, it is eg evidenced by the requirement under indent 35 (Gross-SFT assets recognised for accounting purposes), ie a provision which apparently depends upon accounting rules. As a consequence, the differences between IFRS and US-GAAP are by no means eliminated.

Many of the requirements mentioned in the consultation paper hav´nt been proposed up to now. Should the requirements in spite of our doubts be requested, this can be handled only with sufficiently long transition periods.

II. Specific Comments

Concerning the amendments submitted in the form of the present Consultation Document, we would furthermore like to address the following specific items.

Definition and minimum requirement (Indent 6-7)

It is worth noting that the technical and operational requirements for calculating each month-end leverage ratio are significant. The average of the monthly leverage ratio over the quarter shall subsequently serve for the purposes of calculating the average quarter-end leverage ratio. At this point, there is a regulatory divergence, given that the reporting requirement for the purposes of regulatory reporting (CoRep) and financial reporting obligations (FinRep) exclusively arise at the end of the quarter. During the implementation of the initial Basel III requirements on a European level and upon request, the competent authorities are entitled to exempt individual banks from the monthly calculation meaning that these banks will only have to calculate and report a leverage ratio at the quarter-end.

However, on the whole it remains unclear whether the implementation costs are justified by the putative information advantage inherent in an average three-month ratio. Also in terms of data quality, one further reason why we hold the view that the calculation of monthly ratios is counterproductive consists in the overall rationale of establishing a transparent and simple leverage ratio: Consequently, we recommend carrying out both the calculation and the reporting at the end of the quarter. This will achieve consistency with the overall regulatory reporting framework (CoRep).

Scope of consolidation (Indent 10-15)

Nr. 11 – Extension of the scope of consolidation

We would welcome a clarification concerning those "investees” who are merely inside the scope of accounting consolidation that are included under the Tier 1 capital. We recommend a corresponding specification, should this translate into a need to include all investees which have to be taken into account according to the regulatory or accounting consolidation scopes. The current wording is open to misunderstandings and fails to explain why a correlation is created between regulatory capital on the one hand and regulatory or accounting consolidation scopes, on the other hand.

Nr. 12 – Extension of the consolidation scope (examples)

Under the provisions of indent 12, where an entity is not included in the regulatory consolidation, its exposure has to be included in the calculation of the leverage ratio. As a consequence, , the regulatory rules for the scope of consolidation are thus being suspended. Accordingly, banks would have to define a divergent consolidation scope specifically for the purposes of the leverage ratio. In our view, also the rationale given for this proposal ("because the investment in the commercial investee remains included in the capital of the bank”) is not applicable at this point. Whilst it may be correct that - *de lege lata* - the book value of the investment shall not be deducted from capital, entities that are not included under the regulatory consolidation scope (or, moreover, their *pro rata* contribution to the provisions) will not be included in the calculation of the capital. Hence, we do not see any reason for any further regulatory consolidation rules that are specifically designed for calculating the leverage ratio. Furthermore, we should like to reiterate that we see an absolute need for clearing the definition of the leverage ratio to the greatest degree possible from differences in accounting standards (see also the GBIC’s general comments on our fundamental scepticism with regard to the feasibility of this endeavour). Due to the fact that the proposed extension of the consolidation scope for the leverage ratio from a mere regulatory consolidation scope to an accounting consolidation scope is at odds with this fundamental principle, we explicitly object to this proposal.

Nr 15 – “*Pro rata* offsetting“

Whenever exposures within a unit shall be excluded on a "*pro rata*" basis, an equivalent *pro rata* exclusion within other banks will usually be impossible. At the same time, whilst the benefits obtained in terms of added precision will remain moderate, this approach would tie up considerable resources. Hence, we feel it would be appropriate to drop the *pro rata* requirement whilst ensuring 100% recognition of any offsetting effects.

On-balance sheet exposures (Indent 19 – 21)

Until now the interdependency between the definition of the leverage ratio and the treatment of HQLA is still not taken into account sufficiently. The LCR requires banks to keep substantial volumes of highly liquid assets in place. This requirement is considerably obstructed by the fact that such assets were not excluded from the calculation of the leverage ratio. We still perceive an urgent need for this and we would appreciate an adequate consideration of this interdependency.

On principle, we welcome the clarification that fiduciary assets which have been accounted for as an on-balance sheet item under national GAAP (eg in line with German Accounting standards for banks) may remain excluded during the calculation of the total exposure level. At the European level, this derogation was already implemented under the provisions of Article 429(11) CRR. However, footnote 11 of the Consultation Document points out quite rightly that, to this end, the IAS 39 criteria for de-recognition and, where applicable, the IFRS 10 criteria for deconsolidation have to be met. At this point, a clarification is lacking as to the treatment of on-balance sheet items which are accounted for under the respective national accounting principles but which are not simultaneously subject to the IFRS rules. Hence, in order to subsequently assess whether the specified de-recognition criteria or, moreover, deconsolidation criteria have been met (for instance when it comes to items accounted for under local GAAP), only a hypothetical IFRS accounting can be assumed. Yet, this can only ever be a hypothetical assessment. After all, under IFRS, items which meet these de-recognition and deconsolidation criteria right from the outset will generally not be accounted for as on-balance sheet items in the first case. Hence, in this regard we would welcome a clarification concerning the required policy.

Apart from the special treatment it sets out for fiduciary assets, the present Consultation Document still remains silent on specific business models. This results in significant disadvantages for banks which are specialised on business lines featuring a lower risk profile such as building finance, commercial property financing or housing finance. Under the provisions of Article 429(11) CRR, particularly loans under promotional schemes (e.g. by the German Reconstruction Loan Corporation (KfW) or the German state development banks) shall only be excluded from the leverage ratio if and when the loans constitute fiduciary assets. However, at present, the majority of loans from promotional schemes fails to meet this criterion and is thus not eligible for preferential treatment. This is inconsistent with the national promotion of, for instance, renewable energies. Hence, the current proposals should clarify in an unambiguous manner that also loans from promotional schemes shall be clearly excluded from the calculation of the total exposure measure.

Furthermore, it is worth noting that, under the Consultation Document’s current proposals, collateral shall not be allowed to reduce on-balance sheet or off-balance sheet exposures. Particularly in the event of cash collateral, we see this as a distorted treatment of on-balance sheet and off-balance sheet exposures. This is of major relevance particularly as regards derivative items which are usually collateralised by means of cash collateral. For a more detailed discussion of the collateralisation of derivatives please see the following paragraphs.

Treatment of derivatives (Indent 22-29)

Under indent 24, the derivative exposure is determined on the basis of the current exposure method (CEM). At the same time, the Basel Committee is holding consultations concerning a newly developed and more precise method for determining the exposure, ie the NIMM. This method should be used as early as possible also for determining the leverage ratio (under the *proviso* that the IMM - which would be the ideal approach – will be rejected).

Whether or not netting is permitted under the bank’s operative accounting or risk-based framework and notwithstanding whether such an approach is fit for purpose, under the provisions of indent 27, collateral received may not be netted against derivatives exposures. Allegedly, this is due to the assumption that collateral received would not be able to reduce the economic leverage arising from a given derivative position. Thus, whilst the Consultation Document recognises the risk mitigating impact of the collateral for counterparty risk, it refers to the potential leverage due to the re-use of the collateral. To us, the rationale for this is not obvious. Banks do not use the collateral received in order to "lever[age]” their balance sheet; instead, they use it in order to hedge their P&L. If a P&L impact is not visible, this shows the effectiveness of the hedging. It is also a proof that, to this effect, the recognition of the netting effect is useful the purposes of the leverage ratio. The current proposals also disincentivize collateralised transactions. This effect is incompatible with the objective of stronger collateralisation which is not only pursued by regulatory initiatives such as EMIR but which is also in the broader regulatory interest of supervisors. Also, this is bound to have a negative knock-on effect on the liquidity of derivatives markets. As a result, there will be an inflation in the corporate costs for hedging against market risks. In this regard, we object to curtailing the netting opportunities motivated by the mere possibility of re-using the collateral. By way of analogy, the same applies to collateral provided.

One simple regulatory choice the BCBS might wish to consider as an alternative to the prohibition of netting would be allowing banks to exclude from the calculation of the leverage ratio any collateral received which they have recognised on the asset side according to the applicable accounting rules. This will regularly cover any cash collateral received by way of a full legal rights transfer. For the receiver of the collateral this results in a stretching of balance sheet: The bank has to capitalise the received cash collateral as an exposure to the account-maintaining bank; at the same time, it has to post in the liabilities section of the balance sheet a liability (subject to call) to the provider of the collateral asset for repayment of the cash collateral. Apart from the cash collateral received, under the provisions of the current exposure method (CEM), the bank also has to show the exposure from the derivative on the asset side of the balance sheet – as a result of this, the aggregate assets almost see a 100% increase. The fact that this treatment of the cash collateral received is inappropriate is illustrated by virtue of a comparison with the security collateral received; according to generally accepted accounting rules, this does not stretch the balance sheet on the part of the collateral receiver (namely even if and when the securities ownership is transferred to the collateral receiver): Given that all risks and opportunities deriving from the securities provided as collateral have to be assigned to the collateral provider (in their capacity as the economic beneficiary, they are entitled to each and any interest income) these securities have to be shown on the asset side of the collateral provider’s balance sheet. However, this differential treatment for accounting purposes should not lead to a differential treatment of collateral during the calculation of the leverage ratio. This is especially true in cases where - in line with indent 27 - the assumption is that cash collateral and non-cash collateral will have an identical impact on the balance sheet leverage. At this juncture, it would be more appropriate to put cash collateral on an equal footing with securities collateral meaning that the collateral received would be de-recognized in each and every case.

Furthermore, in our preliminary understanding, the language under indent 28 is unclear because it does not stipulate any unambiguous policy for treating off-balance sheet collateral. We therefore suggest a clarification that the off-balance sheet collateral provided (eg from lending transactions) will not increase the exposure, either.

Additional treatment for written derivatives (Indent 30-33)

For credit derivatives, an additional, notional exposure to the reference entity is assumed. This leads to a considerable increase in the volumes meaning that this, too, constitutes a clear tightening of the rules. However, there are no reasons why credit derivatives should receive any different treatment to other derivatives.

Under the provisions of indent 31, netting such transactions will only be an option in the event of a perfect hedge (the remaining maturity of the purchased credit derivative has to be equal to or greater than the remaining maturity of the written credit derivatives). In our view, the netting options are not far-reaching enough. We therefore suggest applying the requirements set out under indent 80, 143, 204 of the Basel Framework. Under said provisions, it is permissible to net purchased credit derivatives with a minimum term to maturity of one year against corresponding written credit derivatives. A one-year-timeline is sufficiently long in order to adopt measures for the purposes of e.g. a “rollover of the purchased hedge”.

Securities financing transaction (SFT) exposures (Indent 34-39)

Under the provisions of indent 35, SFT exposures shall be calculated as the sum total of

1. Gross SFT assets recognised for accounting purposes (ie no recognition of accounting netting)
2. The current exposure as a measure of counterparty default exposure.

In our view, the gross SFT value exaggerates the transaction’s exposure,which ought to be relevant for the leverage ratio. Hence, at this point, there is a lack of an economic assessment approach. Using the gross figure also means that netting between the cash leg and the securities leg is not allowed. Both legs are characteristic for these transactions and they allow the bank to gain access to a secure source of short-term funding. We have difficulties in comprehending the rationale for the failure to recognise collateral – even cash collateral. *De facto,* the use of the gross figure leads to a double counting of such transactions which seems to lack any economic motivation. The transactions are subject to master netting agreements (MNA). As a result, merely the net value will be subject to a counterparty default and should thus be treated as the exposure value which can be compared to regular lending operations, i.e. the key measure which is relevant for defining the leverage ratio.

The reference to the respective accounting standard in calculating the gross SFT value may furthermore lead to a renewed violation of the international level playing field; whilst not limited to, this especially applies to scenarios where certain standards require recognition of the transactions whilst other standards not. This should be absolutely avoided.

Should the gross SFT value remain relevant as an exposure measure for the leverage ratio, adding a further exposure value for recognition of the counterparty exposure is unjustified. The gross ratio is the highest possible exposure (in the event of a counterparty default).

The approach described in this Consultation Document incurs a number of unintended yet serious negative side effects which turn the rules into considerable market stress (particularly for the repo market and for the government bond market) and which will lower financial stability:

- For the purposes of the leverage ratio definition, compared to collateralised transactions, uncollateralised transactions generally feature a lower exposure (or, at most, an identical exposure). This results in disadvantages for collateralised securities lending / repo transactions compared to uncollateralised transactions thus creating a massive incentive for uncollateralised transactions. Given the fact that - compared to the reverse repo - the risk inherent in an uncollateralised credit exposure is clearly higher, this approach is unjustified. From a supervisory and macro-prudential point of view, these incentives for uncollateralised transactions will have negative repercussions for the financial stability.
- Given the fact that the repo market is an important monetary transmission mechanism which assists central banks in verifying the effectiveness of their decisions, the current proposals will also have negative repercussions on monetary policy.

- The current proposals will result in less deep repo markets. In combination with the associated inflation in liquidity premiums, repo rates both for banks and also for companies will see an increase.In the context of the LCR rules, the Basel Committee explicitly mentions active repo markets as a fundamental criterion for HQLA. However, the rules proposed in the present Consultation Document will have a rather detrimental effect upon these markets.
- Given that the liquidity is mostly based on repo transactions, there is bound to be a less liquid market for government bonds.
- We expect, that there will also be a spill-over of the aforementioned effects upon corporate borrowing in the form of bonds. Banks ensure the liquidity of primary markets by means of SFTs in the secondary markets. We hold the view that the new definition of the leverage ratio will tremendously burden this SFT function thus resulting declining liquid funds being made available by the SFTs; this will seriously impair the financial options available to larger corporations.

Hence, we are of the opinion that the extreme overstatement of the exposures inherent in such transactions should be remedied and we recommend preserving the existing Basel III rules which date back to the year 2010. Alternatively we suggest the application of the comprehensive method regard to the allowance of financial securities according to the Basel framework agreement; this method is sufficiently conservative due to the application of Haircuts subject to the banking supervisory regulations.

Concerning the treatment of agent transactions in SFTs set out under indent 37 ff., the treatment of agent transactions in derivatives remains unclear. Banks generally act exclusively as financial intermediaries ("in its own name and on behalf of its customers"). As a consequence, when it comes to the underlying transactions they do not participate in risks or benefits, nor do these transactions have to be shown on the balance sheet. Hence, we hold the view that these transactions do not have to be included in the exposure calculation of the leverage ratio and we would welcome a corresponding clarification.

Other off-balance-sheet-exposures (Indent 40-42)

We recommend deleting the second sentence under indent 40. The reference in footnote 24 to Annex I is sufficient and avoids inconsistencies between the regulatory text and Annex I. Furthermore, we would appreciate a clarification why there is a reference to "failed transactions and unsettled securities“; after all, they are not mentioned under Annex I.

With the exception of unconditionally cancellable commitments, banks should include off-balance sheet exposure items in the calculation of their aggregate exposure position by applying a 100% credit conversion factor (CCF). Under the provisions of the Consultation Document, unconditionally cancellable commitments shall keep their 10 percent weight. On the other hand, the credit conversion factor for calculating the risk weighted assets when determining the regulatory capital requirements for credit commitments that are unconditionally cancellable amounts to zero percent whilst any other credit lines are usually subject to 75 percent (instead of the 100 percent proposed for the purposes of the leverage ratio in the present Consultation Document).

Whilst the Basel Committee’s endeavours to establish in general a 100% conversion factor for off-balance sheet items in order to take account of the risks in the estimation of conversion factors which have materialised in the past is essentially understandable. When it comes to credit commitments, however, it is worth noting that banks featuring a major volume of highly diversified retail business along with local roots as well as real estate financing would suffer a clear discrimination if credit commitments were to receive a 10 percent or, moreover, 100 percent conversion factor. Furthermore, the actual, likely exposure will see a material exaggeration. In this respect, we hold the view that using the conservative CCFs of the standardised approach for credit risk will also be appropriate for the purposes of defining the leverage ratio and we recommend a corresponding definition.

Also, for trade and export finance, a 100 percent CCF shall remain applicable. We recommend adopting the provisions set out under of the European Capital Requirements Regulation (CRR) which envisages a 20 percent CCR. Given the importance of trade and export finance for the real economy we hold the view that such a facilitation is called for and objectively feasible. A 100% CCF would inflate transaction costs and/or reduce the availability which would be detrimental to economic growth. Furthermore, the 20 percent CCF takes account of the average cancellation patterns in this area which means that a 20 percent CCF is fit for purpose when it comes to transforming the off-balance-sheet exposure items into an equivalent on-balance-sheet exposure.

Disclosure Requirements

In our opinion, the requested quarterly disclosure of the leverage ratio is clearly excessive. In line with the disclosure requirements for the Pillar 3 reports, we suggest an annual disclosure interval. Furthermore, we are of the opinion that the disclosure in the annual financial statements proposed in the present Consultation Document is inappropriate. We suggest a disclosure in combination with the supervisory ratios in the Pillar 3 reports (this approach is also envisaged under the CRR). The Consultation Document refers to the possibility of incorporating a Pillar 3 reference in the financial statement. In our view, this is neither efficient, nor is it feasible. Hence, this requirement should be deleted.

Indent 44 ff sets out specific disclosure requirements with regard to balance sheet items as well as different components of the leverage ratio. At this point, it is first and foremost questionable whether the additionally incurred considerable costs will be justified by the benefit gained. The technical and operational costs incurred especially by smaller banks might lead to considerable competitive distortion. Hence, the rationale provided under indent 44 merits a critical review.