French Banking Federation Comments on the BCBS Consultative Document

on Leverage Ratio BCBS 251

The French Banking Federation supports the risk-based framework devised by the Basel Committee on Banking Supervision during 25 years..The leverage ratio may have had its rationale in the “good old days” but is nowadays totally powerless to assess the leverage level of the economy. Except for its apparent simplicity, the Leverage Ratio has no objective and clear justification. No demonstration has been convincingly made of its ability to keep the leverage of the economy within a reasonable range compatible with the financial stability, in particular in the jurisdictions where it was in force such as the USA given its conceptual flaws. Consequently, the leverage ratio must remain a backstop measure.

We appreciate the efforts made by the BCBS to clarify the definition of the leverage ratio in order to include off balance sheet commitments and to deal with derivative treatment independently from the accounting standards.

The leverage ratio cannot be read, as well, without considering 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.
The ratio needs therefore to be carefully interpreted by the supervisor in conjunction with other indicators before any conclusion can be drawn.
In any case the “crude and neutral” proposed definition of the leverage ratio is only conceivable as a 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 only achieved through a single banking ratio. Such leverage ratio is harmful when commingled with the hardened solvency and liquidity ratios it will create conflicting pressures to reduce balance sheets, especially inter-bank money markets and repos which combine high volumes and low risks. It will also create a pressure to reduce lending and may thus be harmful to the economy especially if a leverage ratio of more than 3% was to be considered by Basel Committee.

In a nutshell we believe that the leverage ratio should:

- remain a backstop measure to complement the risk-based capital ratio to be considered by supervisors among other indicators
- be limited to 3% calculated on Tier one capital
- be applied to the prudential scope of consolidation and not on the accounting scope of consolidation: capital taken into account at the numerator of the leverage ratio being calculated on the prudential scope of consolidation, the exposure measures at the denominator of the leverage ratio should be calculated on the same scope of consolidation;
- be computed in a uniform, consistent and reasonable manner.

Please find hereafter our comments on the proposals put forward by the BCBS on the calculation of the leverage ratio.

1- Back stop measure

The leverage ratio should remain a simple backstop measure to complement the risk based measure that is the main indicator to appreciate the solidity of a bank.

The FBF is concerned that the exposure measure proposed by the BCBS in its Consultative document would be too punitive without specified economic rationale. In the FBF's view, the proposed Exposure Measure would lead to such a significant increase of the denominator that the leverage ratio would become the binding constraint of regulatory capital. A backstop measure should be a safety net and not a binding constraint. Putting into place a leverage ratio more binding than the risk sensitive regulatory capital ratio would be a critical issue for banks having a low risk profile. Moreover, in a recent discussion paper[1] the BCBS states that: "*The Committee believes that a risk-based capital regime should remain at the core of the regulatory framework for banks, supported by liquidity and funding metrics as well as other measures such as a leverage ratio*". **The FBF therefore insists that the BCBS adjusts the proposed rules to keep the leverage ratio as a veritable backstop measure to complement the risk based capital ratio.**

2- Calculation of the leverage ratio

FBF is especially concerned about the proposed treatment of Securities Financing Transactions (SFT) exposures and derivatives. The main issues are threefold; gross measure of SFTs, derecognition of the collaterals and notional treatment of written credit derivatives. All these three measures would disproportionately increase the capital required to sustain essential banking activities in compliance with the leverage ratio and potentially make them unviable. While FBF understands that the leverage ratio as a blunt backstop measure does not intend to measure the risk of loss, it should be a fair reflection of the banks' activity without double counting, avoid discentivising prudent risk practice and mostly importantly should not create unintended knock-on effect on the real economy.
With a view to minimise the distortive effect of the proposed measure, a possible way for the BCBS to consider is to allow the netting of the SFTs and derivatives exposures as far as they are legally enforceable by the relevant contracts. This caters for BCBS' goal to neutralise the difference in accounting regimes for the level playing field purposes, nevertheless without unreasonably and artificially inflating the exposures. In the following this argument is further developed for each of the asset types mentioned.

1- *Treatment of related collateral (points 26-29)*

This framework suggests that derivatives be calculated as the replacement cost plus an add-on for potential future exposure.

This is particularly true for cleared transactions. Indeed, international market infrastructures reforms have led to increase massively the use of central counterparties to clear derivatives transactions. Of course we support such reforms as they will improve the financial stability. But on the other hand, because these reforms will lead to heavily collateralized transactions, we think they are inconsistent with the collateral treatment proposed by the Basel Committee for leverage ratio purposes. In the same vein, we encourage the Committee to clarify the provisions for exposures to QCCP where the institution acts as an intermediary and does not guarantee the performance of the CCP to the client. We believe such exposures should be exempted from leverage ratio as they are from the risk based ratio.

[1] The regulatory framework: balancing risk sensitivity, simplicity and comparability – BCBS paper 258.

In the revised leverage ratio proposal, however, collateral received would not be allowed to be netted against derivatives, resulting in collateralised and uncollateralised exposures being treated the same way for the purpose of the leverage ratio. Hence, the risk-reducing effect of collateral would be ignored based on the assumption that collateral would create leverage[2]. FBF does not agree with this view. If the bank re-uses collateral for another transaction to leverage itself, it would be required to include the assets generated in that transaction in the Exposure Measure. Thus, the bank would be compelled to hold additional capital resulting from those increased assets to meet the leverage ratio requirement. On the contrary we believe that the exchange of collateral eliminates or reduces leverage within the banking system.

2- *Written credit derivatives (points 30-33)*

In addition to the Current Exposure Method (CEM) or the Non-Internal Model Method (NIMM) treatment of derivatives and related collateral this framework also incorporates the full effective notional value of written credit derivatives (the exposure measure for credit protection sellers) into the exposure measure to capture the credit exposure to the reference entity. There is no reason that credit derivatives should be treated any differently from other derivatives. Hence,FBF proposes that the same Net PV + add-on approach be applied. The BCBS concern addressed here is especially not relevant for a trading book activity.

3- Securities financing transaction (SFT) exposures (points 34-39)

The proposed treatment for SFTs in the exposure measure of the leverage ratio seems to be based on a flawed vision on financing the economy via these market instruments. Primary securities issuing activity is of course very useful for the economy, but the secondary market transactions through SFTs are also essential to supply liquidity to finance the economy.

They are not designed for excessive leverage or speculation. Furthermore, the proposed approach is somewhat inconsistent with structural reforms of the banking sector currently under way in the US and in Europe which to a certain extent recognises the important role played by these transactions by exempting those from the definition of speculative activities to be separated.

According to the proposed framework SFT exposures should be measured by adding gross accounting assets and a measure of counterparty credit risk calculated as the sum of positive and negative haircuts within the same netting agreement with a floor at 0. Gross accounting assets correspond to the cash legs of reverse repos and security borrowing transactions, i.e. to the financing element inherent to those transactions. No netting is allowed against the security leg of the same transactions or between reverse repos and security borrowing transactions on the asset side of the balance sheet and repos and security lending transactions on the liability side of the balance sheet. Reverse repos and security borrowing transactions would receive the same treatment as unsecured financing despite their highly secured nature.

Furthermore counterparty credit risk is added resulting in the SFT exposures exceeding not only their book value and the amount of financing extended through those transactions, but also the exposure measure of an unsecured loan of the same cash amount. Put differently, gross exposure (as measured by gross accounting assets) and net exposure (measured by credit counterparty risk, as defined above) are wrongly added, whereas only the latter is relevant.
FBF does not understand why the BCBS does not allow to determine the exposure value of repurchase transactions, securities or commodities lending in accordance with article 220

[2] Point 26: "… the bank can use the collateral to leverage itself".

and article 222 of CRR, taking tinto account the effects of master netting agreements (except contractual cross-product netting agreements). Portfolios that are in essence risk and leverage neutral should not inflate the reported leverage. Furthermore, we believe that for "trading "portfolios in securities financing transactions one should only look at the net exposure and the credit exposure as reflected in the haircuts. With regard to the latter FBF understands that comparability is sought. However, this will lead to double reporting requirements for banks who report on internal model methods (IMM and RepoVaR).
The unintended consequences of the proposed treatment of SFT exposures include the followings among others:

- A less liquid sovereign bond market for which the liquidity is supplied mostly by repo transactions;
- A less efficient transmission of the central banks' monetary policy by discouraging banks to take on these collateralised transactions with other players;
- A sharp increase in price for repos due to liquidity premium for both banks and corporates. The latter usually uses repos to manage their cash balances;
- A knock-on effect on corporate debt financing. Lots of corporates finance their activities by issuing debt. The liquidity of this primary market is ensured by banks through SFTs on the secondary market. The punitive rule of SFT in leverage ratio therefore will seriously undermine the financing capacity of corporates by dying out the liquidity supplied into the debt market by SFTs.

FBF suggests that an appropriate SFT measure should recognise the highly secured nature of those transactions and allow for netting so that they are treated more favourably than unsecured financing transactions carrying more risks for banks and the financial system.

3- Scope and level of consolidation

3-3-1 Scope of consolidation

In the consultative paper, the BCBS proposes that where the investment by a bank in the capital of an investee is included in the definition of Tier-1 capital of the bank, the investee's assets and its other exposures are to be included in the exposure measure of the bank. This proposal is not conceptually sound because it will lead to an asymmetrical treatment between the denominator and the numerator of the leverage ratio.

We think that the leverage ratio is tied to banking activities and should be based on the prudential scope of consolidation and not on the accounting scope of consolidation. More specifically, the exposure measure of a bank should be based on assets and off-balance sheet exposures as they are recorded in the balance-sheet and off-balance sheet determined on the prudential scope of consolidation.

In particular, investees' assets and other exposures subject to prudential regulation (e.g. insurance, reinsurance companies and insurance holdings) do not contribute to the leverage effect of banking activities, notably because they are secured by technical and mathematical provisions (not deducted of assets). Moreover, they are subject to a lot of regulatory rules and to their own sectorial regulatory capital requirements.

Therefore, including insurance assets and exposures in the banking leverage ratio would have 2 undesired consequences:

- an asymmetrical treatment between the numerator and the numerator of the leverage ratio, because insurance regulatory capital is not taken into account in banking regulatory capital as it is the case in the financial conglomerates supervisory approach;
- a level playing field issue between insurance companies: insurance companies that are subsidiaries of banks would be de facto subject to a binding banking leverage ratio, whereas this would not be the case of other insurance companies.

Consequently, we consider that the carrying amount of the investee (after regulatory adjustments) should be taken into account in the calculation of the exposure measure instead of the investee's assets and other exposures.

3-3-2 Level of consolidation (consolidated, sub-consolidated, individual)

As a backstop measure, the leverage ratio should have to be managed at the higher level of a banking group. Indeed, another approach should result in allocating capital according to the leverage ratio rather than according to a risk-based approach. Moreover, in some groups (notably mutual groups), some entities are in charge of the funding of the whole group, secured by internal process of solidarity.

In these cases, a calculation based on sub consolidated or solo approach should be very difficult because of non-risked intragroup transactions and should need an undue allocation of capital to comply with the leverage ratio. We consider that the ratio should not interact with the management and the organization of a group.

Implementing a close monitoring of ratios, solvency and leverage, at the same time for each entity of a group could lead to regroup all activities in the same legal entity which is at odds with the works on the separation of activities.

More generally, we think that the leverage ratio can only be monitored at the consolidated level and that only internationally active groups must comply with a 3% requirement.

Even if the Basel Committee in its general framework leaves the door open for supervisors to test that individual banks are adequately capitalized on a stand-alone basis, we think that for sub-consolidated levels or individual entities, the leverage ratio must remain a pillar 2 indicator to be considered by supervisors among other indicators and according to the activities and the specificities of each entity, as envisaged in the European CRR/CRD4 package.

4-3 Disclosure requirements (points 43-46)

The proposed amount of information to be reported seems excessive as the leverage ratio should remain a backstop measure. Detailed information should be limited to supervisors. Banks should not publish the different components of the leverage ratio as the calculation of the leverage ratio is not as simple as some people think. They must rely on the calculation done by banks and verified by supervisors. The public disclosure should be limited to the figure 1, eventually including T1 data to mention the leverage ratio. FBF questions the need for and benefit of the excessive information requirements. It gives too much importance to the leverage ratio that should remain a "green light" when banks comply with the minimum level required.