

Finance Watch response to the Basel Committee on Banking Supervision Consultative Document “Revisions to the Basel III leverage ratio framework”

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Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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Finance Watch welcomes the agreement of the Group of Central Bank Governors and Heads of Supervision of the Basel Committee on Banking Supervision (BCBS) to introduce the Basel III leverage ratio (LR) as a Pillar 1 measure by 1 January 2018.

Characterisation of the leverage ratio

Finance Watch would like to reiterate its position that the Basel III regulatory framework should not rely on risk-weighted assets (RWA) as its principal Pillar 1 indicator of capital. While we welcome the BCBS's continued efforts towards reducing variation in RWAs, incremental improvements are still unlikely to remedy the fundamental shortcomings of the risk-based capital adequacy framework¹. These limitations, which have been amply demonstrated and commented on, include complexity and modelling risks, susceptibility to regulatory arbitrage, competitive distortion and pro-cyclicality². We strongly support the view that the leverage ratio should be implemented as a primary capital measure, on a par with the RWA-based metrics, and construed as a binding constraint³.

The build-up of excessive leverage has proven to be one of the main threats to financial stability in 2007/08 crisis and many of the crises before. The leverage ratio has been identified as a significantly more reliable indicator of a bank's distance to default than risk-based capital measures⁴. It is also simple for banks to implement and more transparent for regulators to monitor and review. An additional benefit of the leverage ratio is its counter-cyclical nature. The leverage exposure measure is more responsive to cyclicality than RWA-based measures and hence a more effective tool to manage excessive credit creation during cyclical upturns⁵.

¹ see also Finance Watch, Response to the BCBS consultation on Reducing variation in credit risk-weighted assets, 24 June 2016; (<http://www.finance-watch.org/our-work/publications/1268-response-bcbs-consultation-rwa>)

²e.g. Admati, Anat R., The missed opportunity and challenge of capital regulation, National Institute Economic Review, No. 235/2016, 3 February 2016; (https://www.gsb.stanford.edu/sites/gsb/files/misssed-opportunity-dec-2015_1.pdf)

Haldane, Andrew, Constraining discretion in bank regulation, Speech at the Federal Reserve Bank of Atlanta Conference on 'Maintaining Financial Stability': Holding a Tiger by the Tail(s) (Atlanta, USA), 09 April 2013; (<http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech657.pdf>)

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Blundell-Wignall, Adrian/Atkinson, Paul, Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity, OECD Journal: Financial Market Trends, Vol. 2010/1; (<http://www.oecd.org/finance/financial-markets/45314422.pdf>)

³ e.g. Fender, Ingo/Lewrick, Ulf, Calibrating the leverage ratio, BIS Quarterly Review, December 2015, pg. 43; (http://www.bis.org/publ/qtrpdf/r_qt1512f.htm); Blundell-Wignall/Atkinson (2010; see Footnote 2)

⁴Blundell-Wignall, Adrian/Roulet, Caroline, Business models of banks, leverage and the distance-to-default, OECD Journal: Financial Market Trends, Vol. 2012/2; (<https://www.oecd.org/finance/BanksBusinessModels.pdf>)

⁵ Brei, Michael/Gambacorta, Leonardo, The leverage ratio over the cycle. BIS Working Paper No. 471, November 2014; (<http://www.bis.org/publ/work471.htm>)

Methodological consistency

While we appreciate that overall consistency within the Basel III framework should be maintained we believe that it is important that the leverage ratio remains what it is intended to be: a simple, transparent and conservative measure that is complementary to, but separate from, the risk-based capital framework. We are therefore sceptical that the increased use of risk-based approaches for the calculation of certain elements of the leverage ratio exposure measure would be consistent with this objective.

We would therefore prefer the Current Exposure Method (CEM) to be maintained for the calculation of counterparty credit risk exposure. With the introduction of the Standardised Approach for Measuring Counterparty Credit Risk (SA-CCR) the calculation of derivatives exposures may become more granular and resemble more closely the outcomes obtained under the risk-weighted framework. At the same time they would also become more sensitive to a wider range of modelling variables, which introduces additional sources of variation, increases complexity and reduces transparency. We would also argue that CEM produces a more conservative measure of exposure than SA-CCR, notably by excluding margining. For all its shortcomings, which we recognise, we believe that CEM is a more consistent and conservative metric of derivatives exposure for the purposes of calculating the leverage ratio.

We note that the BCBS is also proposing to apply the revised standardised approach (SA) to the calculation of Credit Conversion Factors (CCFs) to capture off-balance sheet exposures. We believe that the risk-weighted approach by exposure categories, as set out in the SA, should still remain subject to a 10% floor.

Calibration of the leverage ratio

We believe that the proposed calibration of the leverage ratio at 3.0% (sec. 6 of the Annex) is not sufficient, neither as a backstop nor as a primary metric. Based on the BCBS's own data as of June 2015⁶, only seven out of a sample of more than 200 banks, i.e. less than 3.5%, would have failed the 3.0% leverage ratio criterion. The total Tier 1 capital shortfall of this sample against the leverage ratio criterion is even lower than against the risk-weighted Tier 1 target ratio of 8.5%⁷, which implies that, at 3.0%, the leverage ratio would, in practice, not act as an effective backstop to enforce a risk-weighted target level of 8.5%. It follows that, at this level, the leverage ratio would only constrain extreme outliers and hence become altogether meaningless as a regulatory benchmark.

Finance Watch strongly supports demands, supported by significant body of institutional research⁸, to set the leverage ratio at a mandatory level of 4.0%, as a minimum. Studies indicate that a leverage ratio at this level would set a binding constraint in ca. 30% of instances for a sample of ca. 100 banks over a 17-year observation period⁹. This is consistent with the

⁶ Basel Committee on Banking Supervision, Basel III Monitoring Report, March 2016; (<http://www.bis.org/bcbs/publ/d354.pdf>)

⁷ EUR 4.3 bn vs. EUR 6.5 bn; see Footnote 6, pgs. 12 and 18

⁸ e.g. Fender/Lewrick (2015; see Footnote 3); Blundell-Wignall, Adrian/Atkinson, Paul, Deleveraging, Traditional versus Capital Markets Banking and the Urgent Need to Separate and Recapitalise G-SIFI Banks, OECD Journal: Financial Market Trends, Vol. 2012/1; (<https://www.oecd.org/finance/financial-markets/Deleveraging,%20Traditional%20versus%20Capital%20Markets%20Banking.pdf>)

⁹ Fender/Lewrick (2015; see Footnote 3)

BCBS data as of June 2015, which indicate that 75% of banks in the sample already have leverage ratios well in excess of the 4.0% level we propose¹⁰.

The calibration of the leverage ratio should be internally consistent with other parts of the Basel framework including, in particular, its risk-based measures. The RWA Density Ratio (DR)¹¹, which represents the average risk weight per unit of exposure, may be considered as a useful benchmark in this context. The 'cross-over' level where a leverage ratio at 3.0% corresponds to the Basel III minimum Tier 1 ratio (incl. capital conservation buffer) of 8.5% implies a density ratio of ca. 35%. Similarly, the Financial Stability Board (FSB), in its definition of Total Loss-Absorbing Capacity (TLAC)¹², has set an implicit density ratio of 37.5%. Density ratios are strongly influenced, among other factors, by the bank's choice of risk reporting under the Basel framework (Standardised or Internal Ratings-Based, Foundation or Advanced) and the business model of the bank. Large, international banks that use Advanced IRB modelling and operate large investment banking businesses, in particular G-SIBs, tend to have significantly lower Density Ratios than universal or retail banks. Banks reporting RWA under the SA, by contrast, are exhibiting consistently higher density ratios than those using IRB¹³. Density Ratios for broader samples of banks tend to be ca. 20-30% higher, on average, than the 35-37.5% benchmark range, which is arguably biased towards G-SIBs¹⁴. In order to calibrate the leverage ratio accurately as a counterpart to the risk-weighted 8.5% Tier 1 requirement, which will be applicable in due course to all banks under the Basel III framework, a higher average density ratio of ca. 45%, would be a more appropriate benchmark, in our view. This, in turn, would be consistent with a leverage ratio of 4.0%.

Micro- and macroprudential aspects

There are concerns that the introduction of a binding leverage cap could encourage banks to shift their asset allocation towards higher-risk assets and displace credit creation towards less regulated parts of the financial system, creating new risks for financial stability. These

¹⁰ Average Basel III leverage ratios (fully phased-in) were 5.2% for Group 1 banks and 5.3-5.4% for Group 2 banks; see BCBS (2016; Footnote 6, Tables A.14 and A.15

¹¹
$$DR = \frac{\text{Risk Weighted Assets}}{\text{Leverage Ratio Exposure Measure}}$$

¹² Financial Stability Board, Principles on Loss-Absorbing and Recapitalisation Capacity of G-SIBs in Resolution: Total Loss-absorbing Capacity (TLAC) Term Sheet, 09 November 2015; <http://www.fsb.org/2015/11/total-loss-absorbing-capacity-tlac-principles-and-term-sheet/>

¹³ e.g. Le Leslé/Avramova (2012; see Footnote 2) ; Brunella, Bruno/Nocera, Giacomo/Resti, Andrea, The credibility of European banks' risk-weighted capital: structural differences or national segmentations?, Speech at the Third European Banking Authority Policy Research Workshop 'How to measure the riskiness of banks' (London, UK), 24 November 2014; (<https://www.eba.europa.eu/documents/10180/846261/The+credibility+of+European+Banks'+risk-weighted+capital+-+B.+Bruno%2C+G.+Nocera%2C+A.+Resti.pdf>); Trucharte, Carlos/Artigas, Carlo/Pérez-Montes, María/Cristófoli, Elizabeth/Ferrer Pérez, Alejandro/Lavin San Segundo, Nadia, Credit Portfolios and Risk-Weighted Assets: Analysis of European Banks, Banco de España - Revista de Estabilidad Financiera, No. 29, November 2015; (<http://www.bde.es/f/webbde/GAP/Secciones/Publicaciones/InformesBoletinesRevistas/RevistaEstabilidadFinanciera/15/NOVIEMBRE%202015/restfin2015294.pdf>) We note, however, that DRs in these studies are usually calculated on the basis of total assets under IFRS, not the leverage exposure measure. Further research on this subject would be desirable.

¹⁴ e.g. Le Leslé/Avramova (2012; see Footnote 2), Brunella/Nocera /Resti (2014; see Footnote 13)

concerns are valid, in our view, but merely illustrative of the ‘boundary problem’, as described by Goodhart¹⁵: any regulation of the formal banking sector will have an impact on adjacent segments of the financial system and can only be successful if accompanied by complementary measures addressing the shadow banking system, in particular. The incentives created by a risk-neutral metric, such as the leverage ratio, are more likely to redirect lower-risk borrowers to the shadow banking system, leaving higher-risk credits within the more strictly regulated and supervised banking sector – a result that should be preferable, in principle, from a prudential point of view¹⁶. In conjunction with other regulatory initiatives aimed at reducing moral hazard and solving the ‘too big to fail’ problem this outcome should be conducive overall to improving financial stability.

The need for a counter-cyclical adjustment to the leverage ratio, advocated by some to cushion the effect of banks deleveraging in a cyclical downturn¹⁷, should also be reviewed. Arguably, it is precisely in stressed conditions, when demand for credit weakens and asset quality deteriorates, that the leverage ratio comes into its own as a backstop and as an early-warning sign for a potentially critical weakening of the bank’s balance sheet. We do recognise, however, that abrupt system-wide deleveraging may be detrimental to financial stability and would therefore support further enquiry into the subject.

Additional requirements for G-SIBs

We support the BCBS’s suggestion that a higher minimum leverage ratio requirement should be introduced to mirror the higher risk-based capital ratio requirements for global systemically important bank (G-SIBs)¹⁸. Certain jurisdictions, including Switzerland and the United States, have already introduced a higher Leverage Ratio for large, systemically relevant financial institutions. That level should be consistent, in our view, with the higher loss-absorbency additions set out by the FSB (1.0-2.5% of RWAs, at present). In order to maintain the principal benefit of the leverage ratio, its simplicity, and its character as a complementary measure to the risk-based capital framework, the G-SIB leverage ratio should be fixed at 5.0%. A tiered approach, e.g. by aligning leverage ratio thresholds with the FSB’s allocation of G-SIBs to ‘buckets’, could create unintended side effects by setting narrow ranges of ‘optimum’ density ratios, which could, as a result, unfairly disadvantage particular business models or asset classes.

In line with the FSB framework for systemically important financial institutions (SIFIs), which recognises systemic importance both at the global and domestic level, the higher leverage

¹⁵ Goodhart, Charles A. E. and Lastra, Rosa M., The boundary problems in financial regulation; in: Barth, James R./Lin, Chen/Wihlborg, Clas (eds.), Research Handbook on International Banking and Governance, Cheltenham 2012, pgs. 321-332

¹⁶ Repullo, Rafael/Martinez-Miera, David, Comparing Flat and Risk-based Capital Requirements, Speech at the Third European Banking Authority Policy Research Workshop ‘How to measure the riskiness of banks’ (London, UK), 26 November 2014; (<https://www.eba.europa.eu/documents/10180/911561/02+Rafael+Repullo+-+Key+note+speech.pdf>)

¹⁷ e.g. D’Hulster, Katia, The Leverage Ratio: A New Binding Limit on Banks, World Bank Crisis Response Note No. 11, December 2009; (<http://www.worldbank.org/financialcrisis/pdf/leverage-ratio-web.pdf>)
Schoenmaker, Dirk/Wierts, Peter, Macroprudential Supervision: From Theory to Policy, European Systemic Risk Board Working Paper No. 02/2016, 23 February 2016; (<https://www.esrb.europa.eu/pub/pdf/wp/esrbwp2.en.pdf>)

¹⁸ BCBS, Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement, July 2013; (<http://www.bis.org/publ/bcbs255.pdf>)

ratio requirement for G-SIBs should also be incorporated into the corresponding framework for domestic systemically important banks (D-SIBs).

We believe that the incremental capital used to cover an additional Tier 1 capital requirement should, at a minimum, not be inferior to the average quality of regulatory Tier 1 capital overall. At present, up to 25% of the Basel III minimum Tier 1 requirement (6% of RWAs) may be satisfied with Additional Tier 1 (AT1) capital whereas buffers must be covered with CET1 capital. Any additional Tier 1 capital requirement should therefore be met with the same combination of CET1 and AT1 capital as the regulatory Tier 1 minimum, including buffers. In any event, AT1 capital should not exceed 25% of the total additional requirement.