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Regulatory brief

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Basel leverage ratio: No cover for US banks

Overview

On January 12, 2014 the Basel Committee on Banking Supervision (Basel Committee) issued the near final version of its leverage ratio and disclosure guidance (B3LR). The B3LR will be subject to further calibration until 2017 with final implementation expected by January 1, 2018.

The B3LR makes a number of significant changes to the Basel Committee's June 2013 consultative paper (Consultative Paper) by easing the approach to measuring the exposures of off-balance sheet items. These changes address the industry's concern that the Consultative Paper's definition of exposure was too expansive (i.e., the leverage ratio's denominator was too large).

The changes eliminate many, but not all, differences between the B3LR and its US counterpart, the supplementary leverage ratio (which applies to US firms with over $250 billion in assets – i.e., Advanced Approaches firms). US regulators must now decide if they will alter the exposure calculations of the supplementary leverage ratio (SLR) to further harmonize it with the B3LR, which US regulators indicated they may do when the SLR was issued in July 2013. More importantly, they must also decide if they will adjust their pending Revised Supplementary Leverage Ratio (RSLR) which has proposed to raise the SLR from 3% to 5% for the eight US bank holding companies with over $700 billion in assets or $10 trillion under custody (i.e., US G-SIBs).

It is our view that US regulators are unlikely to lower the RSLR's 2% buffer, even though its sting is sharpened by the competitive advantage the now more aligned B3LR provides non-US banks. US regulators view the RSLR as a needed complement to risk-based capital standards (not as a "backstop," as the Basel Committee views the leverage ratio). We believe US regulators will likely finalize the RSLR by spring.

The other distinct advantage the revised B3LR gives non-US banks relates to the SLR's treatment of off-balance sheet commitments. The B3LR moves from including these exposures at 100% of notional amount to using Credit Conversion Factors (CCFs) that reduce some exposure items to as low as 10% of notional amount. However, the SLR continues to measure these at 100%.

The B3LR also provides near-parity for non-US banks by allowing them to:

- Deduct the cash variation margin from their OTC derivatives exposure under certain conditions, similar to US banks under the SLR.
- Utilize US GAAP-like netting of on-balance sheet Securities Financing Transaction (SFT) exposures. This improvement does not fully bridge the gap with US banks due to the SLR's apparent exclusion of off-balance sheet SFT exposure.

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- Limit exposure of written credit derivatives and use a broader variety of hedges that include more reference securities.

This **Financial Services Regulatory Brief** analyzes the differences between the B3LR and the Consultative Paper, compares the B3LR to the US's SLR, and provides our view of what US regulators will do next.

Leverage ratio improved for non-US banks

The Basel Committee introduced the leverage ratio as a simple, transparent, and non-risk based measure to backstop Basel's risk-based capital requirements. The June 2013 Consultative Paper defined this ratio as (a) Tier 1 capital, divided by (b) total exposure to both off-balance sheet (OBS) and on-balance sheet items, using relatively straightforward but conservative assumptions for OBS exposures.

In July 2013, the US regulators implemented their SLR and issued a proposed rule establishing the RSLR.[1] Under the US's leverage ratios, OBS SFTs are excluded from the exposure calculation.

The B3LR's key areas and improvements are discussed below, and further outlined in **Appendix 1** of this brief.

On-balance sheet exposures

The B3LR maintains the same calculation for on-balance sheet exposures from the Consultative Paper. Balance sheet assets that are deducted from Tier 1 capital may also be deducted from the exposure measure (e.g., goodwill). Liability items, however, cannot be deducted from the exposure measure (e.g., gains/losses on fair valued liabilities).

Derivative exposures

The B3LR reduces derivatives exposure in three ways as compared to the Consultative Paper.

First, the cash portion of variation margin exchanged between derivatives counterparties may now be viewed as a form of pre-settlement payment and can be used to reduce the leverages ratio's exposure measure if certain conditions are met. One of the key goals of the financial regulations passed after the financial crisis was to ensure banking institutions held a higher percentage of high quality, low risk assets to better withstand adverse market conditions. To achieve that goal, the Consultative Paper did not allow for qualifying collateral to be netted against derivative exposures, even in instances where netting is permitted under the financial institution's accounting or risk-based framework. Furthermore, banks were required under the Consultative Paper to increase their gross exposure measure by the amount of the collateral posted to others.

Second, under the B3LR, Clearing Member financial institutions (CM) no longer need to count derivatives trading exposures to a Qualifying Central Counterparty (QCCP) in most cases. However, CMs are still required to recognize the trading exposures to QCCPs and other Central Counterparties (CCP) when the CM guarantees the performance of a CCP to its clients, and when the CM guarantees the performance of its clients' derivative trade exposures to the CCP.

Third, for written credit derivatives, the effective notional amounts included in the exposure measure can now be capped at the maximum potential loss level, and the effective notional amount may be reduced by any negative change in fair value amount that has been incorporated into the calculation of Tier 1 capital. The definition of eligible hedges also has been expanded to include subordinated reference securities (provided the hedge protection is triggered by the same default event).

One key change financial institutions were hoping to find in the B3LR was the replacement of the Current Exposure Method (CEM) with the Non-Internal Model Method for calculating derivative exposures. Analysis by financial institutions points to the conclusion that the CEM overstates the economic measure of exposure and a more sensitive methodology is needed. With the updated B3LR, the Basel Committee indicates that it is considering alternatives to the CEM for use under the Basel risk-based capital framework to calculate counterparty credit risk exposure amounts. Specifically, if an alternative approach is adopted to replace the CEM, the Basel Committee will consider if the adopted approach is appropriate for use in the context of calculating the B3LR.

Securities financing transaction exposures

The contribution of SFTs to total exposure has also decreased based on a key change from the Consultative Paper. The change allows cash payables and cash receivables to the same counterparty to be netted against one another if certain conditions are met.

[1] The US standard leverage ratio does not include OBS exposures (unlike Basel's leverage ratio), so the US established the 3% SLR as part of its implementation of Basel III's capital rules in July 2013. The US then proposed the RSLR which heightens the SLR for US G-SIBs to 5% at the bank holding company level. For additional detail, see PwC's *Financial Services Regulatory Brief, Heightened leverage ratio: US regulators unveil next act for regulating large banks – a long way until the end* (July 2013).

Other off-balance sheet exposures

The B3LR improves upon the Consultative Paper by measuring OBS exposures using CCFs,[2] instead of using 100% of notional amounts. These CCFs reduce some exposure items to as low as 10%. A detailed breakdown of CCFs under the B3LR is included in **Appendix 2** of this brief.

Disclosure requirements

The B3LR maintains the same timeline and framework for detailed public disclosures. Banks will be required to disclose the leverage ratio, and its numerator and denominator, beginning on January 1, 2015 using common templates. The Basel Committee added the clarification that disclosures should take place on an at least quarter-end basis and should include the figures of the prior three quarter-ends. Banks may, however, subject to regulatory approval, use more frequent calculations (e.g., daily or monthly averaging) as long as they do so consistently. In addition, the Basel Committee updated the summary comparison template to provide greater detail of the total leverage exposure measure.

Differences persist between US and Basel leverage ratios

The changes since the Consultative Paper have reduced the disparity between the B3LR and the US's RSLR. However, major differences persist which are described below and further detailed in this brief's Appendices.

Ratio level – Advantages foreign banks

To ensure that the SLR remains sufficiently stringent for the eight largest US G-SIBs, US regulators in July 2013 proposed the RSLR which calibrates the SLR's 3% threshold with the Basel III risk-based capital requirements. US regulators view the RSLR as a needed complement to risk-based capital standards (not as a "backstop," as the Basel Committee views the leverage ratio).

Therefore, the RSLR adds a 2% buffer for G-SIBs' bank holding companies (BHCs), and applies a 3% ratio for their bank subsidiaries to be considered "adequately capitalized" (and a 6% ratio to be considered "well capitalized"). Details are provided in **Appendix 3** of this brief.

[2] CCFs convert non-derivative off-balance sheet transaction amounts (e.g., a loan commitment) to exposure amounts.

Securities financing transactions – Advantage US banks

The B3LR closes the gap in ability to net on-balance sheet SFT exposures with respect to the SLR. US banks, however, still enjoy the continued exclusion of OBS SFTs from leverage exposure.

Other off-balance sheet exposures – Advantage foreign banks

The B3LR reduces the exposure of OBS commitments, resulting in a treatment that is much more favorable than the SLR's treatment. The disparity in CCFs for commitments results in a comparatively higher capital cost for US banks of providing credit commitments to retail and corporate borrowers. Therefore, this reduction creates a distinct advantage for non-US banks versus their US counterparts.

Infrastructure challenges

Technology infrastructure requirements are increased by the B3LR, as more data is needed to take advantage of revised exposure adjustments across jurisdictions. This infrastructure requirement is amplified to the extent that differences persist between the B3LR and SLR, so global banks will need to extend their systems to support calculations of multiple and complex exposure definitions (particularly with respect to written credit derivatives). Additionally, the extent to which risk exposure definitions vary from a local accounting view of exposure or internal management view of exposure makes communicating and reconciling risk more difficult for banks across jurisdictions.

How will US regulators respond to the B3LR?

The Basel Committee's easing of the B3LR raises the question of whether US regulators will adjust for the remaining differences in the measure's components in order to harmonize the SLR with the international standard. That the US regulators have raised questions among themselves regarding the appropriate leverage framework only makes full global harmonization less likely.

The biggest issue is the RSLR's G-SIB buffer. We do not believe that US regulators will lower the buffer because US regulators have viewed the RSLR as a needed complement to risk-based capital standards. Furthermore, US regulators have placed great emphasis on the importance of the SLR to financial stability, especially in light of the US's ongoing Too-Big-To-Fail debate. In fact, US regulators have indicated they may expand the RSLR's buffer to US Advanced Approaches institutions.

With respect to the second major disadvantage for US banks, i.e., the B3LR's use of CCFs to adjust certain OBS exposures, we again do not believe US regulators will relent. US regulators have already indicated their view that such adjustments are inappropriate for use in a leverage ratio because they introduce risk factors similar to the risk-weighted capital framework – in other words, CCFs undermine the purpose of the leverage ratio. Although statements in the US's final capital rule explicitly left open the possibility for revising the SLR's exposure calculations after release of the B3LR, it does not look like US regulators will take great advantage of that opening by making this or other major changes.

Appendix 1 – Comparison of US and Basel leverage ratio proposals

Type of exposure	US SLR (July 2013)	Basel Consultative Paper (June 2013)	B3LR (January 2014)
On-balance sheet	• On-balance sheet assets recognized according to GAAP	• On-balance sheet assets recognized according to IFRS	• On-balance sheet assets recognized according to IFRS
OTC derivatives	• Exposure recognized as the sum of (1) the replacement cost and (2) Potential Future Exposure (PFE) • Cash variation margin may reduce replacement cost portion of exposure • CMs do not recognize trade exposures to the QCCP if the CM does not guarantee the performance of a CCP to its clients (or guarantee the performance of its client's derivative trade exposures to a CCP)	• Exposure recognized as the sum of (1) the replacement cost and (2) PFE • Cash variation margin does not reduce exposure • CM trade exposure amount for cleared derivative contracts is the derivative contract exposure plus the fair value of the collateral posted by the CM client (no difference if CM is acting as an intermediary)	• Exposure recognized as the sum of (1) the replacement cost and (2) PFE • Cash variation margin may reduce replacement cost portion of exposure (subject to specific conditions) • CMs do not recognize trade exposures to the QCCP if the CM does not guarantee the performance of a CCP to its clients (or guarantee the performance of its client's derivative trade exposures to a CCP)
Written credit derivatives	• Exposure measure is the effective notional amount of the written credit derivative • Effective notional amount is the fair value as captured (1) on-balance sheet with (2) PFE if positions are included in the market risk computation (however, if written protection, PFE is capped to unpaid premiums) • Effective notional amount may be reduced by any negative change in fair value amount that has been incorporated into the calculation of Tier 1 capital • Eligible hedge definition includes credit derivatives transactions referencing a pari-passu or subordinated position of the same underlying reference obligation	• Exposure measure is the effective notional amount of the written credit derivative • No cap on exposure (e.g., exposure could exceed the level of maximum potential loss) • Eligible hedge definition only includes credit derivatives transactions referencing a pari-passu position of the same underlying reference obligation	• Exposure measure is the effective notional amount of the written credit derivative • Exposure capped at the level of maximum potential loss • Effective notional amount may be reduced by any negative change in fair value amount that has been incorporated into the calculation of Tier 1 capital • Eligible hedge definition expanded to include credit derivative transactions referencing both a pari-passu or subordinated position of the same underlying reference obligation

Type of exposure	US SLR (July 2013)	Basel Consultative Paper (June 2013)	B3LR (January 2014)
Securities financing transactions	• SFT exposure is recognized as the on-balance sheet amounts • OBS SFTs are not included in exposure	• Gross SFTs are recognized without considering impact of netting • Exposure includes measures of counterparty risk (without an add-on for potential future exposure) • Exceptional treatment for exposures when the bank is acting as an agent in SFTs if certain conditions are met	• Gross SFTs are recognized without considering impact of netting; however netting of cash payables and receivables is allowed with the same counterparty if: (i) Transactions have the same settlement date (ii) Netting agreements are legally enforceable (iii) Counterparties intend to settle net, settle simultaneously, or the settlement mechanism is functionally equivalent to net settlement • Exposure includes measures of counterparty risk (without an add-on for PFE) • Exceptional treatment for exposures when the bank is acting as an agent in SFTs if certain conditions are met
Other off-balance sheet items	• 100% CCF for all covered OBS items • 10% CCF for commitments unconditionally cancellable by the bank at any time	• 100% CCF for all covered OBS items • 10% CCF for commitments unconditionally cancellable by the bank at any time	• CCFs based on the risk-based capital framework standardised approach • 10% CCF for commitments unconditionally cancellable by the bank at any time

Appendix 2 – B3LR credit conversion factors (CCFs) for off-balance sheet items

	Consultative Paper	B3LR
Off balance sheet item	**Exposure Level**	**Exposure CCF**
Commitments that are unconditionally cancellable without prior notice (or effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness)	100%	10%
Commitments other than securitization liquidity facilities (maturity <= 1 year)	100%	20%
Commitments other than securitization liquidity facilities (maturity > 1 year)	100%	50%
Direct credit substitutes	100%	100%
Forward asset purchases, forward deposits, and partly paid shares and securities, which represent commitments with certain drawdown	100%	100%
Certain transaction-related contingent items	100%	50%
Note-issuance facilities and revolving underwriting facilities	100%	50%
Short-term self-liquidating trade letters of credit arising from the movement of goods	100%	20%
All off-balance sheet securitisation exposures, except an eligible liquidity facility or an eligible servicer cash advance facility as set out in paragraphs 576 and 578 of the Basel II framework	100%	100%
Eligible liquidity facilities	100%	50%

Appendix 3 – US leverage ratio requirements versus B3LR

	Jan 1, 2014*	Jan 1, 2015	Jan 1, 2016	Jan 1, 2017	Jan 1, 2018
US leverage ratio					
Standard Leverage Ratio for Insured Depository Institutions (IDIs) and BHCs	4%	4%	4%	4%	4%
Standard Leverage Ratio for IDIs (to be considered "well capitalized")	5%	5%	5%	5%	5%
Supplementary Leverage Ratio for BHCs*		Disclosure starts Jan 1, 2015			3%
US leverage ratio – proposed enhancements**					
Revised Supplementary Leverage Ratio for BHCs (with 2% buffer)		Disclosure starts Jan 1, 2015			5%
Revised Supplementary Leverage Ratio for IDIs (to be considered "adequately capitalized")		Disclosure starts Jan 1, 2015			3%
Revised Supplementary Leverage Ratio for IDIs (to be considered "well capitalized")		Disclosure starts Jan 1, 2015			6%
Basel leverage ratio					
B3LR for BHCs		Disclosure starts Jan 1, 2015			3%

*Applicable to Advanced Approaches firms (BHCs with $250 billion in consolidated assets)

**Applicable to G-SIBs (BHCs with $700 billion in consolidated assets or $10 trillion in assets under custody)

Additional information

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