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# Leverage ratio in Europe – how level is the playing field?

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In January 2014 the Basel Committee on Banking Supervision (BCBS) updated its 2010 guidelines on the leverage ratio (LR). The leverage ratio is only monitored at this stage with no firm minimum requirement in place. But the European Commission still needs to transpose the revised rules into EU regulation. The pressure is on, because any amendments need to be implemented before January 1 2015 when new LR disclosure rules come into effect.

In October the EC published delegate regulation to streamline the calculation of the LR in Europe, which is now pending adoption.

In the meantime the debate for the right minimum LR requirement gains pace. The UK has published national rules, and authorities and politicians in Sweden and the Netherlands discuss the need for higher thresholds.

## The BCBS proposal

The BCBS published the original standards for measurement of the leverage ratio in its Basel III LR framework in December 2010.

From January 1 2013, regulators are encouraged to monitor the LR on a semi-annual basis for large international banks. The BCBS proposed a design and calibration of a minimum tier 1 ratio of 3% and proposed to monitor whether this is appropriate for the full credit cycle and for different types of banks.

The LR is primarily aimed at reducing extreme market pressures on banks in an economic downturn, which would force them to deleverage in accelerated unorderly sales processes causing disruptions in the real economy.

Following the monitoring period, the BCBS plans to introduce the LR as a pillar 1 capital requirement in addition to the risk weighted capital adequacy requirements from January 1 2018.

The LR is expressed as a percentage where the numerator is the capital measure (i.e. the capital held by the bank) and the denominator is the so-called exposure measure (the assets on the balance sheet and off balance sheet items) without taking into account (credit) risk mitigating techniques or risk weightings.

## European implementation

The proposals of the BCBS have been transposed into European law by means of a number of provisions of the Capital Requirements Regulation (CRR) and the Capital Requirements Directive IV (CRD IV). European banks have to report their LR to supervisory authorities on a quarterly basis. The reported figure is the simple arithmetic mean of the monthly LR over a quarter.

As of January 1 2015 banks are required to publicly disclose those figures. By the end of 2016 the EC will, based on a report by the EBA, submit a legislative proposal to introduce a binding

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LR as a pillar 1 requirement. The proposal may introduce a ratio applicable to all banks, or may make distinctions depending on different business models of the banks concerned. The measure would become effective from January 1 2018.

Europe also has to decide whether or not to follow the BCBS' proposed 3% minimum LR.

For the time being national supervisory authorities may impose a minimum leverage ratio as a pillar 2 requirement.

## BCBS 2014 revision

This year the BCBS published a revised version of its global LR standards. Notably, the January 2014 document updates the valuation of the denominator of the LR, ie the exposure measure.

The exposure measure is calculated as the sum of

i) on-balance sheet items;

ii) derivatives exposures;

iii) securities financing transactions; and

iv) off-balance sheet items.

Generally, exposure measures need to be included at the accounting value. On-balance sheet, non-derivative exposures are included net of specific provisions or accountant valuation adjustments. Netting of loans and deposits is not permitted. Physical or financial collateral, guarantees or other credit mitigation may not be applied to reduce the exposure measure, in principle.

Assets resulting in a deduction from tier 1 regulatory capital items pursuant to the common capital adequacy framework may not be included when calculating the exposure measure.

Derivatives exposures are to be calculated, in principle, by taking the individualised exposure into account, unless proper bilateral netting contracts are in place. Further refinements are proposed with regards to counterparty risks.

The 2014 standards also address existing differences in accounting treatment of securities accounted for on the balance sheet of the receiving bank, for instance in a securities lending transaction. Cash payables and cash receivables with the same counterparty are eligible for netting if certain strict conditions are met. Further rules determine, among others, the exposure of a bank acting as an agent for securities financing transactions of its customer, where the bank does not control the underlying cash or securities' exposure belonging to the customer. In such case a reduced exposure measure may be accounted for.

The most significant change to the 2010 standards relates to the treatment of off-balance sheet items.

The risk-based capital framework with regards to exposures from commitments (bank guarantees, letters of credit and so forth) may be included for the LR calculation of the exposure measure of off-balance sheet items. This means that the system of credit conversion factors of the standardised approach of the common risk based framework is included in the LR calculation framework, and the impact of such exposures for the calculation of the LR is reduced.

This may, for instance, have significant effects for off balance sheet items where banks benefit from sovereign or central bank guarantees, where the mitigating effect of such guarantees also results in a 0% weighting for the exposure value of the leverage ratio.

## European adoption of the 2014 standards

The European implementation of the LR is included in the CRR that entered into force on January 1 2014. European banks calculate and report their ratios under CRR rules.

The biggest impact of the overhauled 2014 BCBS standards is on article 429 CRR, which deals with the calculation of LR components.

A draft delegated regulation dated October 10 2014 includes a revised text for article 429 CRR and introduces two new articles 429a and 429b CRR. The amendments must be adopted before the new LR disclosure regime begins on January 1 2015.

The EC proposal largely follows the new BCBS standard, but deviates from it when it comes to the scope of the LR calculation. It has a wider scope than the BCBS framework which applies for large international banks, taking into account EU specifics, for instance types of banks more commonly found in Europe, such as cooperatives.

## European level playing field?

Notwithstanding the efforts by EC and EBA to align leverage ratio rules across Europe, recent developments point at different approaches being introduced in some EU member states. In particular, the UK and the Netherlands are moving towards a distinctive approach. Sweden may follow this development based upon a published recommendation of the Swedish central bank, Riksbank, to introduce a leverage ratio of 5%.

The three countries are, to varying degrees, about to deviate from the EU approach, which includes an observation period with an informal benchmark rate of 3% until the end of 2017, quarterly LR disclosure as of 2015, and the introduction of the actual leverage ratio as a pillar 1 requirement as of January 1 2018.

With reference to the ‘freedom’ national regulators have until 2018 to deviate from the CRR framework, the Dutch finance minister has repeatedly said that banks should be bound to a leverage ratio sooner and higher than the internationally promoted benchmark rate of 3%.

In various communications to the Dutch parliament he promoted a 4% ratio, and until recently he has made no clear distinction between different types of banks. He took a more nuanced position in a discussion in parliament in October 2014, when he said the 4% figure should apply to systemically important banks.

But the Dutch initiative is not based on clear provisions of Dutch law describing the relevant rule. It must therefore be assumed that the finance minister refers to the introduction of pillar 2 requirements by the Dutch central bank, the DNB.

The UK is taking a different path. In October 2014 the Financial Policy Committee (FPC) of the Bank of England published a comprehensive policy document which outlines pillar 1 requirements for certain banks ahead of the EU’s 2018 implementation date. The UK regulator sees “a strong case” for such extraordinary exception to the harmonised European legislative framework:

> *“This reflects the number of systemically important institutions present in the United Kingdom; the size of the UK banking system relative to the domestic economy; and the importance, therefore, of being able to manage effectively model risk and to respond consistently to risks to financial stability that might emerge before an international standard on leverage is agreed and implemented.”*

The FPC proposes the introduction of three distinct measures. A common 3% leverage ratio should be introduced for UK G-SIBs and major banks and building societies as soon as practicable, and for all other banks in accordance with the European timing.

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Additionally, a supplementary LR buffer would apply to systemically important firms as an add-on to the systemic risk buffer, increasing the rate of the systemic risk buffer by 35%. This second LR measure would apply for G-SIBs in parallel with the corresponding risk weighted systemic risk buffers from 2016.

Thirdly, the FPC proposes a countercyclical LR buffer which would increase the countercyclical buffer rate of the common risk-weighted requirement by 35%. This would apply for all UK banks once the UK authorities set a countercyclical buffer for the UK.

Notwithstanding the thoroughness of the approach of the FPC, the framework promoted by the UK authorities significantly deviates from the overall capital adequacy framework as agreed upon internationally and in Europe.

The reasons for this bespoke framework apply also for other member states in Europe: the UK is not the only jurisdiction where the financial sector represents a significant part of the GNP or where a relatively high number of G-SIBs are established.

In balance, however, the FPC proposal is fairly aligned to the timelines for the introduction of (other) stricter capital measures of the European CRR framework, and the proposed measures for the bespoke UK framework are not a complete deviation from the agreed upon principles in Europe.

For instance, the CRR permits a 5% systemic risk buffer if this higher level (the default ceiling rate being 3%) is deemed necessary to address specific systemic risks in an economy. The FPC proposal is less rigorous than measures promoted in other member states, where simply quoting a benchmark rate of 4% applicable to certain banks most certainly changes the conditions for banks subject to this measure. Concerns expressed by Dutch banks claiming that a 4% LR may negatively impact the domestic mortgage loan market for consumers are simply dismissed by politicians without proper research and further investigation or discussion with European authorities.

The Swedish central bank recently proposed a LR of 5%, while Finansinspektionen, the Swedish supervisory authority, reportedly rejected the proposal, noting that a LR that high would discourage Swedish banks to maintain low risk assets on the balance sheet. A high LR could stimulate risk taking by banks, rather than applying prudential policies, Finansinspektionen argued.

From 2015 the four largest Swedish banks will be subject to a systemic risk buffer of 3% and an additional pillar 2 requirement of 2%, both measures based on risk weighted positions. Sweden therefore already applies a stricter regime for its systemically important banks than many other jurisdictions in Europe. In its rejection of the Riksbank proposal, Finansinspektionen referred to those measures as being sufficient, arguing there was no need to deviate from the European timing and level for the introduction of an LR.

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