

THE BASEL III LEVERAGE RATIO FRAMEWORK

CONSIDERATIONS ON ITS TRANSPOSITION AT EU LEVEL

Following the January 2014 BCBS publication on the Leverage Ratio (LR) framework, the European Commission is in the process to amend the definition of the calculation of this ratio as defined in the CRR¹ by mean of a delegated act by the 30th of June 2014 for the purpose of the disclosure of the ratio as of 1 January 2015².

This memo aims at addressing some considerations both on the process for the transposition of January 2014 BCBS as well as on the unintended consequences if the European market practices would not be sufficiently taken into consideration.

1. Process on amending the calculation of the ratio at this stage while the observation period is not completed

The CRR states that the LR is a new regulatory and supervisory tool for the European Union. In line with international agreements it should - as a first step - be introduced as an additional feature that can be applied on individual institutions at the discretion of supervisory authorities. Reporting obligations for institutions would allow appropriate review and calibration with a view to migrate the LR to a binding measure in 2018 (Recital 94). In addition, **Article 511 introduces an observation period to gather sufficient data for the implementation of a binding leverage ratio under Pillar I in Europe.**

Article 456 (1) (j) CRR states that the “*EC will be empowered to adopt a delegated act concerning the amendment of the capital measure and the total exposure measure of the leverage ratio referred to in Article 429 (2) {Calculation of the leverage ratio} in order to correct any shortcomings discovered on the basis of the reporting referred to in Article 430 (1) before the leverage ratio has to be published by institutions as set out in Article 451 (1)(a)*”.

Under the above-mentioned article of the CRR (delegated act), the EC has the power without a specific calendar to amend the definition of capital measure (numerator) and the total exposure measure (denominator) of the LR to correct **any shortcoming on the basis of the reporting requirements**³ for the observation period ending in 2016 but before the disclosure by 1 January 2015 (Article 521 a).

Legally speaking the CRR empowers the EC to amend the LR calculation **if the reporting requirements** show **shortcomings**. Against this legal approach the first reporting would be completed only in June 2014 via a common standard elaborated by EBA. Therefore, if the

¹ Article 429

² Article 451(1)(a)

³ Article 430

EC aims to adopt a delegated act to transpose the recent Basel III framework, the reporting will not be completed before the envisaged date (June 2014).

The absence of consistent data on the impact of January BCBS framework is clearly shown by the recent EBA own initiative report on the impact of differences in the leverage ratio definitions⁴. The EBA report based its analysis on data gathered for Basel III monitoring up to June 2013 recognizing that *“The CRR definition of the leverage ratio and the Basel III definition have not yet been tested through a quantitative impact study (QIS), which implies that the corresponding estimations are based on a number of simplifying assumptions as the available data did not always allow for an assessment with full precision”*.

Despite this lack of quantitative impact assessment, the EBA recommends the alignment of the CRR to the Basel III in terms of definition of LR for the benefit of a consistent LR calculation within the EU and the other jurisdictions.

Finally, it is worth to note that the EBA is claiming that the CRR would offer different interpretations of the treatment of the Securities Financing Transactions leading to a discrepancy in the level of the LR, and hence they would support a full alignment with the Basel III framework whereas flexibility on the interpretation of the exposure measure responds to the EU legislation (CRR) main objective of the observation period aiming to **test a ratio** as requirement under Pillar II.

Given the absence of consistent data on the impact of the latest BCBS framework regulators should carefully assess its European transposition in the Delegated Act by 30 June 2014. Indeed, flexibility on the interpretation of the exposure measure is needed as the observation period is precisely meant to give the EC the power and opportunity to amend the definition of the leverage ratio to correct any shortcoming on the basis of the reporting. This observation period should also be used to perform of a proper impact assessment of the January 2014 BCBS framework.

⁴ <http://www.eba.europa.eu/-/eba-reports-on-impact-of-possible-leverage-ratio-definitions>

2. The Basel III Leverage Ratio framework is penalizing in particular Securities Financing Transactions.

The BCBS June 2013 text was problematic because it penalized collateral in SFTs by not allowing any netting within repo and reverse repo transactions in the exposure measure (denominator) of the leverage ratio. This represented a negative regulatory bias in favour of unsecured funding compared to secured funding, putting at stake the role of the repo markets played in financing the real economy.

The BCBS January 2014 text introduced some changes but **foresees only a partial netting of cash legs between repos and reverse repos subject to restrictive conditions and it still denies any value to security collateral (like government bonds), as it does not allow netting between the cash and the security legs in repos and reverse repo transactions.**

Primary securities issuing activity is very useful for the economy, but the secondary market transactions through SFTs are even more essential to supply liquidity to finance the economy. They are widely used to refinance stocks of public debt securities: **in Europe government bond collateral account for about 80% of EU-originated repo collateral. They also enable companies to actively manage excess cash in a secure manner.** In particular sovereign markets would suffer from severe disruptions as the sovereigns bond market is mostly supplied by repo transactions.

Equally there is a knock-on effect on corporate debt financing, i.e. corporates financing their activities by issuing a debt. The liquidity of this primary market is ensured by banks through SFTs on the secondary market. Punitive treatment of the SFTs will therefore seriously undermine the financing capacity of corporates by drying out the liquidity supplied into the debt market by SFTs.

The softened approach in the January 2014 Basel III text matches more the US practices hence not taking into consideration European specificities. Repo markets indeed play a specific role in monetary policy transmission to the European economy, compared to the US. In this regard a detailed comparison between the European and the US market for Repos it is included at pag.7. Therefore, the impact of this new Basel III framework should be carefully assessed at European level.

3. The Basel III Leverage Ratio framework still raises concerns of interpretation at international level

The Basel III Leverage Ratio framework should not be considered as completely stabilized because it still raises **question of interpretation among the regulatory community and the industry**. The approach taken by BSCB 270 raises the following concerns:

1. **STFs exposure** criteria for the netting the condition for netting of cash receivables from repos/reverse repos transactions with the same counterparty raise strong concern for the EU Repos market, in particular with regard to:
 - a) “same explicit final settlement date” (Point 33(i) a in BCBS 270)
 - b) the “settlement” criteria (Point 33 (i) c in BCBS 270) .
2. **Derivatives exposures** : Treatment of cash variation margin : the condition of “same currency” (Point 25 (iii) in BCBS)

1. **STFs exposures criteria for the netting the condition for netting of cash receivables from repos/reverse repos transactions with the same counterparty**

1.a) **same explicit final settlement date** (Point 33(i) a in BCBS 270)

In the leverage ratio exposure measure Article 33 of the BCBS 270 text allows the netting of repo and reverse repo cash receivables and payables if the **“Transactions have the same explicit final settlement date”** .

Securities Financing Transactions do not always have an explicit final settlement date, as some of them are undated. This is the case for open or evergreen repos (in the EU), which are market practice in certain countries. In these cases, the transactions can be unwounded unconditionally at any time, by either counterparty, which makes them substantially similar to overnight repos rolled over every day (US practice). These transactions should be treated as if they had a one-day maturity and that the requirement that they have the “same explicit final settlement date” should be deemed to be met, in order to allow the netting of cash payables to, and cash receivables from, the same counterparty. The BCBS leverage framework would otherwise result in different exposures depending on market practice, for instruments which are economically equivalent (i.e. open repos and overnight repos).

In order to capture the EU market practices, this criterion when transposed in the delegated act should be drafted in the following way:

“Transactions have the same explicit final settlement date. Transactions with embedded call features «open» transactions are deemed as settling on a daily basis.”

1.b) The “settlement” criteria (Point 33 (i) c in BCBS)

In the leverage ratio exposure measure Article 33 of the BCBS 270 text allows the netting of repo and reverse repo cash receivables and payables, with the same counterparty if “The counterparties intend to **settle net, settle simultaneously**, or the transactions are subject to a settlement mechanism that results in the **functional equivalent of net settlement**, that is, the cash flows of the transactions are equivalent, in effect, to a single net amount on the settlement date”.

The aforementioned draft raises question of interpretation as if this condition would capture European and US market in the same way. The condition seems more aligned with the US ‘tri-party repos framework, whereas for the European market tri-party repos only represent 10-12% of the market versus from 66% to 80% in the US.

Moreover the **European repo market is much more diversified : the three types of settlement should be eligible to the BCBS settlement criteria:**

- 10% tri-party repo (which is more secure than in the US as explained below)
- 30%-40% bilateral repos cleared through CCPs
- 50%-60% other bilateral repos mainly settled through Euro-clear and Clear-stream and in delivery-versus-payment mechanism.

In order to capture the EU market practices, this criterion when transposed in the delegated act should be drafted in the following way:

*“(c) The counterparties intend to settle net, **or** settle simultaneously or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement, that is, the cash flows of the transactions are equivalent, in effect, to a single net amount **at the end of ~~on~~ the settlement date. This will occur if the gross settlement mechanism has features that eliminate, or result in insignificant credit and liquidity risk. To achieve such equivalence, both transactions are settled through the same settlement system, and the settlement arrangements are supported by cash and/or intraday credit facilities intended to ensure that settlement of both transactions will occur by the end of the business day and the linkages to collateral flows do not result in the unwinding of net cash settlement.”***

2. Derivatives exposures : Treatment of cash variation margin : the condition of “same currency” (Point 25 (iii) in BCBS)

The final Basel rules text (paragraphs 25 to 26) introduced a treatment whereby variation margin paid in cash that fulfils **five** criteria can be deducted from the current replacement cost of the derivative (fair value). **The criterion referring to “The cash variation margin is received in the same currency as the currency of settlement of the derivative contract” raises operation concerns.**

A bank may execute numerous derivatives (like basic cross currency swaps) with a counterparty, all of which are governed by the same Master Netting Agreement (MNA). In some cases, these derivatives may provide for different currencies of settlement of contractual payments. The purpose of a MNA is to provide for a single netting structure to cover all of these positions even when denominated in different currencies. **If** the same-currency criterion is applied on a narrow basis, inconsistencies would arise in the net exposure. MNAs necessarily rely on the principle that a single variation margin payment can be applied against multiple positions denominated in various currencies.

The condition in point 25(iii) in BCBS 270 when transposed in the delegated act should be drafted in the following way:

“The cash variation margin is received in the qualifying currency as set forth in the master agreement governing the related transactions.”

Differences between the repo market in Europe and in the US

1) Difference in Market size

A clear view of the size of the repo market is not as straight forward as it seems: available figures need careful interpretation.

Europe: In Europe, we find 3 different sources of data on the repo market: the ICMA European Repo Market Survey⁵, the ECB Euro Money Market Survey⁶ and the ECB Monetary Aggregates.⁷ However, these data are based on different methodologies as to geographical scope, type and number of contributors, currencies, outstanding transactions versus turnover etc. After careful consideration they seem to converge to a result that estimates the **European repo market at around €3000 billion** at the end of 2013.

US: In the US, official statistics by the New York Federal Reserve⁸ are only available on the tri-party repo market, i.e. activity done by the 2 tri-party agents: JP Morgan Chase and Bank of NY Mellon. Figures for February 2014 estimate the size of this market at \$1600 billion. Based on the total amount of collateral held through two tri-party agents, it is “common knowledge” that this market segment should represent about 80% of the overall **US repo market**. The size of the bilateral market is not based on exact data but rather derived from the “common knowledge” and **could be estimated at \$2000 billion**.

2) Difference in market structure

Repo trading can take 3 different forms: trades can either be done on a bilateral basis between counterparties and remain un-cleared, on a bilateral basis and be centrally cleared, or on a tri-party basis.

Bilateral repo – un-cleared: Bilateral repos are privately negotiated between 2 parties. All operational and counterparty risk remains with these 2 parties. The lender makes sure that the haircut is maintained by the borrower via a daily valuation of collateral, claiming margin calls whenever the value of the collateral declines and making sure that the quality collateral given is in line with what the lender is willing to accept.

Europe: Bilateral repo takes up about 90% of all repo transactions on the European Market. The ECB Money Market Survey shows that by end of 2013, 30% of these were un-cleared.

US: On the US side there are no statistics available on the importance of the bilateral market, but based on the assumption that the tri-party market in the US accounts for about 80% of all repo activity, we can deduct that only 20% is done on a bilateral basis.

Bilateral repo – centrally cleared: Post-trade these bilateral trades can be registered onto a CCP. Central clearing means that the CCP will stand in the middle of the transaction and take over the counterparty risk from both sides. The CCP will also net security positions between multiple transacting parties.

Europe: The ECB Money Market Survey shows that by end of 2013, 70% of these were centrally cleared

US: As stated above already, it is assumed that 20% of repo activity in the US is done on a bilateral basis; central clearing is very limited.

Tri-party repo: In a tri-party repo post-trade services such as payment, settlement and collateral management, margining etc. during the life time of the transaction, are done by a third party agent, i.e. a custodian bank. It will

⁵ <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/repo/latest>

⁶ <http://www.ecb.europa.eu/pub/pdf/other/euromoneymarketsurvey201311en.pdf?e34259b291b21d9dee4bc45bcc611b95>

⁷ <http://www.ecb.europa.eu/stats/money/aggregates/aggr/html/index.en.html>

⁸ http://www.newyorkfrd.org/banking/tpr_infr_reform.html

manage the collateral on behalf of the lender and take care of daily valuation and margin calls and will make sure that the borrower respects the lender's collateral guidelines. The tri-party agent does not have the role of a central clearer: the counterparty risk between lender and borrower remains in place, the agent does not have any exposure to the lender or the borrower.

Europe: The ECB Money Market Survey shows that by end of 2013, only 10% of European repo activity is done on a tri-party basis.

US: Figures by the New York Federal Reserve estimated that about 80% of US repo activity is done on a tri-party basis.

Differences between the tri-party markets in the US and in Europe

1. In terms of **volume**: according to the ECB Euro Money Market Survey of November 2013, about 10% of repo transactions in Europe are done on a tri-party basis. In the US, however, tri-party trades count for about 80% of all repo volumes done;
2. In terms of **number of tri-party agents** involved: the tri-party repo market in the US is built on 2 clearing banks only: Bank of New York Mellon and JP Morgan Chase, where in Europe the number of active clearing banks is much larger, the main ones being Clear stream, Euroclear and SIS, next to JPM and BNY;
3. In terms of **settlement procedures**: in Europe tri-party repos are considered term repos which are subject to daily margining. In the US the 2 clearing banks will unwind cash and collateral for non-maturing trades on a daily basis, so that sellers can substitute collateral and adjust daily price fluctuations. This procedure works as follows:
 - a) The clearing bank will unwind all repos in the morning (both maturing and non-maturing): cash is returned to the lender's account at the clearing bank and securities are returned to the borrower's account
 - b) During the day, as new trades are executed, the dealer borrows money from the clearing bank to finance its securities, till the time of settlement at the end of the day. This means that the clearing banks have a secured exposure to the dealer during the day. On the other side the lender can keep cash at the clearing bank prior to settlement, which means that the clearing bank has unsecured exposure to the lender during the day.
 - c) At the end of the day, the clearing bank settles the trades and moves cash from the lender to the borrower's account, and securities are moved from the borrower to the lender' account.

Via this settlement system of daily unwinds, JP Morgan Chase and BNY Mellon extend intra-day credit to the sellers. This practice basically creates a huge intra-day credit exposure for these 2 banks: they no longer play the role of a pure agent, but become principals with a counterparty exposure versus all the broker dealers that make use of them. This means that they could easily be destabilized if they lend to a failing dealer. It also leads to over-reliance by repo sellers on intra-day credit, thus enhancing systemic risk in the financial sector. By mid-2008, about \$2.8 trillion were financed intra-day!

Risks of daily unwinds are (i) the excessive reliance by the market on intraday credit provided by clearing banks, (ii) the lack of transparency on liquidity risk and credit risk and (iii) the risk of fire sales of collateral in case a dealer defaults.

Therefore, the FED announced in 2010 reforms to reduce the intraday credit risk in the tri-party market. The aim is to that term trades become "true" term trades that are locked till maturity so that lender and borrower are only exposed to one another during the life time of the trade. Next to that, clearing banks should only commit intra-day credit on a committed basis (incurring capital charges!) and limit credit provision to dealers to maximum 10% of their notional tri-party repo book. This target should be achieved by end 2014.

3) Difference in legal status

Europe: In repo transactions in Europe, the title of ownership of the collateral will be transferred from the seller to the buyer: the party that receives the collateral has the full property right as if he had bought it and as such, he can re-use it as he likes during the life time of the transaction.

US: The transfer of collateral in the US takes the form of the seller giving the buyer a pledge, in which the collateral is transferred into the control of the buyer. Re-hypothecation is a discretionary right that the seller gives to the buyer to re-pledge the collateral and that the buyer needs to exercise before he owns it. If he exercises this right the pledge is replaced by a right to return the assets, which means that if the buyer defaults, the seller is a mere unsecured creditor. If the buyer does not exercise this right, the ownership remains with the seller, unless the seller defaults: in that case the buyer can freely dispose of the collateral.

So even if from an economic point of view, the outcome of “re-using” collateral via title transfers or re-hypothecation via pledges is similar, the consequence in case of a default of one of the transacting parties is quite different from a legal point of view. Indeed, when Lehman Brothers failed, a lot of uncertainty was created over which re-hypothecation rights had been exercised and who actually owned the collateral.

4) Difference in accounting

Europe: In Europe under IFRS rules, the balance sheet shows values and risk, it does not reflect the legal form of a transaction. This means that the collateral will remain on the balance sheet of the seller, despite the fact that a legal title transfer has taken place. The seller of the repo commits to repurchase collateral at a fixed future price and retains risk and return on collateral. Consequently, cash received for collateral is added as an asset on the seller’s balance sheet. Repayment due to buyer at maturity is added as a liability. The balance sheet will show seller has increased his leverage by borrowing

US: In the US under GAAP rules, the repo transaction is booked as secured borrowing, i.e. as a loan. Here too, the securities remain on the asset side of the seller’s balance sheet. The liability side will show an increase in the Accounts Payable. The difference between the selling and the repurchase price is booked as an interest expense. Changes were introduced by FASB in Jan. 2013 in the wake of Lehman “repo105”. Lehman had circumvented the FAS 140 rule that allowed a loan to be considered as a sale, if the repurchase price fell outside a certain band, and the securities would not be reported on the balance sheet until they were bought back. In this way, Lehman managed to move away \$50 billion off its balance sheet to conceal its leverage.

5) Difference in central bank operations and monetary policy

Since the 2008 crisis, the US and Europe have conducted their long-term monetary policies in very different ways. Consequently, the repo markets on both sides of the Atlantic are impacted in different ways as well.

Europe: In Europe, the ECB provides financing to banks via long-term refinancing operations (LTROs). In practice it means that banks will receive cash to provide loans to the economy against the (illiquid) collateral they post at the ECB. In other words: an LTRO is a repo transaction between the central bank and the banks! All this means that repo is the tool that banks use to distribute central bank money into the real economy in Europe.

US: Since 2007, the Fed has introduced a number of programs to support liquidity of financial institutions and financial markets, such as emergency lending facilities. As of 2008, the Fed has expanded its holding of longer-term securities via Quantitative Easing (QE) programs. QE increases the monetary basis and allows banks to keep on lending, as the central bank directly buys bonds off the balance sheets of banks. Asset risk is replaced by cash. The process of QE in the US does not involve any use of repos.