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## **Do Competitive Disadvantages Really Arise From „Over Complying“?: Proposed Basel III Leverage and Supplementary Leverage Ratios Re-visited**

### **ABSTRACT**

The Basel III Leverage Ratio, as originally agreed upon in December 2010, has recently undergone revisions and updates – both in relation to those proposed by the Basel Committee on Banking Supervision – as well as proposals introduced in the United States. Whilst recent proposals have been introduced by the Basel Committee to improve, particularly, the denominator component of the Leverage Ratio, new requirements have been introduced in the U.S to upgrade and increase these ratios, and it is those updates which relate to the Basel III Supplementary Leverage Ratio that have primarily generated a lot of interests. This is attributed not only to concerns that many subsidiaries of US Bank Holding Companies (BHCs) will find it cumbersome to meet such requirements, but also to potential or possible increases in regulatory capital arbitrage: a phenomenon which plagued the era of the original 1988 Basel Capital Accord and which also partially provided impetus for the introduction of Basel II.

This paper is aimed at providing an analysis of the most recent updates which have taken place in respect of the Basel III Leverage Ratio and the Basel III Supplementary Leverage Ratio – both in respect of recent amendments introduced by the Basel Committee and revisions introduced in the United States. Amongst these notable developments, the Final or rather nearly finalised Standard issued by the Basel Committee in January 2014, as well as the 2014 U.S Enhanced Supplementary Leverage Ratios are worth mentioning.

Sometimes the competitive disadvantages resulting from over compliance or stringent measures may generate costs which are actually minimal when compared to those costs which could potential arise in a scenario where economic disruptions and crises do occur where such „over compliance“ measures are not implemented.

So when do measures become overcompliant? What may be regarded as overcompliance for a particular jurisdiction may not necessarily be the case for another. Conversely what may be required for minimal compliance purposes in certain jurisdictions may prove inadequate for certain major economies.

**Key Words:** credit risk, global systemically important banks (G-SIBs), leverage ratios, harmonisation, accounting rules, capital arbitrage, disclosure, stress testing techniques, U.S Basel III Final Rule

## Do Competitive Disadvantages Really Arise From „Over Complying“?: Proposed Basel III Leverage and Supplementary Leverage Ratios Re-visited

*Marianne Ojo<sup>1</sup>*

### A. Introduction

The first consultative paper on a new capital adequacy framework, which was issued by the Basel Committee on Banking Supervision, introduced the „three pillar“ model which encompasses the minimum capital requirements, supervisory review and market discipline - „as a lever to strengthen disclosure and encourage safe and sound banking practices.“<sup>2</sup> As well as the criticism related to the fact that it rewarded risk lending, the fact that „capital requirements were just reasonably related to banks' risk taking activities and that the credit exposure requirement was the same regardless of the credit rating of the borrower,“<sup>3</sup> a general criticism of Basel I relates to the fact that it promoted capital arbitrage. Such capital arbitrage being attributed to its wide risk categories which provided banks with the liberty to „arbitrage between their economic assessment of risk and the regulatory capital requirements.“<sup>4</sup>

„Regulatory capital arbitrage“, a practice which involves banks „using securitisation to alter the profile of their book“ usually produces the effect of making bank's capital ratios appear inflated.<sup>5</sup> Four identified types of capital arbitrage are:<sup>6</sup> cherry picking, securitisation with partial recourse, remote origination and indirect credit.

The Second Consultative Paper, issued by the Basel Committee in January 2001, introduced the two Internal Ratings Based (IRB) methodologies – the Foundational IRB and the Advanced IRB methodologies. The Internal Ratings Based approach to capital requirements for credit risk, not only relies significantly on the internal assessment carried out by a bank, in relation to counterparties and exposures, but is also geared towards the achievement of two primary goals, namely:<sup>7</sup> „additional risk sensitivity“ and „incentive compatibility“.

Basel 2 is premised on a three level approach which permits banks to select from three models, namely: the basic standardized model, the IRB foundation approach and the advanced ratings approach.

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<sup>2</sup> Basel Committee on Banking Supervision, 'Consultative Paper on a New Capital Adequacy Framework' 3rd June 1999 <<http://www.bis.org/press/p990603.htm>>

<sup>3</sup> See M Saidenberg and T Schuermann, 'The New Basel Capital Accord and Questions for Research' (2003) Wharton Financial Institutions Center Working Paper 2003 at page 4

<sup>4</sup> Basel Committee on Banking Supervision, 'Capital Requirements and Bank Behaviour: The Impact of the Basel Accord' Basel Committee on Banking Supervision Working Papers April 1999 at page 21

<sup>5</sup> See *ibid*; Bank's capital ratio may appear inflated „relative to the riskiness of the remaining exposure“ see *ibid*

<sup>6</sup> *Ibid* at pages 22-24

<sup>7</sup> In establishing an Internal Ratings Based approach, the Committee's intention was directed at „fine tuning capital requirements with a greater degree of accuracy to the level of a bank's exposure to credit risks.“ Basel Committee on Banking Supervision, 'The Internal Ratings Based Approach' Supporting Document to the New Basel Capital Accord 2001 at pages 1 and 3 <http://www.bis.org/publ/bcbsca05.pdf>

According to the Consultative Document on Standard Approach to Credit Risk,<sup>8</sup> capital requirements under the standardized approach are considered to be more synchronised and in harmony with the principal elements of banking risk – owing to the introduction of more differentiated risk weights and a broader recognition of techniques which are applied in mitigating risk whilst such techniques attempt to avoid undue complexity. As a result, capital ratios generated through the standardized approach, should adapt more to present and actual risks encountered by banks, than was the case previously.

Under Pillar One minimum capital requirements, operational risk is to be corroborated by capital. Measurement approaches for operational risk can be found in the Capital Requirements Directive (CRD) and there are three broad approaches to the capital assessment of operational risk which are as follows:

- Basic Indicator Approaches
- Standardized Approaches
- Internal Measurement Approach

The developments and evolution across the Basel Capital Accords have illustrated their focus to address prevailing financial risks at the time, their focus on the regulation of complex financial instruments such as hedge funds, the pro cyclical nature of risks and the need to mitigate occurrences related to regulatory capital arbitrage. The era of Basel III has also witnessed the introduction of liquidity standards – these being the first of their kind, However the need to address off balance sheet instruments, complex derivative products, exposures of various kinds – and particularly those exposures relating to derivatives, off balance sheet and leverage, as well as those risks attributed to non-bank institutions, continually constitute a vital focal point.

The ensuing section considers the most recent updates that have taken place since the 2013 Revised Basel Leverage Ratios were proposed – as well as the 2013 U.S Supplementary Leverage Ratios. Section B traces the Basel Committee's efforts to update the original 2010 Basel III Leverage Ratios – as well as U.S proposals and revisions to supplement Basel Leverage Ratios. Section C then analyses and considers the significance of adjustments to components of the Basel III Leverage Ratio and also recent updates to these components

In re-capping and highlighting developments which have taken place since the introduction of the 2013 Rule and the Final Rule, the more recent Enhanced Supplementary Leverage Ratios (ESLR) – 2014 U.S Revisions, are considered under section D. This will be followed by a consideration of how far consistency, comparability and harmonization could actually be achieved, the importance of achieving these goals, before a conclusion is arrived at.

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<sup>8</sup> Basel Committee on Banking Supervision, Consultative Document, Standard Approach to Credit Risk, Supporting Document to the New Basel Accord January 2001 at page 1 <http://www.bis.org/publ/bcbcsca04.pdf>

## **B. Basel Committee's Efforts to Update Original 2010 Basel III Leverage Ratios and U.S Proposals to Enhance Basel Leverage Ratios**

Several revisions, particularly relating to the denominator component of the Basel III Leverage Ratio, have recently been undertaken by the Basel Committee, as illustrated in its June 2013 Guidelines, and more recently, its January 2014 Standard. From this viewpoint, measures aimed at minimising regulatory capital arbitrage become all the more evident since banks are able to manipulate their way into increasing the leverage ratio by getting many assets allowed in the numerator and as little in the denominator: „cherry picking“ arbitrage having constituted a problem since the original Basel Capital Accord. Hence it could be argued that it is not the mere increase of leverage ratios that truly matters (even though this is also important), but measures aimed at ensuring that permissible contents/instruments are incorporated into the numerators and denominators of such leverage ratios.

Certain factors influential in the recent proposals and efforts aimed at achieving higher leverage capital requirements, according to U.S federal agencies,<sup>9</sup> include the belief that higher standards for the supplementary leverage ratio would reduce the likelihood of resolutions, and would allow regulators more time to tailor resolution efforts in the event those are needed. In their opinion, by further constraining their use of leverage, higher leverage standards could offset possible funding cost advantages that these institutions may enjoy as a result of the “too-big-to-fail” problem, which will be considered in the following section.

### The Too Big to Fail Problem and Its Impact on Recent Legislative Proposals

According to a notice jointly issued by the Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance, „the perception continues to persist in the markets that some companies remain “too big to fail,” - posing, in their view, an ongoing threat to the financial system.<sup>10</sup> It is also added that:<sup>11</sup>

- First, the existence of the “too-big-to-fail” problem reduces the incentives of shareholders, creditors and counterparties of these companies to discipline excessive risk-taking by the companies.
- Second, it produces competitive distortions because companies perceived as “too big to fail” can often fund themselves at a lower cost than other companies. This distortion being regarded as unfair to

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<sup>9</sup> See Federal Reserve, 'Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions' at page 11 <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20130709a1.pdf>.

<sup>10</sup> See Federal Reserve, 'Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions' at page 7 <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20130709a1.pdf>.

<sup>11</sup> *ibid*

smaller companies, damaging to fair competition, and such distortion tends to artificially encourage further consolidation and concentration in the financial system.

As well as the important objective of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) aimed at „mitigating the threat to financial stability posed by systemically-important financial companies“<sup>12</sup> another vital and important means of fostering financial stability in averting another Financial Crisis, safeguarding and assisting financial institutions to navigate periods of financial or economic stress, in the agencies’ experience, is strong capital. In their opinion, the „maintenance of a strong base of capital at the largest, systemically important institutions is particularly important because capital shortfalls at these institutions can contribute to systemic distress and can have material adverse economic effects. Further, they contend that higher capital standards for such institutions would place additional private capital at risk before the Federal deposit insurance fund and the Federal government’s resolution mechanisms would be called upon, and reduce the likelihood of economic disruptions caused by problems at these institutions.“<sup>13</sup>

In accentuating the need for its complementary function and role to the risk-based capital framework, the Basel leverage ratios must be linked to the risk based capital adequacy framework – both in respect of their calculations, metrics and measures, as well as primary objectives and goals in introducing such leverage ratios. Some of the objectives for originally introducing leverage ratios in 2010 being the creation of a “secondary metric which was simple and transparent – whereby regulators could assess balance sheet sizes appropriately” as well as the need to facilitate more consistent modes of measurements of risk weighted assets.

In its aims to address concerns raised by the Basel Committee’s June 2013 consultative paper, namely concerns that the Consultative Paper’s definition of exposure was “too expansive”, that is, “the leverage ratio’s denominator was too large”<sup>14</sup> changes have been made to the June 2013 paper, as evidenced by the more recent January 2014 update and the April 2014 Final Standard for measuring and controlling large exposures. These changes introduce a more simplistic, consistent approach to the measurement of exposures through incorporating the use of credit conversion factors (CCFs).

According to the January 2014 revised leverage ratio standard,<sup>15</sup> in the risk based capital framework, off balance sheet items are converted under the standardised approach into credit exposure equivalents

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<sup>12</sup> Federal Reserve, 'Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions' page 8

<sup>13</sup> Ibid at page 11

<sup>14</sup> See PricewaterhouseCoopers, “Regulatory Brief: Basel Leverage Ratios: No Cover For US Banks” January 2014 [http://www.pwc.com/en\\_US/us/financial-services/regulatory-services/publications/assets/fs-reg-brief-dodd-frank-basel-leverage-ratio.pdf](http://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/assets/fs-reg-brief-dodd-frank-basel-leverage-ratio.pdf). Also see Basel Committee on Banking Supervision, “Supervisory Framework for Measuring and Controlling Large Exposures - Final Standard”

See particularly paragraph 35 “For the purpose of the large exposures framework, off-balance sheet items will be converted into credit exposure equivalents through the use of credit conversion factors (CCFs) by applying the CCFs set out for the standardised approach for credit risk for risk -based capital requirements, with a floor of 10%.”

<http://www.bis.org/publ/bcbs283.htm> and

Basel Committee on Banking Supervision, Consultative Document: The Non Internal Model Method for Capitalising Counterparty Credit Risk Exposures (June 2013) <http://www.bis.org/publ/bcbs254.htm> and:

Basel Committee on Banking Supervision, “The Standardised Approach for Measuring Counterparty Credit Risk Exposures (March 2014) Available at <http://www.bis.org/publ/bcbs279.htm>

<sup>15</sup> see paragraph 39 Basel Committee on Banking Supervision, “Basel III Leverage Ratio Framework and Disclosure Requirements” January 2014

through the use of credit conversion factors. It is also stipulated that the CCFs set out in paragraphs 14-22 of its Annex must be applied to notional amounts – for purposes of determining the exposure amount of Off Balance Sheet (OBS) items for leverage ratio.

### **C. Components of the Basel III Leverage Ratio and Recent Updates to the Components**

The Basel III Leverage Ratio is defined as the Capital Measure (the numerator) divided by the Exposure Measure (the denominator), with this ratio expressed as a percentage and with the basis of calculation being the average of the three month-end leverage ratios over a quarter.<sup>16</sup> As reported by DB Research, the Basel Committee's issuance of its consultation paper on common definitions for the non-binding leverage ratio enshrined in Basel III, is not only considered to be an indication of a clear preference to move to a binding leverage ratio, the new Basel definition, it is further contended, would „disallow much of the derivatives netting which had seen US banks post substantially stronger leverage ratios than most European institutions.”<sup>17</sup>

As highlighted under section B, one of the goals of leverage ratios, as intended by the Basel Committee on Banking Supervision, is to ensure that both on and off balance sheet leverage of banks are adequately captured and accounted for. Given the revisions which have occurred, following the introduction of the original 2010 Basel Leverage Ratios, it would be expected that subsequent revisions would have the effect of expanding the denominator component, namely the exposure component – as a means of highlighting the commitment to expand the horizons being accounted for, as regards exposures – particularly credit exposures. Even though the numerator component, comprising Tier One capital of the risk-based capital framework, is also important, in line with the goals of adequately capturing on and off balance sheet exposures, the importance of focussing on the denominator component (which comprises of the exposure measure) of the Basel III Leverage Ratio is also illustrated thus:

#### Components of the Exposure Measure

A bank's exposure measure is considered to be the sum of the following:

- On balance sheet exposures
- Derivative exposures
- Securities Financing Transaction Exposures
- Off balance sheet (OBS) items

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<sup>16</sup> Basel Committee on Banking Supervision, Consultative Document Revised Basel III Leverage Ratio Framework and Disclosure Requirements at page 5 of 22 <http://www.bis.org/publ/bcbs251.pdf>

<sup>17</sup> DB Research, 'Leverage ratio: Pressure on Europe is rising' [http://www.dbresearch.de/servlet/reweb2.ReWEB?addmenu=false&document=PROD0000000000317297&rdShowArchivedDocus=true&rwnode=DBR\\_INTERNET\\_DE-PROD\\$NAVIGATION&rwobj=ReDisplay.Start.class&rwsite=DBR\\_INTERNET\\_DE-PROD](http://www.dbresearch.de/servlet/reweb2.ReWEB?addmenu=false&document=PROD0000000000317297&rdShowArchivedDocus=true&rwnode=DBR_INTERNET_DE-PROD$NAVIGATION&rwobj=ReDisplay.Start.class&rwsite=DBR_INTERNET_DE-PROD)

According to the most recent, updated Standard on leverage ratios (hereinafter referred to as “the Final Standard”), issued by the Basel Committee on Banking Supervision in January 2014,<sup>18</sup> the exposure measure for the leverage ratio, should generally, follow the accounting value, subject to the following:

- On-balance sheet, non-derivative exposures are included in the exposure measure net of specific provisions or accounting valuation adjustments;
- Netting of loans and deposits is NOT allowed.

As well as disallowing the “netting” of loans and deposits, the January 2014 final standard<sup>19</sup> on leverage ratios, as issued by the Basel Committee on Banking Supervision, in compliance with the June revision, also provides under paragraph 30 that, in order to capture the credit exposure to the underlying reference entity, in addition to the prescribed CCR treatment for derivatives and related collateral, the effective notional amount referenced by a written credit derivative is to be included in the exposure measure.

However, in contrast to its predecessor, which highlighted under paragraph 27 that:

- collateral received in connection with derivative contracts does not reduce the economic leverage inherent in a bank’s derivatives position. In particular, the exposure arising from the contract underlying is not reduced. As such, collateral received (cash or non-cash) may not be netted against derivatives exposures whether or not netting is permitted under the bank’s operative accounting or risk-based framework

the Final Standard, paragraph 23 projects a more lenient and cautious tone in its approach to netting:

- collateral received in connection with derivative contracts does not necessarily reduce the leverage inherent in a bank’s derivatives position, which is generally the case if the settlement exposure arising from the underlying derivative contract is not reduced. As a general rule, collateral received may not be netted against derivative exposures whether or not netting is permitted under the bank’s operative accounting or risk-based framework. Hence, when calculating the exposure amount by applying paragraphs 19 to 21 above, a bank must not reduce the exposure amount by any collateral received from the counterparty.

Furthermore, extended provisions have been included to permit certain netting transactions between counterparties – to the extent that certain provisions and conditions stipulated in the Final Standard are met.

As a means of ensuring consistency, comparability and accuracy in its calculations and measurements, the same coverage as that adopted for regulatory consolidation – as used within the risk-based capital framework, is applied by the Basel III leverage ratio framework.

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<sup>18</sup> Basel Committee on Banking Supervision, “Basel III Leverage Ratio Framework and Disclosure Requirements” January 2014 Bank for International Settlements Publications, see paragraph 12. It is however contended that this version is a “near final version”.

<sup>19</sup> Basel Committee on Banking Supervision, “Basel III Leverage Ratio Framework and Disclosure Requirements” January 2014 Bank for International Settlements Publications



In contrast to many other jurisdictions, the U.S has introduced proposals aimed at enhancing the Basel III leverage ratios, (the recently revised Supplementary Leverage ratios), as well as the Dodd Frank Leverage Ratio.<sup>20</sup>

In November 2012, the FSB and BCBS published a list of banks that meet the Basel Committee for Banking Supervision definition of a G-SIB based on year-end 2011 data. The eight globally systemically important banks in the U.S, identified as G-SIBs by the Financial Stability Board, are: Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup Inc., Goldman Sachs Group, Inc., JP Morgan Chase & Co., Morgan Stanley, State Street Corporation and Wells Fargo & Company.<sup>21</sup>

#### **D. The 2013 Rule and the Final Rule**

The 2013 Rule „revised and replaced the agencies’ risk-based and leverage capital standards and established a 3 percent minimum supplementary leverage ratio for banking organizations subject to the agencies’ advanced approaches risk-based capital rules.“<sup>22</sup> The 2013 rule was adopted as a final rule on July 2, 2013.

Moreover, this final rule:

- Implements a revised definition of regulatory capital;
- A new common equity tier 1 minimum capital requirement;
- A higher minimum tier 1 capital requirement; and

For banking organizations subject to the advanced approaches risk-based capital rules, a supplementary leverage ratio that incorporates a broader set of exposures in the denominator.<sup>23</sup>

Following the publication of the U.S Basel III Final Rule, many U.S banking agencies proposed higher leverage capital requirements for the eight U.S bank holding companies (BHCs) which have been identified by the Financial Stability Board, as global systemically important banks („referred to as

<sup>20</sup> “Dodd Frank section 165 compels foreign banks to comply with banking rules. Whereas eight of the largest U.S banks meet the 3% ratio, many foreign banks are permitted to meet the 4% ratio”. See S Skyrms, “New Regulation and the Repo Market: Leverage Ratios” <http://scottskyrms.com/2014/03/new-regulation-and-the-repo-market-leverage-ratios/>

<sup>21</sup> See Financial Stability Board, Update of Group of Global Systemically Important Banks (G-SIBs) (Nov. 1, 2012) [http://www.financialstabilityboard.org/publications/r\\_121031ac.pdf](http://www.financialstabilityboard.org/publications/r_121031ac.pdf)

<sup>22</sup> See Federal Reserve, 'Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions' at page 12 <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20130709a1.pdf>. and also Federal Reserve, 'Federal Reserve Approves Final Rule...' „, The final rule minimizes burden on smaller, less complex financial institutions. It establishes an integrated regulatory capital framework that addresses shortcomings in capital requirements, particularly for larger, internationally active banking organizations, that became apparent during the recent financial crisis. The rule will implement in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act.“ See <<http://www.federalreserve.gov/newsevents/press/bcreg/20130702a.htm>>

<sup>23</sup> See Federal Reserve, Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule <http://www.federalreserve.gov/bcreg/20130702a.pdf>

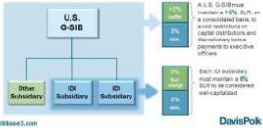
„covered BHCs“) and their insured depository institution (IDI) subsidiaries: namely, Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup Inc., Goldman Sachs Group, Inc., JP Morgan Chase & Co., Morgan Stanley, State Street Corporation and Wells Fargo & Company.

An overview of some of the differences between the revised Basel III Leverage Ratios (as reflected by the January 2014 update) and the US Supplementary Leverage Ratios is illustrated in the following table:<sup>24</sup>

Source: <http://blog.usbasel3.com/category/leverage-ratios/>

Topic	Revised Basel III Leverage Ratio (Jan. 2014)	Supplementary Leverage Ratio (SLR) (including Apr. 2014 proposed denominator revisions)
Level of the ratio	<ul style="list-style-type: none"> <li>• 3% minimum</li> <li>• Applies to “internationally active banks”</li> <li>• Basel Committee Chairman <b>stated</b> in February 2014: “Only now that we have an agreed [measure of leverage exposure] can the Committee begin to turn to the issue of calibration, and the relationship of the leverage ratio to the risk-based framework. We have quite a bit of work to do to get this balance right.”</li> </ul>	<ul style="list-style-type: none"> <li>• 3% minimum for advanced approaches banking organizations and advanced approaches U.S. intermediate holding companies (“IHCs”) of foreign banks</li> <li>• Surcharge for 8 U.S. global systemically important banks (“G-SIBs”) and their U.S. insured depository institutions (“IDI”) subsidiaries (&gt;5% for consolidated group and 6% for IDI subsidiaries)</li> </ul>

<sup>24</sup> See D Polk, Visual Comparison Chart : US Supplementary Leverage Ratio (SLR) vs Basel III Leverage Ratio

Topic	Revised Basel III Leverage Ratio (Jan. 2014)	Supplementary Leverage Ratio (SLR) (including Apr. 2014 proposed denominator revisions)
	$\text{Basel III Leverage Ratio} = \frac{\text{Tier 1 Capital}}{\text{Exposure Measure}}$	 $\text{SLR} = \frac{\text{Tier 1 Capital}}{\text{Total Leverage Exposure}}$
Numerator	<ul style="list-style-type: none"> <li>Tier 1 capital as defined in Basel III, taking into account transitional arrangements</li> <li>Basel Committee will "track the impact" of using either Common Equity Tier 1 capital or total capital as the numerator</li> </ul>	<ul style="list-style-type: none"> <li>Tier 1 capital as defined in the U.S. Basel III final rule, taking into account transitional arrangements</li> </ul>
Denominator	<ul style="list-style-type: none"> <li><b>Exposure Measure</b> (components discussed below)</li> </ul>	<ul style="list-style-type: none"> <li><b>Total Leverage Exposure</b> (components discussed below)</li> </ul>
Frequency of calculation	<ul style="list-style-type: none"> <li>Not specifically addressed in January 2014 revisions</li> <li>July 2013 consultative document: "The basis of calculation is the average of the three month-end leverage ratios over a quarter."</li> </ul>	<ul style="list-style-type: none"> <li>Tier 1 capital (numerator) is calculated as of the last day of each reporting quarter</li> <li>Total Leverage Exposure (denominator) is calculated as the arithmetic mean of the Total Leverage Exposure calculated <u>each day</u> of the reporting quarter</li> </ul>
Compliance timing	<ul style="list-style-type: none"> <li><b>January 1, 2018:</b> Becomes a minimum requirement after any final calibration and adjustments</li> <li><b>January 1, 2015:</b> Public disclosure begins</li> </ul>	<ul style="list-style-type: none"> <li><b>January 1, 2018:</b> SLR becomes a minimum requirement and SLR surcharge for U.S. G-SIBs becomes effective</li> <li><b>January 1, 2015:</b> Public disclosure begins</li> </ul>

## Arguments Favouring 2013 Basel Committee Revisions over those Updates Made to Basel Leverage Ratios in the U.S

In commencing this section, it needs to be highlighted that the recent moves and proposals in the U.S, in relation to the Basel Leverage Ratio, are very much welcomed and quite encouraging given the prior concerns that the implementation of Basel rules, regulations and initiatives appeared to be implemented at a slow pace in the U.S. The recent proposals in the U.S serve as indication, not only of the willingness to adopt Basel rules, but also reveal the extra steps being taken to ensure that financial stability is fostered and more rigid and stringent measures to avert another global scale crisis.

Arguments favouring 2013 Basel Committee updates over those 2013 proposals introduced in the US, are partly based on the following:

1) The fact that revisions and proposals undertaken in the U.S are premised on Tier 1 capital, instead of higher-quality Core Tier 1.

2) Recent Basel Guidelines (June 2013) are more extensive in scope as opposed to the denominator of the U.S. leverage ratios which are based on original 2010 Basel Leverage ratios.

3) The cumbersome nature of the supplementary leverage ratio – which in the opinion of many commentators, will be more burdensome for subsidiaries of BHCs to comply with than the generally applicable leverage ratio for U.S. banks. It is calculated using a „tighter definition of Tier 1 capital in the numerator and the denominator includes off-balance sheet exposures such as the grossing-up of derivatives to include collateral and cash“ (which is why many banks are likely to want to evade as much inclusion of such derivatives in the denominator – given the value/magnitude of derivatives). The 6% standard is considered by many to be onerous for bank subsidiaries covered by the proposal and may encourage banking groups to conduct certain activities, such as derivatives based activities, away from their subsidiaries.

Furthermore, an introduction of the supplementary leverage ratio, it is most likely envisaged, will result in lower dividends being distributed by the BHCs.

4) The focus accorded to disclosures of the numerator and denominator components of the Basel Leverage Ratios in the Basel June 2013 Guidelines.

### **Enhanced Supplementary Leverage Ratios (ESLR) – 2014 U.S Revisions**

In April 2014, the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (the FRB) and the Office of the Comptroller of the Currency (the OCC) took two important steps:<sup>25</sup>

- 1) The Agencies approved a notice of proposed rulemaking (the “NPR”, and the rules stipulated therein, the “Proposed Rules”) which would revise the definition and scope of the “total leverage exposure”, which is the denominator of the SLR (hence, also the denominator of the enhanced SLR).
- 2) The Agencies approved final rules (the “Final Rules”) that would effectively result in a rise from the SLR’s usual 3% minimum SLR standard to 5% for bank holding companies with total consolidated assets of more than \$70 billion or assets under custody of more than \$10 trillion and 6% for their insured depository institution subsidiaries.

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<sup>25</sup> See Sullivan & Cromwell LLP, „Bank Capital: Supplementary Leverage Ratio, Federal Banking Agencies Propose Revisions to the Supplementary Leverage Ratio’s Exposure Measure and Approve Final Rules Implementing an Enhanced Supplementray Leverage Ratio for the Largest U.S Baking Organizations“ April 16 2014

In April 2014, the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) “adopted a final rule to strengthen the leverage ratio standards for the largest, most interconnected U.S. banking organizations. The final rule applies to U.S. top-tier bank holding companies with more than \$700 billion in consolidated total assets or more than \$10 trillion in assets under custody (covered BHCs) and their insured depository institution (IDI) subsidiaries.“ See Agencies Adopt Enhanced Supplementary Leverage Ratio Final Rule and Issue Supplementary Leverage Ratio Notice of Proposed Rulemaking <http://www.federalreserve.gov/newsevents/press/bcreg/20140408a.htm>

Following the issue of the January 2014 revised Basel leverage ratios, PriceWaterhouse were of the opinion that U.S regulators would not only have to decide whether an alteration of the exposure calculations of the supplementary leverage ratio (SLR) would be necessary (as a means of further harmonizing with the January 2014 revised Basel leverage ratios), but also decide if they would, more importantly, adjust the Enhanced Supplementary Leverage Ratios.<sup>26</sup> It is PriceWaterhouse' view that U.S regulators are unlikely to lower the ESLR's 2% buffer – primarily attributable to the fact that U.S regulators are considered to view the ESLR as a “needed complement to risk-based capital standards (as opposed to a “back-stop”).<sup>27</sup>

The need for consistency in the implementation of Basel requirements and regulations is all the more vital and necessary if practices relating to regulatory capital arbitrage are to be minimised and controlled. Differences in the implementation of Basel requirements and rules across various jurisdictions are evident from the very stringent application of rules in certain jurisdictions – as is recently evidenced by the U.S initiatives aimed at increasing Basel III Leverage ratios (above global standards) to those jurisdictions where more lax approaches have been adopted.

Evidence which highlights the fact that different countries could be inconsistently implementing parts of the Basel rules and regulations – either by consolidating or weakening the original requirements, is illustrated through the following:<sup>28</sup>

- In the EU, in relation to the Capital Requirements Directive/Regulation IV (CRD/RIV) - where based on evidence from latest proposals and negotiations, EU member states will assume greater independence in their ability to increase capital requirements.
- In China, where the implementation framework for Basel III is considered to be more stringent than the international standard (with a requirement of a higher core tier 1 capital adequacy ratio – 5% as opposed to 4.5%, as well as a higher leverage ratio requirement of 4% as opposed to 3%).
- In the U.S, as discussed through this paper, through recent proposals relating to standard and supplementary leverage ratios.

Having highlighted the above, it is also worth mentioning that “over compliance” with rules (and particularly where it appears that such rules or ratios appear to be insufficient) – as indicated by the supplementary ratios in the U.S, is certainly much better than under compliance.

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<sup>26</sup> PricewaterhouseCoopers, “Regulatory Brief: Basel Leverage Ratios: No Cover For US Banks” January 2014 [http://www.pwc.com/en\\_US/us/financial-services/regulatory-services/publications/assets/fs-reg-brief-dodd-frank-basel-leverage-ratio.pdf](http://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/assets/fs-reg-brief-dodd-frank-basel-leverage-ratio.pdf)

<sup>27</sup> Ibid. This view being shared by PwC even though “the impact of the ESLR's 2% buffer is further accentuated by the competitive advantage which the now more aligned revised January 2014 leverage ratio provides non-US banks.”

<sup>28</sup> See JP Morgan, 'Basel III Implementation: Is the Industry Running Out of Time?'

[http://www.jpmorgan.com/tss/General/Basel\\_III\\_implementation\\_Is\\_the\\_industry\\_running\\_out\\_of\\_time\\_/1320504512062](http://www.jpmorgan.com/tss/General/Basel_III_implementation_Is_the_industry_running_out_of_time_/1320504512062)

## E. Conclusion

The effects and consequences of the cumbersome nature of the supplementary leverage ratio, it is envisaged, will induce some banking groups to conduct certain activities, such as derivatives based ventures, away from their subsidiaries. Other consequences of recently introduced proposals in the U.S (on Basel III), include a reference by Myles to a separate Federal Reserve proposal – which from December 2012, „requires certain foreign banks to establish a U.S intermediate holding company to house their operations.“ In Myles opinion, if these holding companies' asset value is significantly high, they would have to comply with the higher leverage ratios.<sup>29</sup>

As already re-iterated in the paper, the impact of the ESLR's 2% buffer is further accentuated by the “competitive advantage” which the now more aligned revised January 2014 leverage ratio provides non-US banks. From the perspective of other off-balance sheet exposures, the reduced exposure of OBS commitments via the January 2014 Basel revisions is considered to result in a treatment which is more beneficial to foreign banks than the Supplementary Leverage Ratio's treatment.<sup>30</sup> This being the case since comparatively higher capital costs for US banks (in providing credit commitments to retail and corporate borrowers) are considered<sup>31</sup> to result from the disparity in CCFs for commitments.

U.S banks however benefit from the perspective of Securities Financing Transactions - since as rightly argued,<sup>32</sup> even though the January 2014 Basel revisions “closes the gap in ability to net on-balance sheet SFT exposures” – with respect to the Supplementary Leverage Ratio, U.S banks still benefit from the continued exclusion of Off Balance Sheet SFTs from leverage exposure.

Despite the merits of improved consistency and harmonisation in the implementation of Basel rules and regulations – such merits including enhanced facilitation of disclosure and transparency, a balance also needs to be struck between the need to avoid a „one size fits all“ situation whereby the needs of respective jurisdictions are not met.

The need to achieve more relevant and accurate results is evidenced by the evolution of the Basel capital accords from the rather „crude“ original 1988 Capital Accord (which even though risk based, focussed exclusively on credit risk and did not apply risk weights in a specific and tailor made manner to asset classes) to the adoption of more tailor made and specific internal ratings models.

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<sup>29</sup> Myles also adds that this is exacerbated by the fact that foreign banks are the biggest dealers in US treasuries – „which are penalised by un-weighted measures such as leverage ratios“ and that further, it is also possible that branches might have to comply with U.S leverage ratios – based on how the Fed Reserve construed its comparability test.“ See D Myles, 'How U.S 5% Leverage Ratio Could Catch Foreign Banks' <<http://www.iflr.com/Article/3234308/Banking/How-US-5-leverage-ratio-could-catch-foreign-banks.html>

<sup>30</sup> PricewaterhouseCoopers, “Regulatory Brief: Basel Leverage Ratios: No Cover For US Banks” January 2014 page 3 [http://www.pwc.com/en\\_US/us/financial-services/regulatory-services/publications/assets/fs-reg-brief-dodd-frank-basel-leverage-ratio.pdf](http://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/assets/fs-reg-brief-dodd-frank-basel-leverage-ratio.pdf)

<sup>31</sup> See *ibid*

<sup>32</sup> *ibid*

Whilst comparability and consistency, which is sometimes attributed to simpler and cruder models, may be desired, it is also vital that results derived from such models reflect the reality and accuracy of prevailing conditions – hence the need to provide for models which provide and generate credible results.

As identified by the Basel Committee on Banking Supervision in its discussion paper „The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability,“<sup>33</sup> the disadvantages attributed to undue complexity and reduced comparability in the capital framework, potentially“ include:

- Increased difficulties for bank management in understanding the regulatory regime;
- The challenges arising in capital planning;
- Less accurate risk assessments;
- The creation of regulatory gaps and opportunities for arbitrage;
- An undermining of the ability of supervisors to effectively assess the capital adequacy of banks
- Impediments presented to the effective review of the capital management process by supervisors.

Achieving an appropriate balance between consistency, comparability, standardization and the need for accurate results is demonstrated by the Federal Reserve's flexible approach in applying bank stress testing techniques. As reported,<sup>34</sup> through the provision of a common set of scenarios to all firms, the results of company-run and supervisory stress tests for bank holding companies are intended to be based on comparable underlying assumptions. To further enhance comparability, the supervisory stress tests and company-run stress tests conducted under the Dodd Frank stress test rules use the same set of capital action assumptions.<sup>35</sup>

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<sup>33</sup> July 2013, Bank for International Settlements Publications at page 12

<sup>34</sup> See Dodd-Frank Act Stress Test 2013: Supervisory Stress Test Methodology and Results March 2013 at pages 5 and 6 BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
[http://www.federalreserve.gov/newsevents/press/bcreg/dfast\\_2013\\_results\\_20130314.pdf](http://www.federalreserve.gov/newsevents/press/bcreg/dfast_2013_results_20130314.pdf)

<sup>35</sup> *ibid*

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