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Global Regulatory Network Executive Briefing

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Basel Committee tightens leverage ratio requirements

The Basel Committee on Banking Supervision (BCBS) recently issued a consultative document *Revised Basel III Leverage Ratio Framework and Disclosure Requirements* ("the Framework"). Comments on the document are due by 20 September 2013. [http://www.bis.org/publ/bcbs251.htm]

The Framework clarifies a range of treatments used to arrive at the exposure measure (or denominator) of the Basel Committee leverage ratio, which is calculated as the ratio of Tier 1 capital to assets.[1] The original proposal was issued in December 2010 and was to be subject to an observation and parallel run period extending out to the end of 2017, during which additional changes could be made. The final implementation date remains January 2018.

IFRS and US GAAP differ substantially in their treatment of what is included in the exposure measure (i.e., the denominator of the leverage ratio). To address this comparability issue, the BCBS proposal contemplates a regulatory framework for arriving at a harmonized balance sheet definition of assets that differs from both the current IFRS and US GAAP frameworks, with major implications for the amount of required capital that banks would have to hold. The overall goal of the BCBS clarifications is to promote greater consistency across banks subject to different accounting regimes.

In particular, the clarifications of the BCBS leverage ratio exposure measure are related to the scope of consolidation; the treatments of derivatives, collateral and securities financing transactions (SFTs); and the treatment of written credit derivatives. In aggregate, the changes amount to a major tightening from the original 2010 BCBS proposal, especially as compared with the current US GAAP treatment. In contrast to US GAAP, the BCBS leverage ratio does not allow for netting of SFTs and does not recognize collateral to reduce derivative exposures. The BCBS measure represents a tightening for both US GAAP and IFRS for potential future exposure add-ons for SFTs and over-the-counter (OTC) derivatives and requires that the notional exposure amount for written credit derivatives be included in the regulatory exposure measure. (See the table beginning on page 5 for a comparison of the BCBS leverage ratio definitions and those under US GAAP and IFRS.)

[1] The Basel Committee is still considering alternatives to Tier 1 capital, including Tier 1 common equity and total capital.

Building a better working world

The clarifications go a long way toward harmonizing the treatment of the leverage ratio across IFRS and US GAAP accounting frameworks. Moreover, the BCBS Framework introduces a harmonized template for disclosing the leverage ratio, its components and how it reconciles to the financial statements.

The commitment to the leverage ratio across the 27-country BCBS membership varies. The EU continues to waver in its support of requiring the leverage ratio as a Pillar 1 measure. For example, the frequently asked question document of the EU Commission states that it is carrying out a review to estimate the impact of the leverage ratio that "would inform the decision on the introduction of the Leverage Ratio as a binding measure."[2] This is much softer than the Basel Committee language "with a view to migrating to a Pillar 1 treatment on 1 January 2018." Moreover, the EU has already softened the Basel Committee treatment of trade finance under the leverage ratio and in its FAQs, indicating that "several levels of the leverage ratio may be introduced in order to reflect the overall risk profile, the business model and size of the institutions."

By contrast, the US is moving in the direction of considering an even higher leverage ratio requirement than the Basel 3% standard. US regulators have proposed a consolidated bank holding company leverage ratio requirement of 5% for BHCs with more than $700 billion in assets or $10 trillion in assets under custody. Bank subsidiaries of such BHCs would face a well-capitalized leverage ratio threshold of 6%. With the US basing the higher leverage ratio on the BCBS measure of exposure, instead of the current US GAAP approach, the proposed ratio would become much more binding relative to the current Basel III risk-based requirement (the BCBS leverage ratio was supposed to act only as a backstop to the risk-based measure). Another question is how the higher leverage ratio under consideration in the US would interact with the additional stress-testing requirements of the US capital regime.

The BCBS leverage ratio would have to be publicly disclosed by January 2015 based on a harmonized disclosure template. This means that the ratio will effectively become the de facto standard three years before its formal implementation date of 2018. It is critical that banks move now to assess the pro forma impact of the BCBS leverage ratio framework, how it interacts with the risk-based requirement, how much of a buffer will be required globally and locally (for example, for a US intermediate holding company subject to both a US and BCBS leverage ratio requirement) and what it means at the level of legal entities, business lines and product classes.

Business impacted most by the new leverage ratio framework includes derivatives trading (particularly credit derivatives) and securities financing transactions. There will also be a significant impact on lending commitments on the retail and wholesale side, as well as trade finance.

Assessing the new BCBS leverage ratio exposure measure

The remainder of this briefing presents the key features of the BCBS leverage ratio exposure measure. In the table below, we discuss how the regulatory balance sheet of the BCBS leverage ratio differs from the current IFRS and US GAAP accounting frameworks and thus the likely effect as compared with banks' current accounting balance sheets.

Scope of consolidation

The Framework follows the general principle that if investments in financial or non-financial entities are included in the definition of Tier 1 capital, then the assets of that entity should also be consolidated for purposes of the leverage ratio. Where such investments are deducted from capital, then the assets of the entity (termed "investee" in the proposal) should also be excluded. While this approach creates consistency between the leverage ratio and risk-based capital treatments of exposure, it could result in discrepancies between the IFRS or US GAAP approaches to consolidation of assets on the balance sheet, each of which follow a different set of criteria (see table beginning on page 5 for more details). Banks will therefore need to assess how the consolidation standards of the BCBS leverage ratio framework line up with their respective accounting treatments.

[2] "CRD IV/CRR – Frequently Asked Questions," European Union website, http://europa.eu/rapid/press-release_MEMO-13-272_en.htm, 21 March 2013.

On-balance-sheet exposures

All on-balance-sheet assets would be included in the leverage ratio exposure measure, net of specific provisions and valuation adjustments. This is broadly consistent with the accounting treatment under IFRS and US GAAP, although the definition of what is consolidated onto the balance sheet continues to differ across these two sets of standards, resulting in some inconsistency across jurisdictions. Banks would have to include derivative collateral and collateral for SFTs within the exposure measure, and there are additional restrictions on the ability to net collateral against the counterparty exposure of derivatives as discussed below.

Derivatives

The treatment of derivatives is broken into the derivatives' replacement cost and the add-on for potential future exposure. When it comes to the replacement cost, banks are permitted to recognize bilateral netting when a qualifying master netting agreement is in place (although cross-product netting is not permitted). Thus, the treatment is closer to US GAAP, whereas IFRS is much more restrictive in its treatment of netting in that there not only has to be the ability to net but also the intent to settle on a net basis.

In addition, banks need to recognize the potential future credit exposure associated with derivative contracts using the conservative add-on factors under the so-called current exposure method of the Basel III capital framework. This method provides only limited netting benefits. Neither IFRS nor US GAAP requires such an add-on factor.[3]

The Framework clarifies that collateral received may not be used to reduce the exposure measure associated with derivative contracts. This is consistent with the Framework's overarching principle that physical or financial collateral, guarantees or any form of credit risk mitigation may not be used to reduce on-balance-sheet exposures. It reflects the Basel Committee's goal to keep the leverage measure simple and is intended to address supervisory concerns that collateral received could be used to further lever up the balance sheet. Under US GAAP, companies generally net cash collateral received against the derivative asset position. The BCBS Framework could significantly increase the leverage ratio of entities reporting under US GAAP. IFRS entities are currently prohibited from offsetting cash collateral against their derivative asset positions.

Written credit derivatives

Credit derivatives would be subject to the above treatment for derivatives. In addition, the 2010 approach has been substantially tightened, as the effective notional amount of the written credit derivatives would be included in the leverage ratio exposure measure in order to treat them in a manner equivalent to a loan or bond exposure. The effective notional amount may be reduced if there is a purchased credit derivative on the same underlying exposure, but subject to a range of restrictions related to seniority and maturity. Neither IFRS nor US GAAP would require such an additional treatment for written credit protection, and this will result in a substantial increase in the balance sheet for major credit derivative dealers.

Securities financing exposures

The treatment of securities financing exposures is clarified relative to the 2010 Basel III agreement, where the approach to be used was ambiguous. In particular, the Framework clarifies that the cash receivable and payables of SFTs may not be netted against each other where the bank is acting as a principal to such transactions. As with derivatives, the bank also will have to include an add-on for the potential exposure of SFTs resulting from the difference in value of the securities/cash lent out and the securities/cash received. Such an add-on is not required under either IFRS or US GAAP.

[3] The BCBS has put out for consultation a proposal to revise the current exposure method that could result in a more risk-sensitive treatment of the potential exposure going forward, albeit based on a so-called non-internal models approach. See http://www.bis.org/publ/bcbs254.htm.

The Basel framework also eliminates a US GAAP/IFRS difference whereby securities received as collateral in a securities lending transaction are not recorded on the balance sheet unless the securities are sold or repledged. This treatment aligns with current IFRS.

Moreover, the proposal clarifies that where the bank acts as an agent in the securities lending business and guarantees a customer against losses associated with differences in the value of securities lent and collateral received, the agent bank would need to include the same potential exposure add-ons as for on-balance-sheet SFTs discussed above. This guarantee is not reported on balance sheet under US GAAP or IFRS.

Other off-balance-sheet exposures

Consistent with the original December proposal, all other off-balance-sheet exposures would be included in the BCBS exposure measure using a 100% credit conversion factor. However, unconditionally cancelable commitments (for example, for credit card portfolios) would be converted to an on-balance-sheet equivalent based on a lower 10% conversion factor. Neither US GAAP nor IFRS require that such exposures be included in the balance sheet.

Disclosure requirements

To provide a consistent disclosure framework, the BCBS agreed that, as of January 2015, internationally active banks will be required to publish their leverage ratio according to a common template with the same frequency as, and concurrent with, their financial statements. The public disclosure components of the common template include: 1) a summary comparison table of total accounting assets and leverage ratio exposures, 2) a common disclosure template that shows the breakdown of the main leverage ratio regulatory elements, 3) a reconciliation requirement that discloses and details the source of material differences between on-balance-sheet exposures in the common disclosure template and total on-balance-sheet assets in the financial statements and 4) other requirements (e.g., key drivers of material change in the leverage ratio over consecutive reporting periods).

These harmonized disclosure standards will allow analysts and other market participants to conduct direct comparisons of banks' leverage and will likely result in additional pressure on banks with low ratios as compared with their peers, unless these banks can provide additional disclosures about the unique nature of their risk profile. (The Enhanced Disclosure Task Force published a paper in October 2012 setting out higher expectations for bank disclosures.)[4]

[4] "Enhancing the Risk Disclosures of Banks," Enhanced Disclosure Task Force, http://www.financialstabilityboard.org/publications/r_121029.pdf, 29 October 2012.

Comparison of BCBS leverage ratio exposure measures with US GAAP and IFRS accounting treatments

Leverage ratio exposure measure	BCBS	US GAAP	IFRS
Consolidation	The primary consideration for the Basel III leverage ratio in relation to consolidation is that the exposure measure (denominator) is consistent with capital (numerator). For example, if the investee consolidated for regulatory or accounting purposes, the investee's assets are included in the exposure measure. If the investee is not consolidated for regulatory or accounting purposes, only the investment in the capital of the investee is to be included in the exposure measure.	Under both US GAAP and IFRS, the determination of whether entities are consolidated by a reporting entity is based on control, although differences exist in the definition of control. Generally, all entities subject to the control of the reporting entity must be consolidated (although there are limited exceptions in US GAAP for investment companies).	
On-balance-sheet assets	On-balance-sheet, non-derivative exposures are included in the exposure measure, net of specific provisions and valuation adjustments. As further discussed below, entities will also include balance sheet derivative collateral and collateral for securities financing transactions (SFTs).	As a general principle, both US GAAP and IFRS require presentation of on-balance-sheet instruments, net of specific provisions and valuation adjustments. However, as noted in the other sections of this briefing, there are different accounting treatments between US GAAP and IFRS in regard to consolidation, offsetting of balance sheet positions and collateral. These differences can be material.	
Derivatives	The leverage ratio framework looks to capture the exposure arising from the underlying contract as well as the counterparty credit risk exposure. For a derivative exposure not covered by a bilateral netting contract, the exposure is calculated by the replacement cost and an "add-on." Netting is allowed if an eligible bilateral netting contract is in place. Collateral received or provided in connection with a derivative contract cannot be netted against the derivative exposure. In addition, banks will need to recognize the potential future exposure by including an add-on factor under the current exposure method.	Based on certain criteria, including having a master netting agreement is in place, US GAAP allows the reporting entity to net its derivative assets and liabilities. No add-on factors are included under US GAAP. Derivative asset positions are offset by any cash collateral received.	IFRS has more onerous offsetting criteria. For example, IFRS does not allow the netting of derivative contracts if there is no intent to settle net or simultaneously in all circumstances (i.e., during the ordinary course of business and in the event of default or bankruptcy of a party to the contract). Therefore, the mere existence of a master netting agreement is not a basis for net presentation. No add-on factor is included under IFRS. IFRS does not permit cash collateral to be offset against the derivative position.

Leverage ratio exposure measure	BCBS	US GAAP	IFRS
Securities financing transactions	The BCBS proposal does not recognize any netting benefit to the extent it is permitted under IFRS or US GAAP. As a result, positions are reported on a gross basis. If a lender of securities receives securities as collateral that require accounting recognition as an asset (and such collateral has not been rehypothecated), the Basel framework would remove the value of such collateral when measuring exposure. This eliminates a US GAAP/IFRS difference and aligns the Basel rules with current IFRS.	In a securities lending transaction, if the securities received by the lender-transferor can be sold or repledged, an asset (to recognize the in-kind proceeds) and a liability (to recognize a related obligation to repay the transferee or return the collateral received) is recorded.	Unlike US GAAP, a lender-transferor in a securities lending transaction does not recognize on its balance sheet securities received as collateral, even if it has the ability to sell or repledge the collateral received. However, if the lender-transferor actually sells the collateral received, it must recognize the proceeds received and an obligation to return the collateral.
Off-balance-sheet exposure	The Basel framework requires a credit conversion factor of 100% to be applied to all off-balance-sheet exposures with the exception of a commitment that is unconditionally cancelable at any time by the bank without prior notice (in which case a factor of 10% is to be applied).	Off-balance-sheet exposures are not shown on the balance sheet. Any potential impairment from an off-balance-sheet commitment is reflected as a liability reserve.	
Written credit derivatives	To capture the credit exposure to the reference entity, the full effective notional value of the credit derivative is included in the exposure measure. Under certain criteria, this position may be reduced by the notional amount of a purchased credit derivative.	Under both US GAAP and IFRS, only the replacement value of the derivative is recorded as an exposure on the balance sheet.	

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Global Regulatory Network

EY's Global Regulatory Network is an integral part of our Financial Services Office and enables EY to offer banks deep experience, leadership and insights on financial regulation.

Our global regulatory services are led by an executive team of former senior regulators, including former Basel Committee Secretary General Stefan Walter. This team, supported by more than 100 other former regulators, drives EY's strategic outlook on global regulatory themes impacting global banks, including capital, liquidity, resolution and recovery planning, risk governance and other emerging topics in banking regulation.

Stefan Walter was secretary general of the Basel Committee on Banking Supervision from 2006 to 2011. During this time, he was also a member of the Financial Stability Board. He has more than 20 years of international bank supervisory experience, including 15 years at the Federal Reserve Bank of New York.

Dr. Tom Huertas is a former member of the FSA's Executive Committee. He also served as alternate chair of the European Banking Authority, as a member of the Basel Committee on Banking Supervision and as a member of the Resolution Steering Committee at the Financial Stability Board.

Patricia Jackson is the former head of the Bank of England Regulatory Policy. She was the head of the Financial Industry and Regulation Division from 1995 to 2003 and was a member of the Basel Committee from 1995 to 2003. She chaired the global Quantitative Impact Studies to test the effect of Basel II and chaired the Calibration subgroup.

Don Vangel, Regulatory Advisor to the Office of the Chairman, joined EY after a 17-year career at the Federal Reserve Bank of New York, where he ultimately served as a Senior Vice President for Bank Supervision.

Urs Bischof is the former head of Risk Management of the Extended Executive Board of Switzerland's FINMA. His responsibilities included risk management supervision and oversight and prudential regulations, along with leadership roles with respect to Basel III, SIFI regulation, payments and clearing.

Marie-Helene Fortesa has extensive regulatory experience. Her posts have included leadership roles at the Autorité de Contrôle Prudentiel (French Prudential Supervisory Authority), the Association Française des Banques (French Banking Association) and INSEE (French National Institute for Statistics and Economic Studies), as well as senior roles at a leading investment bank.

John Liver's experience includes a number of regulatory roles with leading investment banks as well as the UK FSA and its predecessors. His roles include head of thematic supervision in the Investment Firms Division, head of Personal Investment Authority Supervision, overseeing the sales regulation of the life and pensions industry, and management roles in Investment Management Regulatory Organization's Enforcement and Supervision Departments.

Phil Rodd, Keith Pogson and **David Scott** have extensive experience working with regulators across the Asia-Pacific region. **Hidekatsu Koishihara** is a former chief inspector and inspection administrator for the Japan Financial Services Agency. He also worked at the Ministry of Finance of Japan (MOF), Japan's former financial regulator, serving as the financial inspector at the Bank Bureau of MOF and Financial Inspection Division, and Minister's Secretariat of MOF.

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