European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

EACB Comments
On the upcoming Commission Delegated Act amending the Leverage Ratio under Art. 456(1)(j) CRR

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Contact:

For further information or questions on this paper, please contact:

a. Mr. Volker Heegemann, Head of Department (v.heegemann@eacb.coop)
b. Mr. Marco Mancino, Adviser, Banking Regulation (m.mancino@eacb.coop)

The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 28 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 3.700 locally operating banks and 71.000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 215 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 56 million members and 850.000 employees and have a total average market share of about 20%.
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Introduction

The Basel III framework of June 2013, and as revised in January 2014, introduced a simple transparent, non risk-based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements. The framework designs the leverage ratio as a simple backstop mechanism and, in the context of its implementation in the EU legislation, we strongly advise against a measure that goes beyond such design.

The revised Basel framework for the leverage ratio published in January 2014 makes some improvements in the method of calculation, such as, less burdensome calculation periods, the definition of a regulatory scope of consolidation etc. We welcome such clarifications, and we believe that the use of a prudential scope of consolidation is of the utmost importance in the specification of the leverage ratio measure. These improvements need to be adequately reflected in the amendments to Art. 429 CRR implementing the leverage ratio in the EU.

The EACB welcomed the Commission's initiative to address these matters (inter alia) at the public hearing on the 10th of March, and EACB Members were pleased to attend and take part. At the hearing, the Commission reaffirmed its view that the CRR regime should align with Basel except where there are European specificities to be taken into account. Regarding many of the improvements to the Basel framework published in January 2014, and in the absence of European specificities, the EACB can see no good reason for not adopting these improvements within the CRR via the delegated act. Also the EBA in its own initiative report of March 2014 on the impact of differences in leverage ratio definitions, notes the need for such alignment.

On the other hand, some provisions of the Basel framework would still have a detrimental effect on our Members and the EU economy, and should be tackled.

Thus, the revised Basel text and the EBA analysis still leave the need for particular attention on certain issues that demand a finer calibration. For the European cooperative banks it is essential that the amendments to the leverage ratio provide for a more balanced specification of such measure.

Finally, regarding the leverage ratio as a Pillar 1 requirement, we consider it crucial that the European decision making process is allowed to take its course without being prejudiced. Therefore, we hold it important that Member States refrain from taking any policy action implementing a national version of the leverage ratio during the calibration period. Once the EBA report in 2016 is finalised, legislation would be proposed that reflects the recommendations set out by the EBA.

1. General design of the leverage ratio: calculation period and consolidation scope

1.1 Calculation and reporting period

We appreciate that the revised Basel text has put forward a calculation of the leverage ratio based on end-of-quarter data.

Indeed, the EACB Members strongly support such an approach (para. 46, 53 of the Basel text), which lowers the administrative burden. We believe that this should also be reflected in the CRR which, on the other hand, envisages a calculation based on the mean of monthly leverage ratios over a quarter.

Therefore we suggest an amendment of Art. 429(2) CRR that reflects the Basel approach (see Annex: point 1).

The use of monthly data would prove, indeed, disproportionately onerous, especially for local cooperative banks.

1.2 Consolidation scope

We believe that the second sub-paragraph of Art. 429(4) CRR should be deleted as soon as possible (see Annex: point 1.2) to reflect the revised Basel text which limits the scope of consolidation for leverage ratio to the prudential consolidation scope. The preparation and collation of these data is very costly for banking groups which include some financial sector entitities in the consolidation scope, according to the applicable accounting framework. Subsidiaries, which have not been calculating any regulatory exposure value so far, are forced to set up a detailed regulatory evaluation for assets for the leverage ratio.

In fact, under the revised Basel III approach the scope of consolidation for the purpose of the leverage ratio is the prudential scope of consolidation as is used for the risk-based capital framework.

On the other hand, the second subparagraph of Article 429 (4) CRR goes beyond this logical framework, as it requires the inclusion of exposures in financial sector entities that are consolidated for accounting purposes but not for prudential purposes.

As pointed out in the EBA report on leverage ratio this treatment determines a lack of alignment between the scope of consolidation of the exposure measure and the scope of consolidation determining Tier 1 capital[1]. The report also points out that "the mere inclusion of these entities is not a proper consolidation and may therefore result in a double counting of intra-group exposures in the leverage ratio exposure measure".

We would strongly appreciate if the European Commission released institutions from the application of this rule, even at short notice and for the first reporting date as of 31st March 2014.

[1] Par. 3.5, EBA Report on impact of differences in leverage ratio definitions

2. On-balance sheet exposures

2.1 <u>Intra-group exposures</u>

The EACB would like to point out how groups and networks with centralised treasury systems, such as the cooperative ones, naturally give rise to a substantial amount of intra-group exposures. Including such exposures in the ratio would lead to additional difficulties at the level of the local banks within cooperative networks, while compliance at group level would not be an issue.

The intra-group operations that would be affected can be summarised as:

- internal refinancing operations;
- transactions in derivatives effected through the central institutions (the centralisation of such operations has been further strenghtened by the EMIR regulation);
- financial guarantees.

Including inter-company exposures in the leverage ratio would prove detrimental in many respects:

a. it would steer away from centralisation of treasury activity within groups and cash pooling, which on the other hand is a desirable and supported outcome for regulators;

b. it would have an unduly negative effect on cooperative banking groups and networks which, due to their peculiar structure, perform a great number of intra-group operations;

c. it would trigger a leverage ratio higher than 3% at the largest level of consolidation (this would also imply that own funds would need to be allocated to every tier of consolidation to cover for intra-group exposures). In this respect we would like to draw the attention to two points:

    i. A leverage ratio greater than 3% would not act as a simple back-stop, instead it would replace the solvency ratio determining the allocation of own funds. This would lead to an unefficient allocation of the own funds mainly based on the size of the balance sheet;

    ii. The leverage ratio should remain a simple back-stop as also stressed by the revised Basel text: "*The Basel III framework introduced a simple, transparent, non-risk based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements. The leverage ratio is intended to […] reinforce the risk-based requirements with a simple, non-risk based "backstop" measure*[2]".

[2] Par. 2, Basel III leverage ratio framework and disclosure requirements

d. it would create a major distortion of thelevel playing field between European banks and other markets. The inclusion of intra-group exposures would result in an additional costly burden due to this specificity of the CRR not foreseen in the Basel framework. The Basel framework looks at the leverage ratio only at a group level. As a result, intragroup exposures are not penalised as they are eliminated on consolidation.

The CRR already exempts intra-group exposures for solvency purposes, under certain strict criteria as laid down in Art. 113(6):

- the operations are carried out by two institutions within the same group;
- within the same country;
- within the consolidation scope of the group;

If the criteria are satisfied the associated credit risk is zero, and including such operations in a measure of the exposure would be distortive. Intra-group exposures are excluded also from the calculation of the large exposures, while Art. 425(1) CRR exempts institutions within the scope of Art. 113(6) or (7) from the cap on inflows.

Therefore, the EACB advocates for inter-company exposures not to be accounted in the leverage ratio.

To this end we propose two amendments to Art. 429, with two new paragraphs based on Art. 113(6) CRR (see Annex: point 2).

2.2 <u>Cash and Central Bank exposures</u>

Moreover, we believe that attention should be given to those neutral, risk free assets which do not increase the leverage. We strongly believe that such assets should not be taken into account in the leverage ratio.

For example, particularly in times of stress solid and resilient banks are perceived and used as a safe haven for depositors. This creates the conditions to receive a great mass of deposits, which are in turn placed directly at the National Central Bank, or, in the Eurozone, at the ECB. Such development would lead to an increase of the total balance sheet and thus of the exposure measure. While such exposures do not imply an increase of risk, they would impact the leverage ratio reducing it.

We strongly propose not to consider in the scope of the ratio cash and central bank monies. Alternatively, we ask for a special treatment, at least temporarily, for such exposures allowing a coordinated deleveraging of the system without having to refuse deposits from clients. Indeed, we consider that depositor confidence, and therefore financial stability, will be enhanced during periods of stress if our Member banks remain open to accepting deposits that clients wish to move from elsewhere, rather than having to turn them away due to concerns over the short term effect on leverage.

2.3 Interplay between LCR and leverage ratio

A further point to be taken into account is the likely interplay between the LCR requirement and the leverage ratio.

The LCR, in fact, urges banks to hold a stock of liquid assets on the balance sheet which will increase the exposure measure. Therefore, this will lead to an increase of the leverage (and a reduction of the leverage ratio). Such an outcome would be extremely penalising for institutions willing to mantain a strong liquidity profile, in particular when higher than the minimum requirements.

We suggest to reconsider the interplay between the two requirements and adjust the scope of calculation for the leverage ratio by exempting the assets used to fulfil the LCR requirement from the leverage ratio.

3. Treatment of SFTs

3.1 Interpretation of Art. 429(5): netting of SFTs and treatment of collateral

The EBA's report on leverage ratio definition addresses the different treatment of SFTs[3] under the CRR and the current Basel III framework.

In particular the EBA points out two different interpretation of Art. 429(5). Art. 429(5)(b) generally stipulates that collateral cannot be used to reduce the exposure value of the assets. On the other hand Art. 429(9) refers to allowing netting for SFTs in accordance with Article 220 and stipulates that determination of the exposure to SFTs should be done in accordance with Art. 220 and 222 CRR.

We believe that these provisions (referred to as "interpretation 1" by the EBA) allow an institution to reduce REPO receivables by the amount of collateral received and that the cash borrowed in a REPO transaction can be deducted from the asset provided as collateral. While the final Basel text (par. 33(i)) does not take into account such possibility, we believe that this treatment is necessary not to unduly hit the EU REPO market. The aggregate effect of netting REPO payables and receivables as envisaged under the strict criteria of par. 33(i) of the revised Basel text (e.g. same explicit final settlement date) would be negligible and close to zero. As calculated from one of our Members, in their specific case the exposures would shift from € 16.6bn to € 16.5bn.

The EACB Members believe that the restrictive Basel treatment of SFTs, or the so called "interpretation 2" of CRR provision (treating SFTs with the accounting value plus an add-on exposure for the risk of not receiving back the collateral), would prove extremely penalising for banks, and have more generally undesirable effects, for a number of reasons:

- It would have a wide impact on repo markets reducing their liquidity and depth;

[3] Par. 3.1, EBA Report on impact of differences in leverage ratio definitions

- It would have repercussions on short-term lending;
- It would interfere with monetary policy transmission.

After all, collateralised REPO receivables still receive a higher exposure value than any uncollateralised receivable. Furthermore, this approach would depend on the accounting rules and would consequently raise a problem of level playing field among banks following different accounting rules.

Our strong view is to maintain the current CRR provisions and to favour "interpretation 1".

3.2 Repos without explicit maturity date

The condition under Art. 220(5) CRR, according to which netting of SFTs is allowed for operations with the same maturity does not take into account the widespread use of SFTs without an explicit maturity date. These operations can generally be seen as overnight operations and their netting should be allowed.

4. Treatment of derivatives

4.1 Treatment of cash variation margins (CVM)

We generally welcome the possibility given under par. 25 of the revised Basel text to treat the cash variation margin as a form of "pre-settlement", thus allowing a reduction of the exposure value due to daily margining. However, we have some concerns with regard to the condition of "same currency" (par. 25(iii) Basel III leverage ratio) to allow partial netting of CVMs in derivatives transactions.

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 should therefore be written as follows:

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

5. For a proportionate leverage ratio

5.1 The leverage ratio review process

According to the CRR, the review process of the LCR will start in mid-2016. The EBA is mandated to provide, by 31st October 2016, a detailed report encompassing a wide range of issues related to the leverage ratio. Among these issues, the EBA shall evaluate the introduction of differentiated leverage ratio for different business models under Art. 511(3)(b),(i).

Based on the EBA assessment, by 31st December 2016, the Commission shall submit a report to the Parliament and the Council on the impact and effectiveness of the leverage ratio together with a legislative proposal, as mandated under Art. 511(1) CRR. In particular, Art. 511(2) CRR explicitly states that the Commission shall submit a legislative proposal on the introduction of differentiated levels of the leverage ratio to be met by institutions according to different business models.

Moreover, Recital 95 and 115 CRR explicitly confirm the need to take into account the peculiarities of different business models and their risk profile.

Thus the CRR is strongly favouring a differentiated leverage ratio based on the peculiarities of business models, risk profiles, and portfolio focus of different institutions.

5.2 Consideration of different business models

Therefore we believe that it is essential that the leverage ratio is implemented in a way that properly reflects European specificities. Europe's economy relies in fact more heavily than other economies on banking intermediation for financing. A rigid and unflexible ratio may seriously harm economic prospects in the Union.

A "one-size ratio" would be inappropriate for credit institutions which are not engaged in a broad variety of business lines, and face limited risks because of their legal structure, their affiliation to an institutional protection scheme or their specialised business model. A uniform leverage ratio distorts level playing field across credit institutions.

An example of a business model that would be hit by a disproportionate approach to leverage ratio is the European mortgage credit industry and public sector lenders. In fact, a one size ratio would not take into account the low-risk and high volume business models. As such, it would instead encourage a shift towards riskier and more expensive mortgage lending and jeopardise the existence of some long-standing business models without any obvious benefits in terms of stability or resilience.

Other banks, while not adhering to a business model that is exclusively focused on a certain type of low risk businesses, may nevertheless have a strong focus on particular low risk portfolios. A one size leverage ratio would certainly be inappropriate, for

example, for banks whose main share of exposures is connected to government lending. Therefore, a differentiated approach considering different portfolios seems advisable. Such an approach would also establish a level playing field among banks with the same type of portfolio.

In this respect, the calibration of the leverage ratio for reporting and disclosure purposes should as well take in consideration the specific profiles of low risk business models.

Therefore, we believe that the current delegated act should reflect the possibility of the introduction of a differentiated leverage ratio at a later stage.

Annex – Proposed amendments to Art. 429 CRR

Point 1 – Art. 429(2)

Institutions shall calculate the leverage ratio ~~as the simple arithmetic mean of the monthly leverage ratio over a quarter~~ *based on end of quarter data*.

Point 1.2 – Art 429(4)

The total exposure measure is the sum of the exposure values of all assets and off-balance sheet items not deducted when determining the capital measure referred to in paragraph 3.

~~Where institutions include a financial sector entity in which they hold a significant investment in accordance with Article 43 in their consolidation according to the applicable accounting framework, but not in their prudential consolidation in accordance with Chapter 2 of Title II of Part One, they shall determine the exposure value for the significant investment not in accordance with point (a) of paragraph 5 of this Article but as the amount that is obtained by multiplying the amount defined in point (a) of this subparagraph with the factor defined in point (b) of this subparagraph:~~

~~(a) the sum of the exposure values of all exposures of the financial sector entity in which the significant investment is held;~~

~~(b) for all direct, indirect and synthetic holdings of the institution of the Common Equity Tier 1 instruments of the financial sector entity, the total amount of such items not deducted pursuant to Article 47 and point (b) of Article 48 (1) divided by the total amount of such items.~~

Point 2 – Art. 429(5),(10)

New: Art. 429(5)(d)

With the exception of exposures giving rise to Common Equity Tier 1, Additional Tier 1 or Tier 2 items, an institution may, subject to the prior approval of the competent authorities, decide to exclude from the total exposure the balance sheet exposures of that institution to a counterparty which is its parent undertaking, its subsidiary, a subsidiary of its parent undertaking or an undertaking linked by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC. Competent authorities are empowered to grant approval if the conditions of Art. 113(6) are fulfilled.

New: Art. 429(10)(e)

With the exception of exposures giving rise to Common Equity Tier 1, Additional Tier 1 or Tier 2 items, an institution may, subject to the prior approval of the competent authorities, decide to exclude from the total exposure the off-balance sheet exposures of

that institution to a counterparty which is its parent undertaking, its subsidiary, a subsidiary of its parent undertaking or an undertaking linked by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC. Competent authorities are empowered to grant approval if the conditions of Art. 113(6) are fulfilled.