



More Leverage for the Unleveraged— Basel Committee Proposes Specific Leverage Capital Framework for Banking Organizations

On June 26, the Basel Committee on Banking Supervision (“Basel Committee”) published a Consultative Document that proposes specific leverage capital requirements, and related disclosure requirements (the “Proposal”), that would more fully implement the leverage capital provision of the 2010-2011 revised regulatory capital accord (“Basel III”) adopted in the wake of the financial crisis. The Proposal specifies the elements of the “Exposure Measure” for calculating leverage capital requirements.¹ Comments on the Proposal are due by September 20, 2013.

A Quick Refresher on Basel III Leverage Capital

Basel III provides for a new non-risk based leverage capital ratio that, when fully effective, will supplement the Basel III risk-based capital requirements. In general, the leverage ratio is intended to reinforce a banking organization’s overall regulatory capital by creating a non-risk-based regulatory capital backstop. Implementation of the leverage ratio has begun with bank reporting to supervisors of the leverage ratio and its components, a process that was supposed to have begun in January 2013, although implementation dates have slipped in various jurisdictions. Nevertheless, the Basel Committee expects full substantive implementation of the leverage ratio by January 1, 2018.

The Basel III leverage ratio is defined as the ratio, expressed as a percentage, of the “Capital Measure” (the numerator) divided by the “Exposure Measure” (the denominator). The Basel Committee has established, for the time being, a three percent (3%) minimum leverage capital requirement.

Although U.S. banking organizations long have been required to comply with leverage capital requirements (which have been buttressed by section 171 of the Dodd-Frank Act, or “Collins Amendment”), a notable feature of the Basel III requirement is that the Exposure Measure includes not only a banking organization’s on-balance sheet assets, but also covers certain off-balance sheet exposures, including derivatives, certain securities financing exposures, and certain types of commitments, direct credit substitutes and standby exposures.

¹ Basel Committee on Banking Supervision, Consultative Document, *Revised Basel III leverage ratio framework and disclosure requirements* (June 2013); *Basel III: A global regulatory framework for more resilient banks and banking systems* (rev. June 2011), paragraphs 151-167.

What the New Consultative Document Proposes

In general, the Proposal would create specific requirements for the calculation of the Exposure Measure. Material elements of the proposal are:

- *Scope of consolidation for the inclusion of exposures.* If a bank includes an interest in a subsidiary that is consolidated for regulatory or accounting purposes as part of its Tier 1 capital, the bank must include the subsidiary's on-balance sheet assets and other qualifying exposures in the bank's calculation of its Exposure Measure, regardless of the nature (financial, commercial, securitization, etc.) of the subsidiary.
- *Measurement of Exposure Measure.* A bank's total Exposure Measure is the sum of on-balance sheet exposures (net of on-balance sheet exposures that are deducted from Tier 1 capital), derivative exposures, securities financing transaction exposures, and other specified off-balance sheet exposures. Calculation of the Exposure Measure is expected to follow the accounting measure of exposure.
 - On-balance sheet, non-derivative exposures must be included in the Exposure Measure net of specific provisions and valuation adjustments. In addition, netting of loans and deposits is not allowed.
 - Unlike the calculation of risk-based capital requirements, physical or financial collateral, guarantees or credit risk mitigation purchased cannot be used to reduce on-balance sheet exposures, although some offsets of exposures between consolidated entities is allowed to avoid double-counting of exposures.
- *Derivatives and related collateral.* Banks must calculate their derivatives exposures (including bank sales of credit protection using a credit derivative) as the replacement cost for the current exposure plus an add-on for potential future exposure, applying regulatory bilateral netting rules specified in the Proposal, and adjusting the exposure amount for related collateral. Notably, collateral received or provided in connection with derivative contracts (cash or non-cash) may *not* be netted against derivatives exposures regardless of whether netting is allowed under the bank's operative accounting (or risk-based) framework.
- *Written credit derivatives.* In addition to the general treatment of derivatives and related collateral, the "full effective notional value" referenced by a written credit derivative must be incorporated into the Exposure Measure. Here, however, some credit risk mitigation is allowed: the effective notional amount of a written credit derivative may be reduced by the effective notional amount of a purchased credit derivative on the same reference name and level of seniority if the remaining maturity of the purchased credit derivative is equal to or greater than the remaining maturity of the written credit derivative.
- *Securities financing transactions.* Securities financing transactions engaged in as *principal*, including repurchase and reverse agreements, securities lending and borrowing transactions, and margin lending transactions are included in the Exposure Measure by adding (i) the gross securities financing transaction assets, less the value of securities received in a transaction and recognized as an asset by the transferor if the transferor has the right to hypothecate but has not done so, and (ii) a measure of counterparty credit risk calculated as current exposure but *without* an add-on for potential future exposure.
 - Where no qualifying master netting agreement is in place, the current exposure for transactions with a counterparty must be calculated on a transaction-by-transaction basis according to a specified formula; a separate formula applies in the case of qualifying master netting agreements.
 - Where a bank acting as an *agent* in a securities financing transaction provides a guarantee to a customer or counterparty that is limited to any difference between the value of the security or

cash the customer has lent, and the value of collateral the borrower has provided, the bank will be required to calculate its Exposure Measure only by calculating the counterparty credit risk as provided above.

- *Other qualifying exposures.* A credit conversion factor of 100% is applied to exposures in the nature of commitments (including liquidity facilities), unconditionally cancellable commitments, direct credit substitutes, acceptances, standby letters of credit, trade letters of credit, failed transactions and unsettled securities.
- *Disclosure requirements.* Banking organizations must make public disclosures of their Basel III leverage ratios beginning on January 1, 2015. The disclosures generally must include a summary comparison table comparing a bank's total accounting assets and leverage ratio exposures; a common disclosure template that banks must use to disclose the breakdown of the main leverage ratio elements; a reconciliation disclosure that details the sources of material differences between on-balance sheet exposures in the common disclosure template on the one hand, and total on-balance sheet assets in their financial statements on the other hand; and other disclosures as specified in the Proposal.
- *Timing.* As proposed, the public disclosure requirements will be effective by January 1, 2015, and banks will be required to comply with these requirements for balance sheet periods that close on or after January 1, 2015. Disclosures must be made with the same frequency as, and concurrent with, the publication of banks' financial statements, except that large banks must make quarterly disclosures of four key elements of the leverage capital ratios: the leverage ratio calculated as the average of monthly ratios during the preceding quarter; three end-of-quarter calculations: the Capital Measure, the Exposure Measure, and the leverage ratio.

Observations

While the Basel III leverage ratio is by its terms limited to the large internationally active banks that are subject to Basel III, the ever-present question, both in the U.S. and internationally, is the extent to which the Basel leverage ratio will filter down to banks below the top tier Basel banking organizations. In the U.S., at least, the current regulatory intent is to apply the Basel leverage ratio as a supplementary capital ratio only to the small number of banks that are subject to the Basel III "Advanced Approaches" risk-based capital requirements; after all, all U.S. banks already are subject to a basic, and somewhat different, leverage ratio measured as the ratio of regulatory capital to average on-balance sheet assets. In the EU, where the leverage ratio is a new regulatory tool, it will apply to a much broader range of financial institutions, including a large population of banks—regardless of whether they are internationally active or large—and other credit institutions, as well as to a large range of investment firms.

The complications and challenges of the Basel leverage ratio for those banks that will be subject to it, however, are further exposed in the Proposal. Although it is a given that leverage and risk-based capital are related but separate capital benchmarks, the Basel leverage ratio extends the leverage capital requirement beyond on-balance sheet assets to key classes of off-balance exposures such as derivatives, repo style transactions and direct credit substitutes. The Proposal further complicates the matter by applying different rules to the calculation of Exposure Measure elements (*e.g.*, the disqualification of many collateral and other credit mitigation activities under the Exposure Measure) than will apply under the risk-based capital rules. Covered banking organizations therefore will be faced with several discrete implementation challenges, including the challenge of applying different capital calculation methods for leverage and risk-based capital.

Those who are responsible for understanding and applying in practice the regulatory capital rules will readily appreciate that the Proposal adds more complexity to what is already a formidable compliance task. In addition, we already are hearing from industry observers substantial concerns about the financial costs of the Proposal's

requirements and calculation metrics, including the potentially significant “double counting” impact of the Proposal’s requirement that received collateral may not be netted against a derivatives exposure, and must be included in a bank’s overall exposures. Undoubtedly, more on this and other issues will be said in the coming weeks and months.

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