What next for the Basel III leverage ratio framework?

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Financial Services analysis: Following the publication of Basel III's leverage ratio framework and disclosure requirements, Peter Green, partner at Morrison & Foerster, analyses the likely impact of the guidance and how it fits in with other developments in the area.

Original news

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The full text of Basel III's leverage ratio framework and disclosure requirements has been issued by the Basel Committee following endorsement on 12 January 2014 by its governing body, the Group of Central Bank Governors and Heads of Supervision. A simple leverage ratio framework is critical and complementary to the risk-based capital framework to help ensure broad and adequate capture of both the on- and off-balance sheet sources of banks' leverage. This non-risk based 'backstop' measure aims to restrict the build-up of excessive leverage in the banking sector.

What is the guidance that the Bank for International Settlements (BIS) has put forward?

The Basel Committee has published a revised framework for the leverage ratio which makes an adjustment to the way the ratio (which forms part of the Basel III accord) is calculated. The basic premise of the proposed leverage ratio is that tier 1 capital should be at least 3% of total exposures, with exposures calculated on a gross (ie without netting in relation to individual transactions) basis.

The adjustments now give greater flexibility for banks to calculate certain exposures, particularly in relation to securities lending and repo transactions on a net basis and to allow the cash variation margin to be deducted from derivatives exposures, in each case subject to certain conditions. Banks have argued since the introduction of the proposed leverage ratio, that such treatment more fairly reflects the risks inherent in such transactions. There is also more flexibility in the way off balance sheet items are treated. The adjustments are likely to make it easier for most financial institutions to comply with the leverage ratio requirements.

How does the guidance fit with other BIS initiatives relating to Basel III?

The leverage ratio remains an integral part of the new Basel III framework for banks that includes minimum capital requirements and leverage and liquidity ratios. The recent paper from the Basel Committee on the leverage ratio maintains the ratio at 3% but makes some adjustments to address concerns raised by the market. Banks will argue that the adjustment in the ratio allows them to reflect the reality of the risks involved in certain transactions.

How will the guidance be interpreted and/or implemented at EU level?

The revised framework for the leverage ratio should not give rise to any major problems in the implementation of Basel III into EU legislation under CRD IV. The exiting provisions relating to the leverage ratio under CRD IV do set out some detail as to how the ratio is calculated and it may be that some amendments are needed. However, much of the detail relating to the leverage ratio will be included in 'level 2' legislation and ECB rulemaking. The adjustments should therefore be able to be accommodated under CRD IV without any major redrafting of the Directive itself.

What are the time frames for implementation?

The new adjustments to the leverage ratio have not affected the Basel III timetable. In relation to the leverage ratio, an observation period starts on 1 January 2015 whereby banks will have to start reporting to national legislators on how they are meeting the leverage ratio requirements. Full compliance with the leverage ratio is currently envisaged for 1 January 2018 and this is not changed by the recent adjustments. The Basel Committee has already noted that further adjustments to the ratio are possible as a result of the observation period.

What are your thoughts on the debate as to whether the leverage ratio percentage should be raised?

The 2011 Vickers Report on banking in the UK recommended a leverage ratio somewhere in the region of 4% for the more systemically important banks. The former Governor of the Bank of England, Mervyn King, suggested it could go as high as 10% in some cases. It should be noted that the Basel III framework sets out recommended minimum criteria for minimum capital, leverage and liquidity ratios and does not preclude the EU or other jurisdictions from imposing greater leverage requirements on their financial institutions. In the EU, CRD IV will impose a level playing field in terms of a minimum leverage ratio but there may still be some flexibility for individual member states to impose higher requirements. There is no evidence of a groundswell of support for the 4% proposal in Europe other than the UK, although there is an ongoing debate as to whether the more systemically important banks should be subject to more stringent leverage requirements. This is a discussion that is likely to continue for some time.

Interviewed by Duncan Wood.

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