Stand out for the right reasons
Financial Services Risk and Regulation

Hot topic

'Basel IV': Leverage ratio revisited

Highlights

*On 7 December, the Basel Committee on Banking Supervision (BCBS) published its **package of reforms** known as 'Basel IV'. The 'Basel IV' package includes final rules on the leverage ratio. The rules set out additional requirements for global systemically important banks (G-SIBs) and provide details on amendments to the exposure measure for calculating the leverage ratio from 2022.*

Background and timeline of developments

The BCBS is the international body responsible for setting prudential standards for large, globally active banks. Since the financial crisis of 2007/09, the BCBS has been updating the Basel II framework to further enhance the risk management and supervision of banks. A commitment to a leverage ratio was made by the G20 in 2009 and was included in the Basel III framework with details on this new ratio published in 2014. The 'Basel IV' package introduces additional requirements for G-SIBs and makes a number of amendments to the exposure measure used for calculating the ratio, which will apply from 2022.

The BCBS designed the leverage ratio as a back-stop measure to risk-based capital requirements. Banks in jurisdictions that adopted the Basel framework have been disclosing the leverage ratio since 2015. The ratio will become a binding Pillar 1 measure on 1 January 2018. The standard applied from 2018 will be based on the 2014 design of the ratio. From 2022, the updated design of the ratio will apply to all banks and the additional requirements to G-SIBs.

The BCBS has been monitoring the impact of the leverage ratio in the parallel run period from January 2013. Discussions with market participants also informed its views on the revisions to the standard. Many market participants noted that the leverage ratio has had an adverse impact on balance sheet intensive activities such as repo or providing clearing services to clients.

A number of major jurisdictions such as the UK, US and Switzerland already have their own leverage ratio in place. Since 2015 the PRA has applied a leverage ratio of 3% to banks and building societies (based on the definition in CRR) with retail deposits equal to or greater than £50 billion on an individual or a consolidated basis. In October 2017 this requirement increased to 3.25% to offset the removal of central bank reserves from the exposure measure.

The Capital Requirements Regulation II proposal currently being negotiated in the EU proposes bringing a binding leverage ratio into force for all CRR firms in the EU.

pwc

The leverage ratio requirement

Leverage ratio definition

The leverage ratio is defined as the capital measure (the numerator), being Tier 1 capital, divided by the exposure measure (the denominator), with this ratio expressed as a percentage:

Leverage ratio % = **Capital measure** x 100

Exposure measure

As set out in previous BCBS publications the leverage ratio will be set at 3% of Tier 1 capital (Common Equity Tier 1 plus Additional Tier 1 capital) against total exposures. Both the capital and exposure measure should be calculated on a quarter-end basis, although supervisors may allow more frequent calculations as long as they are consistent.

Additional requirements for G-SIBs

The thirty banks identified as G-SIBs by the Financial Stability Board will also face additional requirements, reflecting their systemic importance. G-SIBs will be required to meet a leverage ratio buffer with Tier 1 capital. The leverage buffer will be set at 50% of the capital add on currently applied (for example a GSIB with a 2% CET1 add on will face an additional 1% leverage ratio). As with the risk based capital buffer for G-SIBs, any bank that does not meet its leverage ratio buffer will not be able to distribute capital through dividends, bonuses etc.

Conceptually the BCBS proposals are similar to PRA requirements that UK systemic banks have a leverage buffer, but the BCBS calibration of 50% of risk weighted buffers differ to the PRA's 35%. However at this point, unlike the PRA, BCBS has not chosen to include a countercyclical leverage requirement in its framework.

The BCBS leverage ratio buffer will apply from 1 January 2022 to all those banks identified as a G-SIB in the 2020 exercise. For those banks subsequently identified as G-SIBs the same transitional arrangements[1] in place for meeting the risk-based buffer will also apply.

Exposure measure

The exposure measure is the sum of the following exposures i) on-balance sheet exposures (excluding on-balance sheet derivative and Securities Financing Transactions (SFT) exposures); ii) derivative exposures; iii) SFT exposures; and iv) off-balance sheet (OBS) exposures.

In light of concerns over the impact of the leverage ratio the BCBS has proposed amendments to the exposure measure of the leverage ratio.

The Basel IV standard includes:

i) more detail and examples in response to specific challenges raised by the industry (e.g. the treatment of regular-way purchases and cash pooling in the exposure measure);

ii) an alignment of the LR framework with other elements of the Basel IV package (e.g. SA-CR and securitisations framework for OBS exposures, SA-CCR for derivative potential future exposure calculations); and

iii) adjustments to various other elements of the calculation of the exposure measure

Some key examples of (iii) above include:
(a) excluding originated securitisations that are de-recognised for risk-weighted capital purposes, because it has been proven that risk has been transferred from the bank; (b) applying a 1.4x scalar to the replacement cost and potential future exposure of derivatives; (c) avoiding double counting of exposures in a multi-level clearing structure where a bank is a 'higher level client'; (d) a maximum credit conversion factor for OBS commitments of 40%; and (e) providing flexibility for jurisdictions (such as the UK) to continue to apply its current policy of excluding reserves held at the central bank while simultaneously increasing the minimum requirement.

Overall these amendments to the exposure measure have the effect of refining the calculation of the exposure measure and avoiding banks having to capitalise exposures twice or capitalise risks that do not directly apply to them.

The standards also call on banks and supervisors to be particularly vigilant to transactions and structures that result in banks inadequately capturing sources of leverage, and suggest that supervisors take action to tackle this risk via Pillar 2.

[1] *The buffer requirement stipulated in the annual assessment of G-SIBs in November will apply from the January in the year after next (i.e. 14 months later).*

Next steps

The BCBS will continue to monitor the impact of the leverage ratio on banks' activities and financial markets, including reviewing the impact of the ratio on SFTs and market liquidity.

In addition to this, the BCBS has committed to monitoring the impact of the leverage ratio on client cleared derivative transactions. For instance banks are already signalling disappointment about the unchanged requirement for banks to count customer cash collateral held at central counterparties towards their leverage exposure and to ignore the exposure-reducing effect of initial margin. The BCBS has committed to undertake a review of the impact of the leverage ratio on banks' provision of clearing services and any impact on the resilience of central counterparty clearing.

What should firms be doing?

- Whilst the proposed implementation timeline for the revised leverage ratio appears generous, it is key for banks to analyse the impact and commence implementation planning now. This will require banks to invest time and resources to understand how the package will impact their business plan.
- For some G-SIBs the leverage ratio may become the binding capital constraint with the application of the leverage buffer in 2022. This will put further pressure on low RWA but balance sheet intensive business lines. Those G-SIBs that may be bound by the leverage ratio buffer should consider the impact on capital allocation and business model viability.
- The BCBS has committed to monitoring the impact of the leverage ratio. Firms should engage in this process to ensure any unintended consequences of the leverage ratio are fully understood.

Contacts

James Hewer

T: +44 (0) 20 7804 9605
E: james.hewer@pwc.com

Michael Snapes

T: +44 (0) 20 7212 3166
E: michael.j.snapes@pwc.com

Agatha Pontiki

T: +44 (0) 20 7213 3484
E: agatha.pontiki@pwc.com

Conor MacManus

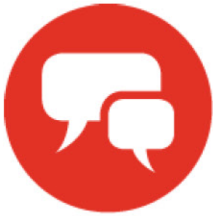
T: +44 (0) 20 7213 8555
E: conor.macmanus@pwc.com

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representa ion or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers LLP, its members, employees and agents do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2018 PricewaterhouseCoopers LLP. All rights reserved. In this document, "PwC" refers to the UK member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.

171220-102841-JD-OS

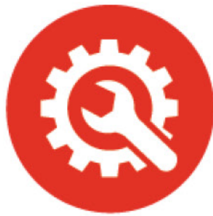
Stand out for the right reasons



Alert

Protect

Adapt



Repair

Financial services risk and regulation is an opportunity

At PwC we work with you to embrace change in a way that delivers value to your customers, and long-term growth and profits for your business. With our help, you won't just avoid potential problems, you'll also get ahead.

We support you in four key areas.

- By alerting you to financial and regulatory risks we help you to understand the position you're in and how to comply with regulations. You can then turn risk and regulation to your advantage.
- We help you to prepare for issues such as technical difficulties, operational failure or cyber attacks. By working with you to develop the systems and processes that protect your business you can become more resilient, reliable and effective.
- Adapting your business to achieve cultural change is right for your customers and your people. By equipping you with the insights and tools you need, we will help transform your business and turn uncertainty into opportunity.
- Even the best processes or products sometimes fail. We help repair any damage swiftly to build even greater levels of trust and confidence.

Working with PwC brings a clearer understanding of where you are and where you want to be. Together, we can develop transparent and compelling business strategies for customers, regulators, employees and stakeholders. By adding our skills, experience and expertise to yours, your business can stand out for the right reasons.

For more information on how we can help you to stand out visit *www.pwc.co.uk*