REGULATION

EU adopts a leverage ratio definition ‘largely’ aligned with Basel standards

Rosa Gómez Churruca / María Abascal

The European Commission has adopted, on October 10, a delegated regulation that amends CRR regarding the leverage ratio definition. It incorporates the necessary changes to largely align it with Basel revised standards as EBA recommended. It follows a similar step taken previously by US authorities on September 3. Mandatory disclosure of the leverage ratio will take effect from January 1, 2015 in both jurisdictions.

Definition fully aligned with Basel standards?

CRR incorporated a leverage rate definition based on the original Basel recommendations, but, later on the Basel Committee introduced some significant changes in January 2014. Changes in the European leverage ratio definition aimed at maintaining alignment with international standards. Among some of these modifications, we would highlight the adoption of the regulatory scope of consolidation, instead of the accounting scope. Moreover, the application of a Credit Conversion Factors for certain off-balance items has been introduced, with a floor of 10%, which reduces the exposure to be considered in the denominator of the ratio. It is also worthnoting that, in the case of repo transactions, collateral received cannot be used to reduce the amount of exposure to be considered. Nevertheless, cash receivables and payables with the same counterparty can be netted, subject to strict criteria.

But to adapt global recommendations to EU specificities, a pair of changes have been introduced in CRR. One of them is the possibility, subject to the approval of the supervisor, of excluding certain intragroup exposures when the leverage ratio is calculated at individual level. For that, compliance with strict requirements is required, such as full consolidation and integrated risk management, transactions between entities in the same Member State and no impediments to transfer capital or repay liabilities. This is particularly relevant for co-operative banking groups that have many smaller entities affiliated to a central body. Since the Basel standard applies mainly at consolidated level and not at individual level, this exemption is not expected to be pointed out as a deviation.

Another change in CRR refers to open repos, that accounts for 13% of all repos in EU and which are considered economically comparable to US rolled-over overnight repos. In this case some changes have been introduced in CRR (a maturity has been assigned to open repos) to allow the netting benefit for these instruments in the same way that those applying to overnight repos. Given that Basel standard requires that operations have an explicit maturity, the European treatment could be considered as a deviation from the global standard, even though it intends to balance the treatment of transactions considered economically comparable.

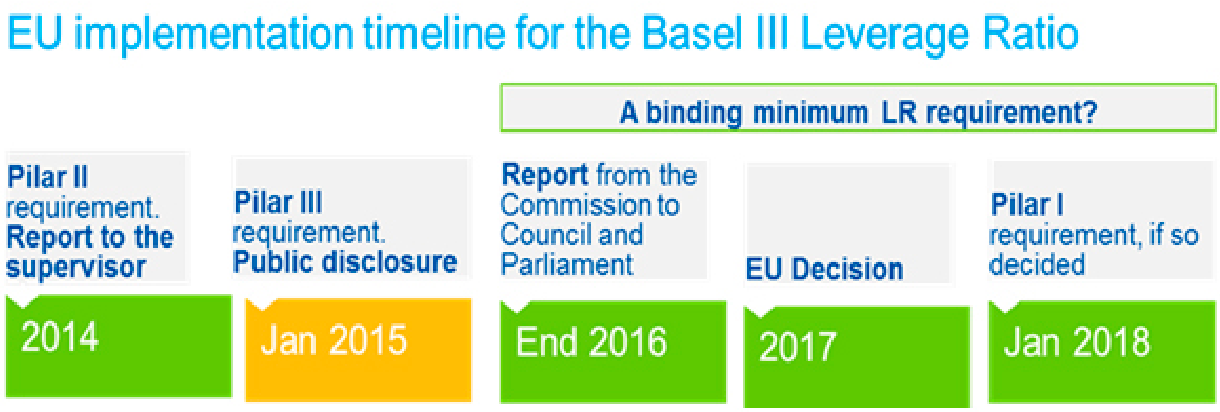
Full comparability in disclosed ratios between EU and US?

It is good news that both the EU and the US have opted for broadly following the Basel standard. Certainly, this will eliminate a very critical source of heterogeneity linked to the application of differing accounting standards, and it will level the treatment of derivatives and off-balance expositions. Nevertheless, leverage ratios to be mandatorily disclosed in 2015 could suffer from other sources of divergence. For instance, differences introduced in the way ratios have to be calculated for supervisory reporting may hinder the comparison between jurisdictions, if these differences influence the leverage ratios disclosed to the markets.

For instance, the EU has decided that exposure to be considered to calculate the leverage ratio should refer to the end of the reporting period (quarter), instead of the three-month average previously considered. This change reduces the operational burden for banks and allows comparability with solvency reporting data, being fully aligned with Basel standards. But it differs from the criteria previously decided by US for leverage exposure, that should be calculated using daily averages for on-balance sheet items and the average of three month-end calculations for off-balance sheet items.

Leverage ratio disclosure in EU starting in 2015: some facts

Most European banks are expected to disclose leverage ratios above the indicative benchmark of 3%, due to the improved capital position. According to EBA's recent report monitoring the impact of Basel III, larger banks have an average leverage ratio of 3.7% and smaller banks 4.5%, considering fully-transitioned Basel III standards. It is worth reminding that banks do not have to comply with minimum leverage ratio requirement until 2018, according to the calendar considered in CRR. Calibration is expected in 2016-2017.



European banking groups will have to disclose the consolidated leverage ratio, at least on an annual basis. Some institutions will be subject to a more frequent publication, for instance quarterly, in the light of their relevance. Additionally, significant European subsidiaries of EU parent institutions, and those that are of material significance for their local markets, shall disclose leverage ratios on an individual basis.

But regulation for this new requirement needs to be finalised, with the following steps to be taken:

1. Council/Parliament's no objection to the delegated regulation submitted by the European Commission.
2. Publication in the OJEU of the regulation, modifying CRR.

3. EBA's update of the supervisoy reporting and review of the disclosure requirements, to be approved by the European Commission.

Assessment

The adoption by the Commission of the Basel definition is a positive step as it will ensure the disclosure of comparable leverage ratios at European level, which is fully advisable as it improves transparency and market discipline. It would be useful as an additional indicator, complementing risk sensitive capital ratios and other relevant information used to judge the strength of banks.

Nevertheless, international comparability could be jeopardized if differences in implemented regulations across jurisdictions, as those mentioned when comparing EU and US (ratio based in end of the quarter data versus average data), affect disclosures and hinder comparison between banks.

The leverage ratio is likely to play an important role to determine the Total Loss-Absorbing Capacity (TLAC) of banks. The TLAC is a complement to the bail in tool. Both elements are aimed at ensuring that any banking rescue is supported in the first instance by shareholders and private creditors. The introduction of leverage ratio recognizes the diversity of business models among GSIBs. Indeed, banks with low Risk Weight Assets density may breach the leverage ratio before the capital ratio and, therefore, the loss-absorbing liabilities would be used to restore the leverage ratio first.

EU banks face the pressure of a tight calendar to implement leverage ratio disclosure, given the need to adapt to the multiple changes in definition and in disclosure requirements introduced by this delegated act, and the fact that the work to review the details of the information to be disclosed (disclosure templates) is unfinished yet. This could be particularly relevant for entities required to report on a quarterly basis, thus starting in 1Q2015.