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Bank Capital Requirements

Basel Committee Significantly Revises Leverage Ratio Treatment of Client Cleared Derivatives and Introduces New Leverage Ratio Disclosure Requirements

Yesterday, the Basel Committee on Banking Supervision released a significant revision to the leverage ratio treatment of client cleared derivatives,[1] as well as new leverage ratio disclosure requirements.[2]

Revised Treatment of Client Cleared Derivatives

Client cleared derivatives are exposures associated with transactions in which a banking organization that is a member of a clearing organization provides clearing services to its clients.[3] In the U.S. clearing model, these exposures include a banking organization's guarantees of the performance of its clients to clearing organizations. For purposes of the Basel leverage ratio—implemented in the United States as the supplementary leverage ratio—client cleared derivatives are treated as derivatives and banking organizations cannot currently recognize initial margin or non-cash variation margin from clients in determining their exposure amounts associated with those transactions. As a result, the Basel leverage ratio has generally ascribed high capital requirements to clearing activity because of the inability of banking organizations to recognize initial margin and non-cash variation margin from their clients. The revision will permit banking organizations to recognize cash and non-cash initial margin and variation margin from their clients in determining their exposures associated with client cleared derivatives for purposes of the Basel leverage ratio.

The treatment of client cleared derivatives in the Basel leverage ratio has been a focus of industry participants, policymakers and banking and markets regulators. Concerns have centered on the extent to which capital requirements attributable to clearing activity have not been appropriately calibrated and have caused banking organizations to leave the client clearing business or reduce client clearing activities, which has been viewed as inconsistent with the long-standing policy goal of increasing the central clearing of derivatives and competition within the clearing business. The Basel Committee notes that the proposed treatments it considered "were informed by the Committee's review of the impact of the leverage ratio on banks' provision of clearing services" and that the revision is designed to "balance[] the robustness of the leverage ratio as a non-risk based safeguard against unsustainable sources of leverage with the policy objective set by the G20 Leaders to promote central clearing of standardised derivative contracts as part of mitigating systemic risk and making derivatives markets safer."[4]

As revised, the Basel leverage ratio will permit cash and non-cash initial margin and variation margin received from clients to offset the replacement cost and potential future exposure for derivatives that banking organizations centrally clear on behalf of clients,[5] subject to a limit on the amount of initial margin that may be recognized based on the amount that is subject to appropriate segregation by the banking organization as defined in the relevant jurisdiction.[6] The revised leverage ratio treatment of client cleared derivatives will generally align with the measurement determined under the standardized approach to measuring counterparty credit risk exposures ("*SA-CCR*") used for risk-based capital requirements.[7]

The revision will apply to the revised version of the Basel leverage ratio released in December 2017 as part of the standards to finalize the Basel Committee's Basel III capital framework (commonly referred to as "*Basel IV*"), which has a January 1, 2022 implementation date.[8] As with all Basel Committee standards, the revision will not be effective for any banking organization until it is implemented in the laws or regulations of the applicable jurisdiction. It remains to be seen whether national authorities—including the U.S. banking agencies—will implement this revision in connection with their broader implementation of Basel IV or as a standalone change to their capital requirements. It also remains to be seen whether national authorities will seek to implement this change in advance of January 1, 2022 in order to address the effects of the Basel leverage ratio on central clearing sooner.

New Leverage Ratio Disclosure Requirements

The new leverage ratio disclosure requirements are aimed at addressing potential "window-dressing," described by the Basel Committee as the reporting and disclosure of elevated leverage ratios following temporary reductions in transaction volumes around reference dates.[9] Under the new requirements, banking organizations must disclose the amounts of adjusted gross securities financing transaction ("*SFT*") assets based on quarter-end values and average daily values over the quarter, in addition to disclosure of the total leverage exposure and the leverage ratio as calculated using the averaged values of SFTs.[10] These revisions will also apply beginning January 1, 2022.[11]

The Basel Committee notes it "may consider extending the scope of disclosure requirements based on averages if warranted to address potential window-dressing behaviours identified for other types of exposures."[12]

U.S. banking organizations subject to the supplementary leverage ratio must already provide information about SFTs on a quarter-end and daily-average basis in the publicly available portions of the FR Y-9C and FFIEC 101 reports. Accordingly, the implications of the additional disclosure requirements—once implemented in the applicable jurisdictions—may be less significant for U.S. banking organizations than for banking organizations in other jurisdictions where disclosure requirements are currently on a quarter-end basis only.

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ENDNOTES

[1] Basel Committee on Banking Supervision, *Leverage Ratio Treatment of Client Cleared Derivatives* (June 2019), *available at* https://www.bis.org/bcbs/publ/d467.pdf (hereafter, the "*Treatment of Client Cleared Derivatives*").

[2] Basel Committee on Banking Supervision, *Revisions to Leverage Ratio Disclosure Requirements* (June 2019), *available at* https://www.bis.org/bcbs/publ/d468.pdf (hereafter, the "*Disclosure Requirements*").

[3] For a U.S. banking organization such as a bank holding company, it is a non-bank subsidiary registered with the Commodity Futures Trading Commission as a futures commission merchant that would provide client clearing services.

[4] Treatment of Client Cleared Derivatives, at 1.

[5] Treatment of Client Cleared Derivatives, at 1.

[6] Treatment of Client Cleared Derivatives, at 1.

[7] Treatment of Client Cleared Derivatives, at 1. *See also* Basel Committee on Banking Supervision, *The Standardised Approach to Measuring Counterparty Credit Risk Exposures* (Mar. 2014, rev. Apr. 2014), *available at* https://www.bis.org/publ/bcbs279.pdf. In October 2018, the Federal Reserve, FDIC and OCC proposed to incorporate SA-CCR into their capital rules. For additional information on this proposal, see our Memorandum to Clients, *Bank Capital Requirements: Federal Bank Regulators Propose Standardized Approach for Calculating the Exposure Amount of Derivative Contracts* (Nov. 28, 2018), *available at* https://www.sullcrom.com/files/upload/SC-Publication-Banking-Agencies-Propose-New-Standardized-Approach-for-Counterparty-Credit-Risk-for-Capital-Rules.pdf.

[8] *See* Treatment of Client Cleared Derivatives, at 1; Basel Committee on Banking Supervision, *Basel III: Finalising Post-Crisis Reforms* (Dec. 2017), *available at* https://www.bis.org/bcbs/publ/d424.pdf. For additional information on Basel IV, see our Memorandum to Clients, *Bank Capital Requirements: Basel Committee Releases Standards to Finalize Basel III Framework* (Dec. 19, 2017), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_12192017.pdf.

[9] Disclosure Requirements, at 1.

[10] Disclosure Requirements, at 1. The release includes an Annex with revised disclosure templates and instructions to implement the new disclosure requirements.

[11] Disclosure Requirements, at 1.

[12] Disclosure Requirements, at 1. Revisions applicable to disclosures regarding other types of exposures, including derivative replacement cost and central bank reserve exposures, were proposed in the December 2018 consultative document. *See* Basel Committee on Banking Supervision, *Consultative Document – Revisions to Leverage Ratio Disclosure Requirement* (Dec. 2018), *available at* https://www.bis.org/bcbs/publ/d456.pdf.

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