

The systemic risks of inhibiting collateral fluidity: Leverage Ratio

What is the leverage ratio?

The [Basel III Leverage Ratio](#) is intended to be a simple, transparent, non-risk based ratio intended to act as a credible supplementary measure to the risk-based capital requirements. The leverage ratio is intended to:

- (i) restrict the build-up of leverage in the banking sector – this is to avoid destabilising deleveraging processes which can be damaging to the broader financial system and the economy; and
- (ii) reinforce the risk-based requirements with a simple, non-risk based ‘backstop’ measure.

The Leverage Ratio is defined as Tier 1 capital (the capital measure) divided by on- and off-balance sheet exposures, derivatives exposures, and securities financing transactions (the exposure measure). The exposure measure is non-risk weighted, and does not allow for netting of loans and deposits. The intended minimum requirement for the ratio is 3%.

Implementation of the Leverage Ratio began with bank-level reporting in January 2013, and will proceed with public disclosure in January 2015. The Committee will continue to monitor the impact of the disclosure requirements, with final calibration and any further adjustments to the definition completed by 2017, and migration to a Pillar 1 treatment in January 2018.

What will be the impact for funding markets, capital markets, and the real economy?

- While the Leverage Ratio is designed to be a ‘back-stop’ for risk-based capital requirements, in the case of securities financing trades (SFTs) it is likely to be the primary constraint on balance sheet. This has already prompted significant deleveraging and a reduction in SFT activity by banks.
- Since the leverage ratio does not differentiate between asset types, reverses of high quality liquid assets will affect a bank’s ratio in exactly the same way as reverses of illiquid, low grade-assets. Given that most repo financing is provided for high quality, very liquid assets (mostly government bonds), it is this SFT activity that will be most impacted and most constrained by the leverage ratio.
- This high volume, low risk SFT activity in liquid government bonds also tends to be low margin. Given the constraints on business that the Leverage Ratio will impose, this could provide an incentive for banks to gravitate towards high-risk, high-margin SFT activity.
- It is probable that some traditional SFT activity will migrate from the regulated banking sector to the non-bank financial sector (shadow banking), which will be less constrained. However, this is likely to be centred on selective, high margin opportunities, and will not fill any liquidity void in government bond markets.

- Given the adverse impact on SFTs in high quality liquid assets, this is likely to lead to an increase in cost and a loss of liquidity in the underlying secondary markets for these assets. This will be detrimental to both investors and issuers.
- These increased borrowing costs for governments will have consequences for government taxation and expenditure.

Does netting help?

The original proposal for the calculation of the Leverage Ratio did not provide for SFT-netting (i.e. offsetting reverses and repos with the same counterparty to recognize a single net exposure). The impact of this would have been enormous. It would have made repo matched-books economically unviable, triggering unprecedented deleveraging by banks and creating significant funding short-falls for high quality liquid assets.

Following consultation with the market, the final framework (published in January 2014) has been updated to recognize legally enforceable netting agreements, and provides for counterparty netting under a number of criteria.

Some of the detail around netting still requires clarification, and additional technical guidance will be needed to avoid idiosyncratic interpretation. For example, while it is expected that in most cases counterparty-netting will be allowable where securities settle in the same system and with the same maturity date of the transaction, the wording relating to the settlement criteria for this appears contradictory¹. The treatment of forward-starting SFTs in the ratio calculation is a further potential issue, and where there could be a risk of double- (or multiple-) counting. The correct treatment of open or callable SFTs would seem to be another omission. However, it is expected that these issues, and others, will soon be clarified by the BCBS, making the impact more assessable.

Any benefits from counterparty netting will be most felt in the inter-bank market. This will also provide an incentive for clearing SFTs through central counterparties (CCPs). However, where counterparties tend to be net providers of either liquidity or collateral, there will be less opportunity to benefit from netting provisions, and less incentive to transact with these counterparties.

Thus, even with netting, the leverage ratio can be seen as significantly inhibiting collateral fluidity, particularly for liquid, high quality collateral.

¹ Regarding the provisions for netting, the text suggests that this is allowable where transactions settle subject to a settlement mechanism that is consistent with normal delivery-versus-payment (DvP) facilities (Paragraph 33(c)). However, a footnote (22) appears to contradict this criterion, suggesting that any issues arising from the securities leg of an SFT should not interfere with the completion of the net settlement of the cash leg.