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Capital Requirements Directive IV Framework *Leverage Ratio*

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CRD IV Framework: *Leverage Ratio*

This briefing paper is part of a series of briefings on the implementation of Basel III in Europe via the Capital Requirements Directive IV¹ (**CRD IV**) and the Capital Requirements Regulation² (**CRR**), replacing the Banking Consolidation Directive³ and the Capital Adequacy Directive.⁴ The legislation is highly complex: these briefings are intended to provide a high-level overview of the architecture of the regulatory capital and liquidity framework and to draw attention to the

legal issues likely to be relevant to the in-house lawyer. This briefing is for general guidance only and does not constitute definitive advice.

NOTE: In relation to the topics discussed in this briefing, the CRR contains a number of discretions for member states in relation to national implementation. The regime may therefore differ across member states in a number of respects.

This briefing paper is based on information available as at 17 January 2014.

¹ 2013/36/EU.

² Regulation 575/2013.

³ 2006/48/EU.

⁴ 2006/49/EU.

Background

The prudential requirements under the Basel II framework (which was directed at internationally active banks) did not take account of banks' leverage ratios. Consequently, the Basel III reforms introduced a leverage ratio, with the aim of containing the build-up of leverage within the banking system (as well as acting as a non-risk based 'backstop' to the existing risk-based capital requirements). The CRD IV framework requires leverage ratio reporting from January 2014, with public reporting from 2015 and a 'hard' leverage limit from 2018.

Sources

CRR (*Regulation 575/2013*): Articles 111, 429-430, 431-434, 451, 499 and 511.

CRD IV (*2013/36/EU*): Article 87.

[UK Financial Conduct Authority \(FCA\) Policy Statement \(PS13/10\) CRD IV for Investment Firms \(December 2013\)](#) (the **FCA Policy Statement**).

[UK Prudential Regulation Authority \(PRA\) Policy Statement \(PS7/13\) Strengthening capital standards: implementing CRD IV, feedback and final rules \(December 2013\)](#) (the **PRA Policy Statement**).

Application

The CRD IV requirements on the leverage ratio apply to all institutions on a solo and consolidated basis. Investment firms which (in broad terms) do

not take proprietary risk, and groups which include only such firms, are exempt from the leverage ratio requirements.

Leverage ratio

Definition

In compiling the leverage ratio (to be expressed as a percentage), the numerator is Tier 1 capital⁵ (based on the strengthened Basel III definition of “capital” – see Client Briefing 2 (*Capital and Capital Adequacy*)) and the denominator is an exposure measure (total assets and off-balance exposures – the **Exposure Measure**).

The basis of calculation of the leverage ratio will be the average three month-end leverage ratios over a quarter⁶ (subject to transitional provisions – see further below under “Transitional provisions”).⁷

Ratio

The leverage ratio will be set at a 3% limit during the testing phase (known as the ‘parallel run’ period - see further below under “Timeline for implementation”).

General principles

- (a) The exposure measure should generally follow the accounting measure of exposure, although:
- (i) on-balance sheet, non-derivative exposures are included in the Exposure Measure net of specific provisions and valuation adjustments (eg credit valuation); and⁸
 - (ii) netting of loans and deposits is not allowed.⁹

Physical or financial collateral, guarantees or credit risk mitigation purchased are not allowed to reduce on-balance sheet exposures.¹⁰

- (b) There is an exception to (a) above for an institution which has an investment in a financial sector institution (an **Investee**) which is included in the accounting consolidation – but not in the regulatory consolidation – of the institution. For capital calculation purposes, investments in the capital of such an Investee must be deducted, to the extent that they exceed certain thresholds; the exposures of that Investee must also, therefore, be excluded from the Exposure Measure of the institution, on a *pro rata* basis (ie in proportion to the capital that is excluded under the capital calculation provisions of the CRR).¹¹
- (c) An institution’s total Exposure Measure is the sum of the institution’s on-balance sheet exposures, derivative exposures, securities financing exposures, and other off-balance sheet exposures. In contrast with the capital ratio (see Client Briefing 2 (*Capital and Capital Adequacy*)), no risk weighting applies to the assets.¹²

¹⁰ Article 429(5)(b) CRR.

¹¹ Article 429(4) CRR.

¹² Article 429(4) CRR.

⁵ During the transitional phase (see further below under “Transitional provisions”), the Basel Committee on Banking Supervision (**BCBS**) will track the impact of using either total regulatory capital or Common Equity Tier 1 as the capital measure.

⁶ With each month-end leverage ratio being calculated by dividing the month-end capital measure by the month-end exposure measure.

⁷ Article 429(2) and (3) CRR.

⁸ Article 429(5)(a) and Article 111(1) CRR.

⁹ Article 429(5)(c) CRR.

(i) **Derivatives:**

- (A) Generally,¹³ an institution must calculate the Exposure Measure of on- and off-balance sheet derivatives (including credit derivatives) using the Mark-to-Market Method used to determine the value of those contracts for the purposes of the Counterparty Credit Risk (CCR) requirement of the CRR (see Client Briefing 8 (*Counterparty Credit Risk*)). In doing so, an institution can take into account the effect of netting agreements (including contracts for novation, but excluding cross-product netting agreements).¹⁴
- (B) The potential future credit exposure of credit derivatives should be determined by applying (to all such derivatives, not only those in the trading book) the principles for calculation of CCR of items in the trading book set out in the trading book element of the CCR provisions of the CRR.¹⁵

¹³ By way of derogation from this requirement, an institution which uses the original exposure method (see Article 275 CRR) in determining the exposure value of interest rate contracts, foreign exchange contracts and contracts concerning gold for the purposes of meeting the own funds requirements can also use that method in determining the Exposure Measure of such contracts (Article 429(7) CRR).

¹⁴ Article 429(6) and Article 429(7) CRR.

¹⁵ See Article 429(8) CRR, which refers through to Article 299 CRR (*Items in the Trading Book*).

(ii) **Securities Financing Transactions:**¹⁶

The Exposure Measure of such transactions (both on- and off-balance sheet) must be calculated as set out in certain of those sections of the CRR dealing with funded credit risk mitigation¹⁷ (see Client Briefing 5 (*Collateral: Funded Credit Risk Mitigation in the Banking Book*)), taking into account the effect of netting agreements (excluding cross-product netting).¹⁸

- (iii) **Other off-balance sheet items:** The Exposure Measure of such items must be calculated in accordance with the Standardised Approach (see Client Briefing 3 (*Standardised Approach to Credit Risk in the Banking Book*)) (albeit with some adjustment to credit conversion factors, which will generally be 100% but will be 20%-50% for certain medium and medium/low risk trade finance and officially supported export credit items; and 10% for undrawn and unconditionally cancellable facilities).¹⁹

- (iv) **Fiduciary assets:** Where a national GAAP²⁰ recognises on-balance sheet fiduciary assets, these can be excluded from the Exposure Measure (provided that the assets meet the IAS²¹ 39 criteria for de-recognition and, where applicable, IFRS²² 10 for de-consolidation).²³

¹⁶ Repurchase transactions, securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions.

¹⁷ Specifically, in accordance with Article 220(1) CRR (*Using the Supervisory Volatility Adjustments Approach or the Own Estimates Volatility Adjustments Approach for master netting agreements*) and Article 220(3) CRR (*Financial Collateral Simple Method*).

¹⁸ Article 429(9) CRR.

¹⁹ Article 429(10) CRR.

²⁰ Generally Accepted Accounting Principles.

²¹ International Accounting Standard.

²² International Financial Reporting Standard.

²³ Article 429(11) CRR.

Disclosure

Commencement

Although the BCBS is currently consulting on revisions to the leverage ratio framework and disclosure thereof, the intention is that, from 1 January 2015, institutions will be required to disclose their leverage ratios as part of their Pillar Three disclosures (ie their general disclosures on capital adequacy).

General principles

Institutions must comply with certain generally applicable principles in disclosing their leverage ratio, including:

- (a) **Disclosure must be public:** Institutions must disclose their leverage ratio publically, and must have in place policies covering both (i) compliance with this requirement; and (ii) assessment both of the appropriateness of disclosures made (including verification and frequency) and of whether the disclosure made constitutes a comprehensive disclosure of the institution's risk profile to market participants (with further disclosures being made if a disclosure fails this assessment).²⁴
- (b) **Timing:** Disclosures must be made at least annually, and in any event in conjunction with an institution's financial statements (which will typically be quarterly/half yearly).²⁵
- (c) **Means:** An institution can determine the means of disclosure (although, so far as possible, all disclosures should be provided in one medium/location – to the extent that this is not the case then each place-of-disclosure should reference any other place-of-disclosure).²⁶

²⁴ Article 431(1) and (3) CRR.

²⁵ Article 433 CRR.

²⁶ Article 434(1) CRR.

Leverage ratio

In accordance with the general principles, an institution must disclose:

- (a) the leverage ratio, and how the institution applies transitional measures (see further below under “Transitional provisions”);
- (b) a breakdown of the total Exposure Measure (as well as a reconciliation of that measure with the relevant information disclosure in published financial statements);
- (c) the amount of derecognised fiduciary items (see further above under “Leverage ratio – General principles”);
- (d) a description of the processes used to manage the risk of excessive leverage (see further below under “Excessive leverage”); and
- (e) a description of the factors that had an impact on the leverage ratio during the period to which the disclosed leverage ratio refers.

Template

To finalise these disclosure requirements, the CRR mandates the European Banking Authority (**EBA**) to develop, and submit to the European Commission by 30 June 2014, draft implementing technical standards. These will determine the uniform disclosure template for the disclosures referred to above (under “Disclosure – Leverage ratio”) and the instructions on how to use such template.²⁷

²⁷ Article 451(2) CRR.

Reporting

Commencement

Institutions began reporting their leverage ratios to their regulators on 1 January 2013.

Requirement

An institution must submit to their regulator:

- (a) all the information set out above (under “Disclosure – Leverage ratio”) on the leverage ratio and its components; and
- (b) any information necessary to aid the EBA in its preparation of a report, to be submitted to the European Commission by 31 October 2016, on the workings of the leverage ratio framework (at the EBA’s request, the relevant regulator will then pass this information to the EBA).²⁸

²⁸ Article 511(3) and Article 430(2) CRR.

Excessive leverage

Alongside the leverage ratio requirements in the CRR, CRD IV requires an institution to have in place policies and procedures for the identification, management and monitoring of leverage risk. Indicators of excessive leverage risk include not only the leverage ratio but also any mismatch between assets and obligations.²⁹

²⁹ Article 87(1) CRD IV.

Template

To finalise these reporting requirements, the CRR mandates the EBA to develop, and submit to the European Commission by 1 February 2015, draft implementing technical standards. These will determine the uniform reporting template, the instructions on how to use such template, the frequencies and dates of reporting and the IT solutions, for the purposes of the reporting requirements.

As part of a precautionary approach to leverage risk, CRD IV also prescribes a range of stress tests, as a means of taking due account of potential increases in the risk of excessive leverage caused by reductions in an institution’s own funds (through expected or realised losses).³⁰

³⁰ Article 87(2) CRD IV.

Timeline for implementation

Institutions have been reporting to regulators on their leverage ratio, and its components, since 1 January 2013 (the start of the testing phase known as the ‘parallel run’ period). Public disclosure will begin on 1 January 2015.

During the test phase (running from 1 January 2013 to 1 January 2017), a minimum requirement of 3% for the leverage ratio will continue to be tested. Any final adjustments to the definition and calibration of the leverage ratio will be made in 2017, with a view to full implementation by 2018.

DATE	ACTION
December 2010	Finalisation by BCBS of initial proposals on the leverage ratio. ³¹
1 January 2011	Start of ‘supervisory monitoring period’ – period during which BCBS developed templates to track underlying components of the agreed definitions of the components of the ratio.
1 January 2013	Start of ‘parallel run’ period – testing phase during which the BCBS is monitoring the interaction between the leverage ratio and the risk-based capital requirement.
1 January 2015	Institutions to publically disclose their leverage ratio and its components.
1 January 2017	Testing (‘parallel run’) phase ends.
First half 2017	Final adjustments to definition and calibration (based on results of the ‘parallel run’ period).
1 January 2018	Full implementation.

³¹ ‘Basel III: A global regulatory framework for more resilient banks and banking systems’ (BCBS189), <http://www.bis.org/publ/bcbs189.pdf>

Transitional provisions

Calculation and reporting

From 1 January 2014 until 31 December 2021, institutions will be obliged to calculate and report the leverage ratio using Tier 1 capital as a capital measure **both** (i) as it is defined in the CRR, and (ii) on the basis of the transitional and grandfathering provisions for calculating Tier 1 capital contained in the CRR.³²

During this time, institutions will be able to choose whether the leverage ratio they disclose is based on either (i) or (ii) above (institutions can also choose to disclose both calculations). When an institution changes the leverage ratio it discloses, the first disclosure after that decision has been made must contain a reconciliation of the information on all the leverage ratios disclosed up until that point.³³

³² Article 499(1) CRR.

³³ Article 499(2) CRR.

Discretionary transitional provision

From 1 January 2014 until 31 December 2017, regulators can choose to permit institutions to calculate the end-of-quarter leverage ratio, on the grounds that institutions may not have data of sufficiently good quality to calculate a leverage ratio that is an arithmetic mean of the monthly leverage ratios over a quarter.³⁴

³⁴ See TP6 (Leverage) which contains the rules that exercise the discretion afforded to the FCA as competent authority under Article 499(3) of the CRR and PRA Policy Statement at paragraph 14.9 (Leverage).

EBA technical standards, reports and guidelines

The CRR mandates that various technical standards, reports and guidelines shall be produced. In connection with the leverage ratio, the following technical standards reports and guidelines shall be produced:

CRR SOURCE	TECHNICAL STANDARDS/REPORTS/ GUIDELINES REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA AND OTHER PUBLICATIONS
Article 430(2) (<i>Reporting Requirement</i>)	Implementing technical standards to determine the uniform reporting template, the instructions on how to use such template, the frequencies and dates of reporting and the IT solutions, for the purposes of the reporting requirements.	28 July 2013 (amended by corrigendum).	<p>Consultation on supervisory reporting requirements for leverage ratio (June 2012) (EBA/CP/2012/06).</p> <p>EBA final draft implementing technical standards on supervisory reporting (July 2013) (EBA/ITS/2013/02).</p> <p>European Commission: draft implementing technical standards with regard to supervisory reporting of institutions (January 2014).</p>
Article 432(1) (<i>Non-material, proprietary or confidential information</i>)	Guidelines on how institutions have to apply materiality in relation to the disclosure requirements of Title II.	31 December 2014.	None to date.
Article 432(2) (<i>Non-material, proprietary or confidential information</i>)	Guidelines on how institutions have to apply proprietary and confidentiality in relation to the disclosure requirements of Titles II and III.	31 December 2014.	None to date.
Article 433 (<i>Frequency of disclosure</i>)	Guidelines on institutions assessing more frequent disclosures of Titles II and III.	31 December 2014.	None to date.
Article 451(2) (<i>Leverage</i>)	Implementing technical standards to determine the uniform disclosure template and the instructions on how to use such template.	30 June 2014.	<p>Consultation on Disclosure for the Leverage Ratio (October 2013) (EBA/CP/2013/41).</p>

CRR SOURCE	TECHNICAL STANDARDS/REPORTS/ GUIDELINES REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA AND OTHER PUBLICATIONS
Article 511 (<i>Leverage</i>)	<p>The EBA shall submit a report to the European Commission on the leverage ratio covering the items set out in Article 511.</p> <p>The European Commission shall submit by 31 December 2016 a report on the impact and effectiveness of the leverage ratio to the European Parliament and the Council (together with, if appropriate, a legislative proposal).</p>	31 October 2016.	None to date.

National discretions and UK implementation

The CRR provides competent authorities with certain discretions:

CRR SOURCE	NATURE OF DISCRETION	FCA/PRA APPROACH
Article 499(3) (<i>Leverage</i>)	By way of derogation from Article 429(2), during the period from 1 January 2014 to 31 December 2017, competent authorities may permit institutions to calculate the end-of-quarter leverage ratio where they consider that institutions may not have data of sufficiently good quality to calculate a leverage ratio that is an arithmetic mean of the monthly leverage ratios over a quarter.	<p>See TP6 (<i>Leverage</i>) which contains the rules that exercise the discretion afforded to the FCA as competent authority under article 499(3) of the EU CRR.</p> <p>See PRA Policy Statement at paragraph 14.9 (<i>Leverage</i>).</p>

Further reading

Client Briefing 1 (*Introduction to Regulatory Capital and Liquidity*)

Client Briefing 2 (*Capital and Capital Adequacy*)

Client Briefing 3 (*Standardised Approach to Credit Risk in the Banking Book*)

Client Briefing 5 (*Collateral: Funded Credit Risk Mitigation in the Banking Book*)

Client Briefing 8 (*Counterparty Credit Risk*)

Client Briefing 11 (*Trading Book*)

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