CSBS SINCE 1902
CONFERENCE OF STATE BANK SUPERVISORS

Comments of the Conference of State Bank Supervisors on the Revised Basel III Leverage Ratio Framework and Disclosure Requirements- Consultative Document

The Conference of State Bank Supervisors ("CSBS") is a nationwide organization in the United States comprised of state bank regulators from all 50 states, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands. State regulators supervise and charter the majority of banks in the United States of America. The bulk of the banks supervised and chartered by CSBS members, however, are not large internationally active banks. Instead, state bank supervisors primarily supervise community banks, mid-sized and large regional banks.

GENERAL COMMENTS

CSBS is supportive of higher quality capital and a greater quantity of capital than was present in the pre-crisis financial system. The crisis demonstrated that the existing risk-based capital regime did not provide the necessary resiliency to prevent substantial harm to the financial system.

In a broad sense, we believe the proposed changes to the Basel III Leverage Ratio provide a foundation for achieving strengthened capital requirements. We think the revised framework provides a significantly more effective Exposure Measure that appropriately responds to many of the shortcomings observed in pre-crisis capital rules for the largest banks. Additionally, by creating a single way to capture leverage across global banking organizations, the Basel Committee on Banking Supervision's ("BCBS") leverage ratio framework and the associated uniform disclosure templates and requirements will significantly advance the goals of Pillar 3 to promote market discipline, transparency and consistency across jurisdictions.

We are supportive of the idea of a credible leverage ratio that will restrict the build-up of excessive on- and off- balance sheet leverage in the banking system. It is essential to have a simple, non-risk based backstop to prepare for market shocks and firm-specific risks. The exclusively on-balance sheet Tier 1 Leverage Ratio, prominently used by supervisors in the United States for decades, has lost utility in accurately measuring risk at the largest institutions as non-traditional funding and off-balance sheet exposures have increased significantly.

The risks from these transactions were poorly understood by investors and regulators and were not fully captured by existing regulatory ratios, accounting frameworks and supervisory methods before the crisis. The crisis demonstrated collateral did not achieve its intended effect in many instances. State regulators are in favor of a capital charge for off-balance sheet activities that contribute significant risk exposure not only to the world's largest banks and their investors, but also to the global economy.

1129 20th Street, N.W. • Ninth Floor • Washington, DC • 20036 •
www.csbs.org • 202-296-2840 • FAX 202-296-1928

State regulators also appreciate the fact that the BCBS appears to have tailored their revised framework to reflect the *actual* practices of the world's largest banks. The new framework more accurately reflects the risk global banks contribute to the overall economy. The revised leverage ratio framework is a significantly better framework for capturing the risk of these institutions. However, state regulators firmly believe that the minimum level of 3% is too low.

Expanded Scope of Consolidation

State regulators support including the exposures of subsidiaries consolidated for accounting or regulatory purposes in the exposure measure regardless of their specific business line. This reflects the reality that the largest financial conglomerates have significant exposures arising from non-bank business lines. We believe this will enhance transparency and make the leverage ratio more credible and effective than under the existing framework.

Treatment of Collateral Related to Derivatives Transactions

Similarly, the Basel Committee recognized in their proposal the reality that collateral can often be used to increase leverage. Despite this, for accounting purposes, the posting or receipt of collateral was often documented as decreasing exposures. The grossing up of exposures will ensure that the inherent economic leverage of a position will be captured. CSBS concurs with the BCBS that collateral, while it can mitigate counterparty risk, does not fundamentally alter the exposure to broad price movements in the underlying asset of a derivative contract. CSBS also commends the BCBS for recognizing the lower risk profile of single currency fixed/floating interest rate swaps by only including their mark to market value in the exposure measure. This preserves the beneficial risk management function of derivatives positions that are genuinely used to *reduce* risk.

Treatment of Securities Financing Transaction Exposures and Other Off Balance Sheet Items

State regulators also support the uniform treatment of securities financing transactions ("SFT") as secured loans rather than as sales transactions. CSBS believes it is also appropriate to not recognize accounting netting for these transactions. While these measures will raise the cost of SFTs, we believe, the increased cost appropriately recognizes the riskiness of these transactions and will discourage excessive reliance on funding mechanisms which can break down in stressed economic circumstances. The 100% Credit Conversion Factor for other off-balance sheet exposures, such as liquidity facilities, direct credit substitutes, acceptances, stand-by letters of credit, failed transactions and unsettled securities is appropriate and prudent.

The Right Level of Leverage: Suggestions for the Quantitative Impact Study

Striking a balance in capital levels is one of the most fundamental challenges in banking and bank supervision. However, we know from the last crisis that this issue is of paramount importance for the global economy. We strongly urge that the quantitative impact study determine the level for the leverage ratio based on what would have prevented the need for intervention and assistance by sovereign authorities in the last crisis. CSBS believes that the leverage ratio should be as prominent in capital held by banks as risk-based-capital. In the United States, the vast majority of traditional banks operate with a Tier 1 Leverage Ratio above 8%. While the Tier 1 Leverage Ratio is sufficient for accurately assessing a traditional bank's leverage, it doesn't adequately capture the extensive off-balance risks of systemically important banks. Therefore, state regulators believe that the minimum level of 3% is too low to adequately protect against unanticipated losses for covered banks because they have demonstrated they pose a significant systemic risk if undercapitalized during periods of abnormal economic stress.

State supervisors urge the BCBS to consider the specific performance of large banks during the crisis. Banks with higher capital levels and lower exposures to off-balance sheet items and non-traditional funding activities tended to fare better than institutions not meeting this profile. We would also suggest, that to fully achieve the objective of the revised leverage framework and to calibrate it properly, the BCBS must retroactively apply the framework to the positions covered banks had prior to the crisis and evaluate how they would have fared with a 33 to 1 leverage exposure, even given the expanded scope of the exposure measure. State regulators believe this type of assessment would demonstrate that this low-level would not have meaningfully mitigated the rapid deterioration of the financial condition of covered banks, particularly Global Systemically Important Banks (G-SIBs).

This level should be thoroughly vetted and explored and should ensure that banks have enough capital to meet completely unanticipated shocks. While the quality of assets banks put on their books should hopefully improve given the Basel III Accords and a number of other domestic financial regulatory efforts, a 33 to 1 leverage ratio does not seem to be a safe and sound level to state regulators. We believe careful assessment will show the need for a higher level.

In principle, CSBS is in agreement with the revised leverage ratio measurement framework proposed by BCBS, if not the proposed level. We also recognize that changes of this significance have the potential to create unintended consequences. We commend the BCBS for a reasonable implementation timeline and the parallel run period to mitigate these potential unintended consequences. CSBS must stress that not only should the appropriateness of capital levels for covered banks be studied, but also the downstream effects of any potential changes in their behavior motivated by the proposed revisions.

In a larger sense, anything that increases the size of the largest banks may foment domestic political opposition. If the revised framework motivates behavior that adversely affects smaller banks, this should be thoroughly understood and potentially mitigated. Evaluation should be of a wide scope aiming to understand how the proposed revisions might affect *all* banks.

Thus, we urge that the Quantitative Impact Study evaluate how changing behavior of the world's largest banks may be affecting community based banks which collect deposits from a community and loan them out in the same community. CSBS believes community based provision of credit is extremely important, especially in America's diverse economy. We recognize many other countries highly value the role community banks or similar institutions play in their economies as well. Thus, while we support the BCBS revised leverage framework, we urge that the committee not only evaluate the downstream impact on small institutions, if any, but also ensure that nations that do have a diverse banking system are able to preserve them. We would also point out that this may help mitigate domestic political opposition to the ratification of the Basel Accords.

CONCLUSION

CSBS appreciates the opportunity to comment on the revised leverage ratio framework. We are generally supportive of this measurement framework and commend the BCBS for taking a meaningful step to more accurately capture the leverage of the world's large banks. We believe this framework will help prevent leverage from being hidden from investors, regulators and even management of the covered banks. We think this is a significant step that responds to the ominous realities and challenges posed by un-captured, excessive leverage observed in the last financial crisis. We think, however, the required level of the ratio should be higher and subjected to comprehensive study to be sure it appropriately protects against unexpected losses such as we observed in the last crisis. We also request the BCBS consider the potential unintended consequences and effects such a significant change could have on smaller institutions, particularly community banks, and similar institutions, in the United States and internationally, to ensure a diverse banking system with adequate capital and stable funding sources will be preserved.

Sincerely,

John Ryan