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Enhanced Leverage Ratios for UK Financial Institutions

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The Financial Policy Committee of the Bank of England recently issued recommendations for enhanced leverage ratio requirements to apply to UK global systematically important banks, and other major domestic UK banks and building societies. HM Treasury has accepted these recommendations and will exercise its powers to enable the Financial Policy Committee to direct stricter leverage requirements for such UK institutions.

Introduction

The leverage ratio was introduced as an essential pillar of the Basel III Accord. It backstops the risk-weighted capital requirements for credit exposures and provides a capital floor that mitigates the variations in the way different banks risk-weight their exposures. A minimum leverage ratio of 3%, which is now the internationally agreed standard, has been the subject of individual national add-ons, particularly for global systemically important banks ("**G-SIBs**").[1] For example, in the US G-SIBs will be subject to a supplementary ratio which means that the overall leverage ratio requirement in the US for those institutions is to be 5%.[2]

In line with this increasingly prevalent trend to tighten the internationally agreed minimum standard, HM Treasury tasked the Financial Policy Committee of the Bank of England (the "**FPC**") to review and recommend an appropriately calibrated leverage ratio framework for UK firms. The FPC has recently completed its review[3] and has recommended to the appropriate leverage standard for UK banks, building societies and significant investment firms regulated by the Prudential Regulation Authority (the "**PRA**").

[1] As designated by the Financial Stability Board.

[2] As a further example, systemically important banks in Switzerland will be required to meet a leverage ratio of 3.1% - 4.56% by 2019, varying with the level of their risk-weighted requirements. In Canada banks are required to maintain an 'assets to capital multiple' of 5%, but which may be reduced to 4.35%.

[3] The Bank of England, "The Financial Policy Committee's review of the leverage ratio," October 2014.

The FPC makes three main recommendations:

- early implementation of the 3% minimum leverage ratio requirement for all banks, building societies and PRA-regulated investment firms;
- a supplementary leverage ratio buffer set at a rate of 35% of the systemic risk-weighted buffer for UK G-SIBs and other major UK banks and building societies; and
- a countercyclical leverage ratio buffer for all banks, building societies and PRA-regulated investment firms set at 35% of the countercyclical capital buffer that may be imposed.

HM Treasury has accepted the FPC's proposals and will set out legislation for the FPC to be given these powers of direction. A further difference from the Basel standard is that at least 75% of the minimum 3% core leverage ratio requirement is required to be met using Common Equity Tier 1 capital. This may be adjusted following any review to reflect any further standards issued at international level.

To implement the recommendations made in their review, the FPC proposes to request the grant of "powers of direction" enabling the FPC to direct the Financial Conduct Authority (the "**FCA**") and the PRA.

Early Application of the Minimum Leverage Ratio Requirement

The FPC proposes a minimum leverage ratio requirement of 3% for UK G-SIBs and other major UK banks and building societies at a consolidated group level as soon as is practicably possible. This is likely to be in advance of the internationally agreed Basel Committee implementation date of 2018 on leverage ratio requirements. The application of this minimum standard at an individual firm level will be part of a progress review in 2017.

All other PRA-regulated banks, building societies and investment firms are required to maintain a minimum leverage ratio requirement of 3% from 2018 onwards. This is subject to the implementation of any equivalent EU legislation and/or further developments in international standards in the meantime.

Supplementary Leverage Ratio Buffer for Systemically Important Firms

The FPC has proposed that, in addition, UK G-SIBs and other major domestic UK banks and building societies be required to maintain a supplementary leverage ratio buffer. This requirement will take effect in parallel with the application of the corresponding supplementary risk-weighted buffer. For UK G-SIBs this will take effect from 2016 onwards in four equal increments to 2019. For major domestic UK banks and building societies it will take effect from 2019.

The supplementary leverage ratio buffer is calibrated at 35% of the systemic risk buffer. This reflects the proportion that the minimum leverage ratio (3%) comprised of Tier 1 capital bears to the overall minimum Tier 1 capital minimum of 8.5% relative to risk-weighted assets (i.e. a core minimum of 6% plus a capital conservation buffer of 2.5%). This is expected to result in supplementary leverage ratio buffer rates ranging between 0.35% and 0.875% for UK G-SIBs (based on the Basel framework which applies risk-weighted buffer rates to G-SIBS of between 1% and 2.5%).

For other major domestic UK banks and building societies if the systemic risk buffer rates were in the range of 1% - 3% then the supplementary leverage ratio buffer rate would be in the range of 0.35% to 1.05%, being 35% of the systemic risk buffer.

Countercyclical Leverage Ratio Buffer

The FPC proposes to apply a countercyclical leverage ratio buffer to G-SIBs and other major domestic UK banks and building societies as soon as practically possible. All other PRA-regulated banks, building societies and investment firms will be subject to this additional buffer from 2018 onwards, subject to a progress review in the course of 2017.

The countercyclical leverage ratio buffer will be calibrated as 35% of the corresponding countercyclical risk-weighted capital buffer.

The FPC already has the power to set the countercyclical risk-weighted capital buffer on a quarterly basis. It is currently set at 0%. Economic and financial indicators are used to set countercyclical buffer rates, such as volumes of credit granted throughout the financial system relative to UK GDP.

Any additional complexity posed by this new countercyclical leverage ratio buffer will be tempered to a degree by the rounding of countercyclical leverage ratio buffers to the nearest 10 basis point increment, and allowing for a 24 month period for compliance, rather than 12.

The Numerator and the Denominator of the Leverage Ratio

The numerator of the leverage ratio is to comprise Tier 1 capital items and instruments. Additional Tier 1 instruments can comprise up to 25% of the minimum leverage ratio of 3%. For the purposes of the supplementary and countercyclical leverage ratio buffers, the capital measure is to be Common Equity Tier 1 capital only.

The denominator tracks the Basel III definition of the exposure measure, as implemented in EU law.[4] Future EU legislative proposals may impact this definition, subject to a review by the European Commission of the leverage ratio in 2016.[5]

Impact

The FPC has chosen not to set leverage ratio requirements for FCA-regulated firms. It notes the possibility of doing so in the future. The powers of direction currently sought by the FPC will also empower it to set leverage ratio requirements at a group and individual firm level.

The FPC acknowledges that the proposed minimum and supplementary leverage ratio buffers would still have been insufficient to absorb all losses seen in the financial crisis, yet believes this is justifiable so long as a sufficiently robust countercyclical leverage ratio buffer is applied in the future. Furthermore, leverage ratio buffers will have no 'bite' for riskier balance sheets where risk-weighted capital requirements are the binding constraint rather than the leverage ratio. Firms particularly affected by the leverage ratio and intending to issue "CoCo" bonds should note that the eligibility of such instruments to meet the minimum leverage ratio requirement will be limited to 25%. Mortgage lenders have noted that, given their lower margin business, they may be required to bolster their regulatory capital because the leverage ratio calibration measure ignores the overall risk mitigation provided by mortgage collateral.[6] That said, the general view is that the FPC's recommendations have not proved to be as draconian as was initially feared by the industry.

[4] Capital Requirements Directive 2013/36/EU.

[5] The European Commission adopted a delegated regulation on 10 October 2014 defining the exposure measure for the purposes of the leverage ratio, amending Regulation (EU) 575/2013 on prudential requirements for credit institutions and investment firms. The delegated regulation will come into force on the day following that of its publication in the Official Journal of the European Union.

[6] Council of Mortgage Lenders, Response to the Bank of England consultation paper, 16 September 2014.

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