CONSULTATION PAPER NO. 139

UPDATING THE LEVERAGE RATIO

26 APRIL 2021

PREFACE

Why are we issuing this paper?

1. The DFSA implements international best practice, including the Basel Committee on Banking Supervision (BCBS) standards and recommendation, as relevant to the DIFC. This Consultation Paper (CP) is to consult on a number of changes to the Leverage Ratio (LVR) after it was finalised by the BCBS.

2. The BCBS introduced the LVR in 2014, when the standard included a monitoring and reporting period from 1 January 2013 to 1 January 2017. The BCBS intended to revise and issue a final LVR once the monitoring period ended. In 2017, the committee issued "Basel III: Finalising post-crisis reforms"[1] in which it finalised the LVR. The effective date was 1 January 2022 but this was later deferred to 1 January 2023 to lessen the burden on firms in the wake of Covid-19 social and economic impacts.

3. The DFSA implemented the BCBS LVR in 2015[2] and is now proposing to update its rules to reflect the BCBS changes and the best international practise in this area. We are also seeking public comments in a number of areas where the DFSA proposes to adopt more conservative treatment than the BCBS LVR standard.

Who should read this paper?

4. The proposals in this paper will be of interest to:

   a) Authorised Firms who are licensed as Deposit takers; credit providers and proprietary dealers; dealers as agent on a matched principal basis; or as an Islamic banking institution;

   b) persons interested in applying for a DFSA licence to conduct the activities specified above;

   c) service providers who assist, or intend to assist, persons conducting the activities in a); and

   d) other industry participants.

Terminology

5. Defined terms are identified by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in the Glossary Module (GLO). Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning. More commonly used terms in this CP have the following meanings:

   a) 'LVR' means the Leverage Ratio as defined in PIB Rule 3.18.2 and represented by the formula:

      Leverage Ratio = Capital Measure ÷ Exposure Measure;

   b) 'Capital Measure' is the Tier 1 Capital as defined in PIB Rule 3.12.1;

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1 https://www.bis.org/bcbs/publ/d424.htm

2 See DFSA Rules at PIB 3.18

c) 'Exposure Measure' is the value of the Authorised Firm's exposures calculated in accordance with PIB Rule 3.18.3;

d) ‘G-SIB’ means a Globally Systemically Important Bank;

e) ‘D-SIB’ means a Domestic Systemically Important Bank;

f) 'LVR Standard', 'BCBS Standard' or 'the Standard' in this CP refers to "Basel III: Finalising post-crisis reforms" issued in December 2017;

g) "Multi-level client structure" is a three level structure that consists of a "Clearing Member" of the Central Counterparty (Level 1), a "High Level Client" (Level 2) which provides clearing services to firms through the clearing member, and the firm that uses the clearing services (Level 3) of the High Level Client; and

h) "Written Credit Protection" refers to a broad range of credit derivatives that provide protection against credit risk. It includes credit default swaps, total return swaps and all options that impose an obligation on the seller to provide credit protection under certain conditions.

What are the next steps?

6. All comments should be submitted to the DFSA using the DFSA survey tool here. The DFSA reserves the right to publish, including on its website, any comments you provide. However, if you wish your comments to be kept confidential, you must expressly request at the time of making comments that this should be the case and your reasons for requesting so.

7. The deadline for providing comments on this consultation is **26 June 2021**. Following public consultation, we will proceed to make the relevant changes to the DFSA's Rulebook. You should not act on the proposals until the relevant changes to the laws and DFSA Rulebook are made. We shall issue a notice on our website telling you when this happens.

Structure of this CP

Part I – Minimum Leverage Ratio (LVR);

Part II – The Exposure Measure;

Annex 1 – Questions asked in this Consultation Paper; and

Appendix 1 – Draft amendments to PIB.

Part I Minimum Leverage Ratio (LVR)

Should the DFSA set a minimum Leverage Ratio and introduce a breach notification requirement?

8. The DFSA rules in PIB 3.18 already require the LVR to be calculated and reported to the DFSA, but they do not set a minimum level for the ratio. In 2017, after running an observation period, the BCBS finalised the LVR standard and introduced a minimum LVR of 3%. The BCBS minimum was widely adopted by international regulators the DFSA has benchmarked against.

9. The LVR is intended to limit leverage and act as a simpler back stop for the risk based capital ratios. The DFSA believes that setting a minimum level for the LVR, and having breaches reported to the DFSA, is essential to achieve the objectives of the LVR.

Proposal 1

10. The DFSA is proposing to adopt the BCBS minimum LVR level of 3% and require firms to report breaches promptly to the DFSA.

Please see draft PIB Rule 3.18.4 in Appendix 1.

Question:

1. Do you agree with our proposal to adopt a minimum Leverage Ratio of 3% and require prompt breach notification? If not, why not?

11. In addition to the 3% minimum LVR ratio, the BCBS standard introduced a higher LVR for G-SIBs, and provided national supervisors with the discretion to set a higher minimum LVR for D-SIBs. The higher LVR is needed to mitigate the systemic risks of these firms to the global and local economies and to preserve financial stability.

12. For G-SIBs, the higher ratio under the LVR Standard is 50% of the G-SIB's higher loss absorbency risk weighted capital requirement. For example, if a bank received a 2% additional risk based capital requirement for being a G-SIB, the bank should also receive a 1% higher LVR, setting the minimum at 4% under the BCBS LVR Standard.

13. There is no specific ratio set for D-SIBs under the Standard. However, the DFSA, based on extensive benchmarking, believes that a higher LVR minimum for D-SIBs set at 3.50% is appropriate.

Proposal 2

14. The DFSA proposes to:

a) adopt a minimum LVR for G-SIBs set at 3% plus 50% of the additional higher loss absorbency risk weighted capital requirement that is assigned under the G-SIB framework; and

b) adopt a minimum LVR of 3.5% for firms that are designated as D-SIBs by the DFSA.

See draft PIB Rule 3.18.4 in Appendix 1.

Question:

2. Do you agree with our proposals to introduce a higher LVR minimum for G-SIBs and D-SIBs? If not, why not?

Part 2 The Exposure Measure

Should the DFSA adopt the BCBS changes to the Exposure Measure of the Leverage Ratio?

A. Deductions from Tier 1

15. The Exposure Measure reflects the gross accounting values of balance sheet assets recognised under the International Financial Accounting Standards (IFRS). The BCBS LVR standard allows an item that is deducted from Tier 1 capital under the capital standard to be deducted from the LVR Exposure Measure.[3] This treatment avoids double counting the same exposure.

Proposal 3

16. The DFSA rules are currently silent when it comes to treatment of exposures, for LVR purposes, that have already been deducted from Tier 1 capital. We are proposing to clarify this area by explicitly allowing a firm to exclude exposures - that are already deducted from its Tier 1 capital - from the LVR Exposure Measure.

See draft PIB Rule 3.18.3 in Appendix 1.

Question:

3. Do you agree with our proposal to allow firms to deduct from the "Exposure Measure" any exposure that has been deducted from Tier 1 capital? If not, why not?

B. Unsettled transactions and cash pooling

17. Another change to the Exposure Measure in the BCBS standard is in relation to the treatment of unsettled transactions. These are transactions where a firm has unsettled financial asset transactions that are recorded under the accounting standards using either a trade date or a settlement date basis.

18. The BCBS LVR standard allows for cash receivables and payables for unsettled transactions accounted for using a trade-date accounting approach to be offset against one another if these amounts relate to:

a) financial assets that are reported at fair value through income and included in the bank’s trading book; and

b) transactions are settled on a delivery-versus-payment (DvP) basis.

19. Similarly, the BCBS rules allow for cash pooling offset, where a firm is allowed to offset assets and liabilities of an individual client. In this case, the firm uses the debt

[3] Except for items that relate to liabilities.

balances to offset the credit balances of the client at the end of each day. The following conditions are required for the cash pooling offset to be allowed under the BCBS LVR standard:

a) the balances of all individual participating customer accounts must be transferred and extinguished into a single account;

b) the firm must have a legally enforceable right to transfer all the balances in the accounts of the individual client and is not liable for the balances on any individual account;

c) the firm must have the discretion and be in a position to exercise the right in b);

d) there are no maturity mismatches among the balances of the individual customer accounts included in the cash pooling arrangement or all balances are either overnight or on demand; and

e) the bank charges or pays interest and/or fees based on the combined balance of the individual participating customer accounts included in the cash pooling arrangement.

Proposal 4

20. We believe that the treatment afforded to unsettled transactions and cash pooling under the BCBS Standard is unwarranted for the businesses models in DIFC. These measures are likely to provide little benefit to DIFC firms in terms of LVR reduction while increasing the complexity of the rules and the cost of compliance. Therefore, we propose not to allow the treatments in paragraphs 17 and 19 to be used for LVR calculation under the DFSA rules.

Question:

4. Do you agree with our proposal not to adopt the BCBS treatment of unsettled transactions and cash pooling? If not, why not?

C. Collateral and Cash variation margin

21. Posting of collateral against derivative positions does not change the economic leverage of the firm. It is also possible for a Firm to use the collateral received against a derivative position to increase its leverage if the firm has rehypothecation rights. For this reason, collateral posted against derivative positions must be included in the LVR Exposure Measure if posting the collateral has resulted in a reduction in the firm's Balance Sheet.

Proposal 5

22. The DFSA proposes to clarify the treatment of collateral posted and received against derivative positions for the purposes of determining the LVR Exposure Measure as follows:

a) a firm should not net collateral received against the derivative position whether or not netting is allowed; and

b) a firm needs to gross up the LVR Exposure Measure by the amount of the collateral posted against a derivative position, if posting of such collateral has reduced the value of Balance Sheet assets under the accounting standards.

See draft Guidance 7 to PIB Rule 3.18.3 in Appendix 1.

Question:

5. Do you agree with our proposal on the treatment of collateral posted and received against derivative positions? If not, why not?

23. Where cash collateral is posted as a Variation Margin (VM), the BCBS standard allows the VM to be treated as a pre-settlement payment between the parties and to reduce the replacement cost of the derivative exposure. This is provided the following conditions are met:

a) for trades not cleared through a Qualifying Central Counterparty (QCCP), the cash received by the recipient counterparty is not segregated. VM would meet this criterion if the recipient counterparty has no restrictions on its ability to use the cash received;

b) VM is calculated and exchanged on a daily basis and calculated using the Mark to Market (MTM) valuation of the derivative positions;

c) VM is received in a currency specified in the derivative contract or the netting agreement with a QCCP;

d) VM exchanged is the full amount that would be necessary to extinguish the MTM exposure of the derivative subject to the threshold and minimum transfer amounts applicable to the counterparty; and

e) derivative transactions and VM are covered by a single legally binding netting agreement between the parties.

Proposal 6

24. The DFSA is of the view that the above treatment of VM would not provide material benefit to DIFC firms in terms of reducing the size of their exposures significantly for LVR calculation purposes when taking into account the compliance cost and the additional complexity to the rules. The DFSA proposes not to allow offset of VM against the exposure position for LVR calculation.

Question:

6. Do you agree with our proposal not to allow offset of VM against derivative positions? If not, why not?

D. Clearing services

25. Under the BCBS Standard, a firm that is a Clearing Member (CM) of a Central Counterparty (CCP), and offers clearing services to clients, should include in the LVR exposure measure the trade exposures to the CCP that arise from the firm being contractually liable to reimburse the client for changes in the value of transactions in the event of CCP default. This exposure should be captured as a derivative transaction.

26. Under the BCBS standard, where the CM guarantees the performance of its client's derivative trade exposures to the CCP, it should calculate its LVR exposure resulting from the guarantee as if it is a derivative exposure entered into directly with the client, including with regard to the receipt or provision of VM.

Proposal 7

27. We consider that it is prudent to include trade exposures in the LVR exposure measure where the CM has provided a guarantee or contractual commitment and propose to include this in the PIB module.

See draft Guidance 9 to PIB Rule 3.18.3 in Appendix 1.

Question:

7. Do you agree with our proposal to treat a CM trade exposure to a CCP as the CM's direct derivatives contract where the CM is contractually committed to reimburse the client or the CCP in the event of the other party's default? If not, why not?

28. A firm that is a Higher Level Client (HLC)[4] to a CM, within a multi-level client structure, does not need to recognise the trade exposures to the CM or to an entity that is a HLC to the firm in the structure, if all of the following conditions are met:

a) the offsetting transactions are identified by the QCCP as HLC transactions and collateral is held by the QCCP or the CM, as applicable, under arrangements that prevent any losses to the HLC due to:

i. the default or insolvency of the CM;

ii. the default or insolvency of the CM's other clients; and

iii. the joint default or insolvency of the CM and any of its other clients.

b) the firm has conducted a legal review and has a well-founded basis to conclude that the arrangements in a) are valid and enforceable; and

c) there are enforceable arrangements in place to ensure that the offsetting transactions with the defaulted CM are highly likely to continue to be transacted by the QCCP, if the CM defaults or becomes insolvent.

Proposal 8

29. The DFSA proposes to require a HLC to recognise trade exposures to the CM in the LVR exposure measure without exceptions. This has the twin benefits of keeping the LVR simple and conservative, in line with its original design. The impact on DIFC firms of not allowing the clearing exemptions is also limited because DIFC firms are not active providers of clearing services as a HLC and the conditions for the reduction are rigorous.

Question:

8. Do you agree with our proposal not to allow any exposure reduction in the LVR for firms providing clearing services as HLC? If not, why not?

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[4] Refers to clearing services provided by an institution which is not a direct clearing member, but is itself a client of a clearing member or another clearing client.

E. Written Credit Derivatives

30. The BCBS Standard requires the effective notional amount of written credit derivatives to be included in the LVR Exposure Measure[5] up to the maximum potential loss. It allows the notional amount to be reduced by a purchased credit derivative subject to the following conditions:

a) the credit protection has the same or more conservative material terms[6] as the written credit derivative where it is certain to deliver a payment in all potential future states;

b) the remaining maturity of the credit protection is equal to or greater than the remaining maturity of the written credit derivative;

c) the credit protection purchased is not purchased from a counterparty whose credit quality is highly correlated with the value of the reference obligation;

d) if the effective notional amount of the written credit derivative is reduced by negative change in fair value reflected in the firm's Tier 1 capital, the offsetting credit protection must also be reduced by the positive change in its fair value if reflected in Tier 1 capital; and

e) the credit protection purchased is not included in a transaction that has been cleared on behalf of a client and for which the effective notional amount referenced by the corresponding written credit derivative is excluded from the LVR.

Proposal 9

31. So that the LVR remains a simple ratio, and because DIFC firms are not active sellers of credit protection, DFSA proposes that:

a) firms writing credit derivatives need to include the notional amount of the credit derivative in their LVR Exposure Measure; and

b) credit protection bought should not be used to reduce the notional amount of written credit protection.

See draft Guidance 8 to PIB Rule 3.18.3 in Appendix 1.

Question:

9. Do you agree with our proposal in relation to written credit derivatives? If not, why not?

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5 The counterparty credit risk is also captured in the same way as other derivative contracts.

6 Including terms such as the level of subordination, optionality, credit events, reference and any other characteristics relevant to the valuation of the derivative.

Annex 1: Questions in this Consultation Paper

Question 1:

Do you agree with our proposal to adopt a minimum Leverage Ratio of 3% and require prompt breach notification? If not, why not?

Question 2:

Do you agree with our proposals to introduce a higher LVR minimum for G-SIBs and D-SIBs? If not, why not?

Question 3:

Do you agree with our proposal to allow firms to deduct from the "Exposure Measure" any exposure that has been deducted from Tier 1 capital? If not, why not?

Question 4:

Do you agree with our proposal not to adopt the BCBS treatment of unsettled transactions and cash pooling? If not, why not?

Question 5:

Do you agree with our proposal on the treatment of collateral posted and received against derivative positions? If not, why not?

Question 6:

Do you agree with our proposal not to allow offset of VM against derivative positions? If not, why not?

Question 7:

Do you agree with our proposal for a CM trade exposures to a CCP to be treated as CM's direct derivatives contracts where the CM is contractually committed to reimburse the client or the CCP in the event of the other party's default? If not, why not?

Question 8:

Do you agree with our proposal not to allow any exposure reduction in the LVR for firms providing clearing services as HLC? If not, why not?

Question 9:

Do you agree with our proposal in relation to written credit derivatives? If not, why not?