Basel Plans Would Weaken Leverage Ratio

By Thomas Hoenig

Risk Magazine

April 22, 2016

Standards of measurement are only useful if they are reliable and trusted. This is no less true for measuring the adequacy of bank capital than it is for measuring weights or distances. After years of unsuccessfully calculating bank capital using the ever-changing scale of risk-based capital, the Basel Committee on Bank Supervision finally turned to the leverage ratio in 2010. It is working. The international leverage ratio is reliable and has caused managers to consider the real cost of assets and investors to better measure risks versus return.

Having accomplished so much, it is disturbing that the Basel Committee on April 6 announced plans to revise the leverage ratio, weakening it by turning it into a risk-weighted measure, which has never worked to protect the industry or the public from even reasonable downside risk of banking.

Risk-based capital relies on modelling techniques to try to predict the riskiness of bank assets. The risk-based standards are subject to periodic revisions that significantly alter the amount of capital regulators deem necessary, and they have proven to be subject to significant error because it is impossible to predict the future or to reliably anticipate how and to what degree risks will change. For example, risk-based capital models in the early 2000's predicted that sovereign debt, residential mortgages, and securitisation positions carried little risk. The leverage ratio has proven to do a better job of aligning a firm's risk appetite with its loss-absorbing capacity.

A concerted lobbying effort is working now to change and, in effect, weaken the international leverage ratio. This effort has focused mostly on its treatment of derivatives exposures, which receive highly lenient treatments under the risk-weighted standard. The Basel Committee now wants to apply this more lenient treatment to the leverage ratio by allowing banks to use a more "risk-sensitive" approach to measure derivatives exposure – the standardised approach to counterparty credit risk, or SA-CCR.[1] The SA-CCR is new and untested but – as is always the case - a "risk-sensitive" measure will result in banks operating with more leverage.

Basel is also considering permitting banks to reduce their reported risks by allowing collateral to reduce any remaining derivatives exposure. The effect of such change would be to make the treatment of derivatives under the leverage ratio equivalent to that under the risk-based capital framework, thus diluting the effectiveness of the leverage ratio and largely ignoring both the direct and the embedded leverage associated with derivatives transactions.

The leverage ratio, until this latest proposal, encouraged the industry to develop alternative and legitimate ways to reduce the impact on their derivatives businesses. For example, several firms

[1] See "The standardised approach for measuring counterparty credit risk exposures" available at: http://www.bis.org/publ/bcbs279.pdf

changed the control of margin posted against derivatives trades to successfully remove tens of billions of dollars of collateral from their balance sheets. In addition, firms have legitimately eliminated trillions of dollars of derivatives notional through trade compression and optimisation. Finally, some firms have been considering spinning off their swaps desks into entities that are separate from the bank and therefore separate from the public safety net.

Importantly, the international leverage ratio as currently designed does not eliminate the market benefits of cleared derivatives. Banks still facilitate clearing: the leverage ratio only ensures they have sufficient capital to continue serving in this capacity, even during market stress, for their counterparties.

It is unfortunate therefore, that Basel is considering undermining its own standards before the industry has finished adjusting to the rule and even before the leverage ratio becomes a required minimum in most jurisdictions.

It’s discouraging to see international regulatory authorities begin to turn the leverage ratio into a modified risk-based capital rule. If history is a guide, there will be endless “technical revisions” to the rule that always reduce its impact in certain areas and weaken the industry's financial strength.

Memories of crises are too easily forgotten, so if Basel is determined to constantly change the standard, then I recommend the leverage ratio be calculated by relying simply on International Financial Reporting Standards (IFRS). Under these accounting rules the leverage ratio would be calculated as tangible equity capital (convertible debt is not permitted to count as equity) to total tangible assets. Perhaps the accountants will be better able to resist the temptation to constantly revise their standards downward.