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The Basel III Leverage Ratio Is A Welcome Addition, But Not A Substitute For Risk-Weighted Capital Metrics

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Amid growing concern by investors and regulators over the comparability and consistency of banks' risk-weighted capital measures, Standard & Poor's Ratings Services observes broadening support among regulators for minimum leverage ratios, such as the one proposed by the Basel Committee on Banking Supervision (Basel Committee). In recent months, for example, U.S. regulators proposed minimum leverage ratio requirements well in excess of the 3% threshold currently proposed by the Basel Committee. In addition, the U.K. regulator unexpectedly demanded that larger financial institutions achieve a 3% common equity Tier 1 leverage ratio after applying certain stress assumptions. Switzerland also implemented its own Basel III leverage ratio regime in January 2013, alongside other Basel III capital requirements.

Overview

- Market support for regulatory leverage ratios for banks appears to be broadening, which in our view reflects the shortcomings of risk-weighted metrics.
- The leverage ratio can, in our view, act as an alert, which should trigger additional investigations, rather than lead to premature conclusions.
- Despite its transparent computation, the proposed leverage ratio does not guarantee a simple interpretation or fully consistent comparison between institutions.
- We will therefore consider new regulatory metrics such as the Basel III leverage ratio, but will continue to use our risk-adjusted capital (RAC) ratio as our key metric for capitalization.

The implementation of a globally comparable leverage ratio--as proposed in the Basel Committee's consultative document of June 2013--is unlikely, in our view, to lead to a uniform approach by national regulators globally. We expect some regulators to adopt minimum requirements in excess of the 3% proposed by the Basel Committee, and to require implementation ahead of the proposed timeframe (with a binding requirement from 2018). This is because the proposed requirement constitutes a minimum baseline, which can be applied to a wide range of bank business models in banking systems with diverse characteristics globally. However, as a result, some regulators will likely regard the proposed 3% minimum (calculated as Tier 1 capital divided by on- and off-balance-sheet exposures--see appendix for more information) as way too lenient for a number of institutions.

We expect that the proposed Basel III leverage ratio will likely affect a number of European banks the most. We base our view in part on the particularly large share of bank-funded mortgages in the region, but also to some extent the ongoing capital strengthening process of a number of institutions. As a result, we do not anticipate that the European Union authorities will impose materially stricter rules than those recommended by the Basel Committee on all the banks in the region, irrespective of their business models.

We continue to consider that the proposed revised Basel III minimum leverage ratio is a useful complement to

risk-weighted capital metrics in the regulatory framework, and believe it can help identify outliers. We also believe that the leverage ratio would be most beneficial for the regulatory assessment of capital adequacy when used alongside risk-sensitive metrics.

Given the apparent "simplicity" of the minimum leverage ratio, and the consistency of its calculation between banks, in our view it is possible that the Basel III leverage ratio could supersede regulatory risk-weighted capital metrics and become the main tool to assess banks' capitalization for a number of regulators and investors. However, if used in isolation, the proposed leverage ratio does not ensure a consistent interpretation or reliable comparison of the ratios of institutions that have very different business models. The excessive reliance on any single capital metric could lead market participants to fail to notice the build-up of specific risks. To avoid excessive reliance on the Basel III leverage ratio alone--which in our view could give a false impression of conservativeness--we consider it critical that standard-setters maintain their focus on increasing the effectiveness of, and confidence in, regulatory risk-weighted capital ratios. It is therefore key, in our view, to address the perceived shortcomings in banks' internal models and reduce the complexity of regulatory risk-weighted calculations and the recourse to national discretion in the Basel III implementation.

In line with our existing criteria, we consider the implications of banks' compliance with regulatory capital requirements, and the potential consequences of restricted regulatory capital flexibility (for more details, see table 8 of "Banks: Rating Methodology And Assumptions"). We also track the impact of changing regulatory requirements on banks' business models or risk appetite. These areas are where we would capture the introduction of a regulatory leverage ratio in our rating approach. However, our risk-adjusted capital (RAC) ratio remains our key metric to analyze banks' capitalization.

One Or The Other Is Not Enough

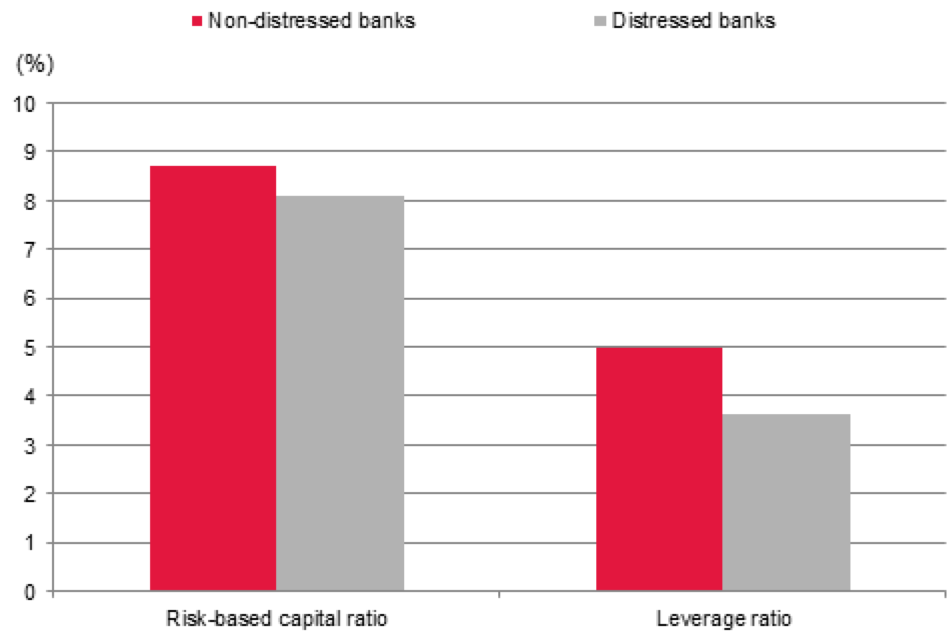
We continue to view the proposed revised Basel III minimum leverage ratio as a useful supplement to risk-sensitive regulatory metrics and believe it can help identify outliers.

One of the key factors behind the Basel Committee's proposed leverage ratio is the observation that banks were able to substantially increase leverage while displaying generally sound risk-weighted regulatory capital ratios in the lead-up to the financial crisis. As a risk-neutral metric, the proposed leverage ratio is designed to help offset shortcomings in existing regulatory risk-weighted ratios and to complement such ratios.

The Basel Committee expects the proposed ratio will become a binding requirement for all banks by 2018, in addition to those arising from existing risk-sensitive metrics.

We continue to see the shortcomings of risk-weighted metrics, in terms of complexity and lack of comparability, even as banks are implementing the new Basel III standards globally. We therefore consider that there is a need for more than one regulatory capital metric as we believe it is impossible for any single metric to be risk-sensitive, simple, and comparable at the same time, and also be difficult for banks to arbitrage.

Regulatory Risk-Based Capital And Leverage Ratios Of Distressed And Non-Distressed Banks Before The Recent Financial Crisis



Source: Bank of England. Leverage ratio defined as Tier 1 capital divided by total assets. Treatment of derivatives under U.S. GAAP reconciled with IFRS on a best effort basis.

We see several drawbacks to using Basel risk-weighted ratios alone--in particular, their lack of consistency, frequent reliance on banks' internal models, and inadequate capital requirements for certain exposures and risk types. We therefore do not rely on regulatory ratios as the central point for our bank capital analysis and have developed our own RAC ratio instead (see "Bank Capital Methodology And Assumptions," published on Dec. 6, 2010).

In our view, the leverage ratio should provide a useful and simple, additional way to analyze a bank's capitalization, even though it does not differentiate between the risk profiles of the bank's underlying exposures. In addition, it is easier to compare the computation of the ratio between two banks than it is with regulatory risk-sensitive metrics.

Some market participants, such as the Bank of England, claim that leverage ratios were better predictors of distress during the financial crisis than risk-weighted regulatory ratios (see chart). However, we do not believe that this will necessarily still be the case in a future crisis, once the leverage ratio is embedded in the global regulatory framework.

Using the Basel leverage ratio as a stand-alone capital measure could, in our view, lead to erroneous conclusions with respect to the relative capital adequacy of two institutions. For example, owing to its risk-neutral calibration, it is more difficult for a bank with a typically low-risk profile--such as a mortgage lender with a conservative risk appetite--to achieve a minimum leverage level well in excess of 3% than it would be for a corporate lending specialist.

We believe that a regulatory approach based on risk-weighted and leverage ratios should provide regulators and market participants with a more comprehensive view of banks' capital strength. We note the Basel Committee's resolve to improve the consistency of risk-weighted capital metrics. We believe that a number of options could, together, help restore market participants' trust in these ratios. However, we expect progress to be relatively slow, and believe that, by their very nature, the reliability of risk-sensitive metrics will to some extent remain constrained by a degree of subjectivity in their computation method. This is because risk-weighted capital metrics rely on assumptions about the relative riskiness of various exposures--made by the international standard setters, national regulators, or banks themselves--and are subject to model risk.

We therefore believe that any improvements in the consistency of risk-sensitive metrics across jurisdictions and between institutions will not reduce the relevance of the leverage ratio as a backstop measure. The leverage ratio can, in our view, act as an alert, which should trigger additional investigations rather than lead to premature conclusions. We believe the purpose of the ratio should be to identity outliers, but we would expect risk-sensitive metrics to remain the main balance-sheet constraint for the majority of institutions.

The Threshold Imposed By Regulators Will Determine The Ratings Impact

We expect the implementation of a minimum Basel III leverage ratio of 3%--under the currently proposed calibration--would be generally neutral for bank ratings globally. In most cases, banks either already comply with this requirement or should be able to do so by 2018--when the Basel Committee expects it to become a binding requirement--with limited adjustments to their balance-sheet strategies. We see regional differences in the level of preparedness and consider that a number of the most leveraged international banks are located in Europe. However, we expect a 3% minimum leverage ratio to be generally compatible with increased risk-sensitive capital requirements over that horizon. In a number of cases, the ratio may encourage banks to make gradual changes to their banking models and balance-sheet structures. We believe that the testing period will give an indication of the extent of likely changes that institutions will have to undergo to comply with the ratio. However, we would expect only a relatively limited number of institutions globally to face more drastic changes to their business models.

Recent announcements by regulators in the U.S. and the U.K. highlight a stricter approach to leverage requirements. In August, the U.S. authorities published proposals for more demanding requirements (see "U.S. proposed leverage requirements" below). In the U.K., the new prudential regulator for banks, the Prudential Regulation Authority (PRA), conducted a capital assessment and unexpectedly demanded that larger financial institutions achieve within a relatively short timeframe a 3% common equity Tier 1 leverage ratio after applying certain stress assumptions. This was one of the factors that prompted Barclays' July 2013 announcement of a range of capital initiatives, including a £5.8 billion rights issue (net of expenses). A stricter implementation of the leverage ratio than currently recommended by the Basel Committee could lead to an acceleration of capital strengthening by a number of banks and/or further balance-sheet downsizing. In most cases, we expect the implementation of the leverage ratio to limit the downside risk to our assessment of banks' capital and earnings. In the cases where the resulting capital strengthening would lead us to materially increase our prospective RAC projection, the introduction of a leverage requirement could be positive for the ratings.

In line with our existing criteria, we consider the implications of banks' compliance with regulatory capital requirements, and the potential consequences of restricted regulatory capital flexibility (for more details, see table 8 of "Banks: Rating Methodology And Assumptions"). If a bank fails to maintain a buffer above the regulatory minimum once the leverage ratio is fully binding, we could revise our capital assessment. In particular, this could increase the risk of regulatory intervention and of losses imposed on certain creditors to rebuild a bank's leverage buffer.

Because it does not differentiate between the risk profiles of various types of exposures, certain market participants believe that the leverage ratio could, in some cases, increase banks' risk appetites. We do not believe that this should be the case, however, provided that regulatory risk-weighted metrics are not sidelined in favor of an excessive reliance on leverage ratios and that standard-setters maintain their efforts to improve the consistency of risk-weighted asset calculations. Equally, we do not believe that the Basel III leverage ratio will prompt banks to materially reduce their balance-sheet liquidity, provided that the regulators maintain their efforts of the past five years to strengthen banks' liquidity requirements.

Once fully implemented, we think that the Basel leverage ratio could impair a relatively limited number of banks' existing business models. For example, we believe the ratio could affect their ability to compete in certain business lines, such as low-margin and traditionally low-risk segments. As a result, we expect banks to reduce certain low-margin activities--for instance, public sector lending--and, in some cases, transfer them to the unregulated financial sector (sometimes referred to as "shadow banking"). If these activities typically make up a critical part of a bank's franchise, we could revise down our assessment of that bank's business position. The strict implementation of the leverage ratio, irrespective of banks' business models, could, in particular, affect some of our ratings on monoline institutions that specialize in typically low-risk activities with limited tail risks.

Possible (Un)intended Consequences

In our view, market participants could use the proposed Basel III leverage ratio as their primary measure to assess and compare banks' capital adequacy, possibly with unintended consequences. This could occur due to the lack of transparency of risk-weighted metrics and their understatement of certain risks in the recent crisis. These shortcomings in regulatory risk-weighted metrics were among the main reasons that prompted us to introduce our RAC framework five years ago.

Failure to address the shortcomings in regulatory risk-weighted metrics--despite three decades of evolution--could, in our view, result in market participants relying excessively on a single metric that is to some extent more crude and less risk-sensitive than the original Basel I ratio. Owing to its simplicity, market participants may wrongly assume that leverage levels are easy to interpret. In addition, although the leverage ratio would have been a useful early indicator to flag a number of banks' vulnerabilities in the financial crisis, we should not assume that this ratio will be the best indicator in a future crisis. If the leverage ratio were to become the most constraining capital requirement for a majority of banks, we believe that the regulatory framework could, over time, provide an incentive for banks to increase their share of riskier exposures. For example, a minimum leverage ratio in itself would not necessarily have prevented a build-up of excessive exposures to commercial real estate--which had a negative impact on a number of banks' credit profiles in recent years--except if set at a level that would likely damage the viability of a number of retail

banks' business models.

Because the ratio doesn't include any risk-weighting of assets, the introduction of leverage ratio requirements is likely to affect some of the banks' low-margin activities. In particular, under its currently proposed calibration, the Basel III leverage ratio captures securities financing transactions, such as repurchase agreements (repos), and reverse repo transactions on a gross basis. Collateral received under these transactions would also be included in the exposure measure if the collateral has been rehypothecated. We expect the trading operations of banks that do not have large flow businesses would be most affected by this and anticipate that banks will further reduce the size of their trading inventories. In the absence of other remedial actions, we expect this would affect certain market-making activities--particularly for lower-risk securities such as government bonds--especially for some of the more leveraged European banks. Given the perceived contribution of repo activities to crisis contagion mechanisms and financial markets interconnectedness, we believe that the possible impact of the Basel leverage ratio on the securities financing market is an intended consequence of the proposed ratio calibration. We note that any material transfer of market activities to the shadow banking sector would call for closer risk supervision of the nonbank financial sector.

The Basel III Leverage Ratio Is Unlikely To Prevent Diverging National Regulatory Approaches

Although we expect to see more consistency and comparability between banks internationally, we believe that the implementation of the Basel III leverage ratio could lead to an unlevel playing field for international banks.

We see growing evidence that a number of regulators may exceed the Basel Committee leverage ratio recommendations in terms of minimum requirements--for domestic banks and sometimes domestic subsidiaries of foreign institutions--and the speed at which banks adopt those minimum requirements (that is, ahead of 2018).

Differences between domestic financial systems may, to some extent, fuel different regulatory approaches. For example, we consider that the EU is unlikely to follow the U.S. in implementing a minimum ratio above the 3% level recommended by the Basel Committee. This is largely due to structural differences between the two regions, including the absence in Europe of government-sponsored enterprises such as Fannie Mae and Freddie Mac. As a result, we acknowledge that the Basel leverage ratio is more constraining for retail banks in Europe than for some of their U.S. counterparts. In some cases, however, we believe that the weaker pro forma leverage ratios of certain European banks highlight a less favorable underlying capital position than regulatory risk-weighted metrics otherwise indicate. This is a view we often share, based on our RAC ratio analysis.

After the conclusion of the testing period, we understand that the European authorities could consider imposing minimum leverage ratios that vary according to each institution's business model, although it is unclear how this differentiation would be implemented in practice.

U.S. Proposed Leverage Requirements

In August 2013, the U.S. regulatory authorities proposed to double the minimum Basel III leverage ratio--referred to as the supplementary leverage ratio--to a 6% minimum to be considered "well capitalized" and avoid prompt corrective action such as dividend distribution limitations. This would affect subsidiary banks of bank holding companies (BHCs) that have more than $700 billion in assets or more than $10 trillion in assets under custody. BHCs are held to a minimum 5% supplementary leverage ratio and their FDIC (Federal Deposit Insurance Corporation)-insured bank subsidiaries will be held to a minimum 6% from Jan. 1, 2018.

As a result of its calibration, the supplementary leverage ratio is a more constraining metric than the existing "generally applicable leverage ratio" for U.S. banks, which is only based on total on-balance-sheet assets under U.S. GAAP. As an illustration, based on recent supervisory estimates, the 6% proposed supplementary leverage ratio for subsidiary banks of covered BHCs corresponds approximately to an 8.6% generally applicable leverage ratio.

As for preparedness, many of the covered firms are either at or near those minimums currently, and we believe those that fall short should be able to reach well-capitalized levels without significant balance-sheet restructuring or capital raises by the 2018 effective date.

Finally, we have seen the emergence of a number of parallel "local" leverage ratios, such as the U.S. "generally applicable ratio" (largely based on U.S. GAAP [generally accepted accounting principles] total assets) or the PRA-adjusted common equity Tier 1 leverage ratio. A multiplication of regulatory leverage indicators across jurisdictions would, in our view, contradict the "simplicity" that we believe is at the core of the leverage ratio initiative. A multiplication of regulatory metrics--and the emergence of various declinations of national leverage ratios--would, in our view, increase the complexity of the regulatory framework and potentially confuse investors and other market participants.

A Big Step Toward International Consistency

One of the benefits of the proposed leverage ratio calibrations would be greater international consistency, regardless of the accounting framework used. Nevertheless, we do not believe that banks' leverage ratios internationally can be interpreted consistently without additional input, such as risk-sensitive capital metrics.

The proposed calibrations reflect a regulatory definition of some on- and off-balance-sheet items that differ from U.S. GAAP or IFRS (International Financial Reporting Standards) in a number of ways (see Appendix below). In some cases, however, the precise impact will still depend on the underlying accounting.

We view the proposed calibrations as similar to U.S. GAAP requirements in some respects--for example, in allowing the netting of derivative positions if "qualifying" master netting agreements are in place--but closer to IFRS in others, in that collateral received cannot be netted against derivative values. Despite some moderate differences, we believe that the proposed calibrations will allow the leverage ratio to be far more comparable across banks overall than a leverage ratio based purely on the accounting balance sheet.

The Basel Committee proposes the use of Tier 1 capital as the numerator of the leverage ratio. We believe that the use

of Common Equity Tier 1 instead could enhance the simplicity and comparability of the ratio over time, especially in light of the only gradual phasing out of certain hybrid Tier 1 instruments under Basel III and the residual risk of national discretions around the eligibility of different types of additional Tier 1 instruments.

Proposed Standardization Enhances Additional Disclosure

Beyond the ratio itself, we see great value in the additional disclosure proposed as part of the Basel Committee leverage ratio framework. Under the Basel Committee proposal, banks are required to disclose commonly calculated leverage ratios from the beginning of 2015 and internationally active banks across Basel-member jurisdictions must do so according to a common template.

The proposed disclosure includes a summary comparison of accounting assets and leverage ratio exposures, a common disclosure template breaking down the main leverage ratio elements, a reconciliation with public financial statements, and an explanation of material periodic changes in the leverage ratio. We consider the use of mandatory, standard templates as a material improvement compared with existing Pillar 3 reports, which currently suffer from a lack of comparability in the nature and format of the disclosure, despite ongoing initiatives to remedy these shortcomings (for more information, see "The Enhanced Disclosure Task Force: S&P Study Finds That Bank Reporting Has Improved But Still Falls Short," published June 26, 2013).

We believe that the standardized disclosure recommended by the Basel Committee will be sufficiently granular and easy enough to access to help inform market participants' analysis of the leverage ratio and address some of the limitations arising from its relatively simple--non-risk-sensitive--calibration.

Appendix: Summary Of the Proposed Calibration Of The Basel III Leverage Ratio

The Basel Committee proposes to use Basel III Tier 1 capital--including transitional arrangements--as the numerator of the leverage ratio. The proposed calibrations also clarify the requirements for the denominator of the leverage ratio (the exposure measure) with regard to:

- The scope of consolidation. For internal consistency, if the numerator of the leverage ratio (the capital measure) excludes certain subsidiaries from the scope of regulatory consolidation, the assets of those subsidiaries are also excluded from the denominator.
- On-balance-sheet assets. These would be included net of provisions and valuation adjustments. To the extent that differences exist in the accounting requirements for such provisions and adjustments, these differences will also affect the leverage ratio. In particular, if the differing U.S. GAAP and IFRS proposals for "expected loss" models for credit losses are finalized without achieving convergence in the models, credit loss provisions under U.S. GAAP would likely be much higher than under IFRS. That said, in most cases, we don't expect that differences in provision policies would substantially distort leverage ratios.
- Derivatives. These are to be included based on their replacement cost and an "add-on" to reflect potential future exposure. The replacement cost element allows for the netting arrangements where a master netting agreement is in place, which means that the treatment is closer to, though not the same as, the way that derivatives are treated on the balance sheet under U.S. GAAP. However, unlike U.S. GAAP--and similar to IFRS--collateral received may

not be netted against the derivative value.

- Securities financing transactions. These are to be included on a gross basis, ignoring any netting of cash payables that is permissible in U.S. GAAP or IFRS. In addition, where collateral has been received and is recognized on the accounting balance sheet, but has not been rehypothecated, the proposed calibrations would remove the value of the collateral from the denominator. This is similar to the treatment of such collateral under IFRS.
- Off-balance-sheet exposures. These are, by definition, excluded from balance sheets under U.S. GAAP and IFRS. The proposed calibrations require that off-balance-sheet exposures be included in the denominator of the leverage ratio using a 10% credit conversion factor (CCF) for unconditionally cancelable commitments (such as credit cards) and 100% CCF for other exposures.
- Written credit derivatives. These must be included in the denominator based on its notional value, which can be offset by the notional amount of related purchased credit derivatives in some circumstances.

Related Research

- The Enhanced Disclosure Task Force: S&P Study Finds That Bank Reporting Has Improved But Still Falls Short, June 26, 2013
- Global Banking And Credit Trends: The Weight Of Frail Economies And Regulatory Reform, June 17, 2013
- The Basel III Leverage Ratio Is A Raw Measure, But Could Supplement Risk-Based Capital Metrics, April 15, 2010
- Banks: Rating Methodology And Assumptions, Nov. 11, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

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