Sabine Lautenschläger: The leverage ratio – a simple and comparable measure?

Speech by Ms Sabine Lautenschläger Deputy President of the Deutsche Bundesbank, at the evening reception of the Deutsche Bundesbank/SAFE Conference "Supervising banks in complex financial systems", Frankfurt am Main, 21 October 2013.

* * *

1. Introduction

Ladies and gentlemen,

I am very happy to welcome you to the Guest House at the Deutsche Bundesbank's Central Office. It's a pleasure to have you here.

Although you will have noticed that our premises are located somewhat outside of the city centre, it's only a ten-minute walk to the Goethe University's campus from here. This isn't just convenient for those of you who decided to walk from the University to the headquarters of the Deutsche Bundesbank. Having a walking distance between the Bundesbank and the Goethe University also facilitates exchange and cooperation between the two institutions, which both have a strong stake in financial market and regulation research. I value this exchange very highly and I am convinced that cooperation in this field is indeed a very good idea. I therefore also would like to thank the SAFE Center at the Goethe University, who has organised this conference together with the Deutsche Bundesbank.

I would also like to extend a particularly warm welcome to all of the contributors to today's conference sessions.

The conference asks a very fundamental question: how can we, how should we supervise banks given that the financial system is inherently complex?

Many books were and still will be written to examine this question comprehensively, and they will offer different and sometimes contradictory answers; at least, that is my prediction. I nevertheless want to share my fundamental view of this topic with you. So, how can or should supervisors deal with complexity? I am convinced that in a complex world – first – supervisors need a toolbox with different instruments to cope with this complexity, and – second – those tools will not generally be that simple.

As I'm sure you are aware, I am not an academic but a practitioner. And as a practitioner I'll give you a practical example to make my point. I'd like to talk about a measure you all know very well: the leverage ratio. It's not really a new concept, but it's certainly a fashionable one. It has been claimed to be a simple fallback measure for dealing with an increasingly complex banking system, a kind of panacea for complexity.

Sometimes one could even get the impression that some supporters of the leverage ratio actually think they have found the fount of all knowledge. I don't. I am very well aware that the concept has its benefits – but it also has its limitations. And I will argue that it is certainly not wise to think a leverage ratio could simultaneously be simple, comprehensive and comparable.

2. The buzz about the leverage ratio

Before I come to the truths and myths regarding the leverage ratio, I want to briefly remind us why capital ratios are sensible concepts and therefore rightly used by regulators and supervisors.

Bank equity is supposed to cover the first losses in the event of a default before the claims of debt holders, and potentially depositors, are affected. If we take a bank's assets as given,

more equity strengthens the debt holders' position at default and makes the bank safer. And that is basically it. By the way, regulators and supervisors like safe banks.

There are, however, two competing concepts. Ratios following the first concept take aspects of banks' asset risk into account and divide capital by assets subject to some risk-weighting – the well-known Basel II Tier 1 capital ratio is a prominent example. By contrast, the second concept is risk-insensitive. The ratio is defined as capital over a non-risk based exposure measure, such as total bank assets. This is the world of the leverage ratio.

In the recent past, some regulators and academics have been very active in pointing out the advantages of using the non-risk based leverage ratio as an element, possibly even the main one, in banking regulation. Andy Haldane's already famous example of a dog which is able to catch a frisbee without knowing the underlying physical laws points to the problem of complexity in current regulatory standards. To some extent, the discussion paper released by the Basel Committee's Task Force on Simplicity and Comparability also emphasises the future role of a non-risk based leverage ratio. Essentially, these voices recognize the high degree of complexity in today's banking, but they doubt that this complexity can be handled appropriately with complex supervisory tools. Therefore they suggest relying on more simple measures such as the leverage ratio.

Over the next few minutes, I will attempt to test some of the advantages of the non-risk based leverage ratio – particularly its alleged simplicity – against reality. I would like to go through three questions with you. Firstly, is the leverage ratio really a simple, comprehensive and comparable measure? Secondly, is it an advantage or a disadvantage that the leverage ratio is risk-insensitive by definition? Thirdly, should we move away from risk-oriented banking regulation?

3. Myths and truths regarding the leverage ratio

3.1 Is it a simple, comprehensive and comparable measure?

How should we define a simple, comprehensive and comparable measure? The Basel Committee on Banking Supervision has been working on such a measure for about three years, without a final outcome. It is apparently not as easy to agree on a sensible concept for a leverage ratio as it might appear. However, proponents of the leverage ratio may argue that its obvious definition would simply be the bank's accounting equity divided by its total assets. Yet a leverage ratio defined in such a simple way has two major drawbacks: it is neither comparable nor comprehensive.

Why isn't it comparable? Banks use different accounting standards. For example, it is well known that the netting rules for derivatives under IFRS are much more restrictive than under US GAAP putting banks reporting under IFRS at a comparative disadvantage.

Another example is the definition of the eligible capital: the Basel Committee has had a hard time reaching a consensus on a consistent and internationally harmonised definition of regulatory capital, as the approach of simply using the accounting equity was found wanting by the respective expert group. It is important to note that while it is often possible to plug these gaps by making some adjustments, this always comes at the price of a more complex and therefore less transparent leverage ratio. And it should also be noted that accounting standards are not simple per se, and their application is subject to some discretion. This is another potential risk for the comparability of an accounting-based measure. And, what is worse, this area is largely outside the control of banking supervisors.

The lack of comparability has implications: comparing the leverage ratios in the United States with those in Canada, Switzerland or with the Basel III leverage ratio is like comparing apples with oranges. This implies that the proposal by the two US Senators Sherrad Brown and David Vitter, which requires minimum ratios of 8 to 15 per cent, depending on bank size, cannot be compared to the calibration of the Basel III leverage ratio, for example.

In a nutshell: a simple accounting-equity-over-assets ratio is not comparable across different countries. Yet another problem with such a simple ratio is that it is not comprehensive. I would like to illustrate this by looking at three different aspects of the Basel III leverage ratio definition:

The starting point is the asset side of the balance sheet, or more precisely, the total on-balance sheet assets under applicable accounting standards. First, knowing that off-balance sheet activities may constitute leverage as well, we decided to include positions such as credit commitments, too.

Second, recognising that derivatives may be offset if certain accounting conditions hold, we preferred to rely on regulatory netting rules instead and require banks to apply a further add-on for "potential future exposure".

Third, the accounting value of securities financing transactions such as repo agreements is replaced by a more prudent and internationally comparable measure; it consists of gross assets, before netting, and an add-on for counterparty risk. Those adjustments are perfectly justifiable and necessary from a supervisor's perspective. They are clearly sensible. But remember that any of these adjustments will come at the expense of simplicity. In short, a simple accounting-equity-over-assets ratio is not comprehensive either.

Given these limitations, let me reiterate that it seems impossible to define a simple leverage ratio that is also comparable and comprehensive. Hence, some of its claimed advantages will not materialise in reality.

3.2 Is it an advantage to be insensitive towards risk?

A leverage ratio is risk-insensitive by definition. Is this an advantage or a disadvantage? As we all know, there is currently an intensive debate on how much we can trust the model-based calculation of risk-weighted assets and how we should understand the corresponding measures. Tomorrow's presentation by Sujit Kapadia on "Taking uncertainty seriously: simplicity versus complexity in financial regulation" will undoubtedly shed some more light on this issue.

For me it is quite clear that our system of risk weightings has some shortcomings; just think of the treatment of government bonds, which allegedly carry zero risk. These shortcomings, however, do not prove that the leverage ratio is superior.

The leverage ratio has its own deficiencies. It punishes low-risk business models, and it favours high-risk businesses, encouraging banks to engage in more risk-taking, for example. This is the world of Basel I, which was relatively indifferent towards credit risk. Let's not forget that a decade ago, the Basel II framework was developed as a response to the Basel I rules of 1988.

3.3 Moving away from risk-oriented banking regulation?

Introducing the leverage ratio as the primary regulatory requirement would mean taking two steps back to the risk-insensitivity of Basel I and even beyond. Why is this a headache for me? There is a danger that we will effectively end up with a leverage ratio only, because a sufficiently high leverage ratio requirement will override the calculation of risk-weighted assets. Why is this?

Let me draw your attention to one result from the recently published Basel III monitoring exercise. Only 30% of the large, international banks analysed is more easily able to fulfil a risk-based Tier 1 capital ratio of 8.5% (including the capital conservation buffer) than a 3% leverage ratio, which is the ratio the Basel Committee favours. This does not look very balanced to me, yet voices from the regulatory community, such as FDIC Vice Chairman Thomas Hoenig or Fed Governor Daniel Tarullo, have recently proposed going higher. Daniel Tarullo is advocating a leverage ratio of 6% for globally systemically important banks (G-SIBs), for example. And economists like Martin Hellwig are even more radical; they are

suggesting that banks should hold minimum capital of 20% to 30%, relative to their non-risk weighted assets. As a practitioner I can only marvel at such notions. Such a step requires thorough consideration and careful analysis – not only regarding the definition and level of capital, but also regarding the transitional period – and I am therefore far from being convinced that we should take such a radical step.

What should we do instead? My answer is straightforward: we should stick to the Basel III timeline. Under the Basel III timeline, banks will be required to disclose their leverage ratios as of 2015, which allows both the supervisors and the investors to use it as an indicator for bank risk. However, the definition will remain under review until 2018, when the decision about its introduction as a binding "Pillar 1" requirement will eventually be taken. I believe that we should use this parallel run period for further analyses regarding the leverage ratio's interaction with risk-based capital requirements, regarding the undesirable incentives it may potentially create, and regarding its impact on low-risk business models.

4. Conclusions

To be absolutely clear: I am not against a leverage ratio. Supervisors should actually make use of a leverage ratio, but they should also rely on a risk-sensitive measure.

A sensible concept for a leverage ratio will, however, require a certain degree of complexity. You probably know that physicist Albert Einstein once stressed that we should "make things as simple as possible, but no simpler", and this applies very much to the design of a consistent, comparable and comprehensive regulatory measure.

Ladies and gentlemen, you have already discussed complexity in various forms at this conference. I hope my thoughts about the leverage ratio will help to stimulate your discussions at this joint Bundesbank/SAFE conference.

Thank you very much for your attention.

References:

DeAngelo, Harry and Stulz, Rene M. (August 2013), "Why High Leverage is Optimal for Banks", Fisher College of Business Working Paper No. 2013-03-08; ECGI - Finance Working Paper No. 356, http://dx.doi.org/10.2139/ssrn.2254998.

Miles, David, Yang, Jing and Marcheggiano, Gilberto (2013), "Optimal Bank Capital", The Economic Journal, Vol. 123, pp. 1–37, http://dx.doi.org/10.1111/j.1468-0297.2012.02521.x.