LEVERAGE RATIO VS RISK WEIGHTED ASSETS

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The Context

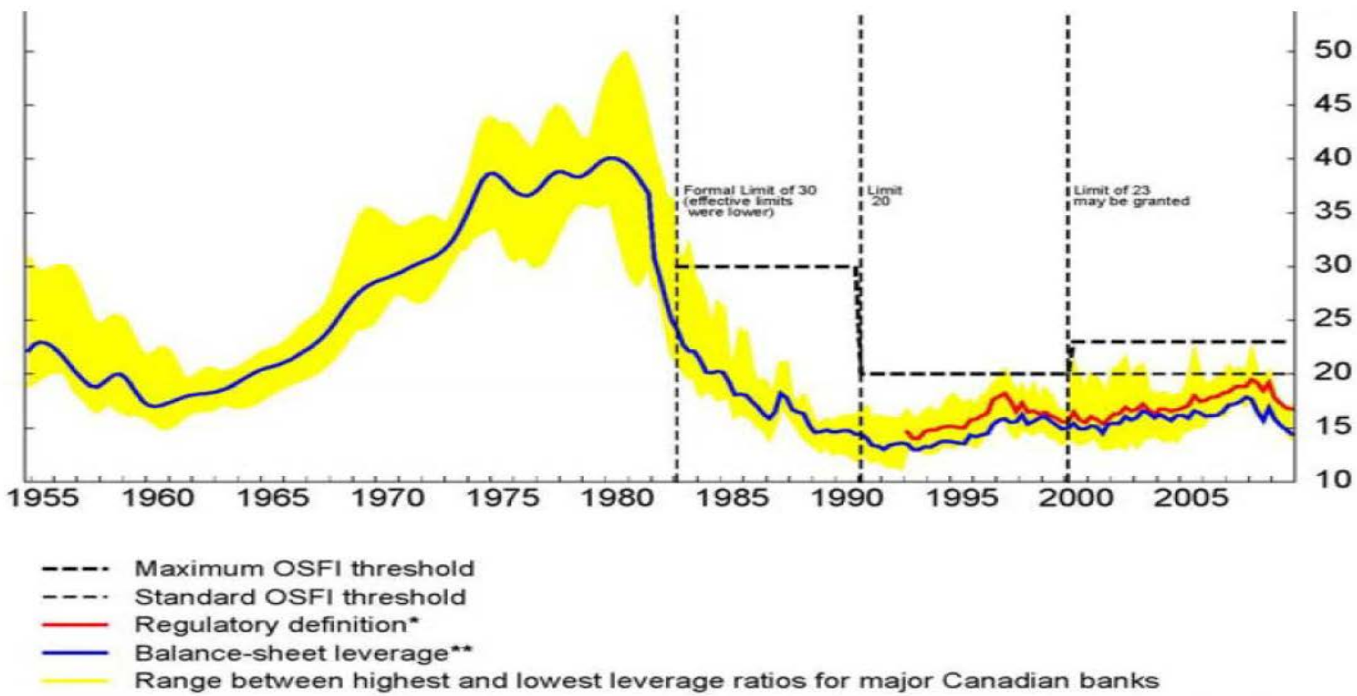
- Basel Committee wants to introduce a minimum leverage ratio (Common Equity Tier 1/Total Assets+ measure of off balance sheet) for banks.
- US regulators also want to introduce a higher LR but using more lax accounting measures.
- In Switzerland, current discussions about introducing such a new regulation.
- LR is viewed as a complement to traditional capital requirements, based on RWA

  (cf presentation by R.Baisch).

Evidence from Canada

- LR was introduced in Canada in the 1980s

Table 10: leverage of major Canadian banks



* On-balance-sheet assets plus certain off-balance-sheet items as a ratio of regulatory capital
** On-balance-sheet assets to shareholders' equity plus subordinated debt
Source: OSFI

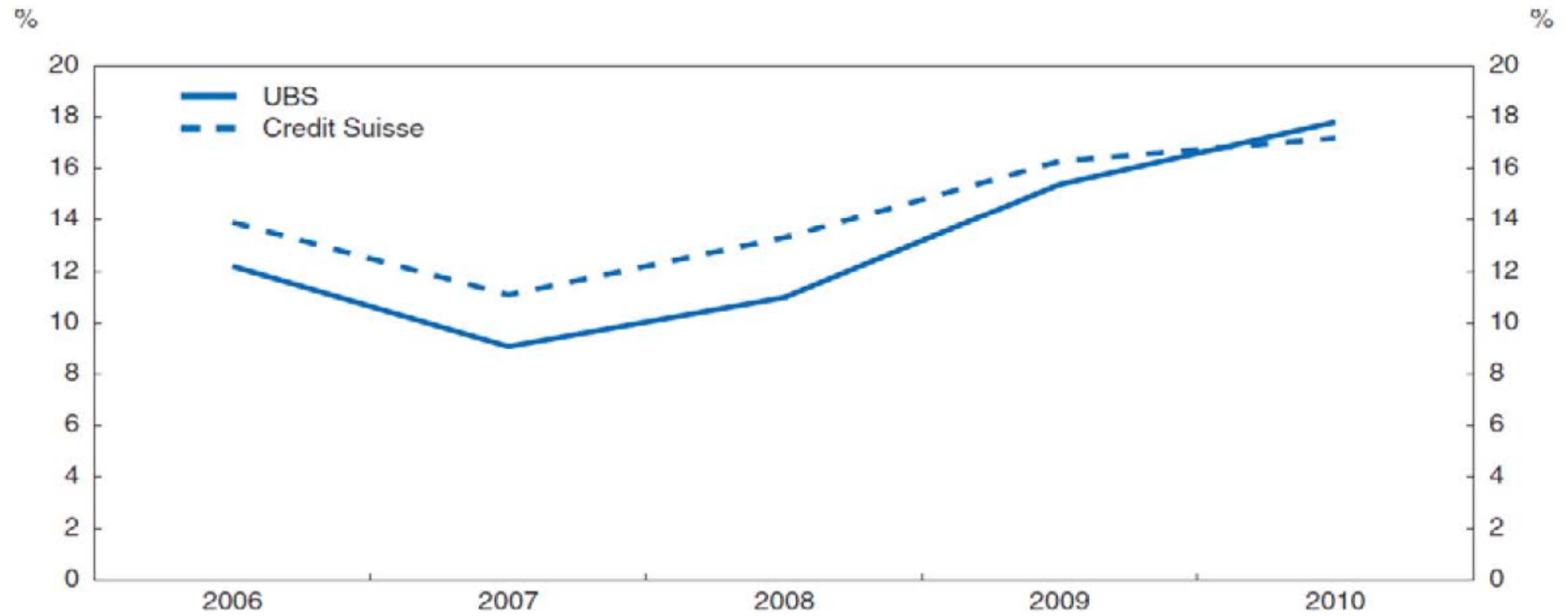
Arguments for a leverage ratio

The proponents of a Leverage Ratio for Switzerland basically put forward three arguments

1. In spite of higher (RWA) capital ratios, Swiss banks are still too leveraged.
2. Risk Weights may underestimate risks.
3. Swiss banks are still too big for the size of the Swiss economy.

Argument 1

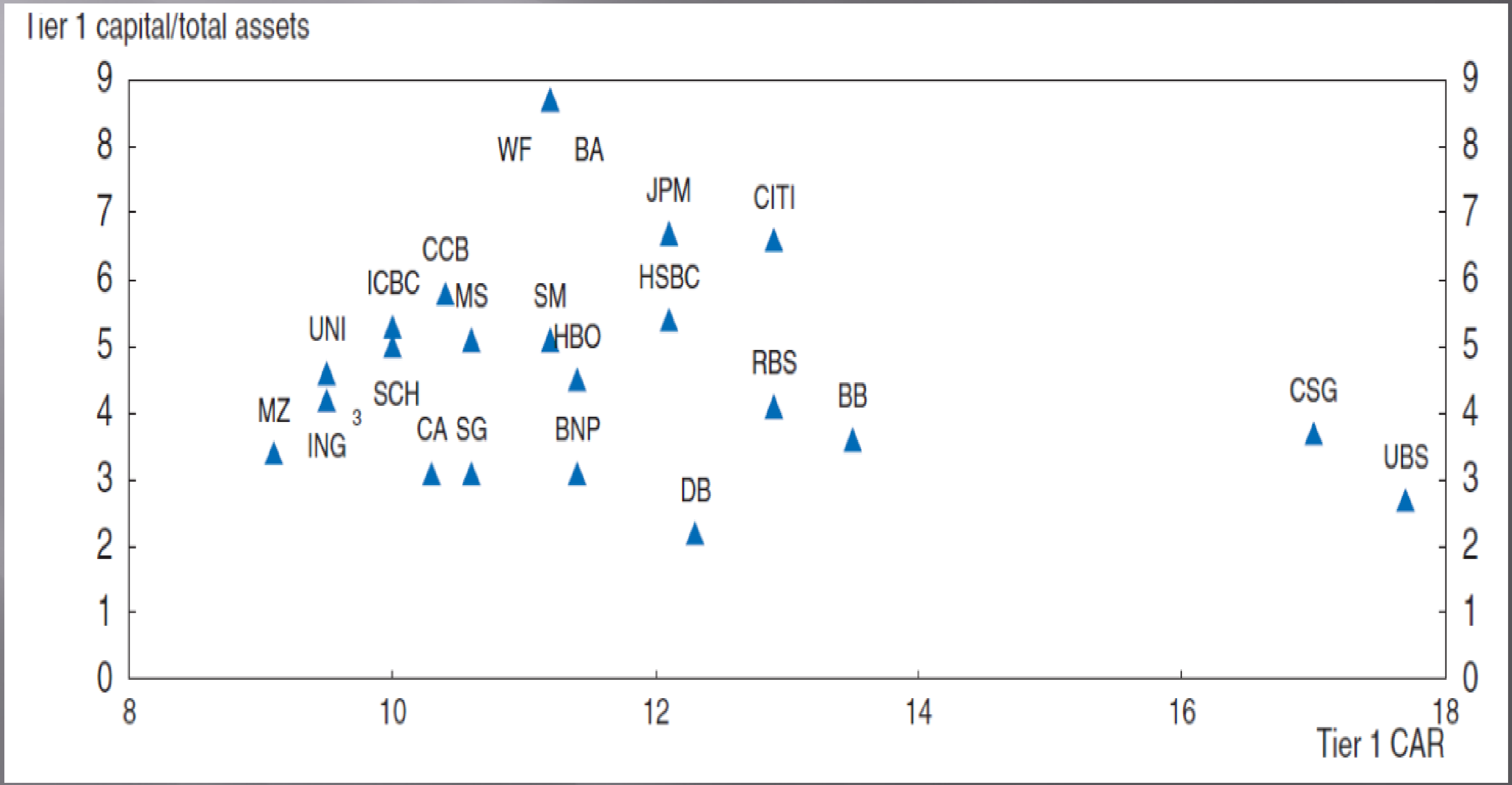
1. Large Swiss banks have increased their (RWA) capital ratios…



Source: Annual Reports of UBS and CSG.

Argument 1(continued)

But they may still be undercapitalized?



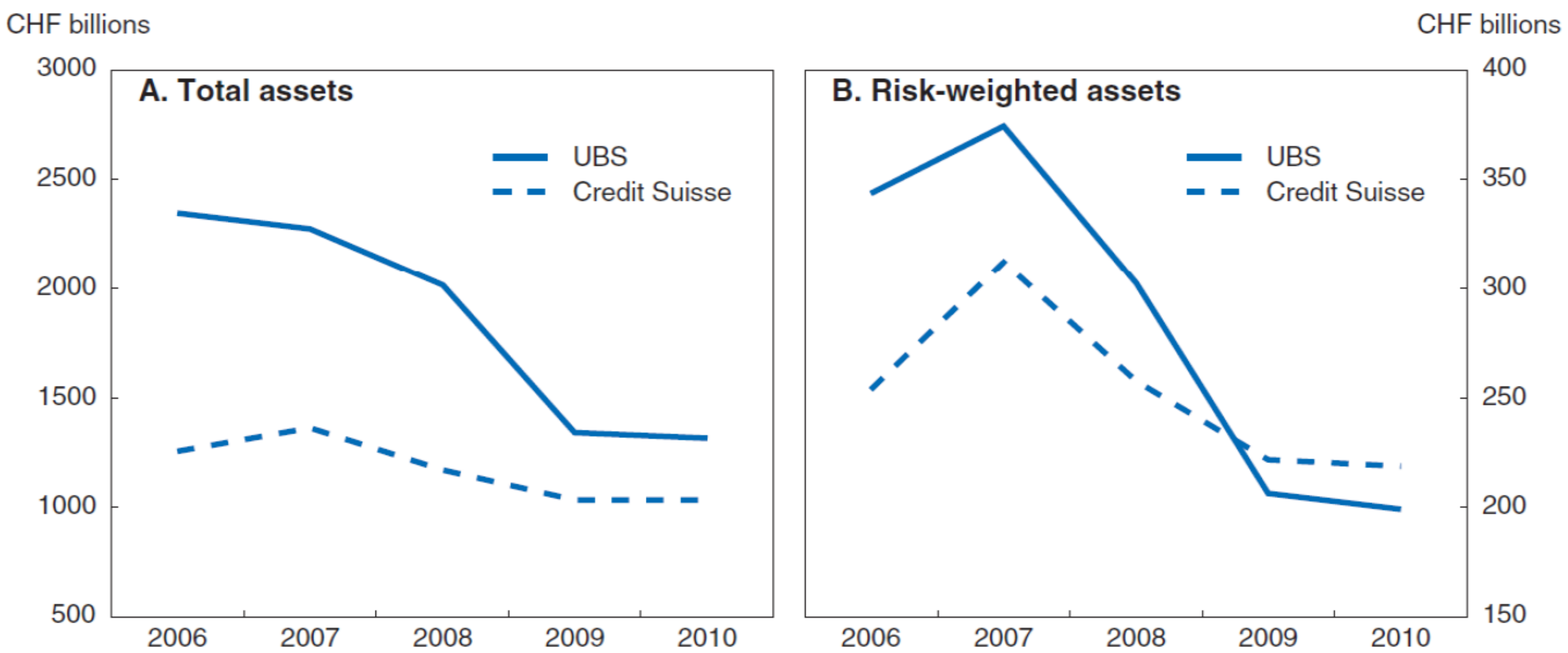
Argument 2

Risk Weights may underestimate risks?

- June 29,2007: FSA allowed Northern Rock to reduce risk weights on its mortgage portfolio from 50% to 15%.
- As a result NR distributed a fat dividend to its shareholders, a few weeks before being forced to ask public support from HMT and BOE.
- Le Leslé-Avramova (IMF 2012): huge variations across jurisdictions in RW used by regulators and internal models for same asset classes.

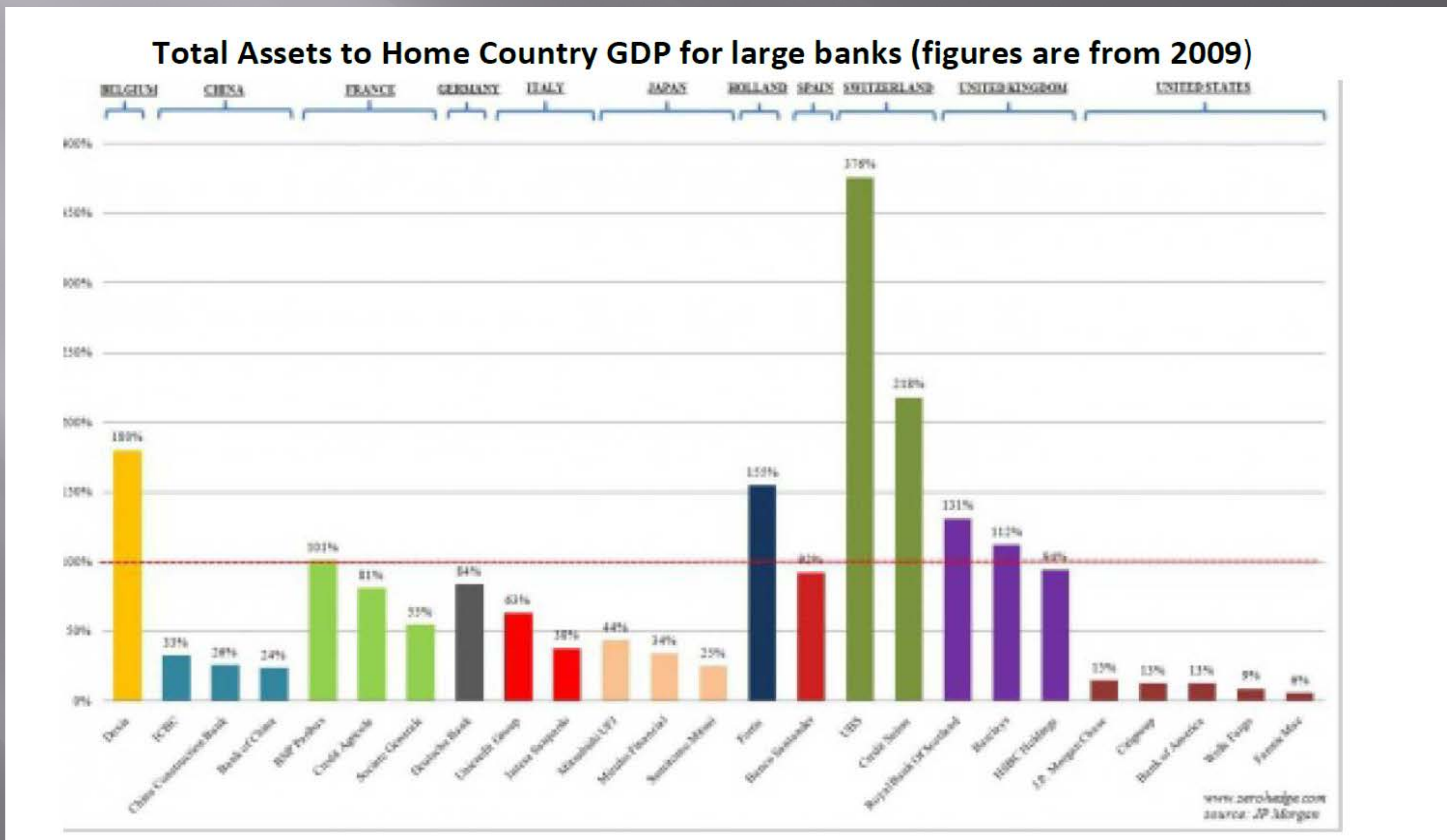
Argument 2 (continued)

Figure 4: Swiss big banks' total and risk-weighted assets (OECD 2012)



Argument 3

Swiss banks may still be too big for the size of the Swiss economy?



IMPACT OF A LEVERAGE RATIO

- LR is just a CAR with equal weights for all assets (adds apples and oranges): very bad measure of risk.
- Capital buffers should reflect different riskiness of different lines of business.
- Adopting a LR as part of the first pillar (i.e. for controlling portfolio decisions of banks on a regular basis) would induce massive distortions (Rochet 1993).

Responses to the arguments in favor of the LR

- If regulators consider that Swiss banks are still undercapitalized the appropriate solution would be to increase the CAR (based on RWA).
- If regulators consider that risk weights under-estimate risks they should increase them.
- But why imposing that they should all be equal?
- In any case LR contains a lot of arbitrariness in the treatment of off balance sheets exposures.

How to deal with TBTF

- If correctly monitored, a successful banking sector contributes a lot to the creation of value in a country.
- Correct response to TBTF: not to downsize successful banks, but to verify that they do not take too much risk at the expense of the taxpayer.
- If regulators have the power and the expertise to act early enough and curb excessive risk taking by large and complex FI, large banks should not create a problem.

The appropriate role of LR

- The LR should be understood as a Early Warning Signal: if a bank has low RWA but large leverage it may be that its risks are not correctly measured.
- LR should be part of Pillar 2, not Pillar 1.
- In normal times risks are well measured by RWA.
- LR should be there to detect abnormal behavior and force supervisory action.

CONCLUSION

- Leverage Ratio: simple regulatory instrument that can be used to detect deviant behavior (or abnormal circumstances).
- Its simplicity improves accountability of supervisors: everyone can check if regulatory forbearance is taking place.
- However in normal circumstances, CAR are the correct measure of risk taken by banks.
- The way to deal with TBTF is to increase the power and the accountability of supervisors vis a vis SIFIs.