

Box 7

EURO AREA BANKS AND LEVERAGE RATIO REQUIREMENTS

As disillusionment has grown with heterogeneous and opaque risk weighting calculations of banks, the use of simple leverage (i.e. leverage that is not adjusted for risk) has been gaining prominence among analysts, investors and regulators alike to serve as a backstop for risk-based requirements. While Basel III reforms already foresaw the use of such a leverage ratio, there

have been some calls for a more rapid and stringent implementation than currently envisaged.¹ This box evaluates euro area banks' capitalisation by comparing their leverage ratios with their risk-weighted capital ratios and investigates the relationship between these ratios and market-based indicators. Finally, it attempts to compare euro area LCBGs' leverage ratios to those of their global peers.

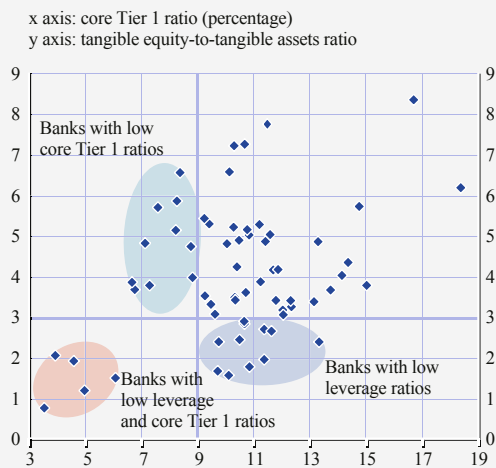
While, conceptually, a simple leverage ratio should be just that – simple (and transparent) – in practice, details such as the netting of derivative positions, the treatment of securities financing transactions or, more generally, differences between accounting frameworks can obfuscate any meaningful comparison of banks' currently reported leverage ratios. In addition, although regulators are regularly monitoring banks' preparedness to meet forthcoming leverage ratio requirements,² it is not possible at present to calculate fully comparable leverage ratios using publicly available information.³

Pending clarification of a commonly accepted measure of bank leverage and adequate public disclosure by banks, illustrative insights into euro area banks' preparedness to meet leverage ratio requirements can be gleaned by analysing a simple proxy for leverage ratios (tangible equity-to-tangible asset ratios) and comparing the outcome with regulatory (risk-based) measures.⁴ While this measure of leverage ratios corresponds to the core Tier 1 capital ratio in the case of most euro area banks, for some banks, these two measures send conflicting signals with regard to solvency (see Chart A).

This may reflect the diversity of banks' business models, in particular in cases where they have large investment banking businesses or large amounts of low risk-weight mortgages on their balance sheets. Interestingly, market pricing of banks appears to bear a closer resemblance to traditional measures of solvency than to leverage ratios, despite the latter's heightened prominence in the current

Chart A Leverage versus core Tier 1 capital ratios of euro area banks

(2012; euro area SBGs)



Source: SNL Financial.

1 A revised Basel III leverage ratio framework was published for consultation in June 2013. In *principle*, implementation of leverage ratios of 3% as a Pillar 1 requirement is only envisaged as of 2018, but the monitoring phase has begun with bank-level reporting to supervisors since January 2013, and public disclosure starting in January 2015. Final adjustments to the definition and calibration of the leverage ratio will be made by 2017. In *practice*, there are proposals for an early implementation of Basel III requirements in the United Kingdom and for increased leverage ratio requirements in the United States where regulators have proposed a significant tightening of the Basel III leverage ratio (based on the initial version of the leverage ratio framework, however, which was generally less conservative) for large banks from the current level of 3% to 5% for bank holding companies and to 6% for subsidiaries with insured deposits.

2 See Basel Committee on Banking Supervision, "Basel III Monitoring Report", September 2013, and European Banking Authority, "Basel III monitoring exercise – results based on data as of 31 December 2012", September 2013.

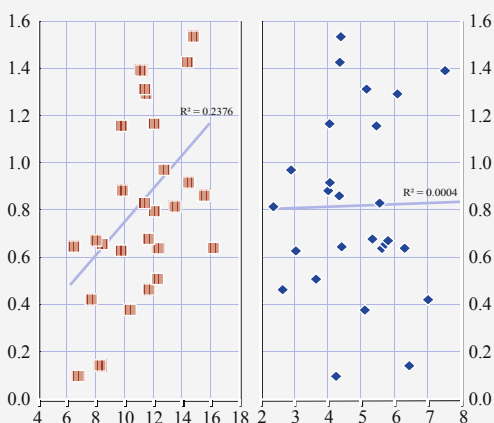
3 Some analysts have identified at least nine different ways of calculating leverage ratios and have highlighted that, for some banks, the ratio halves or doubles depending on the definition used. See Barclays, "European banks and the leverage ratio", September 2013.

4 However, the Basel III leverage ratio has a broader scope since it is defined as Tier 1 capital divided by total exposure including off-balance-sheet exposures.

Chart B Capital and leverage ratios vs. price-to-book value ratios of listed euro area banks

(H1 2013; SBGs)

x-axis: left panel; core Tier 1 ratio (percentages)
right panel; tangible equity-to-tangible assets ratio
y-axis: price-to-book value ratios

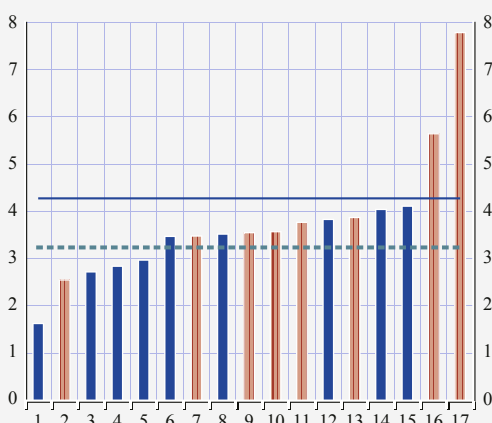


Source: SNL Financial.

Chart C Leverage ratios of selected large euro area and US banks

(Q4 2012; percentages; IFRS-equivalent estimates of adjusted tangible equity over adjusted tangible assets)

■ euro area banks - - - euro area banks - average
■ US banks - - - US banks - average



- | | | |
|--------------------|---------------------|------------------|
| 1 Deutsche Bank | 7 JP Morgan | 13 Goldman Sachs |
| 2 Morgan Stanley | 8 BPCE | 14 BBVA |
| 3 Crédit Agricole | 9 Bank of America | 15 ING Bank |
| 4 Société Générale | 10 Citigroup | 16 State Street |
| 5 Santander | 11 Bank of New York | 17 Wells Fargo |
| 6 BNP Paribas | 12 Unicredit | |

Source: Federal Deposit Insurance Corporation (FDIC).

Notes: For US banks, assets are adjusted to account for the different treatment of derivatives under US GAAP and IFRS rules. Adjusted tangible equity and adjusted tangible assets do not include goodwill, other intangibles and deferred tax assets.

debate (see Chart B).⁵ This could be explained by a multitude of measures of leverage, or by the fact that implementation is only envisaged as of 2018.

Viewed in international terms, while price-to-book ratios of euro area banks tend to be lower than those of their US peers, leverage ratios do not appear to be a consistent explanatory factor – at least not on a comparable basis.⁶ Specifically, even when corrected for accounting differences such as the treatment of derivative positions,⁷ the leverage ratios of large euro area banks still tend to be lower than those of their US peers on an IFRS-equivalent basis (see Chart C). This holds particularly true of euro area banks with large or significant investment banking activities. The remaining differences between euro area and US banks' leverage ratios can be explained, to some extent, by the different frameworks for regulation on capital requirements. Indeed, there is some evidence that euro area/European banks tended to have a higher share of assets with a low risk weight, allowing them to report strong capital ratios under Basel II rules. By contrast,

5 Similarly, no positive relationship was found between SBGs' share price changes between June and September, a period when the focus of analysts and investors shifted towards leverage ratios, and their leverage ratios.

6 See, for example, Thomas M. Hoening, "Financial Stability: Incentives Matter", speech presented by the Vice Chairman of the Federal Deposit Insurance Corporation (FDIC) at the Asian Banker Summit, April 2013.

7 Banks reporting under the Generally Accepted Accounting Principles (GAAP) in the United States only report the net value of derivative positions under a single master agreement with the same counterparty. The same treatment is also allowed for repurchase agreements and reverse repurchase agreements.

US banks have traditionally been subject to binding leverage ratios and the less risk-sensitive Basel I requirements, which may have induced them to focus on assets with higher returns.⁸

All in all, from a financial stability perspective, the inclusion of a simple, transparent, non-risk based leverage ratio in the regulatory toolbox as a complementary measure to the risk-based capital requirements is welcome, since it will help to contain the build-up of leverage in the banking sector. At the same time, such a measure on its own has clear limitations, such as its indiscriminate treatment of collateralised lending (e.g. mortgages) alongside assets of a clearly riskier nature (e.g. unsecured lending to risky borrowers). As such, its calibration and implementation needs to be careful and well thought out, so that it is indeed complementary to risk-weighted measures as foreseen, and not a binding substitute with a potential to create incentives for banks to shift their businesses towards higher-risk assets. Moreover, in finalising the rules related to the Basel III definition of the leverage ratio, particular attention should be paid to avoiding unintended consequences for repo markets, which may affect the liquidity of related financial markets, and could potentially impair the transmission of monetary policy. Parallel initiatives should be fostered to shed light on the opacity of risk-weighting formulas by enhancing transparency and disclosure.

⁸ See V. Le Lesle and S. Avramova, "Revisiting Risk-Weighted Assets", *IMF Working Paper*, No 12/90, International Monetary Fund, March 2012.