A Binding Leverage Ratio

Key Considerations

Context

The OECD Secretariat is increasingly active in international discussions on the reform of banks’ business models and the design of financial regulation. Specifically, we note that the G20 Leaders’ Statement in St. Petersburg in September 2013 encouraged the OECD to work with the Financial Stability Board (FSB) in this area.

In this context, BIAC wishes to hereby contribute perspectives from the finance and non-finance sectors of the OECD business community which we believe merit significant attention in OECD work in this area. Specifically, we re-examine some of the basic assumptions about the need for a binding leverage ratio and highlight possible unintended consequences of such assumptions. We underline the need for greater focus on a risk-based assets approach.

The reasons for introducing a binding leverage ratio: How valid are they?

The roots of the 2008 global financial crisis were complex. In the context of discussions on introducing leverage ratio as a binding capital constraint, we encourage the OECD to bear in mind that:

- **It was the nature of assets that was problematic, rather than their size.** The leverage ratio, as it is currently articulated, captures the leverage of a bank and not the underlying leverage of the pool of assets on the bank’s balance sheet. The crisis occurred primarily due to poor risk management and inability to account for systemic risks. Stability will not be undermined if an institution possesses robust risk management systems and sufficient amount of low risk assets, even if those assets are in large quantities.

- **The leverage ratio is not necessarily correlated with bank failure.** Many European banks show relatively high leverage, but have fared well during crisis since they have low-risk asset-based models in place, such as low risk public sector exposures and low risk retail assets.

- **While the leverage ratio may reduce risk for some institutions, this would not be the case for the majority.** This is because the leverage ratio is not risk sensitive: two financial institutions could have completely different risk profiles and yet present the same leverage ratio. Thus, in most cases, the leverage ratio is a misinformed criterion.
for the stability of financial institutions. Moreover, a binding leverage ratio could reduce low-return, low-risk credit activities in banks while incentivising high risk activities.

- **Leverage ratios as currently published are not comparable across jurisdictions:** There are significant differences in the way both the numerator and the denominator are calculated for regulatory-driven leverage ratios and implementation schedule differences across jurisdictions result in non-comparable disclosures. The Basel III definition introduces a more appropriate denominator calculation, as it takes into account off-balance sheet assets. When and if fully and consistently implemented by all jurisdictions, the use of the Basel III definition will improve comparability. In addition, the same leverage ratios do not necessarily mean the same risk profile. The same ratios may not be comparable due to different business models and balance sheet structures.

Considering the above, it is evident that identifying appropriate solutions to prevent future crises cannot be reduced to overly-simplistic measures. Close consultation with the financial industry as well as the broader business community users of financial services should be encouraged in order to take into account specific needs of different actors.

### The unintended consequences of setting leverage ratio constraints

While intended to bolster financial stability, the implementation of a binding leverage ratio on banks could lead to numerous side-effects that should be taken into careful consideration. Specifically, we wish to highlight the following possible consequences:

- **Higher risk activities, with potentially destabilising effects.** A binding leverage ratio could reduce low-return, low-risk credit activities in banks (such as cash or government bonds), since it could incentivise financial institutions to look for higher-yield, higher-risk assets to offset the capital locked in by the ratio. This could create the unintended consequence of fuelling greater risk-taking and instability as banks are pressured to seek appropriate returns on investment. In addition, a binding leverage ratio could discourage banks from holding assets which provide low return relative to the risk, such as lending to SMEs or project finance, even although these types of investment are crucial for growth in the “real” economy. This could be especially problematic in Europe, where corporate financing is heavily dependent on bank lending. European SMEs, which constitute a majority of the economy/economic growth in many European countries, are particularly likely to be affected. A large number of these European SMEs have only restricted access to capital markets and could struggle to find alternatives to bank loans in order to finance their business/growth.

- **Decreased liquidity.** Considering that a binding leverage ratio may have the unintended impact of encouraging banks to invest in higher-yield, higher-risk assets, and banks may end up holding no more than the bare minimum amount of high quality liquid assets (HQLA) required under liquidity coverage ratios.
• **Decreased trade finance.** Given that trade finance does not receive preferential treatment in the leverage ratio proposal (the credit conversion factor is 100%, which is not aligned with reality), banks may refrain from engaging in large-scale trade finance activities, also because these activities are generally not well rewarded. This could have deleterious effects for international development.

• **Cumulative side-effects.** Measures to set a binding leverage ratio should not be considered in isolation from the myriad of other financial regulatory measures being proposed and introduced since the 2008-09 global financial and economic crisis. The cumulative impacts of these various measures being introduced at the same time, which diverge from or gold-plate the internationally agreed regulatory programme, could significantly damage economic growth. Comprehensive analysis at the global level of the cumulative impacts of different regulatory approaches is needed.

### Directions for more balanced financial regulatory approaches

BIAC calls for any regulations to be clear-cut, designed in co-operation with the private sector, and harmoniously implemented for a genuinely level playing field.

Due attention should be given to a **risk-weighted assets approach.** This should effectively capture risk profiles and accommodate differences in local specificities and risk appetites, but also provide a rigorous framework by subjecting banks to numerous imposed parameters and test compliance models. Ratios should be calibrated carefully to avoid creating negative repercussions, taking full account of different business models. Within this framework, supervisors should play an active role in overseeing risk management and setting standards.

We strongly recommend the OECD to take the above considerations into account when developing its advice on a leverage ratio. More generally, there needs to be **greater balance between financial stability, economic growth and returns on investment.** A comprehensive view is needed that takes into account not only a leverage ratio, but also the multiple other regulatory measures being phased in, and which also considers not only the possible impacts on the finance sector, but also the knock-on impacts for the non-financial sectors of the economy.