Basel III and beyond

Deleverage take two: making sense of the revised Basel III leverage ratio

The leverage ratio has emerged from the shadows following the Basel Committee's launch of consultations on a revised new global leverage ratio framework and the UK Prudential Regulatory Authority's announcement of an accelerated timeline for implementation. What are the implications for regulatory capital demands, bank funding and business strategy?

Here, we summarise the key points raised during presentations and roundtable discussions at September's Basel III breakfast briefing for bankers, which was hosted by PwC.

Having spent several years primarily looking at bank capital through the lens of capital ratios based on risk-weighted asset (RWA), the renewed focus on the leverage ratio has led to a significant shift in the goal posts.

Banks will now have to juggle the three regulatory measures of the Common Equity Tier One (CET1) ratio, Liquidity Coverage Ratio (LCR) and Leverage Ratio (LR). Each has its own distinctive and potentially conflicting implications for the business mix, the kind of assets institutions need to hold and how this affects pricing and profitability. The challenge will be compounded by the differences in regulatory capital and liquidity rules in different territories.

So what does the Basel Committee want these proposals to achieve? As the discussions at the briefing highlighted, the Committee's intentions are not immediately clear. It has presented the proposed new framework as a 'simple' and 'transparent' 'non risk-based 'backstop', which would seek to 'restrict the build-up of leverage' through a 'supplementary measure to risk-based capital requirements'[1]. But what's now on the table is much more exacting and far-reaching than the original proposals in 2010. While risk-based capital is still seen as the most coherent way to regulate capital adequacy, the LR may actually emerge as the 'front stop' capital measure, which could undermine many other aspects of Basel III.

Model risk

Rather than simply seeking to restrict the build-up of leverage, it would appear that the backstop is also designed to address concerns that either the bar for the CET1 ratio may be set too low or that risk may not be adequately reflected in RWA model results. Participants questioned whether additional capital to cover model risk is necessary as any gaps should already be addressed by Basel responses on RWA, supervisory review and existing capital buffers. Independent of underlying motivation, there is a clear need for banks and supervisors to strengthen confidence in RWA model results.

Unintended consequences

There are concerns over the extent to which the proposed framework would impose a 'tax' on the safest balance sheets (e.g. institutions primarily focused on high quality residential mortgages or other collateralised lending).

The LR may even encourage banks to take on more credit and liquidity risk as there is no risk weighting in this blanket charge. It may also provide banks with an incentive to maintain their buffers of cash-like liquidity assets at the minimum permissible level.

1 Revised Basel III leverage ratio framework and disclosure requirements – consultative document', published by the Basel Committee on Banking Supervision, Bank for International Settlements, 26.06.13

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A further result may be to accelerate the shift of bank assets to the shadow banking sector, which could contribute to a build-up of systemic risk in the less regulated non-banking sector.

Participants also voiced concerns over the limited recognition of collateral held against derivatives and the netting arrangements for securities financing transactions (e.g. repos). This raises questions over product pricing and could lead to an increase in demand for wholesale funding from larger international groups.

Capital shortfall

What is clear is that, if the proposed new LR is not recalibrated to align on average with the target CET1 ratio, it will significantly increase the amount of equity capital banks will need to hold or exposures they may need to shed. A rough evaluation of recently published studies and analyst commentaries indicates that there could be an aggregate equity capital shortfall of $200-250 billion in the US and Europe, if the proposed ratio were to be applied to current balance sheets. The options for closing the gap fall into four main buckets – consultation and lobbying ('fight it'), technical and business mitigation ('dodge it'), asset deleverage ('flog it') or financial deleverage ('fund it') – see Figure 1.

Figure 1

Market responses

De-leverage take 1	De-leverage take 2
Fight it (Lobbying)	***Limited scope*** Maybe some concessions on liquidity buffers and cash collateral
Dodge it (Technical mitigation; business mitigation)	***Limited scope*** Some scope for BS compression but simple catch-all measure hard to escape
Flog it (Asset de-leverage)	**Limited scope** Barrel already scraped clean, and prime targets are unappealing
Fund it (Financial de-leverage)	**Balancing figure** Capital restructuring; profit retention; new equity issuance

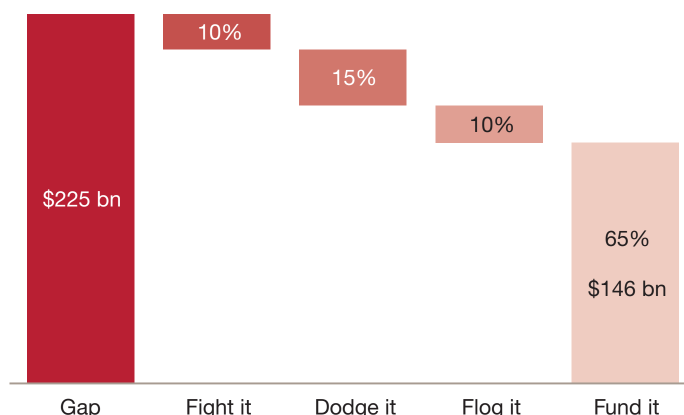
As Figure 1 suggests, there may be some scope for refinements to the proposals in areas such as the treatment in the exposure measure for high quality liquid assets, the treatment of cash collateral, credit derivatives and various other risk mitigation structures. Banks can also look to reduce their LR assets by cleaning up their balance sheets effectively, working harder at netting and perhaps rationalising trade booking and legal structures.

Asset deleverage is a further option, and there is some of this already in the pipeline in the shape of RWA reduction. But the steps in place may need to be adjusted to ensure they balance RWA and leverage priorities. Some banks have announced that they will reduce liquidity buffer assets. Given how much asset deleveraging has already taken place in the wake of the financial crisis, further deleveraging might erode banks' ability to generate capital organically or trigger damage to the wider economy – particularly where the economic recovery is fragile.

This leaves equity raising and profit retention to make up the rest of the shortfall. Figure 2 illustrates what proportion of the gap can realistically be closed by reducing assets (the denominator in the ratio) and how much therefore will be left to financial deleverage (the numerator).

Figure 2

Market responses – closing the gap



The roundtable discussion on this question suggested that the 'fight it' estimation in Figure 2 is perhaps overly optimistic (5% was felt to be more realistic), but that there may be more scope to 'dodge it' (20% was the general feeling). But there was a general acknowledgement that the bulk of the gap will still need to be closed through new equity issues and therefore one way or another investors will need to be brought on board.

The roundtable discussions highlighted grounds for optimism on this front. Confidence is building in many developed market economies and banks are returning to profitability. As bank valuation multiples begin to recover, we could see renewed investor interest. There would certainly be first mover advantages for banks that seek to raise funds ahead of the pack, though this is tempered by the continuing uncertainty over where the leverage proposals will eventually land.

Impact on returns

With financial de-leverage, many see the main fly in the ointment as the potential dilution of return on equity (RoE), even though the steps taken to strengthen capital ratios through asset deleverage and de-risking are reducing the cost of equity (and hence required RoE). While investors have already lowered their RoE expectations for banks from the high to mid-teens, many bankers question how much more dilution investors will accept.

In any event, in responding to the LR, banks will need to make sure that investor expectations for future returns are effectively managed.

Key considerations

So what are the key considerations for banks as they finalise their responses to the consultations and prepare for the implementation of the new leverage ratio? Drawing on the roundtable discussions, we have drawn up a list of five key priorities:

1. Press for globally consistent implementation of the regulation and a clear articulation from regulators on how the leverage ratio and risk-based capital ratios are intended to interact.
2. Highlight the potential for unintended consequences by major business line and product. This includes the impact on relatively safe balance sheets on the one side and potential increases in credit and liquidity risk on the other.
3. Be proactive and explain the consequences to investors and analysts. Many may be concerned about the impact on RoE, so it will be important to explore their expectations and how these fit with the bank's response to the new framework and its impacts on the cost of capital.
4. Invest in improving performance management – it will be important for banks to understand the interaction between the leverage, capital and liquidity ratios at a granular level, and ensure key functions (risk, finanace, treasury, the business) work together to optimise business performance with reference to all three.
5. Recognising that the LR is there in part to mitigate RWA model risk, it remains for banks to strengthen the reputation of RWA models – confidence in the CET1 ratio is fundamental to the banking industry, investors and supervisors alike. This requires collaboration and rebuilding of trust between supervisors and banks.

PwC is helping a range of banking and capital markets businesses to get to grips with the practicalities of Basel III. If you would to know more about the leverage ratio provisions and how they will affect your business, please call your usual PwC contact or one of the Basel team leaders listed here:

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