

Matt Levine writes: Ever since about mid 2008, when everyone had a massive panic about bank capital, there has been a community of people who wanted to ignore the Basel Committee on Banking Supervision, and their “Tier One Ratio” (based on equity divided by “risk weighted assets” or RWA). Instead, people like Anat Admati or Andy Haldane have suggested that we should just take the equity in the balance sheet, and divide it by the assets to get a “leverage ratio” without any of this complicated risk weighting stuff.

Are they right? In my opinion, yes to the extent that they want to look at the leverage ratio, but very much no to the extent that they want to get rid of risk weighting. It’s true that risk weighted assets and the Basel framework have gone badly wrong in the past and even contributed to some failures. But to take that as a reason for throwing the whole system away is not helpful.

MYTH—Leverage is a “simple” and objective calculation

FACT—Only if you think that calculating a bank balance sheet is simple and objective

A balance sheet is fundamentally not a measure of risk, or even really of financial condition and ownership. It is what the name implies—it is the cumulative record of the transactions carried out in the other financial statements, which ensures that the debits and credits “balance”. Balance sheets often don’t contain important items like undrawn overdrafts, potential future derivatives liabilities, guarantees and so on. Balance sheets are still very much a matter of judgement as to what sorts of things can be considered certain or quantifiable enough to put them in the balance sheet.

Historically, auditors have done what I would call a pretty reasonable job in making these decisions. But historically, the size of the balance sheet has not been a particularly contentious matter. If you turn it into the basis for the most important regulatory ratio there is, then you’re putting more pressure on this relationship, and you can expect that pressure to show up on the auditors.

MYTH—Leverage is a more conservative standard than RWA

FACT—Unless you make major adjustments to the “simple” leverage ratio, it misses whole categories of risk.

How much capital should a bank set aside to cover the risk of having to make a massive legal settlement for LIBOR manipulation? How much to cover the variability of trading P&L? How much to cover “wrong way risk”, The Basel Committee’s adjusted leverage measure (a proposal, which they’re in the process of finalising) addresses all these questions, but it isn’t a simple measure.

This matters, of course, because it’s related to the previous point. Sometimes banking reformers make a nod in the direction of derivatives by saying that they want “all off-

balance sheet risks taken into account”. But they never say what they mean by this, because they can’t. Risks faced by a big bank are not simple. a

MYTH—Leverage ratios can’t be “gamed” by the banks.

FACT—Leverage ratios are very often gamed

A useful way of thinking about a “simple” leverage ratio is that it is a risk-weighted asset measure with a very specific weighting scheme—a weighting of 0% for anything that you can get off the balance sheet and 100% for everything else. When you think about it in these terms, it’s easy to see what the biggest incentive for a bank is when it’s regulated according to balance sheet leverage—to try and get off-balance sheet treatment for things that don’t really deserve it.

If and when RWA calculations go wrong, you can always look at balance sheet leverage as a backstop. If the leverage ratio is miscalculated, then this means that the financial statements themselves have been corrupted, and there is nothing left to help you

MYTH—Risk weighted asset calculations are always fudged and faked by the banks

FACT—No evidence has been found of this despite a dozen studies

The international regulatory authorities suspected in around 2010–11 that there might be some overly aggressive assumptions made in the calculation of risk weighted assets, and so they launched a big exercise in assessing their comparability. There have now been something like a dozen reports produced by the Basel Committee and by national regulators on this subject, and the results have been fairly consistent. First, there is variability in the RWA assigned to assets. Second, that the biggest driver of that variability is differences in the way in which the supervisors themselves have drawn the rules up. Third, there is really almost no evidence of systematic gaming of the system. In the vast majority of cases, the standard deviation of the capital requirements on a given portfolio has been around a third of the mean. And there is one real statistical tell-tale—as the exercises have progressed to include more and more portfolios, the variance has tended to decrease as a proportion of the average. This is what you’d expect to see if the variation was being driven by random errors. If the RWA were being systematically and intentionally miscalculated, you’d expect to see the opposite result—the errors wouldn’t cancel each other out, because they would all be made in the same direction.

There are two, related, legitimate reasons why the leverage ratio is a big step forward.

First, it acts as a checksum. Most of the things that a bank might do to fool the risk-weighted asset ratio would have the effect of making the balance sheet bigger and the leverage ratio worse. Most of the things that a bank might do to fool the leverage ratio

would have the effect of piling up tail risks and making the risk-weighted assets ratio worse. It's comparatively difficult to think of measures which can fool both ratios at the same time.

Second, and related to this, it helps to avoid "corner solutions". What you don't ever want to do in banking is to create the impression that a particular line of business has a zero capital requirement. If you have more than one ratio, you have much less chance that any activity is going to get a very low capital charge.

So that's the real point of the leverage ratio. It's a good idea. But steer clear of anyone who treats it as if it might be a panacea. And definitely, the moment that the word "simple" is used to describe a bank leverage ratio, you should mark the speaker down as somebody who has never really thought hard about a balance sheet in concrete rather than abstract terms in his or her life.