Bloomberg

March 12, 2013 | bloomberg.com

News

Banks' Debt Addiction Said to Face Scrutiny at Basel Group

A planned international limit on bank indebtedness will be on the agenda of every meeting of the Basel Committee on Banking Supervision this year as regulators seek to wean lenders off their addiction to debt, according to three people familiar with the talks.

Regulators are preparing to fight lenders over the details of the so-called leverage ratio as they seek to toughen rules on the minimum amount of capital they must use to back their investments. The Basel group, which brings together supervisors from 27 nations, will meet in the Swiss city tomorrow, according to the people, who asked not to be identified because the meetings are confidential.

Concerns over how banks calculate reserves has led U.K. bank regulator Adair Turner and U.S. Federal Deposit Insurance Corp. board member Jeremiah Norton to call for tougher leverage ratios. Global supervisors in 2010 included a draft leverage ratio in an overhaul of rules, known as Basel III, drawn up in response to the financial crisis that followed the collapse of Lehman Brothers Holdings Inc.

"Early on, banks did not see it as such a big danger, or as a priority for lobbying, because it looked less likely to be implemented in the EU than other parts of Basel III," Philippe Lamberts, the lawmaker leading the work on the Basel III rules for the European Parliament's Green group, said in a telephone interview.

Leverage ratios force banks to hold capital equivalent to a percentage of the value of their assets. Such measures are simpler than standard capital requirements as they don't give banks any scope to take into account the riskiness of their investments when calculating the reserves they must hold.

'LOST CONFIDENCE'

Investors have "lost confidence" in banks calculations of the riskiness of their assets, Andrew Bailey, head of banking supervision at the Financial Services Authority, told U.K. lawmakers earlier this year. "They don't understand it."

A review of how banks calculate the risks they face on assets they intend to trade found "material variation" across the industry, Stefan Ingves, the Basel committee's chairman, said in a speech in Cape Town in January. Regulators could respond with tougher disclosure rules or "limitations in the modeling choices for banks," he said.

Under the draft Basel plan in 2010, banks would have to hold so-called Tier 1 capital equivalent to 3 percent of their assets, so capping a lender's debt at no more than 33 times those reserves.

NATIONAL REGULATORS

Settling the details of the leverage ratio is a priority for the Basel committee because of a Jan. 1, 2015, deadline for large banks to begin disclosing how well they measure up to the rule. The Basel leverage ratio would be a minimum standard for banks from 2018, with national regulators free to set tougher rules.

Basel regulators are unlikely to change the fundamentals of the leverage rule compared with the 2010 draft, according to the people. The final version will keep the requirement for banks to hold Tier 1 capital, a measure of financial strength, equivalent to 3 percent of their assets, they said, which was a compromise between different regulators on the committee.

Work on the measure should "be largely completed this year," Ingves said in a speech in Basel today. The group's activities will be focused on defining how assets are captured by the leverage ratio, he said.

STRICTER RATIO

The U.K. parliamentary commission scrutinizing a bill designed to make Britain's banks safer this week called for regulators to be given the power to set a stricter leverage ratio than the one included in Basel III.

Andrew Haldane, the Bank of England's executive director for financial stability, and John Vickers, who led a review of the banking industry in the U.K. have also called for leverage caps lower than 33 times lenders' equity. The FDIC's Norton said last month that U.S. banks should have to meet a tougher leverage rule than the draft international standard.

The temptation for banks to boost their reserves through changes to risk calculations, rather than real steps to raise capital, could be countered by a strong leverage ratio, said Lamberts, the European lawmaker. One example of this is how German lender Commerzbank AG sought to meet EU capital rules in part by adjusting its risk calculations, rather than simply raising fresh reserves, Lamberts said.

INTERNAL MODELS

"Details that are coming to light about how banks misuse their internal models, for example when Commerzbank said it would make up half of a capital shortfall through changes to its models, show the need for this kind of rule," he said.

Commerzbank (CBK) was one of more than 60 lenders told by the European Banking Authority to hold capital equivalent to 9 percent of its risk-weighted assets.

Committee discussions will focus on how to make sure the measure captures the risks banks are taking, including from derivatives and off-balance sheet activities, the people said.

Banks have criticized the design of the leverage ratio, saying it would penalize lenders that carry out many small transactions with different counterparties because it doesn't consider the collateral banks take on to reduce risk.

"The Basel committee really needs to look at how the rule is going to affect different business models," said Jouni Aaltonen, a director at the Association for Financial Markets in Europe, a banking lobby group. The plans would mean "client-facing commercial banks are hit harder by the rule than inter-bank broker-dealers."

ACCOUNTING STANDARDS

Divergences in accounting standards between the U.S. and the rest of the world also complicate attempts to create a universal standard. Under U.S. rules, banks' exposure to derivatives is calculated on a net, rather than nominal, basis, which could make it easier for them to hit target leverage ratios.

This so-called netting gives lenders scope to reduce the size of their balance sheets by allowing them to subtract what they are potentially owed on contracts they have bought, from obligations arising from derivatives contracts they have sold to the same company.

The Basel committee has sought to overcome this problem, and ensure that banks follow a common approach, by drafting its own netting rules for the leverage ratio.

"The challenge for setting leverage ratios is the question of how you account for derivatives," Kathryn Dick, managing director of Promontory Financial Group LLC, a financial-services consultant, said in an interview in London.

BANK CAPITAL

While U.S. regulators already require large lenders to meet a leverage ratio, such a standard isn't part of the EU's bank capital requirements.

Some central bankers may be concerned that a stricter leverage ratio may damage an economic recovery, said Patricia Jackson, head of prudential advisory at Ernst & Young LLP in London and a former Basel committee member.

"There is an appetite among some regulators in the U.K. for a tougher leverage ratio, but I think on the continent people are increasingly worried about the economic impact of the rule," Jackson said in an interview.

"An internationally comparable leverage ratio is anything but simple to design," Wayne Byres, the Basel Committee's secretary general, said in a speech in Portugal last year. "Believe me, it is not easy."

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