Leverage Limits
Why And How Much?

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A Speed Limit, Not A Steering Wheel

- Leverage requirements are not a risk model.
- Leverage requirements reduce the costs of errors in your risk models.
  - High leverage amplifies profits, but also the loss impacts of errors in your risk model predictions.
- Risk modeling is inherently very uncertain. Arbitrage pressures create a disastrous situation.

Only Leverage Predicts Bank Failure

- Gross leverage ratios predict bank failure. Risk weighted capital ratios do not.

- At least seven separate empirical studies over the past four years find this.
  – IMF, Bank of England, Wharton School, OECD, etc.

- Will Basel III will be different? Do you want to bet $13 trillion on it?

Calibrating a Leverage Ratio

- 3 percent?
  - “An estimated half of the covered BHCs that were BHCs in 2006 would have met or exceeded a 3 percent minimum supplementary leverage ratio at the end of 2006, and the other half were quite close to the minimum”
- 5 percent?
  - “The average ratio of total capital and reserves to total assets for the 14 largest OECD countries from 1980 to 2007 is 5.3%....associated with a probability of a systemic crisis of 4.6%”

Calibrating a Leverage Ratio

- 8%? Sheila Bair recommendation.
  - About $400 billion in additional capital by 2019.

- 15-20%? Loss absorbency needed for SPE resolution.

- $200+ trillion in global assets in 2011.
  - Six largest U.S. banks hold about 5 percent of it.
  - Market stress test.

Cost Benefit Analysis?

- Basel CBA full of unrealistic assumptions.
  - No cost of undercapitalization short of failure.
  - No benefit of capital during economic downturns.
  - Required ROE of 15%; no relationship between market ROE (equity risk premium) and capitalization.
  - Full assumed increase in WACC passed on to borrowers in higher spreads.
- Still appears to imply leverage ratio somewhat above U.S. SLR for largest banks.

Need to question ‘tradeoff’

- Empirical evidence for a relationship between leverage and lending spreads?
- Optimal credit growth is a macroeconomic question, not an accounting question.
  - Money supply, leverage spirals.
- Lower leverage means credit relationships more durable, lending higher during downturns, economic volatility lowered.

Leverage Ratio Denominator

- Don’t let risk weighting sneak in through the back door.
- Be very skeptical of exposure netting.
- Netting relies on:
  – Legal procedures + back office operations
  – Bankruptcy exemptions with potentially significant costs for other borrowers, wider economy.
  – Modeling assumptions for future exposures.