With emphasis on leverage ratios by the market, does European banking have to change?

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Goal of this contribution

- To connect different themes together
- Taking the example of the leverage ratio - what is driving thinking re proportionality?
- What the implications are for the structure of European banking
- What the EU can do about it

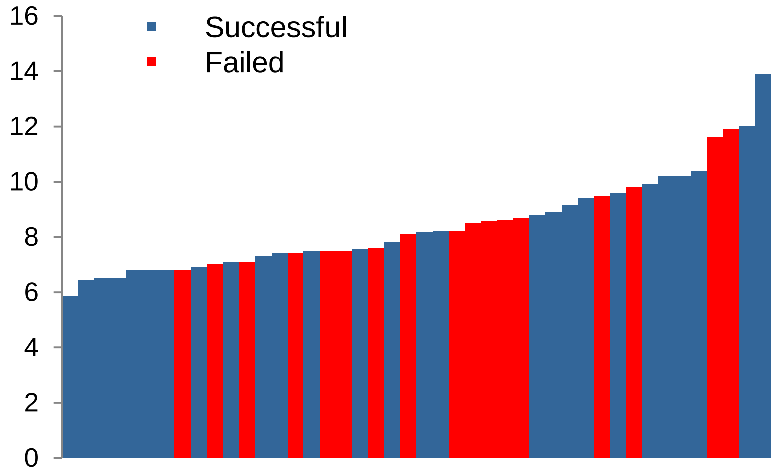
Following the different papers on bank risk asset ratios v the leverage ratio – the belief is now embedded that leverage is a more important and comparable measure of bank risk.

- Recent quote from market commentator (Market Realist)
- ‘Leverage ratios are financial regulators favourite yardstick…European banks have higher leverage than their US counterparts.. this makes European banks more vulnerable to downturns than US banks….’
- Even though their risk weighted asset ratios are higher than those of the US banks

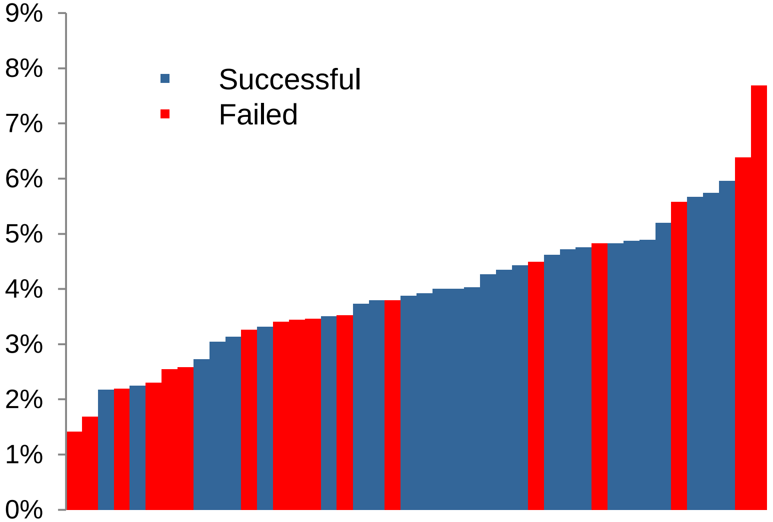
All the studies of risk weighted assets against leverage (including the Dog and Frisbee) compare Basel 1 and the leverage ratio – so compare a leverage ratio with a quasi leverage ratio – none look at Basel II introduced in 2008 – and are driven by the inclusion of securities players

44 commercial banks (excluding investment banks) drawn from top 100, 17 clear failures and 27 clear survivors

Tier 1 Basel 1 Capital Ratios (%)



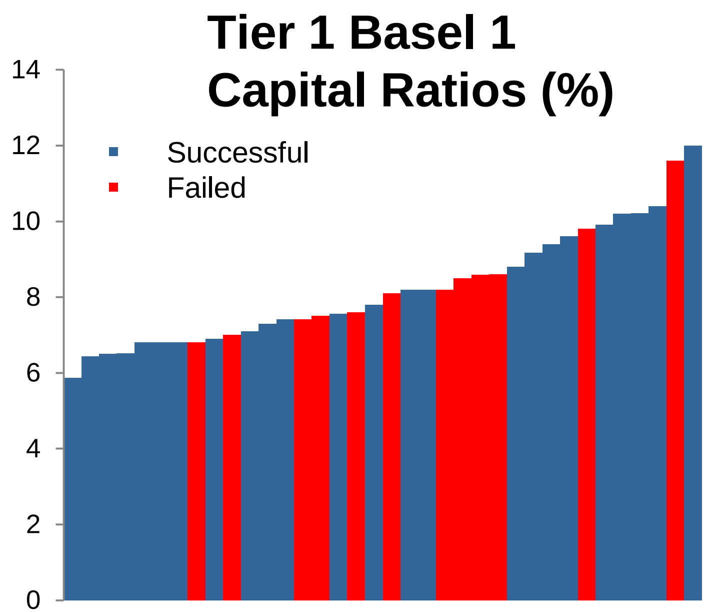
Leverage ratio (%)

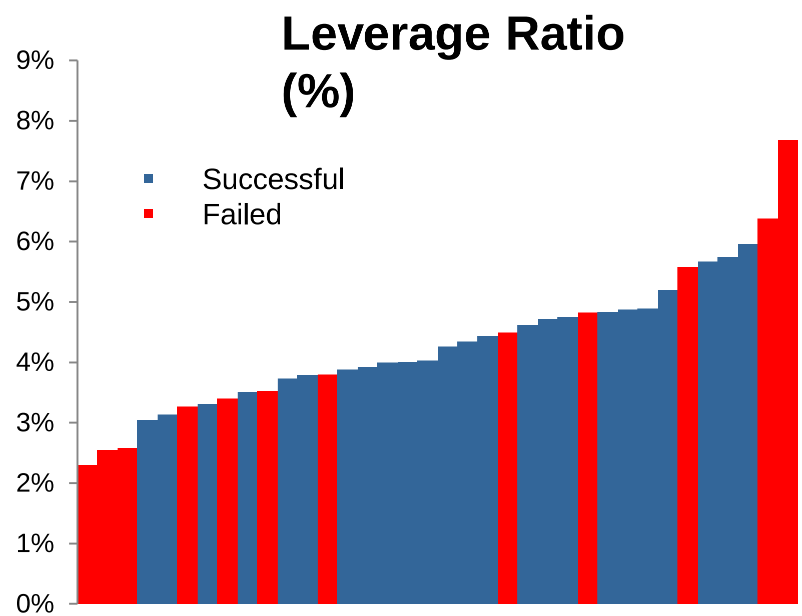


Basel I had an 8% capital requirement for all private sector exposures except for mortgages and limited allowance for collateral

Removing banks with less than half income from net interest income - 36 banks of which 12 failed

This reduces the dominance of the VaR calculations as the driver

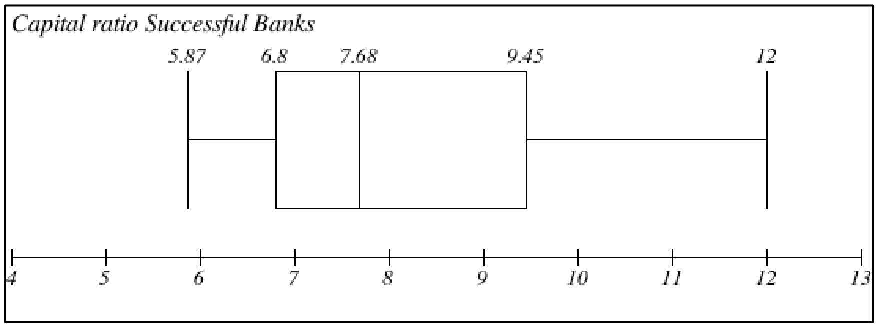


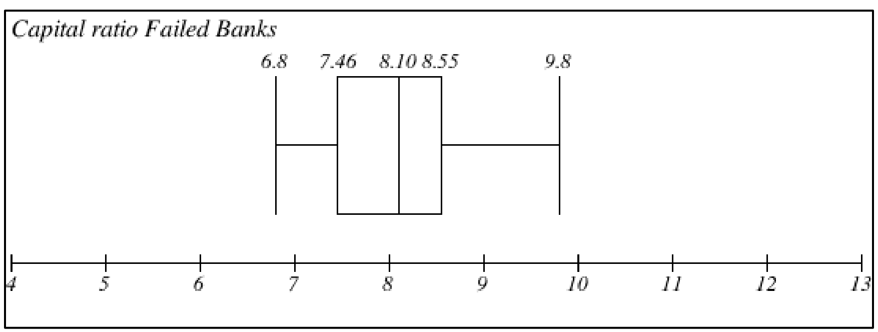


The relationship between either measure and failure is minimal

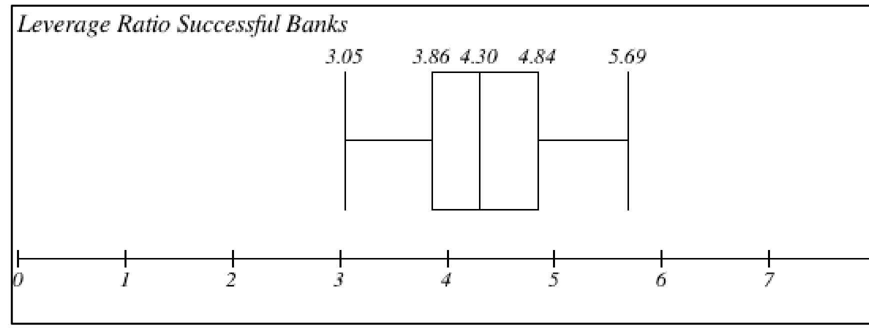
Box plots even after removal of outliers

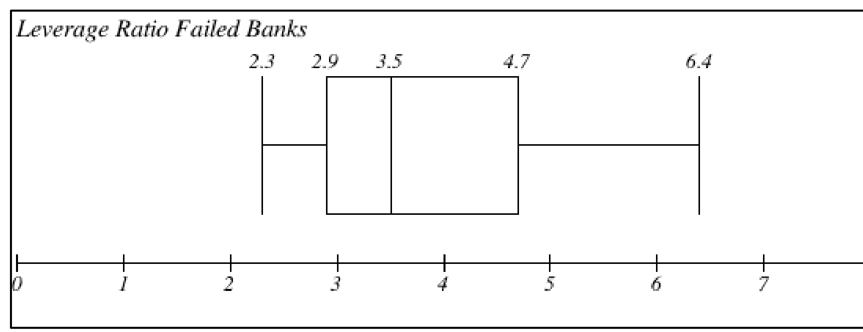
Tier 1 Capital Ratio





Leverage Ratio





How comparable are the leverage ratios of European v US banks?

- Composition of balance sheets quite different
  - Around 13% of assets in EU banks are in high quality mortgages – penalised under a leverage ratio if it bites – in the US these are sold to federal agencies and securitised
  - Lending to large corporates is important in Europe
  - These are the two main lending categories which result in lower risk weights under the IRB.

This undermines the comparability of the leverage ratio between European and US banks

The effect is potentially to penalise the European banking model

- High capital for mortgage books under the leverage ratio cannot be remunerated
  - depends if it is a backstop behind the risk based requirements, and if market pressure pushes higher leverage ratios.
- Investors pressing banks for increased ROE (80% of banks in 51 bank 29 country survey)
- Likewise lending to high quality corporates cannot be remunerated – at the leverage ratio capital levels

- Revitalisation of the securitisation market for mortgages in Europe would help

Loss of investor confidence in securitisation

- Globally there has been a loss in confidence of investors in the market
- Europe has been affected even though loss rates on European RMBS was far less
- "Standard and Poor's default rates for all European structured finance issues of 0.95% between mid 2007 and end of 2010 compared with 7.7% for all US structured finance issues"[1].
- Most securitisation issues in Europe since crisis on book of ECB.

European securitisation activity (Euros)	
2006	2012
460bn	72bn

A different story in the US

- Agencies are playing a crucial role

- In 2006, the agency mortgage backed securities (MBS) accounted for 27% of originations in the MBS market

- But now relatively few non- agency RMBS

Europe needs to look at success of agencies and replicate it

- Not replicate the agencies

- But the characteristics of the market
  - Lower risk - Supported by credit guarantees from GSE, but also strict criteria on loans in pools. E.g. maximum LTVs
  - Standardisation
  - Simplicity
  - Transparency – Less important in US because of credit guarantee, but more important in Europe because there would be no credit guarantee
  - Trading structure - platforms
  - Capital requirements reflecting lower risk

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EU proposals

- Go part way in this direction but not far enough

  Need to consider quality filters on loans in pools –or credit insurance
  Standardisation
  Simplicity
  Transparency
  Trading platform

- Not enough focus in proposals on high quality
- Nor standardisation

- Also not clear on simplicity

Reference

- 1) Patricia Jackson ' The Outlook for Shadow Banking, Including the EU Securitisation Proposals' Bancaire et Financiere November 2015

Thank you