Chapter 6

Credit Risk Measurement, Leverage Ratios and, Basel III: Proposed Basel III Leverage and Supplementary Leverage Ratios

ABSTRACT

The Basel III Leverage Ratio, as originally agreed upon in December 2010, has recently undergone revisions and updates – both in relation to those proposed by the Basel Committee on Banking Supervision – as well as proposals introduced in the United States. Whilst recent proposals have been introduced by the Basel Committee to improve, particularly, the denominator component of the Leverage Ratio, new requirements have been introduced in the U.S to upgrade and increase these ratios, and it is those updates which relate to the Basel III Supplementary Leverage Ratio that have primarily generated a lot of interests. This is attributed not only to concerns that many subsidiaries of US Bank Holding Companies (BHCs) will find it cumbersome to meet such requirements, but also to potential or possible increases in regulatory capital arbitrage: a phenomenon which plagued the era of the original 1988 Basel Capital Accord and which also partially provided impetus for the introduction of Basel II. This paper is aimed at providing an analysis of the recent updates which have taken place in respect of the Basel III Leverage Ratio and the Basel III Supplementary Leverage Ratio – both in respect of recent amendments introduced by the Basel Committee and proposals introduced in the United States. As well as highlighting and addressing gaps which exist in the literature relating to liquidity risks, corporate governance and information asymmetries, by way of reference to pre-dominant based dispersed ownership systems and structures, as well as concentrated ownership systems and structures, this

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paper will also consider the consequences – as well as the impact - which the U.S Leverage ratios could have on Basel III. There are ongoing debates in relation to revision by the Basel Committee, as well as the most recent U.S proposals to update Basel III Leverage ratios and whilst these revisions have been welcomed to a large extent, in view of the need to address Tier One capital requirements and exposure criteria, there is every likelihood, indication, as well as tendency that many global systemically important banks (GSIBS), and particularly their subsidiaries, will resort to capital arbitrage. What is likely to be the impact of the recent proposals in the U.S.? The recent U.S proposals are certainly very encouraging and should also serve as impetus for other jurisdictions to adopt a pro-active approach – particularly where existing ratios or standards appear to be inadequate. This paper also adopts the approach of evaluating the causes and consequences of the most recent updates by the Basel Committee, as well as those revisions which have taken place in the U.S, by attempting to balance the merits of the respective legislative updates and proposals. The value of adopting leverage ratios as a supplementary regulatory tool will also be illustrated by way of reference to the impact of the recent legislative changes on risk taking activities, as well as the need to also supplement capital adequacy requirements with the Basel Leverage ratios and the Basel liquidity standards.

INTRODUCTION

The first consultative paper on a new capital adequacy framework, which was issued by the Basel Committee on Banking Supervision, introduced the “three pillar” model which encompasses the minimum capital requirements, supervisory review and market discipline – “as a lever to strengthen disclosure and encourage safe and sound banking practices” (BIS, 1999a). As well as the criticism related to the fact that it rewarded risk lending, the fact that “capital requirements were just reasonably related to banks’ risk taking activities and that the credit exposure requirement was the same regardless of the credit rating of the borrower,” (Saidenberg & Schuermann, 2003) a general criticism of Basel I relates to the fact that it promoted capital arbitrage. Such capital arbitrage being attributed to its wide risk categories which provided banks with the liberty to “arbitrage between their economic assessment of risk and the regulatory capital requirements” (BIS, 1999b).
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