Excluding central bank exposures from euro area leverage ratio a logical move

The ECB's decision to allow banks under its direct supervision to exclude central bank exposures from leverage ratio calculations until 27 June 2021, the day before the ratio becomes binding, is consistent with its pragmatic approach.

The temporary measure is aimed at easing implementation of euro area monetary policy and includes deposits at the central bank as well as coins and banknotes. The move brings euro area banks into line with the UK (where the leverage framework has been in place for some time) and Switzerland.

Finma temporarily excluded central bank deposits from Swiss banks' leverage ratios at the end of March, initially for three months. But the exemption was later extended to 1 January 2021. The UK PRA exempted such exposures in 2017, at which time it also raised the leverage ratio floor for UK banks to 3.25% from 3.00% as a counterbalancing measure. Large UK banks are also subject to an additional leverage ratio buffer.

The euro area leverage ratio floor that becomes binding on 28 June 2021 is 3%, although the ECB noted that this will require an upward recalibration if the deadline for excluding central bank exposures needs to be extended.

In the circumstances created by the effects of Covid-19, having the principal supervisor for the euro area's largest banks declare exceptional circumstances to enact this temporary measure via the quick fix amendment to the Capital Requirement Regulation was unsurprising.

Between the PEPP and the latest TLTRO 3 round, the amount of excess liquidity in the system has ballooned. So has the use by banks of the ECB deposit facility. This excess liquidity ends up being parked with the central banks.

The leverage ratio is meant to be a non-risk-based backstop to bank solvency to allay concerns that banks optimising their use of risk models may lead to insufficient capital. Arguing that a bank deposit at the central bank is risk free is hardly a stretch.

The ECB's move is a positive step as euro area banks, including the large investment banks in France and Germany, are seen as lagging US peers on this metric, even if the bald numbers require interpretation.

Based on end-March 2020 data, the ECB said excluding central bank exposures would raise the 5.36% aggregate euro area leverage ratio by about 30bp. "This is important for globally systemically important banks and subsidiaries of foreign G-SIBs, for whom the measure additionally provides relief under the already binding total loss-absorbing capacity (TLAC) requirement," the ECB noted in its press release announcing the new measure.

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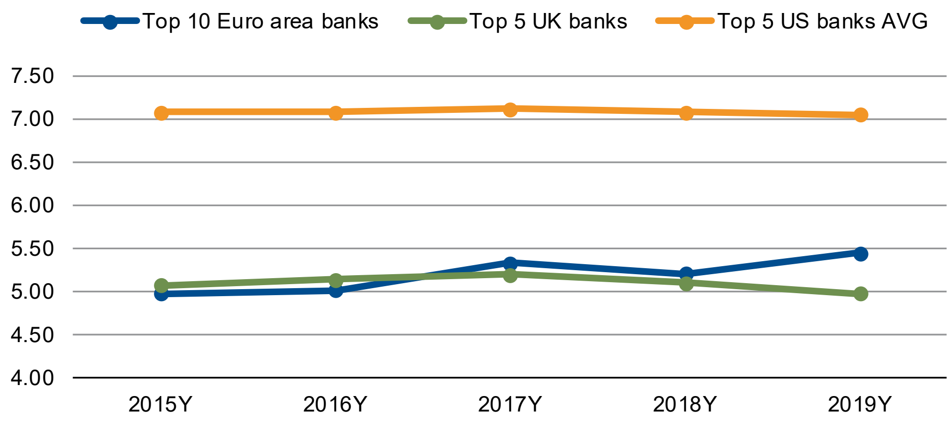
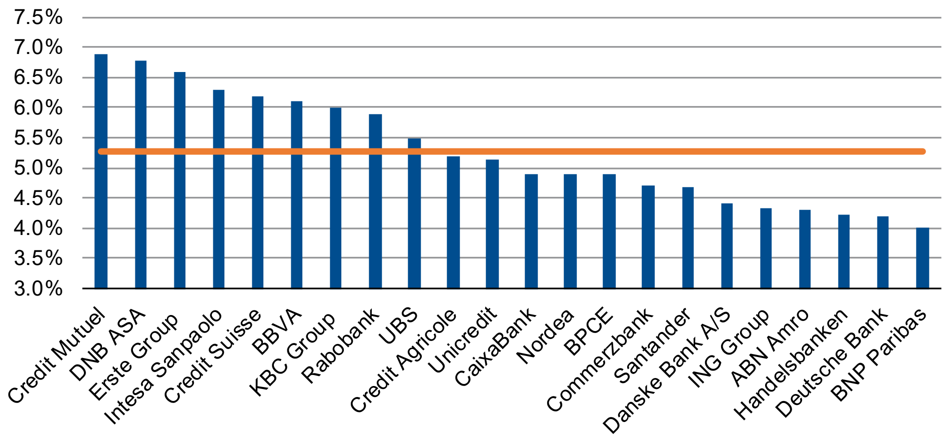
Figure 1 shows that while the aggregate leverage ratios of the top five UK and top 10 euro area banks are close, the ratios have moved inversely since year-end 2018 as the ratio for the top five UK banks declined to year-end 2019, in contrast to their euro area counterparts. This reverses the tendency for UK banks to gold-plate their solvency and other regulatory metrics.

Figure 1: Leverage ratio comparison: US, UK, and EA banks



Source: Scope Ratings

Figure 2: Leverage ratios: selected EEA banks (excl. UK)



Data as of H1 2020 except Credit Mutuel (YE 2019).
Source: Scope Ratings

On the clear differentiation between the leverage ratios of leading US banks versus UK/euro area banks, the gap demonstrates that as relevant as the ratios might be for investment banks with large trading and derivatives books, they do not otherwise differentiate for risk: a classic example being the prime mortgages that sit on the books of the EU banks while US banks are heavily engaged in risky consumer lending. Within the EU, it’s a similar story with the emerging market exposures of banks like Erste Bank, BBVA and Santander relative to banks with a much heavier European skew.

Franco-German initiative seeks nuanced Basel III avenues

One as-yet unresolved question revolves around what regulators do about risk-weighted asset floors from 2023. The French and German finance ministries have circulated a joint paper with regard to Basel III implementation that reiterates a need for Europe to have a robust banking system in a position to extend credit to the economy but which is not held back by higher capital requirements. The paper seeks ways to maintain the variety of European banks' business models and respecting the notion of a level global playing field.

Floored stack capital outputs prudentially sound

The Franco-German paper suggests introducing the capital output floor as a "floored stack to risk-based capital requirements" in the same way the leverage ratio already operates. This, the paper says, is prudentially sound (i.e. achieves the Basel objectives) and is compatible with the political mandate. "Banks will have to meet the output floor requirement comprising strictly the requirements specified in the Basel standard, at the same time as they would have to meet the leverage ratio," the joint paper notes.

Lower risk weights for financially sound companies

To facilitate continued bank lending in the euro area, specifically regarding the undifferentiated 100% risk-weight applied to unrated borrowers (comprising 75% of the European corporate landscape), the paper suggests a more appropriate risk-weight of 65% for financially sound companies.

More lenient rules for small and non-complex banks

And because the EU has opted to apply the Basel standard to all banks, the paper believes maintaining proportionality should see disclosure requirements for small and non-complex banks reduced. These banks should also be exempt from rules on variable compensation, while the definition of small and complex should exclude derivatives executed for customer hedging.

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