BANK OF ENGLAND

News release

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20 November 2014

Why we need a leverage ratio, and how bank boards might take charge

In a speech to the Oliver Wyman Institute's annual conference on Thursday, Martin Taylor, an external member of the Financial Policy Committee, addresses two subjects: the role of the leverage ratio in the UK's capital framework for banks, and the corporate governance of financial institutions, in particular, the over-development of board committees.

Martin considers four questions in relation to the leverage ratio: Why is it needed in addition to risk-weighted capital ratios? How should it be calibrated? Why are the FPC's proposals not simpler? And what type of capital is appropriate to count towards the leverage ratio?

On the first question, Martin cites two reasons why UK banks should be held to a leverage ratio in addition to risk-based measures of capital adequacy. First, risk-weighted measures are not infallible: they rely largely on models, which are imperfect, and may also be inherently procyclical because risk weights tend to rise as economic circumstances deteriorate. Second, unlike the leverage ratio, risk-weighted measures do not usually capture a bank's entire balance sheet, only a proportion of it.

"We're trying to give ourselves more ways of reading the financial weather. Come to think of it, wasn't it always very strange to believe that all that is known about the risk characteristics of an immensely complex bank could be boiled down to a single ratio?"

On the question of calibration, Martin makes the point that the FPC has aimed as far as possible for a position of "complementary neutrality" between the leverage ratio and the risk-weighted capital ratio. "Which will bind first ought then to depend on the business models individual firms pursue."

On the third question, Martin's view is that if the two ratios are to be genuinely complementary, and if the risk-weighted capital ratio is to vary over time as envisaged in the new international regulatory architecture, it is necessary that the leverage ratio should vary as well, or perverse incentives will come into play.

"I think it's fair to say that without this principle of time variance the Committee would be looking to set a much higher…base leverage ratio."

Lastly, in relation to the quality of capital that should count towards the leverage ratio, Martin's view is that Additional Tier 1 instruments carry "a real structural disadvantage", because they only trigger as a consequence of declines in the risk-weighted capital ratio, not the leverage ratio, and it is possible for these to diverge quite sharply if risk weights change, as happened in the run-up to the crisis.

But Martin says he is comfortable with the pragmatic view taken by the FPC to allow AT1 instruments to account for up to 25% of the minimum leverage ratio provided that they have a conversion trigger of 7% or more on a risk-weighted capital ratio basis, and that the time-varying and systemic add-ons are met with proper equity.

Turning to the subject of corporate governance at banks, Martin observes that, in response to governance failures of the past, and in order to operate more efficiently, boards of directors have increasingly delegated important decisions on risk, remuneration, audit, and capital allocation to board committees.

"I believe this efficiency has been bought at a high price in reduced board cohesion. It has got harder – perhaps because some organisations are ungovernably large – for boards to see any sort of big picture. Unable to encompass the blurred outlines of a sometimes ugly reality, individuals take refuge in trivial detail."

In Martin's view, that there are some matters that the board of a bank must have a collective understanding of and take collective responsibility for. These include, whether it understands the model that determines how much capital a bank believes it requires; whether it understands the incentives that underlie the remuneration system, and what behaviours are likely to be encouraged by the way employees are paid. In addition, does the board understand all the different activities in which the organisation is engaged?

Every one of these considerations is too big to delegate to board committees, Martin concludes. "They are quintessentially matters for the whole board, and a board that applied itself to them all properly would not have to worry about spending its next awayday in Pentonville. The board committees, in banking and elsewhere, need to be the obedient servants of the board, not its masters."

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Note to Editors:

The FPC published its review of the leverage ratio on 31 October 2014
http://www.bankofengland.co.uk/financialstability/Documents/fpc/fs_lrr.pdf