Introduction to Bank Regulation: Leverage and Capital Ratio Requirements

Banks generally must comply with a variety of requirements to hold minimum levels of capital. These requirements are designed to create certain benefits (e.g., fewer bank failures, more systemic stability) but impose certain costs (e.g., greater bank funding cost, reduced credit availability). Recent legislative changes have led regulators to propose rules that would alter a number of capital requirements. This In Focus provides a brief overview of these requirements and examines related policy issues.

Background
A bank’s balance sheet is composed of assets, liabilities, and capital. A bank is exposed to potential losses on its assets, and its liabilities subject it to payment obligations to depositors and creditors. Capital instruments—unlike liabilities—generally do not require payment of a specified amount of money at a specified time. Thus, capital gives the bank the ability to absorb losses while continuing to meet its rigid obligations on liabilities and avoid failure. To decrease the likelihood of bank failures and to minimize taxpayer exposure, regulators generally require banks to meet a regulatory ratio requirement—i.e., to hold a minimum level of capital expressed as ratios between items on bank balance sheets.

Current Requirements
Banks must satisfy several different capital ratio requirements. A detailed examination of how these ratios are calculated is beyond the scope of this In Focus. (For a highly simplified example, see Figure 1.) Broadly speaking, capital ratios are one of two main types—a leverage ratio or a risk-based capital ratio.

Leverage Ratio. A leverage ratio treats all assets the same, meaning banks must hold the same amount of capital against an exposure regardless of how risky the exposure is.

All banks must maintain at least a minimum 4% leverage ratio of assets to a capital measure that includes equity, retained earnings, and other loss-absorbing balance sheet items. To be considered “well capitalized”—which lowers a bank’s FDIC assessment fees, among other benefits—a bank must maintain a 5% leverage ratio. Furthermore, 19 large and complex U.S. banks classified as advanced approaches banks must maintain a minimum 3% supplementary leverage ratio (SLR) that uses an exposure measure that includes both balance sheet assets and certain other exposures to losses that do not appear on the balance sheet. Finally, a subset of eight of the largest and most complex U.S. banks classified as globally systemically important banks (G-SIBs) must meet an enhanced SLR (eSLR) requirement of 5% at the holding company level and 6% at the depository level.

Section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (P.L. 115-174) created an option for banks with less than $10 billion in assets to meet a higher leverage ratio—the Community Bank Leverage Ratio—in order to be exempt from having to meet the risk-based ratios described in the following paragraph. Bank regulators have issued a proposal to implement this provision wherein banks below the $10 billion threshold that meet at least a 9% ratio of equity and certain retained earnings to assets and had limited off-balance sheet exposures and limited securities trading activity (among other requirements) would qualify for the exemption.

Risk-weighted Ratio. A risk-weighted ratio assigns a weight—a percentage based on the riskiness of the asset that the asset value is multiplied by—to reflect the fact that some assets are more likely to lose value than others. Riskier assets receive a higher risk weight, and thus banks must hold more capital against these assets.

Figure 1. Simplified Example Calculation

<table>
<thead>
<tr>
<th>Assets</th>
<th>Hypothetical Bank Balance Sheet</th>
<th>Funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Treasuries: $100 (Risk Weight = 0%)</td>
<td>Deposits: $200</td>
<td></td>
</tr>
<tr>
<td>Mortgages: $100 (Risk Weight = 50%)</td>
<td>Debt (bonds): $45</td>
<td></td>
</tr>
<tr>
<td>Commercial Loans: $100 (Risk Weight = 100%)</td>
<td>Capital: $15</td>
<td></td>
</tr>
</tbody>
</table>

Leverage Ratio = Capital / (Treasuries + Mortgages + Comm. Loans)
= $15 / ($100 + $100 + $100)
= $300
= 5%

Risk-Weighted = Capital / ([Treasuries x 0% + Mortgages x 50% + Comm. Loans x 100%] + $10)
= $15 / [($90 + $50 + $100) + $10]
= $15 / $150
= 10%

Source: CRS.

All banks are required to maintain at least a 4.5% risk-weighted ratio of equity and retained earnings, and ratios of 6% and 8% for capital measures that include additional loss-absorbing instruments. (To be considered well capitalized, banks must maintain an additional 2% above the minimum for those measures, raising them to 6.5%, 8%, and 10%, respectively.) To avoid limitations on capital distributions (such as dividend payments), banks must hold an additional 2.5% of high-quality capital on top of the minimum level, called the capital conservation buffer (CCB). In addition, advanced approaches banks could be subject to a 0-2.5% countercyclical buffer that can be deployed by the Federal Reserve (the Fed) if credit conditions warrant increasing capital (the buffer is currently and always has been set at 0%). Finally, the G-SIBs are subject to an additional capital surcharge of between 1%
and 4.5% based on the systemic importance of the institution.

**Broad Policy Considerations**

Because capital absorbs losses, minimum requirements play a more prominent role in prudential regulation. However, prudential regulation involves requirements besides capital ratios, such as liquidity requirements, asset concentration guidelines, and counterparty limits. Some observers assert that if a bank has sufficient capital in place, it should not be subject to some of these other regulatory requirements. However, others believe that the different components of prudential regulation (of which capital requirements are only one) each play an important role in ensuring the safety and soundness of financial institutions and are essential complements to bank capital.

Whether the benefits of capital requirements are outweighed by the potential costs is another debated issue. Capital is typically a more expensive source of funding for banks than liabilities. Thus, requiring banks to hold higher levels of capital may raise banks’ funding costs, possibly affecting the costs and availability of credit. It is possible this would slow economic growth over a period of time. However, no economic consensus exists on this question, because a more stable banking system with fewer crises and failures may lead to higher long-run economic growth.

**Specific Policy Issues**

**Appropriate Role of the Two Types of Ratios.** The exemption from risk-based ratio requirements provided by P.L. 115-174 (and other bills that would make such an exemption even more widely available, such as H.R. 10 in the 115th Congress) reflects an ongoing debate about the prominence that leverage and capital ratios play relative to each other in the regulatory framework.

Some policymakers argue that having both risk-weighted and leverage ratio requirements is important, because each measure addresses certain weaknesses of the other. For example, without risk weighting, banks would have an incentive to hold riskier assets because the same amount of capital must be held against risky, high-yielding assets and safe, low-yielding assets. In addition, a leverage ratio alone may not accurately reflect a bank’s riskiness because a high concentration of risky assets could produce a similar ratio as a high concentration of safe assets.

However, critics of risk-weighted ratios argue their use should be limited. Certain risk weights could potentially be an inaccurate estimation of some assets’ true risk, especially since they are unlikely to be adjusted as quickly as risks might change. Furthermore, banks may have an incentive to overly invest in assets with risk weights that are set too low, or inversely to underinvest in assets with risk weights that are set too high. Some observers believe that the risk weights in place prior to the 2007-2009 financial crisis were poorly calibrated and encouraged overinvestment in risky assets, exacerbating the downturn. For example, banks held many mortgage-backed securities (MBSs) before the crisis, likely in part because MBSs offered a higher rate of return than other assets with similar risk weights. MBSs subsequently suffered unexpectedly large losses.

There is also debate as to whether compliance with a risk-weighted system involves complexity and costs that could benefit larger banks with the resources to absorb the added regulatory cost compared to small banks that could find compliance more burdensome.

**Appropriate Requirements for Large Banks.** As previously discussed, as banks get larger and more complex, they face progressively more stringent capital requirements. These requirements have been implemented because many observers believe that (1) the largest banks pose a relatively higher risk to systemic stability than individual small banks; (2) the largest banks have the resources and sophistication to comply with additional requirements without being unduly burdened; and (3) certain of these banks may enjoy funding advantages due to being “too big to fail” (i.e., investors and creditors do not require returns that fully reflect the risk of the bank’s failure due to a belief that the government would rescue the bank before failure). However, whether these additional requirements are appropriately calibrated is a debated issue.

Some argue that certain requirements that are set at a fixed number, including the CCB and eSLR, are inefficient because they do not reflect varying levels of risk posed by individual banks. In response to this concern, the Fed has released proposals for public comment that would link individual large banks’ CCB requirements with their stress tests results and eSLR requirements with their G-SIB systemic importance score. Opponents of these proposals assert these changes would relax the capital requirements facing certain large and profitable banks, and in doing so needlessly pare back important safeguards against bank failures and systemic instability.

In addition, whether the surcharges currently facing U.S. G-SIBs are too high has been subject to debate. Certain other countries use methodologies to determine surcharges on their G-SIBs that would result in lower surcharges for certain U.S. G-SIBs if implemented here. Some observers assert this puts U.S. G-SIBs at a disadvantage and call for the Fed’s surcharges to be reevaluated and possibly altered to more closely resemble other countries’ surcharges. Opponents of this view argue that the methodology used by the Fed generally results in appropriate surcharges given the size, complexity, and risks posed by the U.S. G-SIBs and doubt the necessity and prudence of lowering capital requirements for large, currently profitable banks.

**CRS Resources**

- CRS In Focus IF10205, *Leverage Ratios in Bank Capital Requirements*, by Marc Labonte

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