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Benefits and Costs of a Higher Bank "Leverage Ratio"

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Highlights

- Estimate benefits and costs of a higher leverage ratio for U.S. commercial banks
- Takes into account the high frequency of U.S. banking crises
- Approach suitable for regulators
- Baseline estimates indicate the optimal ratio equals 19 percent

Abstract

This study reports estimates of the marginal benefits and costs of increasing the regulatory minimum bank equity-to-asset "leverage ratio" from 4 to 15 percent. Benefits arise from reducing the probability of a banking crisis. Costs arise from reduced lending, should banks pass off higher equity costs onto borrowers. Net benefits increase with a higher discount rate, a smaller tax advantage of debt, a lower non-financial corporate debt-to-capital ratio, a higher cost of crises, a longer duration of crises or if crises have some permanent effects. Baseline estimates indicate that the benefits equal costs at 19 percent.

Keywords: Bank Regulation, Benefit-Cost Analysis, Capital Adequacy Standards, U.S. Banking Crises

JEL Classification: D61, G28, K20, L51, N21, N22, N41, N42

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