Abstract: This paper examines the determinants of banks’ balance-sheet and leverage-ratio dynamics and their role in increasing financial fragility. Our results are twofold. First, we show that there is a value of bank's leverage that minimises financial fragility. Second, we show that this value depends on the overall business climate, the expected value of the collateral and the riskless interest rate. This result leads us to advocate the establishment of a dynamic leverage ratio, depending on economic conditions, rather than the fixed ratio provided for under the new Basel III regulation.

Keywords: Bank Leverage, Financial Instability, Prudential Regulation.

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