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Comment: Weakening leverage ratio undermines banks' accounting

Removing derivatives from banking rules is contrary to basic accounting practice, says Thomas Hoenig

By Thomas M. Hoenig

The essence of banking is leverage. For every dollar of capital a bank's owners contribute to its funding, some multiple of money borrowed from depositors and other creditors finance its operations.

When this leverage — the ratio of debt to equity — is properly balanced, it facilitates economic growth and wealth creation. However, to use the proverbial line, leverage is a double-edged sword — a fact we too often forget.

During an economic expansion, increasing leverage provides what appears to be greater liquidity, enables more lending and feeds euphoria — until it suddenly doesn't. The other side of the sword swings back and the deleveraging begins when individuals can't determine how all the new debt will be repaid. If there is insufficient capital to help absorb losses, panic ensues, lending contracts, and wealth is destroyed.

The global economy learnt this lesson the hard way during the recent great recession. In particular, the use of risk-based capital ratios to judge a bank's financial strength contributed significantly to over-leveraging in the banking system. Investors learnt quickly how these ratios overstated a bank's ability to absorb loss, and instead they began relying on the more transparent leverage ratio.

This ratio is the most easily understood and provides the best insight into a financial firm's true loss-absorbing capacity. Most financial supervisors also recognise the advantages of the leverage ratio as a better indicator of resilience, and as a consequence the Basel Committee on Banking Supervision (BCBS) included a leverage ratio in the revised international capital standards.

Recently, however, industry representatives, some legislators and even some financial regulators are pressuring the BCBS to weaken the leverage treatment for certain derivatives.

Their concern is that the leverage ratio is impeding the leverage-fuelled growth of derivatives markets, which they charge harms end-users. In fact, the opposite is true. One of the purposes of the leverage ratio is to require banks to maintain a healthy balance between equity and debt in good times so that the downside swipe of the sword doesn't kill the economy, which is what ultimately hurts end-users as we saw in 2008.

The most recent attempt to undermine the leverage ratio focuses on cleared derivatives transactions, where a customer is required to post collateral to a bank. The bank then clears the trade with a clearing house on behalf of the customer and provides a guarantee of the customer's derivatives transaction to the clearing house. The collateral, when it is cash, is placed on deposit with the bank, which can invest it and earn a return.

Critics are pressing to exempt this collateral and corresponding asset from the BCBS's leverage ratio calculation. Also, because the bank guarantees the full value of the derivative to the clearing house, the bank's leverage ratio includes a small percentage of the notional amount of the derivative. The industry wants this amount reduced by any collateral received from the customer.

Critics claim this treatment is driving banks out of the clearing business. However, the fact is that after the finalisation of the leverage ratio, the largest banks have increased their clearing activities significantly — one by more than 170 per cent last year.

Asking to remove properly accounted-for assets from the leverage ratio is completely contrary to accounting standards and basic accounting principles. Asking that derivatives exposure be reduced by the presence of collateral undermines the integrity of the leverage measure. It is equivalent to asking that all collateralised loans be removed from the balance sheet. Combined, these requests clearly violate the basic principles the BCBS laid out when it drafted its leverage ratio and would tip the balance of funding for these derivative positions almost entirely away from equity.

The BCBS published the leverage ratio to provide investors and the public a simple, transparent means to measure the balance between capital and debt on a bank's balance sheet, noting that it systematically calculates "the on- and off-balance sheet sources of banks' leverage and risk exposures to which ultimately the investor and all too often the taxpayer are exposed."

To do this, it must meet the following criteria laid out by the BCBS: it should include assets as measured by accounting guidelines; asset values should not be reduced by collateral or guarantees; and off-balance sheet sources of leverage that are not included in the accounting guidelines should be added to the leverage ratio (eg commitments and derivatives).

No industry, other than banking, is allowed to remove assets or reduce the carrying value from assets on the balance sheet before reporting capital levels. The usefulness of the leverage ratio would be directly undermined if it was calculated without using basic accounting values, as the banking industry is pressing for.

It is true that granting such a wish would boost short-term profits for highly leverage banks, but it would come at the ultimate expense of the end-user and the public.

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