

FDIC Vice Chairman Thomas M. Hoenig:

The Leverage Ratio and Derivatives: Presented to the Exchequer Club of Washington, DC.
September 16, 2015

As I begin my remarks I want to acknowledge that September is an anniversary month. Not of the Dodd-Frank Act or Basel III, but of the most memorable events of the financial crisis itself. A partial list of the events seven years ago this month includes the conservatorship of Fannie Mae and Freddie Mac, the Lehman Brothers bankruptcy, the Treasury guarantee of money market funds, the merger or conversion of the remaining three large investment banks to bank holding companies, the failure of Washington Mutual, and the announcement of what was initially envisioned as an assisted acquisition of Wachovia. Those events soon were followed by federal capital injections into nine of the largest banks and many smaller ones, additional assistance to Citigroup and Bank of America, and an FDIC guarantee of holding company debt and all transaction accounts at insured banks.

This is quite a list of events, and it is too soon to forget their lessons. Yet this seems to be happening in a critical area of regulatory policy. I refer to efforts in the U.S., and internationally at Basel, to weaken the leverage ratio treatment of cleared derivatives, and possibly all derivatives. It is ironic to be talking about these issues on September 16, because it was seven years ago today that the Federal Reserve authorized a line of credit to AIG in an amount up to \$85 billion, subsequently increased with the Treasury to more than \$180 billion. The impetus for this action was a liquidity crisis at AIG brought on by its derivatives activities and concerns about the effects an AIG bankruptcy would have on its large derivatives counterparties.

As substantial as derivatives risks were then to the broader economy, they remain no less substantial, opaque, and interconnected today. If anything, the case for more capital is greater today. These facts being what they are, I am concerned that calls to weaken leverage capital requirements for derivatives are being taken seriously by some regulators.

In thinking about this new attitude, I am struck by how capital is most often described as only a cost, a burden that slows economic growth. However, capital is far more than an expense and, as background to my comments on derivatives, I want to summarize some of its benefits. I will then contrast the two primary approaches for setting regulatory capital requirements: leverage and risk-based standards. I will touch on some facts that I think are important in discussions of whether the leverage ratio poses a threat to clearing. Finally, I will provide a fifty-thousand-foot overview of how the leverage ratio treats derivatives and outline my criticism of efforts to weaken this treatment.

As a starting point, it is useful to remember that capital is not “set aside,” unavailable for lending or other activities. Rather, capital is a source of funding for a bank’s activities, just like deposits or borrowings. It is funding provided by the bank’s owners, and it benefits the bank in important ways. Equity owners cannot withdraw funds on demand and therefore do not present a risk of unexpectedly draining the bank’s liquidity. Equity owners cannot throw the bank into default if their dividend is too small. Capital reassures counterparties, helping the bank to fund itself at a reasonable cost. Ample capital gives banks the financial flexibility to take advantage of business opportunities, as we have seen since the crisis when comparing U.S. banks to their less strongly capitalized counterparts in Europe.

Capital has broader benefits as well. Meaningful owners’ equity reduces the moral hazard problem, where firms with little equity have a perverse incentive to take excessive risk. The dynamic at work has been described as heads the stockholders win, tails taxpayers lose. Capital allows banks to perform their intermediary function consistently through the cycle. Evidence exists that better capitalized banks sustain their lending during downturns to a greater extent than banks with less capital, and better capitalized banks have lower rates of failure or

bail-out.¹ And as we learned in the crisis, when large financial institutions enter a period of economic stress with insufficient capital and liquidity, the results can be devastating to our economy and to millions of individuals, business owners, and entrepreneurs.

Given the important role capital plays in financial markets, it is critical that capital requirements are set properly. To that end, leverage capital and risk-based capital are different ways regulators measure the amount and adequacy of capital. Leverage does this in a simple way: capital must exceed a percentage of balance sheet assets. The Basel III leverage ratio also requires capital against some off-balance sheet exposures, including a measure of derivatives exposure.

In contrast, a risk-based capital framework requires that capital be contributed in proportion to the perceived risk of individual assets and activities. This is intended to discourage banks from concentrating risks—a good idea if the risk categories in the rules are able to accurately reflect risk. Unfortunately, in my experience, relying on risk-weighting has proven entirely unsuccessful because, to state the obvious, it is impossible to predict the future. During the recent crisis, for example, some of the largest industry losses were in asset classes judged to be low-risk in the risk-based framework. These included residential mortgages, AAA-rated tranches of structured MBS, and certain trading account derivatives. Following the crisis, there have been large losses in sovereign debt, which also receives a very favorable risk-based capital treatment. In fact, the risk-based framework encouraged concentrated risks in these products by allowing them to be financed to a much greater extent with debt—that is, leveraging up.

To highlight this contrast and its significance, consider the experience of the five large investment banks in the pre-crisis years. These were Goldman Sachs, Morgan Stanley, Merrill

¹ Lending Through the Cycle. Source: FDIC. <https://www.fdic.gov/about/learn/board/hoenig/lendingcharts.pdf>. Failed Bank Capital Ratios. Source: FDIC. https://www.fdic.gov/about/learn/board/hoenig/Failed%20Bank%20Capital%20Ratios%20at%20YE%202007_03%2026%202015.pdf

Lynch, Lehman Brothers, and Bear Stearns. From year-end 2003 through year-end 2007, shortly before they all failed, merged, or became bank holding companies, their combined assets more than doubled, with an annualized growth rate of 21 percent per year. During this time, the weighted average leverage ratio of that group, measured simply as total shareholders' equity as a percent of total assets, declined from 4.8 percent to 3.3 percent. However, a risk-adjusted capital ratio remained above 15 percent, giving an incorrect impression of a strong balance sheet.

Some of the large commercial banking organizations that benefitted from federal assistance in 2008 had a similar pattern of rapid growth pre-crisis. Their leverage ratios also edged downwards, in one case to barely over 4 percent. The increase in financial leverage, however, was not as pronounced for the commercial banks in part because of the banking agencies' leverage requirements. U.S. bank capital regulation has a long tradition of using a leverage ratio, which goes a long way to explaining why large U.S. banks are generally stronger than large European banks. This relatively stronger capital position of the U.S. banking system is a competitive strength for us as a country, and for our banks.

With this said, I now turn to the assertion by some that the leverage ratio is a threat to the clearing of derivatives. We are told that we need to change the leverage ratio to provide special treatment for this more favored activity. Some are going so far as to argue for a special treatment that would weaken the leverage ratio treatment of all derivatives.

I begin with a few key observations regarding the statutory clearing mandate itself. First, it is a limited mandate. It applies only to certain classes of interest rate swaps and credit default index swaps. By law, the mandate specifically excludes non-financial end-users that are hedging commercial risk.

Second, cleared swaps activity has grown strongly in aggregate since the mandate came into effect. This growth has occurred even without the incentives for clearing that a final margin rule for non-cleared swaps will bring.² It would seem that strongly capitalized U.S. banks, including some of those subject to the most stringent leverage requirements in the form of the Enhanced Supplementary Leverage Ratio, are capturing an increasing share of the clearing business from some less well-capitalized firms that are exiting the business.

Third, the clearing mandate is not a mandate to weaken the prudential regulation of banking organizations as a means to stimulate the derivatives business. Yet this is precisely what is being contemplated through the recent intense effort to weaken the treatment of derivatives in the Basel III leverage ratio. The stated concern is that bank-affiliated futures commission merchants are subject to Basel III capital charges that they were not subject to before, and that this cost is onerous. However, as a general matter, many capital markets activities were subject to insufficient capital requirements under the old capital rules. The post-crisis lesson is that capital market activities must be conducted with meaningful capital support.

In the risk-based framework, capital requirements have increased for the trading book, for securitizations, and in certain respects for derivatives. The inclusion of off-balance sheet assets in the Basel III leverage ratio was intended to generate some level of capital for these activities regardless of the risk-based charge or the accounting treatment. There is no reason why derivatives entered into with a central counterparty should be exempt from these overall efforts to strengthen capital. In fact, some observers are concerned that the migration of derivatives to central counterparties may create new forms of concentrated and opaque risk that we do not yet understand.

² Risk Magazine: "FCMs try to 'off-board' credit and commodity funds"
<http://www.risk.net/risk-magazine/feature/2419614/fcms-try-to-off-board-credit-and-commodity-funds>

Now let me turn to some more specific arguments for weakening the leverage ratio as it affects the clearing of derivatives. One argument is that a bank-affiliated clearing member is only acting as an agent for the client. The fact that the clearing member must report client cash initial margin on its balance sheet is viewed as a technicality, albeit one that unfairly results in a leverage ratio charge. The recommended “remedy” is to exclude the segregated client cash initial margin from the denominator of the Basel III leverage ratio.

However, in thinking about this point, it should be apparent that when financial institutions must place assets on the balance sheet under U.S. generally accepted accounting principles, or U.S. GAAP, it is for a reason. In the context of clearing, the clearing members typically are able, within certain parameters, to invest the cash initial margin. They assume risk, and they receive and earn income. If clearing member Futures Commission Merchants (FCMs) wish to avoid balance sheet treatment for the collateral, contracts can be modified, in part by the FCM forgoing any right to investment income from the collateral. If the resulting contract ensures the FCM truly is acting merely as an agent, it need not record an asset. Some institutions have done this.

Some end-users have argued that requiring capital for derivatives trades cleared for clients could increase the cost of hedging their exposures. As noted, clearing members traditionally have taken initial margin from clients and invested it for themselves. It is possible that the leverage ratio will shift this arrangement such that the client retains the income on the invested funds and then pays a fee to the clearing member. This might be labeled an increase in cost, but retaining income and paying a fee is comparable to forgoing the income and paying no fee. Also, to the extent that the net costs do marginally increase, it reasonably reflects the reduction of a subsidy that resulted from artificially low capital on this activity.

A second and equally significant motive for those seeking to weaken the Basel III leverage ratio treatment of derivatives is to reduce the amount of exposure the leverage ratio attributes to off-balance sheet risk. This measure is called potential future exposure, and it reflects the potential that markets will move such that the derivative comes into the money,

exposing the bank to the risk of non-payment by the derivatives counterparty. Some discussions of this issue assert that the clearing member is not exposed to this off-balance sheet risk because it is only an agent for the client. The fact is that the clearing member typically guarantees the performance of the client. Under this guarantee, if the client does not meet its obligations under the derivatives contract, the clearing member becomes responsible for those obligations. Such guarantees, whether for derivatives or other obligations, are included in the leverage ratio to ensure that banks do not move significant sources of exposure off-balance sheet.

Critics also voice a concern that the Basel III leverage ratio measure of potential future exposure is simply too high and should be reduced. The leverage ratio measures the potential future exposure of derivatives using a look-up table that assigns a percentage of notional amounts based on the type and maturity of the derivative. The approach allows some recognition of netting to reduce exposure, but not full recognition.

The look-up table approach and the limits on netting recognition in the leverage ratio have been part of risk-based capital since the early 1990s. Large banks have long objected that the look-up table and the limits on netting recognition are too conservative. As a consequence, in March 2014 the Basel Committee took steps to weaken this requirement. This included scrapping the look-up table and greatly expanding the recognition of netting and collateral. This new approach is supposed to be more risk-sensitive and provide incentives for clearing and margining. It also is expected to greatly reduce overall risk-based capital charges for derivatives compared to the old look-up table. These changes go into effect in 2017.

A decision has not been made yet whether to extend this new measure of exposure for calculations affecting the leverage ratio. If this were to be allowed, large amounts of economic exposure to derivatives—meaningful financial leverage and risk—would vanish from the regulatory capital radar screen by virtue of having a measured exposure of zero. Such a change would potentially affect the treatment of all derivatives, not just those cleared on behalf of

clients. The only capital requirements for these “zeroed out” exposures would be whatever is required under the model-intensive market risk rules. This treatment might be appropriate under a risk-based capital framework, but it is grossly at variance with the goals of a simple, non-risk sensitive constraint on financial leverage.

In summing up, I would emphasize that the lessons of the recent crisis were learned at great expense. I see no credible case that strong capital requirements undermine the U.S. financial system or economy, as some contend, or that the system has suffered from insufficient bank derivatives activity. Weakening derivatives capital requirements would encourage even larger volumes of interlinked and opaque derivatives activity. Such an outcome strikes me as a counterintuitive and jarring abandonment of post-crisis regulatory initiatives. For myself, as a U.S. regulator, I would be hard pressed to support proposals that weaken the leverage treatment of derivatives for U.S. banking organizations.

Those who work with regulatory capital issues know that there is a never-ending tension between the industry’s wish to deploy greater financial leverage and the safety-and-soundness interest in ensuring that the party doesn’t get out of control, creating long-term costs to the public that outweigh the short-term benefits to the banks. The leverage ratio—because it is a relatively straightforward check on excessive debt financing and, yes, because it has teeth—has always been a lightning rod in the debate and always will be. If regulators can stay the course on this important measure, our financial system will be stronger and more resilient going forward.

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