Statement of FDIC Vice Chairman Hoenig

on the Semi-Annual Update of the Global Capital Index

April 12, 2016

The semi-annual update of the Global Capital Index, showing the capital ratios for Global Systemically Important Banks, was released Tuesday by FDIC Vice Chairman Thomas M. Hoenig.

The Global Capital Index relies on International Financial Reporting Standards (IFRS) to measure a firm's tangible equity (loss-absorbing capital) against a more complete reporting of balance sheet assets, as shown in column 8 of the table.

Among the data:

- For the largest U.S. banking firms, the average tangible equity capital ratio – known inversely as the leverage ratio – increased 24 basis points to 5.97 percent from 5.73 (column 8). In other words, the US GSIBs fund each dollar assets with about 94 cents of borrowed money.
- The largest regional and community banks, shown in the last three rows of column 8, have higher tangible capital ratios ranging from 8.31 to 9.76 percent.
- The largest financial firms continue to report that their risk weighted measure (column 3) computes to a relatively higher level. This occurs because assumed risk weighted assets represent only 49 percent of total assets under IFRS. The effect is to reduce assets used in computing the leverage ratio, thus overstating the capital available to absorb losses relative to the total balance sheet.

"The loss-absorbing tangible capital levels of the largest U.S. banks are increasing, and it is important that this progress continue to a point where they reach solid levels of tangible capital to effectively move the cost of downside risk from the public to the firms," Vice Chairman Hoenig said. "It is noteworthy that as the tangible capital of U.S. GSIBs has increased relative to their foreign counterparts, so have the lending levels of American firms and the overall health of the American economy compared with Europe."

"As encouraging as the trend in capital is for U.S. GSIBs, I find it unfortunate that the Basel Committee last week has recommended changes to the international leverage ratio that would significantly weaken it – even if its capital requirements are increased -- by turning it into a risk-weighted measure. Doing so would significantly dilute the effectiveness of the most reliable measure of bank capital and result in increased leverage that does not serve the financial system, broader economy, or even the firms well over the full course of an economic cycle."

The Global Capital Index, among other things, illustrates the difference in capital ratios when bank assets are measured using US Generally Accepted Accounting Principles (GAAP) versus IFRS. IFRS includes the fair value of all assets including derivatives (column 7), while GAAP

does not (column 5). Specifically, the tangible capital measurement in the Global Capital Index is calculated by comparing equity capital to total assets, after deducting goodwill, other intangibles, and deferred tax assets from both equity and total assets. The IFRS's balance sheet also reports the fair value of derivatives and other assets that are otherwise off-balance-sheet in GAAP. The tangible leverage ratio measures funds available to absorb loss against total balance sheet assets reported under the IFRS standard. It does not attempt to predict or assign relative risk weights among asset classes. In contrast, the ratios of Tier I capital to risk-weighted assets for all banks (column 3), largest to smallest, are above 10 percent and some of the largest have ratios of more than 15 percent. The higher capital ratio is achieved by reducing on-balance sheet assets by a pre-assigned risk weight and excluding off-balance sheet assets, such as derivatives.

"This risk-based measure is misleading and overstates the strength of these firms' balance sheets. No other industry is allowed to make these kinds of adjustments," Vice Chairman Hoenig said. "In contrast to risk-based calculations, the tangible leverage ratio accurately measures bank risk and prices it correctly. It has done a reliable job of aligning a firm's risk appetite with its loss-absorbing capacity, providing more direct insight into the amount of loss-absorbing capital available to a firm and providing a consistent and comparable measure across firms."

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Thomas M. Hoenig is the vice chairman of the FDIC and the former president of the Federal Reserve Bank of Kansas City. The Global Capital Index and his other material can be found at http://www.fdic.gov/about/learn/board/hoenig/

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