Statement of FDIC Vice Chairman Hoenig on the

Semi-Annual Update of the Global Capital Index

April 13, 2017

Equity capital ratios increased at most of the largest U.S. banks over the past six months, and all reported higher price-to-book ratios with most now trading at a premium, according to data in the semi-annual report of the Global Capital Index released today by FDIC Vice Chairman Thomas M. Hoenig.

The IFRS tangible leverage ratio for U.S. GSIBs was 6.28 percent at the end of 2016, up from 5.75 percent at mid-year 2016. Their average price-to-book ratio increased from a discount to book of 0.90 percent to a premium of 1.29 percent (column 12) over the past six months.

"The data show that by any number of measures, the benefits of higher capital outweigh the costs[1]," Vice Chairman Hoenig said. "Global banks with stronger capital as measured under the leverage ratio and with fewer problem assets generally trade at a premium or at less of a discount to book value than banks with weaker capital[2]. Better capitalized banks lend more and do so on a sustained basis over the business cycle[3], and they are less likely to fail or require bailouts[4]. As capital levels have increased since 2009, loans have increased by $2.1 trillion, or 4 percent a year on average, and bank earnings have continuously improved[5]. In other words, capital does not remain idle. Along with debt, capital is a primary source of funding for lending. As tangible equity grows from retained earnings, lending and earnings continue to grow."

While the largest banks continue to improve their tangible capital relative to assets, they remain among the most highly leveraged, providing the lowest returns on equity among U.S. industries, as illustrated in the attached chart. "Other major U.S. industries operate with higher equity capital ratios, yet they produce a higher return on equity than the banking sector[6]. While banking

[1] Pogach, Jonathan, "Literature Review on the Macroeconomic Impacts of Capital Requirements," FDIC Division of Insurance and Research, https://www.fdic.gov/about/learn/board/hoenig/2016-05-12-lr.pdf

[2] Global Capital Index

[3] A 1 percentage point increase in equity-to-total-assets is associated with a 0.6 percentage point increase in annual loan growth. Gambacorta, Leonardo; Shin, Hyun Song; BIS Working Papers No. 558: Why Bank Capital Matters for Monetary Policy, April 2016, https://www.bis.org/publ/work558.pdf
and FDIC on IDI tier 1 leverage ratios and IDI total loans to average assets

[4] FDIC data on IDI tier 1 leverage ratios and IDI failure rate

[5] Federal Reserve Y-9C data

[6] Equity-to-assets and ROE of S&P 500 companies
https://www.fdic.gov/about/learn/board/hoenig/sp500.pdf

is a leverage business, studies and experience indicate that capital ratios among the largest banks remain too low undermining long-term economic growth," Vice Chairman Hoenig said.

"Overall, I am encouraged that the loss-absorbing tangible capital ratios of the largest U.S. banks are increasing, and it is important that this progress continue to a point where they reach requisite levels of tangible capital to effectively move the cost of downside risk from the public to the firms," Vice Chairman Hoenig said.

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 derivative exposures, as shown in Column 7 of the table. The largest financial institutions continue to reference their risk weighted capital ratios (Column 3) rather than their tangible equity capital ratios (Column 8) to suggest they are well capitalized. However, this higher number occurs because assumed risk weighted assets represent only 43 percent of total assets measured under IFRS. The net effect is to reduce assets used in computing the risk based ratio, thus overstating the true equity capital available to absorb losses relative to the total risk of on- and off-balance-sheet exposures.

The Global Capital Index can be found at:
https://www.fdic.gov/about/learn/board/hoenig/global.html

###

Thomas M. Hoenig is the Vice Chairman of the FDIC and the former President of the Federal Reserve Bank of Kansas City. His material can be found at http://www.fdic.gov/about/learn/board/hoenig/.

The views expressed are those of Vice Chairman Hoenig and not necessarily those of the FDIC.