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How banks learnt to play the system

di John Gapper

Those who cannot remember the past, wrote George Santayana, are condemned to repeat it. Twenty years ago, global banking regulators declared that every bank ought to hold core capital equivalent to 4 per cent of its risk-weighted assets. Today, the US government will say the same thing differently.

This repetition will be expensive. It may force Bank of America to raise an extra $34bn (€25.6bn, £22.6bn) of common equity, and Citigroup to raise up to $10bn. More than half of the 19 banks under scrutiny could be told to drum up capital.

The difference between 1988 and today is that tangible common equity is the new tier 1 capital.

To all but bankers or regulators, that last sentence is incomprehensible, of course. Yet it encapsulates why two decades of reform intended to protect banks against collapse not only failed to work but had the perverse effect of hiding the problem.

If governments want to do better this time, they must learn the lesson that banks faced with new balance sheet rules will expend an inordinate amount of time and effort trying to evade those rules. Indeed, the cleverer the rules, the greater the opportunity for financiers to arbitrage them. This is why investors have lost faith in tier 1 and prefer a more basic sum.

The stress tests on the largest 19 US banks carried out by regulators over the past couple of months, the results of which will be disclosed this Thursday, echo the 1988 Basel Accord. Basel I was the first effort by regulators to set capital adequacy standards for global banks.

The accord tried to do two things: to raise the level of capital held by banks – notably those in Japan – and to measure leverage (their ratios of capital to assets) better.

That was how the trouble started.

Banks are highly leveraged institutions that hold only a small amount of capital compared with their assets. That is what gives them their economic importance – they can lend far more to people and companies than their capital base – but also what makes them vulnerable.

A comparatively small loss in the values of assets, including commercial and residential property, during recessions can eat through the capital base of a bank, making it insolvent. This is what has occurred over the past 18 months.

Basel I attempted to address this by setting a maximum leverage ratio – or a minimum ratio of capital to assets – for global banks. That figure was 8 per cent, which is equivalent to allowing a bank to be leveraged a conservative 12.5 times.

If that was how leveraged banks actually were, we would not be in half this trouble. But some investment banks entered this downturn with capital-to-asset ratios of 30 times or more. That was because neither their assets nor their capital were what they seemed.

On assets, Basel introduced the notion of risk weighting, which essentially meant that some kinds of loans – for example, highly rated corporate bonds and, yes, residential mortgages – were considered less risky than others, so less capital needed to be held against them.

It was not a bad idea in principle but it set off two decades of financial engineering by banks to classify as many of their assets as possible as low-risk weighted in order to swell their balance sheets and so make a higher return on capital.

One of the puzzles of the financial crisis is why banks were caught with huge amounts of securitised mortgage debt when the point of securitisation – turning assets into securities – is to be able to sell loans.

Viewed through the Basel lens, however, the hoarding of securities made sense. By transforming 50 per cent risk-weighted mortgage loans into triple A securities, and with the help of rating agencies, banks reduced the amount of capital that they needed to hold against these assets.

A bit of insurance wizardry took the regulatory arbitrage further. Banks could cut their capital charge to near zero by laying off the credit risk of mortgage securities to AIG through credit default swaps. Hey presto, billions of dollars of assets absorbing virtually no capital!

On capital, Basel was not as strict as it sounded. The 8 per cent figure was split into two groups – tier 1 and tier 2 capital. Nobody talks much about tier 2 capital now because it is pretty flimsy stuff – it includes subordinated debt and other securities only distantly related to equity.

For years, regulators and investors have focused on tier 1 capital, which is made up of equity, preferred shares, goodwill and intangibles. Banks must hold a minimum of 4 per cent tier 1 capital to risk-weighted assets.

Yet even tier 1 is a loose measure of capital strength, since it includes preferred shares and other miscellany. In practice, it is a bank's common equity that absorbs the losses from its troubled loans and assets.

The result of this relentless deflation of assets and inflation of capital is the absurdity that the banks the US will today instruct to raise billions more in equity are, by Basel standards, in rude health.

Bank of America, for example, had a tier 1 ratio of 10.1 per cent in the first quarter of this year, while Citi's tier 1 ratio was 11.9 per cent. Both banks had between two and three times the minimum ratio.

It would be wrong to throw away the entire Basel framework (including the Basel II revision of 2004) because global banks found ways to game the system. There is still a place for broad measures of banks' capital strength and risk weighting of assets.

But this Thursday's stress test results are both a harsh judgment on the biggest US banks and a damning verdict on Basel and two decades of capital adequacy regulation. We should remember that.