The illusion of UK bank capital strength

Lenders say they are flush with capital but leverage ratios tell a different story

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Here are two words you don’t often associate with Royal Bank of Scotland: excess capital.

Ever since its near-death experience in the financial crisis a decade ago, the general view has been that the UK bank needs every penny of capital it can get.

But now RBS is apparently feeling rather flush with the stuff, and wants to thrust some of that wonga back into the paws of its shareholders.

Sir Howard Davies, the bank’s chairman, has suggested either a special dividend or using it to buy back part of the state’s 62 per cent stake.

Nor is the bank alone in feeling that capital is burning a hole in its pocket.

Other big UK lenders are making similar noises: Lloyds is thinking about returning £2bn next year, while Barclays is also hoping to confect a new year offering for its investors.

Bosses are breathing confidence about their balance sheets. But how much capital do these banks really have to burn?

That depends on how you measure it. The ratio that banks favour compares an accounting measure
of book equity with the value of their assets, weighted for the amount of risk the lender assumes itself to be taking.

The book equity is itself adjusted to deduct goodwill and deferred tax assets — items that are generally valueless in a liquidation. The idea is that all this tells you what proportion of the assets you can lose before your core loss-bearing equity runs out.

The result certainly looks pretty good from the bank’s perspective. Take RBS for instance. Before the crisis, its “core equity tier one” (CET1) ratio was tiny, standing at about 2.9 per cent in 2006.

Since then it has climbed steadily and hit 16 per cent last year, implying that the bank could lose more than a sixth of its risk-weighted assets before running out of equity capital.

It’s also conveniently three percentage points higher than the bank’s own 13 per cent target, implying that it can return up to £6bn while still staying within its own capital rule.

So everything’s hunky dory then? Not so fast. One concern with using risk-weighted assets is that bank bosses can influence the calculation by tweaking the asset number.

As Professor Anat Admati observed with others in a letter to the Financial Times eight years ago this “encourages ‘innovations’ to economise on equity which undermine capital regulation”.

Bank chieftains have incentives to engineer the “right” capital ratio. Most institutions use CET1 as the “capital safety” measure of choice when computing how big a bonus to pay top executives.

Banks claim they’ve learnt from the crisis and have no incentive to monkey around with their own safety. But look at their capital through another, less gameable prism and a very different picture appears.

This measure compares equity not with a risk weighted measure of assets, but simply the total unadjusted asset number.

And because accounting measures of book equity are backward-looking and may conceal losses, it uses the bank’s market capitalisation as a proxy. Using this “market adjusted” measure, we see that so-called leverage ratios are actually lower than before the crisis.

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**Look at banks' favoured measure of capital strength and all seems well...**

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<th>CET1/RWAs (%)</th>
<th>RBS</th>
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Barclays, whose leverage ratio in 2006 was 4.8 per cent, now sits at just 2.5 per cent after an anaemic post-crisis recovery petered out. RBS has fallen from 7.2 per cent to 3.6 per cent. Neither looks like it has much surplus capital. Barclays is below the 3.25 per cent floor that the Bank of England sets (although it officially passes using accounting book values).

The biggest reason for the slide is a decline in the price to book ratio from 1.74 times in 2006 for Barclays to just 0.45 times now. RBS has slipped from 1.38 to 0.55. Lloyds and HSBC also have ratios of less than one.

Observers tend to be blase about low price-to-book numbers, arguing that they reflect concerns about future cash flows that have nothing to do with asset quality.

But as Sir John Vickers, the architect of Britain’s post-crisis banking reforms, said in a speech last week: “A bank’s obligations to creditors and depositors are met, or not, by those cash flows. Their weakness is a problem, whatever the cause.”

It is not that long since Mervyn King, the former Bank of England governor, was calling for straight equity to fund 10 per cent of a bank’s total assets. Prof Admati wanted 15 per cent.

As banks contemplate large capital returns with equity levels a fraction of those levels, one might
usefully wonder how we’ve arrived at such an outcome. And more importantly for taxpayers, who is fooling whom?

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