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COMMENT & ANALYSIS

Letters

Adjustments that flatter banks' capital strength

Sir, As shareholders of UBS, Citigroup, Barclays and Royal Bank of Scotland can attest, having a strong tier one ratio is no guarantee that a bank will not require more capital. Traditional measures of balance sheet leverage, such as total assets divided by tangible equity (or "gross leverage"), have been much better at predicting the risks borne by shareholders throughout the crisis. Although many banks now publish this ratio, there is a growing tendency to "adjust" the total assets number, thereby producing a lower gross leverage ratio and flattering capital

strength. This is done, in part, by netting off derivatives held for trading against related liabilities.

The argument for netting off certain derivative assets and liabilities fundamentally comes down to the assumption that any change in the value of the asset is exactly matched by a corresponding change in the value of the liability and that shareholders therefore bear no risk. This cannot be true. A perfectly matched pair of derivatives transactions will rarely be profitable – due to the costs – and profits are earned only by taking some risk. For example, one bank discloses that its credit

derivatives portfolio mostly consists of insurance sold on the senior tranches of a structured debt portfolio and insurance bought on the more junior tranches of the same portfolio. This is clearly a massive one-way bet on the future direction of credit spreads. Although banks do not separately disclose profits from derivatives trading, in 2008 the value of derivative assets held by most banks increased by far more than the value of derivative liabilities – in some cases by more than \$20bn. Although there are other explanations, this supports the idea that trading in derivatives can be a highly profitable – but

risky – business, and that derivative assets should not be ignored when calculating leverage.

Derivatives now account for more than 40 per cent of the balance sheet of several of our largest banks. The impact of netting these assets and liabilities can result in a third or more of the bank's balance sheet being excluded for the purposes of calculating leverage, in effect creating a metric that looks very much like the discredited tier one ratio!

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