Statement of FDIC Vice Chairman Hoenig on the Capital Treatment of Derivatives and Variation Margin

August 14, 2017

It is important for the financial regulatory agencies to be responsive to legitimate burdens posed by rules and regulations that may have unintended consequences. Unfortunately this is not the case of the recently published supervisory guidance on the regulatory capital treatment of certain centrally-cleared, settled-to-market derivatives contracts, which may have its own negative and unintended consequences. The guidance effectively lowers the amount of capital required for certain derivatives contracts although the underlying economics of the transactions do not change. Under the Agencies' interpretation of footnote 2 of section 34 of the regulatory capital rule[1] the counterparties ostensibly settle on a daily basis, in effect lowering the potential future exposure of the derivative. However, the contract itself has not matured and therefore the potential future exposure and risks of settlement remain. Consequently, the capital available to absorb these risks will be artificially lowered and the residual burden shifted to the public.

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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. His material can be found at https://www.fdic.gov/about/learn/board/hoenig/.

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

[1] See Table 1 "CONVERSION FACTOR MATRIX FOR DERIVATIVE CONTRACTS" under FDIC Section 324.34 https://www.fdic.gov/regulations/laws/rules/2000-4350.html#fdic2000part324.34

Statement of FDIC Vice Chairman Hoenig on the Semi-Annual Update of the Global Capital Index

April 25, 2018

The Global Capital Index (GCI), released today by FDIC Vice Chairman Thomas Hoenig, shows the largest U.S. banks reporting higher capital ratios at year-end 2017. The U.S. G-SIBs' average IFRS tangible leverage ratio estimate — a measure of tangible equity funding a bank's assets — increased to 6.92 percent, up from 6.62 percent in June 2017. However, these results reflect two important events that occurred during 2017 that affected the different leverage ratios for the largest banks reported in the GCI.

First was the adoption by the largest banks of the clearinghouses' settle-to-market (STM) rule change for certain centrally cleared derivatives transactions that treats the exchange of variation margin as a settlement rather than collateral.[1] The accounting impact of this rule change results in the derecognition of gross balances of the netted derivative assets, liabilities and associated collateral disclosed in a firm's financial statements. This is estimated to have reduced the reported off-balance sheet derivative exposure by approximately $845 billion for the U.S. G-SIBs from year-end 2016 to year-end 2017.[2] Without this change, their IFRS tangible leverage ratio estimate drops 44 basis points to 6.48 percent. Second, the largest U.S. GSIBs distributed 125 percent of earnings to shareholders through dividends and share buybacks for the full year 2017.[3]

"The STM rule change allows banks to derecognize these assets and liabilities in their financial statements allowing capital to appear greater relative to assets when including off balance sheet risk, when no real increase in capital has occurred," Vice Chairman Hoenig said. "The implications can eventually become profound especially as these banks ramp up capital distributions, as we saw in 2008 when the true capital position of the largest banks became painfully revealed".

Although the adoption of STM represents a significant easing in capital requirements, U.S. G-SIBs continue to benefit from their better capitalized and financially stronger position than their counterparts across the globe. U.S. G-SIBs continue to trade at a premium of 1.41 to book value, while their European and Canadian counterparts trade at a median discount to book of 0.89 and Asian counterparts are trading at 0.67.

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

[1] Statement of FDIC Vice Chairman Hoenig on the Capital Treatment of Derivatives and Variation Margin - https://www.fdic.gov/news/news/speeches/spaug1417.html

[2] STM treats the exchange of variation margin as a settlement instead of collateral and resets the value of those derivatives to zero. Financial statements generally footnote the gross balances. Adding this exposure back results in the much lower IFRS estimated tangible leverage ratio and a more accurate reflection of the reliance on debt.

[3] Capital Distribution Tracker - https://www.fdic.gov/about/learn/board/hoenig/capitaldisttracker.pdf

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 51 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.