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Off the balance sheet, then on again

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IN A globally integrated economy, it is essential that banks worldwide be subject to common capital standards. Under-capitalised banks are highly vulnerable to bank runs. Absent worldwide standards, banks in countries with lower capital standards could undercut those in countries with higher capital standards. The race to the bottom would precipitate cross-border bank runs and international financial contagion.

All this might have seemed academic until Iceland's recent experience. Icelandic banks leveraged aggressively. From 2003 to 2007, its three largest banks - Landsbanki, Kaupthing and Glitnir - increased their lending from two times to nine times the national GDP.

Landsbanki and Kaupthing aggressively pursued foreign deposits with high interest rates. Through its Internet arm, Icesave, Landsbanki amassed £4 billion (S$8.5 billion) in deposits from 300,000 British clients.

In October, with the banks unable to refinance their debt, the Icelandic authorities seized control of Landsbanki, Kaupthing and Glitnir. With Landsbanki in receivership, the funds of the British depositors were frozen, sparking the most intense diplomatic row between Britain and Iceland since the Cod Wars of the 1950s and 1970s.

Basel II is supposed to prevent such financial catastrophes. The Basel Committee on Banking Supervision sets capital standards for banks with international businesses. The Basel II framework, agreed in 2004, specified a minimum regulatory standard: Banks must have capital of at least 8 per cent of their risk-adjusted assets.

However, until recently, every bank single-mindedly sought to increase its return on capital. Senior management were highly incentivised - through bonuses, profit-sharing and stock options - to increase the return on capital.

There are two ways to increase return on capital: raise earnings or reduce capital. The name of the game in banking was to get the relatively risky assets off the balance sheet.

Under Basel II, the riskier assets required relatively more capital. But once these assets were removed from the balance sheet, the bank would not have to provide capital against the assets. It was a double win because the riskier assets offered higher returns. So the incentive to shift assets off the balance sheet was greater the riskier the assets were.

Banks systematically shuffled their riskier assets into an array of off-balance special purpose entities (SPEs). The key was to structure the SPEs in such a way that their assets and liabilities need not be consolidated into the balance sheet of the bank. Then the management of the SPE could decide for itself how much (or actually, how little) capital to

provide for the entity. It could also decide how much leverage to employ, away from regulatory scrutiny. Essentially, banks shifted assets into SPEs so as to avoid regulation and get as much earnings as possible with as little capital as they could manage.

The range of SPE assets included securities based on credit card receivables and mortgage loans, and an alphabet soup of products derived from financial engineering: ABCP (asset-backed commercial paper conduits), CDOs (collateralised debt obligations), CLOs (collateralised loan obligations), TOBs (municipal securities tender option bond trusts), and SIVs (structured investment vehicles).

However, beginning in the middle of last year, the entire landscape changed. As the sub-prime mortgage crisis broke, many major banks - including HSBC, Citibank and UBS - were forced to bring SPEs back onto their balance sheets. For instance, just last month, Citibank completed the consolidation of seven SIVs, with assets worth US$17.4 billion (S$25 billion). This increased its risk-adjusted assets by US$2 billion.

The crisis wrought a double whammy on banks that had played the off-balance sheet game. As they consolidated SPEs into their balance sheet, the assets side of their balance sheet rose, with the increase weighted towards relatively risky investments, with higher risk adjustments. Hence, on the liabilities side, banks had to provide proportionately more capital to meet their capital adequacy ratio.

As the financial crisis ballooned, major financial institutions, especially those which had indulged in high leverage and off-balance sheet plays, were hard- pressed to meet capital adequacy. Moreover, with investors everywhere becoming more risk averse, banks were expected to not just maintain capital, but also to deleverage and increase capital. In November, the price of Citigroup shares fell to just US$3.05, or just 10 per cent of its value at the beginning of the year.

National governments all over the world decided that their major financial institutions were too big to fail. The British, American and other governments purchased shares in key banks. The US Treasury rescued Citigroup twice, the second time coming just a month after the first.

In Switzerland, the government bought 6 billion Swiss francs (S$8.2 billion) of convertible notes in UBS, which amounted to a 9.3 per cent share of the bank. In addition, the Swiss government agreed to establish - what else - an off-balance sheet SPE so as to lighten UBS's balance sheet.

The Swiss National Bank lent US$54 billion to the new entity, called SNB StabFund, with UBS contributing capital of just US$6 billion. The government loan was non-recourse to UBS, which meant that it committed to bear any losses of the SPE beyond the US$6 billion contributed by UBS.

Recently, the Swiss National Bank announced that SNB StabFund had acquired US$16.4 billion worth of toxic assets from UBS. UBS has until March next year to sell up to a total of US$60 billion of assets to the SPE. When the SPE was announced, UBS happily declared: 'The transaction will result in a significant reduction in UBS' risk-weighted assets and its balance sheet total.'

Off the balance sheet, on the balance sheet, then off again - financial engineers are still hard at work.

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Economic Watch is a weekly column rotated among Senior Writer Tion Kwa and guest columnists.

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