Opinion **UK banks**

Coronavirus exposes illusion of UK bank capital strength

Despite the 'great capital rebuild' since 2009, market values are scarily low

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Royal Bank of Scotland's "core equity tier one" ratio before the 2008 crisis was tiny, standing at about 2.9 per cent in 2006. In February, the bank announced that it hit 16.2 per cent last year © Bloomberg

Jonathan Ford 2 HOURS AGO

Here's a question about the Bank of England's intervention last week to stop some of the country's leading banks paying out £7.5bn in dividends on last year's profits.

No, it is not whether the central bank should have acted: few seriously dispute that the country's lenders should be conserving their capital given the economic shock Britain is experiencing. Rather, it's the opposite. Why did it take so long?

Remember, the central bank stepped in just three days before Barclays was due to pay its investors, which hardly smacks of a considered change of direction; more a handbrake U-turn that left black rubber marks all over the road.

The official explanation is, of course, coronavirus. The pandemic has put banks under pressure to lend more while simultaneously facing mounting defaults from hard-pressed customers whose revenues have fallen precipitously because of the lockdown. It was for this reason that the BoE last month cancelled the stress tests and released banks' so-called countercyclical "capital buffers", allowing them to accommodate more loans on their balance sheets funded by a constant level of equity.

But the virus did not become news only last Tuesday. What is puzzling is the failure to gate earlier all capital distributions. It's hard to believe the central bank trusted bank bosses to show restraint, especially when the likes of Barclays' Jes Staley had big bonuses riding on the payouts.

More likely, the central bank believed its own story that the lenders were super well-capitalised. That has certainly been the mood music from Threadneedle Street, with the now departed governor Mark Carney boasting recently that their balance sheets were now so strengthened that, unlike 2008, the banks could be "part of the solution".

The idea of bulletproof banks depends on the way you calculate capital ratios. The one the BoE often points to compares an accounting measure of book equity with risk-weighted assets (RWAs) — that is assets weighted for the amount of risk the bank assumes itself to be taking.

On this basis, everything looks pretty hunky dory. Take Royal Bank of Scotland for instance. Before the crisis, its "core equity tier one" (CET1) ratio was tiny, standing at about 2.9 per cent in 2006. In February, the bank announced that it hit 16.2 per cent last year — allowing it to lose more than a sixth of its weighted assets without running out of capital.

So all well then? Not so fast.

The real issue is whether the CET1 gives a true sense of capital strength.

One concern with RWAs 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 a decade ago, this “encourages ‘innovations’ to economise on equity which undermine capital regulation”.

A less gameable measure involves comparing equity not with a RWAs, but simply the total unadjusted asset number. Moreover, because accounting measures of book equity are backward-looking and may conceal losses, it makes sense to use the bank’s market capitalisation in their stead — especially when events are moving fast.

Using this “market adjusted” measure, a very different picture appears.

Barclays’ leverage ratio now sits at just 1.2 per cent on this basis, according to figures from Professor Kevin Dowd of Durham university. RBS is at 1.7 per cent. Neither looks “part of the solution”. Both are well below the 3.25 per cent floor the central bank sets (although it uses accounting measures).

The biggest reason is a collapse in the price to book ratio; from 2.32 times pre-crisis for Barclays to just 0.23 times now. All UK banks, including HSBC, have ratios of a long way south of one.

These are scarily low numbers and cannot be wished away in the hope that they reflect concerns about low future profitability, and not asset quality. As the economist Merton Miller said, a 50 per cent book ratio is “just the market’s way of saying; ‘We gave those guys a dollar and they managed to turn it into fifty cents’”. It is ultimately their ability to turn a dollar into more than a dollar that allows banks to meet their obligations.

None of this is news to Britain’s central bank. Price-to-book ratios have been below one for years.

It is not long since Mervyn King, the former BoE governor, was calling for straight equity to fund 10 per cent of unadjusted total assets. Prof Admati wanted at least 15 per cent. The banks now face a real-life stress test with equity levels only a fraction of those levels.

The “great capital rebuild” was supposed to restore confidence in banking institutions. Many, including Mr Carney, insist it has been delivered. The very low

valuations of Britain's most systemic banks today point to the hollowness of those claims.

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