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Transparency on banks' balance sheets?

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Regulators seem to be torn between the need for transparent fair-value accounting and the perceived need to minimize the losses that banks report on their balance sheets. Some commentators thus proposed that we suspend mark-to-market rules for 'toxic' assets, arguing that the current market for such securities simply does not exist or does not value them correctly.

However, there is another class of "assets" on the balance sheets that has so far been overlooked. During the boom years, many banks accumulated large amounts of intangible assets – such as a company's reputation, know-how, employee morale or market position – that are supposed to generate future profits. When banks took over other institutions at inflated prices, they booked the difference between the price paid and book value as "goodwill".

Asset-price bubbles clearly lead to goodwill inflation as can be seen from the fact that in the U.S., according to the latest available data, goodwill and other intangibles quadrupled to more than $300 billion from $80 billion over the last five years. During the same time, the proportion of equity backed up by tangible assets only doubled, to close to 40% from 19%.

Bank of America, for example, has more than $90 billion in goodwill and other intangible assets on its balance sheet, more than twice the company's market value of less than $40 billion. Many other banks are in a similar situation. The largest eight U.S. banks have a total of more than $300 billion in goodwill and other intangible assets on their balance sheets. In Europe the situation is not much different. According to the latest data available, the dozen largest European banks reported €270 billion in intangible assets on their balance sheets. It's not surprising that the largest banks have proportionally the largest amounts of goodwill on their balance sheets since most of them grew via acquisitions during the boom years.

Now that the bust is with us, the question is whether all that "goodwill" still exists. Under today's market circumstances, the "fair value" of this hot air could be close to zero. The banking bailout thus could become much more expensive.

The U.S. banking system still has about $1 trillion in capital left, according to the latest estimates from the U.S. Federal Reserve, and could thus absorb at least part of the losses on its toxic assets. However, for the largest eight U.S. banks, intangibles amount to close to 50% of their equity. For the entire U.S. banking system this ratio is somewhat smaller, around 40%. In reality, then, the U.S. banking system has much less capital left to absorb losses on "toxic assets". After accounting for the fair value of its goodwill and other intangibles, it may need an

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additional $400 billion just to re-establish an adequate capital base. ‘Detoxification’ would have to come on top of this.

Accountants might object that setting the value of goodwill to zero would be too radical. But “fair value” accounting principles imply that one should use market prices to value goodwill. With stock prices of most banks down between 80% to 90%, any mark to market of goodwill would suggest that a commensurate proportion of the goodwill is ‘impaired’. Markets seem to have recognized this already as bank stocks are now trading below book value – but in many cases not far from ‘tangible book’, i.e. the value of the banks’ tangible assets. The realization that bank balance sheets are much weaker than they appear is certainly another reason why banks are hesitant to resume lending.

Globally, the total of goodwill and other intangible assets on banks’ balance sheets is around $900 billion to $1 trillion. A realistic valuation of this ‘hot air’ would thus probably lead to accounting losses of hundreds of billions, possibly up to $800 billion around the world.

How much goodwill is left?

Leverage of European banks with and without intangible assets, June 2008

	Total leverage	*Leverage excluding intangibles*
UBS	46.9	61.5
HSBC Holding	20.1	26.7
Barclays Bank	61.3	86.1
BBV Argentaria	20.1	26.4
Fortis	33.3	39.9
KBC	24.4	30.2
Lloyd's TSB	34.1	41.7
RBS	18.8	27.8
Credit Agricole	40.5	73.9
BNP Paribas	36.1	44.4
Credit Suisse	33.4	42.8

Source: Author's own calculations based on bank balance sheets.

Under present circumstances, neither regulators nor management have any interest in revealing the true extent of goodwill impairment. Writedowns of goodwill would not have a direct impact on regulatory capital ratios, but regulators would prefer not to have further huge accounting losses revealed in such unsettled market conditions. Auditors, though, would then have to decide whether they are willing to sign off on the banks’ balance sheets. As markets have already started to price in the real value of goodwill, it might be better for banks to clean the slate in their 2008 year-end balance sheets and align the accounting with reality.

Another implication of assigning a “fair” value to goodwill on bank balance sheets is that the leverage ratios of particularly European banks are even higher than widely realized. The nearby chart shows the usual leverage ratio – total assets over total equity – and the “tangible” leverage ratio – tangible assets divided by tangible capital.

It is apparent that the “tangible” capital base of European banks is extremely thin. In many cases each euro of tangible capital supports more than €50 of assets, a much higher ratio than in the U.S. The need to recapitalize European banks is thus even greater than regulators and the bankers themselves have admitted so far.