

The False Tradeoff between Economic Growth and Bank Capital

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The Purported Tradeoff

“More equity might increase the stability of banks. At the same time, however, it would restrict their ability to provide loans to the rest of the economy. This reduces growth and has negative effects for all.”

Josef Ackermann, CEO of Deutsche Bank
(November 20, 2009, interview)

Much More Equity (Capital) is the Simplest, Most Direct and Cost-Effective Approach to Financial Stability and Crisis Prevention

- “Had the share of financial assets funded by equity been significantly higher in September 2008, it seems unlikely that the deflation of asset prices would have fostered a default contagion much, if any, beyond that of the dotcom boom.”

Alan Greenspan, “The Crisis,” Brookings paper, April 15, 2010.

- “.. if capital and collateral are adequate...losses will be restricted to equity shareholders who seek abnormal returns; Taxpayers will not be at risk. Financial institutions will no longer be capable of privatizing profit and socializing losses.”

Alan Greenspan, (quoted in “Greenspan Defends Legacy, Urges Higher Capital, Collateral Standards,” *WSJ*, April 7, 2010.

A Consistent View from UK

- “The most important elements of the regulatory reform need to be: **Much higher capital requirements** across the whole of the banking system, and liquidity requirements which significantly **reduce aggregate cross-system maturity transformation in both banks and shadow banks.**”
- “There is no clear evidence that the growth in the scale and complexity of the financial system in the rich developed world ... has driven increased growth.... *It is possible for financial activity to extract rents from the real economy rather than to deliver economy value.*”

Adair Turner, Chair of UK Financial Services Authority, 2010

Bank Capital and Lending: False Tradeoff

- Capital requirements *do not* force banks to stop lending, only to fund with relatively more equity.
- Credit and lending is clogged when excessively leveraged banks (funded with too little equity) suffer from “debt overhang.” It is *not* “excessive capital” (equity) that interferes with lending.
- The economy, and lending, will improve if lending is financed with a lot more equity and a lot less debt; this will create better incentives, fewer distortions, and more private ownership of downside risk.

More Equity = Better Lending Decisions

- Banks funded with more equity suffer fewer distortions and make **better, more appropriate,** decisions.
 - Less likely to *over*-invest in excessively risky loans,
 - Less likely to *pass up* of profitable loans because of “debt overhang” (commitments to existing creditors).
- Debt overhang from current high leverage can affect adjustments. Solution: no equity payouts during adjustment.
- Valuable loans will be made. There is funding except through banks; fine if done by well capitalized, non-systemic entities.

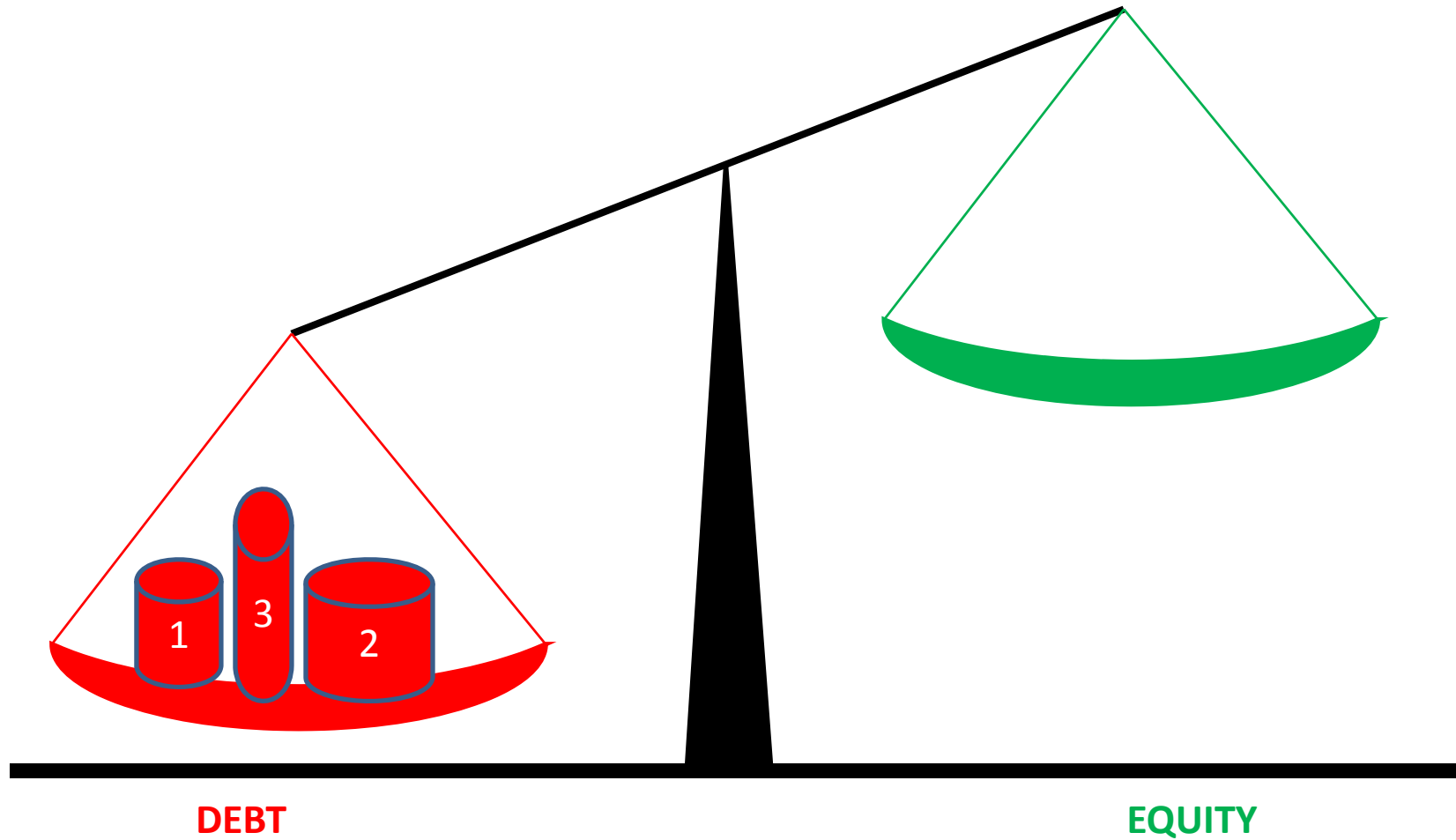
Is Bank Equity “Expensive?”

- **No!** The policy debate must focus on all costs; equity is a bargain when viewed from a full cost-benefit analysis.
- Bank debt funding is *subsidized*.
 - Taxes: the more debt, the lower the tax bill.
 - Underpriced guarantees
 - Underpriced deposit insurance.
 - Implicit guarantees (too big to fail)
 - Both imply that borrowing rates do not fully reflect riskiness of assets.

The Real Deal

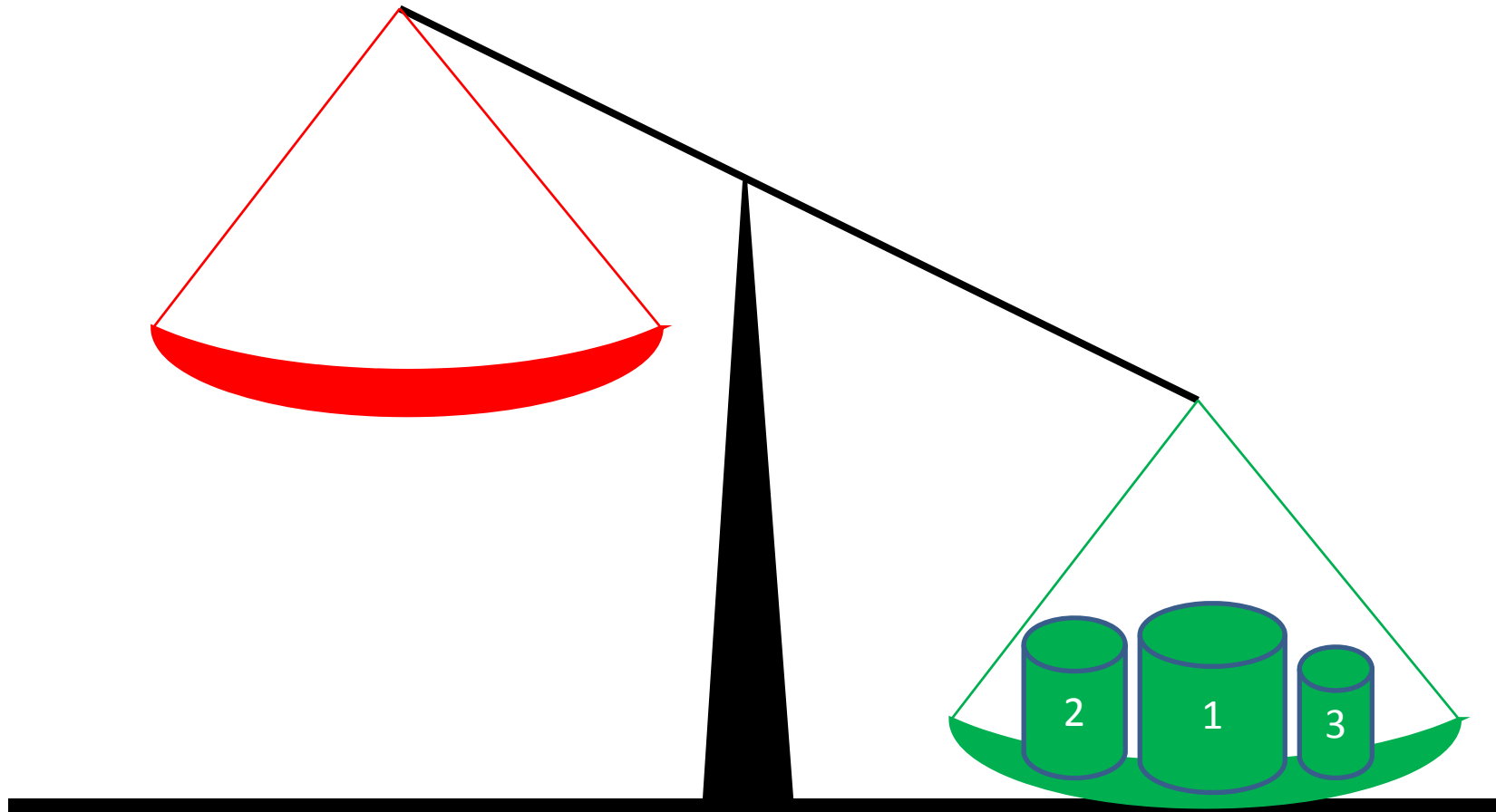
Well-designed capital regulation that ~~requires~~ *much* more equity, ~~might~~ *will* increase the stability of banks. At the same time, ~~however,~~ it would ~~restrict~~ *enhance* their ability to provide *good* loans to the rest of the economy *and* ~~remove~~ *significant distortions*. This ~~may~~ *reduces* ~~the~~ *growth* of banks. *However,* ~~it and has~~ *will have* ~~negative~~ *positive* effects for all (*except possibly bankers*).

Private “Benefits” of Equity and (non-demand-deposit) Debt



1. Tax advantages make it cheap
2. Implicit guarantees make it cheap
3. ROE fixation

SOCIAL Benefits of Equity and (non-demand-deposit) Debt



DEBT

- ~~1. Tax advantages make it cheap~~
- ~~2. Implicit guarantees make it cheap~~
- ~~3. ROE fixation~~

EQUITY

- 1. Reduces systemic risk
- 2. Reduces incentives for excessive risk-taking
- 3. Reduces deadweight costs associated with bailouts

Balance Sheet Fallacy #1: Which Side?

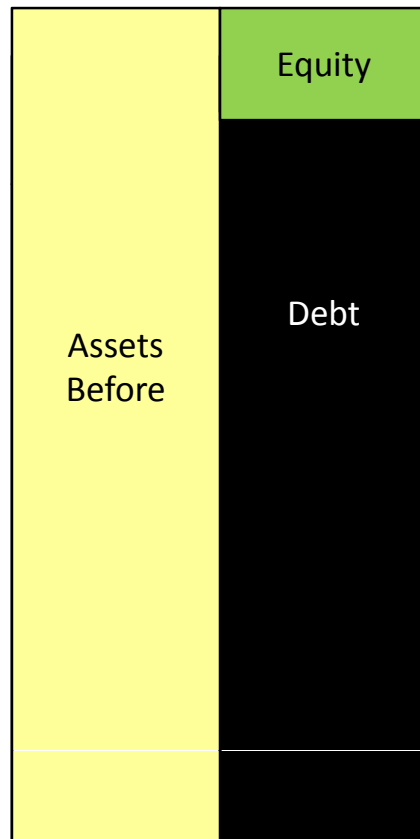
- “**Capital** is the stable money banks sit on... Think of it as an **expanded rainy day fund.**” (*AP* July 21, 2010).
- “**Every dollar of capital is one less dollar working in the economy**” (Steve Bartlett, Financial Services Roundtable, Sep. 17, 2010.)
- “The British Bankers' Association ... calculated that demands that they bolster their capital will require the UK's banking industry to **hold** an extra £600bn of capital **that might otherwise have been deployed as loans to businesses or households.**” (*The Observer*, July 11, 2010).

Confusing Language!

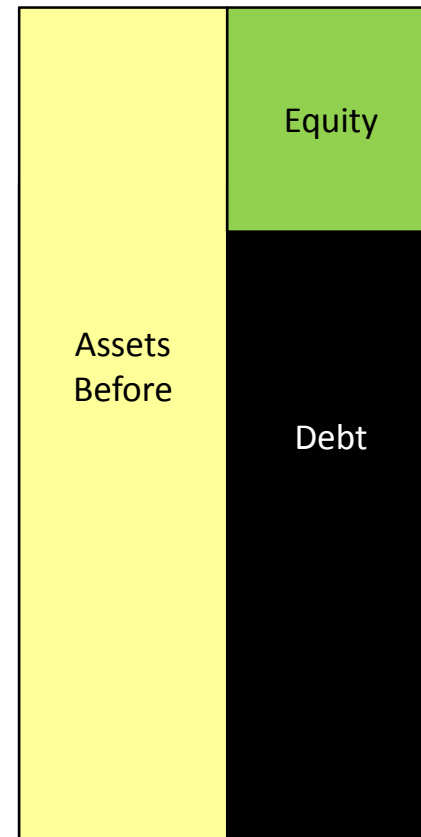
- “Hold” or “set aside” misleadingly suggests idle funds, passivity, cost.
- Capital requirements concern *funding side* only.
 - A firm does not “hold” securities it issues, investors do!
- liquidity/reserve requirements concern *asset* side of balance sheet, restrict holdings.
- **“Hold capital” = fund with equity.**

Equity Absorbs losses but is NOT idle!

Is the (100%) Apple Equity Idle??



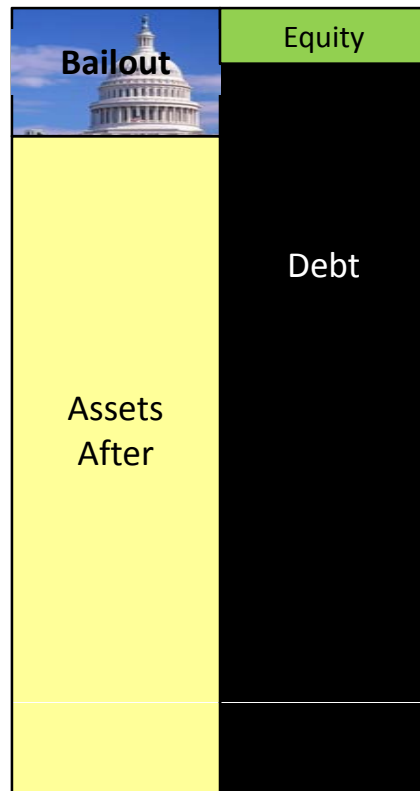
**Too Much
Leverage**



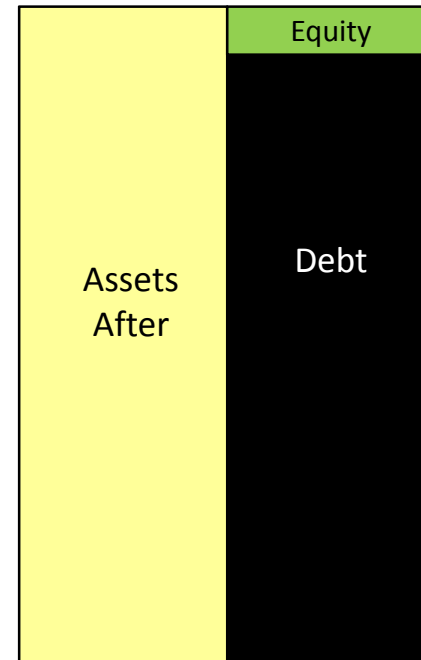
More Equity

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**Too Much
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More Equity

Fallacy: “Equity is expensive because it has a higher required return than debt”

- Contradicts first principles of finance: *cost of capital is determined by the market (investors) according to the risk to which capital is exposed.*
- Lower leverage, fixing the assets, lowers the required return on equity, because equity becomes less risky.
- *Redistributing risk among providers of funds does not by itself affect overall funding costs.*
- Bankers operate daily on the assumption that investors know how to price risk!

ROE *Should* be Irrelevant to this Debate

- Return on Equity (ROE) does not measure shareholder value.
- No one is entitled to a “target ROE.”
 - Expected/required ROE is determined in the market *according to the risk of the equity.*
- Leverage increases the risk of the per-dollar return on equity, thus increasing required ROE *whether or not value is created.*
- Any firm or manager can increase average ROE by increasing leverage (or risk).
- Unless leverage and risk are fixed, ROE comparisons are meaningless.

Bottom Line on Social Cost-Benefit of High Bank Leverage

- High leverage in banking entails a large social cost and virtually no social benefit.
- Debt lowers banks' funding costs only because of subsidies; other considerations favor equity.
- Banks can engage in all valuable activities with 15%-30% equity of total assets.
- If subsidies are desirable, they should not encourage high leverage.
- The natural size of banks/banking should be determined by economic value creation.

**Fallacies, Irrelevant Facts, and Myths
in the Discussion of Capital Regulation:
Why Bank Equity is *Not* Expensive**

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For paper and more writings see
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<http://www.gsb.stanford.edu/news/research/admati.etal.html>