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More equity, less risk

By Tim Harford

How can we make banking safe? A head of steam has been building behind the idea of restructuring banks so that their retail arms are cushioned from riskier activities, and can be plucked neatly from the clammy grasp of any future floundering bank. That is sensible – if easier said than done.

But why leave it there? The simplest way to reduce the risk of a future banking crisis is to force banks to hold more equity.

More equity makes banks safer, other things being equal, because the shareholders who provide the equity have no claim to being paid any particular sum of money. They simply get whatever is left after the bank takes its profits and its losses. That flexibility is what provides room for mistakes – essential in any complex system.

The Basel III accord, unveiled last autumn by banking regulators, was a big step forward in requiring banks to hold more equity. But David Miles of the Bank of England argues that banks should go much further, and recently Tim Geithner, the US treasury secretary, and particularly Daniel Tarullo of the Federal Reserve, have done the same. They are right to do so.

After the crisis, it might seem obvious that Miles, Geithner and Tarullo are right. Why might they not be?

The banks themselves point out that equity is expensive: shareholders demand high returns because they are taking high risks. These returns were previously delivered by keeping the capital cushion as thin as possible: as money from a bank's investments flowed in, much of it would be paid out to the bank's creditors. The modest amount left over would still be enough to provide rich rewards to shareholders because equity was so small compared to the scale of the banking operations.

But with much more shareholder equity, the banks claim, there won't be enough money to compensate shareholders for taking risks. Fewer loans will have to be made, and at higher interest rates. Small businesses and would-be housebuyers will suffer. This is plausible, widely repeated, and nonsense.

Forcing banks to fund themselves more through equity than debt makes shareholders safer, unless they were always safe because of a government guarantee – exactly the situation we wish to abolish. This safety reduces the return shareholders require. If shareholders really want to combine high returns with a high risk of being wiped out, they can always borrow money themselves and use the borrowed money to buy shares in banks. There is no reason that the banks themselves, the basic infrastructure of the world economy, should be allowed to make themselves fragile in order to deliver these returns.

All this is obvious in theory – the theory being the famous Modigliani-Miller theorem, which shows that under certain conditions whether a company is funded by debt or equity makes no difference – but it also seems to be borne out in practice. Miles and his colleagues have produced empirical research showing there seems to be no strong relationship between fat equity cushions and anaemic bank lending.

More equity would not solve every problem in the banking system. For instance, Basel III retains the problematic “risk weighting” concept of Basel II, in which banks can hold less equity if their assets are very safe. Historically, safe assets have included Greek government bonds and mortgage-backed securities. It is easy to see the flaw in this rule, and since there is little cost to funding banking through equity rather than debt, it is hard to see the point of it.

There can be no panacea for banking regulators. No rule change will be without its unintended consequences in such a complex system. But insisting on more equity – much more – is something banking regulators must find the courage to do.

Tim Harford's new book is 'Adapt: Why Success Always Starts With Failure' (Little, Brown)

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