

(Translated from German)

## **Enough Complaining**

The banks are running out of excuses against a higher capital ratio. And rightly so, writes Uta Harnischfeger

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Finally, the banks' constant lamenting about excessive capital ratios can no longer be taken seriously. Ever since Commerzbank announced it was going to come up with 6.3 billion Euro worth of fresh core capital – apparently without too much strain – in order to pacify the European Financial Supervisory Authority, bank lobbyists should be on their guard: it's high time for new arguments against more equity capital!

The lobbyists and others have been telling us for years that higher equity capital provisions are choking the banks. They argue that ultimately there is no money left for providing credits to small and medium-sized businesses. In the recent past, directors of the European Central Bank have increasingly followed suit by depicting the same horror scenario of ever-diminishing credits.

But lo and behold! Suddenly Commerzbank announces that it wishes to retain a 2.4 billion Euro profit as equity capital – and the stock exchange is jubilant. Germany's second-largest financial institution announces the temporary freeze of dividends and bonuses, and still the bankers don't throw in the towel. And what is even more extraordinary: during the announcement of the measures, CEO Martin Blessing repeats like a mantra that the bank will continue to provide loans to small and medium-sized businesses.

Stanford Professor of Finance Anat Admati must have thought she was dreaming. For years she has been demanding equity ratios of 20 per cent and more. And now a bank promises to raise its most valuable core capital – valuable, since it's liable for losses – to 11 per cent of its risk-weighted assets, believe it or not, and still wants to continue to lend money to clients. (NB: Obviously the bank also used certain balance-sheet ruses, diminishing the balance sheet in order to reach the higher quota.)

It is no wonder, then, that a naïve observer may be a bit surprised in view of the constant complaining that has been going on. For hardly a day passes when the banks don't complain about the new Basel III capital demands, finding new arguments all the time to fend off harsher regulation. They never run out of excuses: growth is threatening to slow down, the debt crisis could spin out of control, and there may be a recession.

Until now, the Basel Committee has remained steadfast. Basel III demands that the banks keep seven per cent of their weighted risk assets at the ready in form of hard cash. The Committee knows that the argument of more capital stifling lending is nothing but bullshit: a Bank of England study has shown that twice the amount of equity capital boosts financing costs by a mere 0.2 per cent and capital costs by only 0.1 per cent.

This is why Basel explicitly states that minimum capital requirements are exactly that: a minimum. Countries are free to ask for more.

As indeed they should. For the example of the Commerzbank shows that all the regulators are right to desire just that: safe banks. From 2019, Switzerland, Sweden, and the U.K. will demand more, i.e., at least ten per cent core capital. Let's bet that the Swiss and Swedish companies will continue to receive loans after 2019, too!

The common mistake that higher equity ratios and credits are incompatible is based on several misunderstandings. First, the banks don't put capital aside, as they like to say. There is no capital resting on a savings account in anticipation of hard times. The banks invest it – as they do all other money – actively, including in Greek government securities. Contrary to insurance premium reserves, however, equity capital is not assigned a particular purpose. Nor is it liability capital. Even the finest equity capital can go up in smoke in a matter of seconds.

Second, no other sector is so much in debt. Why should the banks be granted exemptions and exceptions here? Put simply, let us imagine the following: a bank with a balance sheet total of 100 Euro is allowed to have 98 Euro worth of debts on the liabilities side (and these are often leveraged several times over) and 2 Euro of profits retained or of shareholder money. Just think about that.

And now please compare: even industries that require a lot of money for plants and fleets are required to have at least 30 to 40 per cent equity capital. In the 19<sup>th</sup> century, banks also frequently had 30 or 40 per cent equity capital. Moreover, banks often require clients to have 25 per cent equity capital for a loan.

However, it is particularly attractive for the banks to operate with borrowed capital because it is tax-deductible. Further, the state implicitly guarantees the survival of the (big) banks – despite all restructuring laws. As long as the system continues to favor debts, the banks will not cease to complain.

A final, much-cited argument is also absurd. Investors, the argument goes, do not want banks with large amounts of capital of their own, since this apparently lowers the rate of return. However, the opposite is true: investors would voluntarily accept smaller rates of return if their investment were safer. For more equity capital makes a bank less vulnerable in time of crisis. Commerzbank could prove this one day.