Letter

Banks are not a special case on debt-equity ratio

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From Prof Anat Admati and Prof Martin Hellwig.

Sir, The title of Mark Roe's Comment article of May 15, "Brown-Vitter is another example of how not to fix the banks," gives the wrong impression. Professor Roe sees Brown-Vitter as useful, but points out that it "would not be enough on its own to solve finance's problem". Both are true.

The Brown-Vitter bill would require large banks to use much more equity funding and rely less on borrowing. It sets a minimum "leverage ratio" of 8 per cent equity relative to total assets for institutions with more than $50bn in assets and 15 per cent for those larger than $500bn. By contrast, capital ratios in Basel III rely on a complex, distortive and manipulable system of risk weights, and equity is allowed to be as low as 3 per cent of total assets.

If banks had incentives to choose equity levels consistent with Brown-Vitter, the law would not have been necessary. Large banks, however, are lobbying heavily against Brown- Vitter. Why? Prof Roe notes that tax incentives and implicit guarantees make using debt cheaper relative to equity. Because banks are already highly indebted, however, bankers' attitudes towards additional borrowing or additional equity are also coloured by the banks' overhanging debt. Additional equity would make the outstanding debt safer, while additional short-term borrowing would make it less safe. There is a fundamental conflict of interest between borrowers and creditors, and this conflict makes it more attractive for heavy borrowers to continue borrowing as long as their existing creditors allow it. Borrowing can be "addictive".

When banks make loans to non-financial companies, they usually insist that borrowers have enough equity. Loan terms and covenants are used to protect creditors. By contrast, the banks' own creditors are too dispersed to impose and enforce such conditions. They may also believe that their risk is minimal because the bank is "too big to fail". Guarantees and subsidies perversely enable and even encourage excessive and inefficient indebtedness that increases the fragility of the financial system.

Changing the tax code, and trying to counter bankers' distorted incentives, as Prof Roe suggests, would be highly desirable. In addition, requiring institutions whose distress or failure would cause significant collateral damage to use much more equity is essential for protecting the public from unnecessary risks. Non-banks rarely have less than 25 or 30 per cent equity, and there is no justification for allowing banks to maintain less only because they want to.

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