The New York Times

Beware of Banks' Flawed Focus on Return on Equity

By Anat Admati July 25, 2011 3:15 pm

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Are you happy with the recent performance of your portfolio? Like the economy, stock markets have not recovered from the financial crisis. The Standard & Poor's 500-stock index is down 16 percent from its October 2007 peak.

The American housing decline was transformed into a global financial tsunami through the extremely fragile funding practices of major financial institutions. Many banks funded 97 to 99 percent of their total assets with debt, and only 1 to 3 percent with equity, or, as bankers call it, "capital." When so much of the asset value is committed to paying back debt obligations, a small loss in this value can freeze refinancing, and this can cause havoc in a highly interconnected financial system.

Despite the financial crisis, bankers lobby furiously against increased equity requirements, lamenting that their return on equity might decline. But return on equity is meaningless without accounting for the risk of the equity, which depends critically on how much debt is used to leverage it. In the financial crisis, the fallout from the risks that banks took devastated your portfolios and the economy.

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Start with basics. With leverage, equity becomes riskier. Imagine investing $30,000 of your own equity, along with $970,000 borrowed at 4 percent, in foreign real estate. If the investment returns 1 percent, you lose your entire equity, because

debt must be paid first. But an increase of 7 percent in the value of the investment more than doubles your $30,000 after interest, producing more than a 100 percent return on equity. Funding with debt magnifies the sensitivity of the per-dollar return on equity, namely your return on equity to the per-dollar return on the underlying investment.

Since investors must be compensated for bearing risk, higher leverage increases the required, or expected, return on equity. To judge whether a manager has created value, one cannot simply look at the return on equity; one must adjust for risk. A bank manager can attempt to reach a "target return on equity" by taking on more risk and by using more leverage, but this, in and of itself, does not create value. It does, however, increase fragility and systemic risk.

Equity requirements and controls on risk-taking by financial institutions can reduce the collateral damage these institutions can impose on the economy through their fragility. The new Basel III international banking rules raised equity requirements modestly, but they are still quite low: 7 percent equity relative to "risk-weighted assets" and up to 9.5 percent for the most systemically important institutions considered "too big to fail."

Risk-weighted assets, however, can be significantly smaller than total assets, which include highly rated securities that are counted less in the calculation of risk-weighted assets. The use of risk weights invites "financial innovation" that increases and hides the true risk and leverage; it also distorts investments toward assets with low risk weights and often away from traditional lending. Equity can be as low as 3 percent of total assets under Basel III.

Previous Basel agreements did not prevent the last crisis. Basel III equity requirements are the result of a highly political process. They are not based on solid science and are dangerously low.

Higher equity requirements are not difficult to meet. They only require that financial claims be reshuffled so incentives are better aligned and more downside risk is shifted from taxpayers to the shareholders that enjoy the upside. If banks retain their earnings and use them to repay some of their debts or to lend, rather than to pay dividends or buy back shares, equity will build up with little negative

impact on the economy and no reduction in lending capacity. The economy stands to reap huge benefits at minimal costs.

Restricting equity payouts until financial institutions are sufficiently well-capitalized is the easiest, least costly way to transition to healthier and safer system.

Aside from their fixation with return on equity, bankers hate high equity requirements and love to fund by borrowing because debt is subsidized through an ever-increasing, underpriced “safety net” from various government guarantees. Debt is also favored by tax codes that allow interest deductibility and thus provide tax incentives to the “financial pollution” generated by high leverage.

The subsidized safety net translates to low borrowing costs for banks that do not reflect their asset risks. Moreover, creditors whose claims are backed up by government safety nets are lax in monitoring banks.

Most companies do not enjoy such support of their debt. Nonbank public companies use on average 70 percent equity funding, and some are 100 percent equity funded despite the tax advantage of debt.

Although some forms of debt, like deposits, are part of the “business of banking,” there is no economic justification for the use of only 5 or 10 percent equity.

Bankers use confusing language that presents equity, or “capital,” as a pile of money that banks must “hold in reserve” or “set aside” passively. This confuses capital requirements, which concern funding only, with liquidity or reserve requirements, which concern how funds are invested. It is you, investors, who hold banks’ equity or capital, not the banks that issued it.

Assertions that increased equity requirements would restrict lending and growth are based on flawed arguments that miss the key points. Lending decisions will be improved with more equity funding; it is too much debt, and not too much equity, that causes credit crunches. Economies can grow and prosper with safer, less complex banks that deliver better value over all.

It is true that higher equity requirements may cause bank stock prices to decline. However, this would only be a result of the loss of tax and safety net

subsidies that banks currently enjoy in using leverage. What might be lost to banks, though, is more than offset by savings to taxpayers in lost taxes and avoiding potential bailouts, and by the significant gains to the broader economy, which includes your other investments, from a healthier and more stable financial system.

Reforming the tax code to put debt and equity on an equal footing would be extremely useful. Arguments based on a “level playing field” between American and foreign banks are also fallacious. It is not a national priority that an industry is successful globally if it exposes the economy to unnecessary risks and costs.

Many challenges remain in devising effective capital regulation and tackling enforcement issues. Investors: to forestall the arrival of another costly financial crisis and help your overall portfolios, you must beware of misleading return on equity measures, monitor bank risks carefully, ask banks to stop lobbying against higher equity requirements, and demand that policy makers not allow flawed arguments and empty threats to affect their decisions.

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