In Hans Christian Andersen’s famous tale “The Emperor’s New Clothes,” two tailors offer to provide the emperor with beautiful and very special clothes. They claim the clothes will be invisible to people who are stupid or unfit for their jobs. The emperor orders a full set.

When he sends his ministers to monitor the tailors, the ministers don’t see anything, but out of fear of being considered incompetent, none of them admits this and instead they extol the splendors of the invisible clothes. The emperor finds his new attire invisible, yet not wanting to appear stupid, praises the nonexistent items. When he tours his capital wearing the “clothes,” onlookers also admire them, even though they don’t see anything. Only when a child shouts: “The emperor has no clothes!” does everyone admit that the emperor is, in fact, naked.

Banks have a similar mystique. There is a pervasive myth that banks are different -- special, somehow -- from all other companies and industries in the economy. Anyone who questions this is at risk of being declared incompetent.

In fact, many claims made by leading bankers and banking experts, including academics, have as much substance as the emperor’s new clothes. But most people don’t challenge these claims, even as the claims affect policy. The specialists’ confidence is too intimidating. Even people who know better fail to speak up. The public is taken in.

“Costly” Regulation

https://www.bloomberg.com/view/articles/2013-02-03/emperors-of-banking-have-no-clothes
Some bankers may admit to mistakes leading to the financial crisis that began in 2007, but they portray the crisis as a fluke or as an accident that is highly unlikely to recur in our lifetimes. It would be costly and wasteful, they claim, to tighten regulation to forestall an event that might happen once in 100 years. Tighter regulation, we are warned, would interfere with what banks do to support the economy, and this would have serious, unintended consequences.

Take bank borrowing. Excessive borrowing was identified as a major factor in the financial crisis. Bankers sometimes admit this. Nevertheless, the banking industry fights aggressively against tighter restrictions on bank borrowing. The constant refrain is that too much tightening would harm economic growth.

This is a typical bugbear, suggesting that we must choose between economic growth and financial stability. After all, who would be in favor of a regulation that reduces growth and therefore might have negative effects for all? In fact, the history of financial crises and instability, including the recent crisis, has shown that the greatest damage to bank lending and growth occurs when banks become distressed from having borrowed too much and lost on their investments.

Why would restrictions on bank borrowing have any effect on bank lending whatsoever? One argument was given in 2010 by the British Bankers’ Association <http://www.bba.org.uk/> , which claimed that new regulations would require U.K. banks to “hold an extra 600 billion pounds of capital that might otherwise have been deployed as loans to businesses or households.” To anyone who doesn’t know what the regulation is about, this argument may sound plausible. In fact, it is nonsensical and false.

The nonsense is due to the misuse of the word “capital.” In the language of banking, this word refers to the money the bank has received from its shareholders or owners. This is to be distinguished from the money it has borrowed. Banks use both borrowed and unborrowed
money to make their loans and other investments. Unborrowed money is the money that a bank has obtained from its owners if it is a private bank, or from its shareholders if it is a corporation, along with any profits it has retained.

Unborrowed Money

Elsewhere in the economy, this type of funding is referred to as equity. In banking, it is called capital. Capital regulation requires that a sufficient fraction of a bank’s investments or assets be funded with unborrowed money. This is similar to the requirement that a homebuyer make a minimum down payment when buying a house. Having a minimal ratio of unborrowed funds relative to total assets is a way to limit the share of assets that is funded by borrowing.

Because unborrowed funds are obtained without any promise to make specific payments at particular times, having more equity enhances the bank’s ability to absorb losses on its assets. From the statement of the British Bankers’ Association, however, we wouldn’t guess that capital requirements are about how much a bank borrows. The statement makes it appear as if capital were a cash reserve -- a pile of cash that banks hold that can’t be used to make loans.

In fact, capital regulation does not tell banks what to do with their funds or what they should hold. It tells banks only what portion of the funds they use that must be unborrowed. Saying that new regulations would require U.K. banks to “hold an extra 600 billion pounds of capital” is nonsense. The implication that loans to businesses or households are automatically reduced by that 600 billion pounds is false. Capital is not a rainy-day fund.

The confusion about the term “bank capital” is pervasive. Numerous media reports say that banks must “set aside” capital to satisfy new regulations. References to capital reserves suggest that the regulation forces banks to hold cash that sits idly in the bank’s tills without being put to work in the economy. A bank lobbyist is quoted as saying, “A dollar in capital is one less dollar working in the economy.”

Another line of argument against increased capital requirements is that capital -- that is, equity -- is expensive and that if banks must have more equity, their costs would increase. This mantra is so self-evident to banking specialists that they usually see no need to justify it.

Hating Equity
But why do banks hate equity so much and view it as expensive? In what exact sense is it expensive, and what does this mean for society and for policy?

We can test this argument by comparing banks to other corporations. Corporations in most industries are free to borrow as much as they want if they can find a lender. Yet there is no other sector in which corporations borrow nearly as much as banks do. For the vast majority of nonfinancial corporations in the U.S., borrowing represents less than 50 percent of assets. Some highly successful companies don’t borrow at all.

By contrast, debt often accounts for more than 90 percent of bank assets. For some large European banks, the fraction is even higher, above 97 percent. It was that high for some major U.S. investment banks before 2007, as well as for the mortgage giants Fannie Mae and Freddie Mac, which were bailed out. The new regulations that the banking industry complains about would still allow debt to fund 97 percent of bank assets.

If a company can count on being bailed out by the government when it can’t pay its debts and if its creditors don’t worry much about a default, creditors would be happy to lend to the company. The company would find that borrowing is cheap and, by comparison, other ways to fund investments, such as equity, would be expensive.

The interest that the company would have to pay on its debt wouldn’t reflect its true default risk because that is partly borne by the taxpayer. From the perspective of the banks, therefore, borrowing is cheap.

Among the lobbying cries is the suggestion that regulation should not harm “our” banks in global competition and thus cannot be tighter than regulations elsewhere. This, too, is an invalid argument.

A country’s public policy shouldn’t be concerned about the success of banks or other firms if that success is achieved through taxpayer subsidies or by exposing the public to excessive risks -- for example, the risk of pollution or a financial crisis.

**Systemically Important**

Why should we care so much about the safety of banks and about how much banks borrow? The damage from a bank’s getting into difficulties from excessive borrowing can be great, affecting many beyond those directly involved.
The potential damage is especially large when the bank is a systemically important financial institution like JPMorgan Chase & Co. or Deutsche Bank AG, with massive operations all over the globe. Excessive borrowing by such banks exposes all of us to risks, costs and inefficiencies that are entirely unnecessary.

The too-big-to-fail problem for banks is greater today than it was in 2008. Since then, the largest U.S. banks have become much larger. On March 31, 2012, the debt of JPMorgan Chase was valued at $2.13 trillion and that of Bank of America Corp. at $1.95 trillion, more than three times the debt of Lehman Brothers Holdings Inc. The debt of the five largest U.S. banks totals about $8 trillion. These figures would be even larger under European accounting rules.

This situation makes it all the more important to prevent scenarios in which governments must choose between letting a major institution fail or committing to an expensive bailout. One approach is to try to create mechanisms that would allow large banks to fail without disrupting the economy or requiring public support. Although useful efforts have been made in this direction, this remains a challenge for global banks. Even the best resolution mechanism is likely to be disruptive and costly.

The present situation is perverse. It is as if we were to subsidize the chemical industry to intentionally pollute rivers and lakes. Such subsidies would encourage additional pollution. If the industry were asked to limit the pollution, it would complain that its costs would increase. Would such complaints make us tolerate the pollution?

Subsidizing banks to borrow excessively and take on so much risk that the entire banking system is threatened is just like subsidizing and encouraging companies to pollute when they have clean alternatives.

(Anat Admati is a professor of finance and economics at the Stanford Graduate School of Business and Martin Hellwig is a director at the Max Planck Institute for Research on Collective Goods in Bonn. This is the first in a series of three excerpts from their new book <http://bankersnewclothes.com/>, “The Bankers’ New Clothes: What’s Wrong With Banking and What to Do About It,” to be published Feb. 24 by Princeton University Press. The opinions expressed are their own.)

This column does not necessarily reflect the opinion of Bloomberg View's editorial board or Bloomberg LP, its owners and investors.
Anat R. Admati is the George G.C. Parker Professor of Finance and Economics at the Graduate School of Business, Stanford University, and a co-author of “The Bankers’ New Clothes: What’s Wrong With Banking and What to Do About It.”

Read more opinion <https://www.bloomberg.com/view/contributors/AQMPvPTp0xw/anat-r-admati/articles>
Follow @AnatAdmati on Twitter <https://www.twitter.com/AnatAdmati>

In this article

<table>
<thead>
<tr>
<th>Stock</th>
<th>Price</th>
<th>Change</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>FNMA</td>
<td>1.56</td>
<td>+0.02</td>
<td>+1.30%</td>
</tr>
<tr>
<td>JPM</td>
<td>114.77</td>
<td>+0.00</td>
<td>+0.00%</td>
</tr>
<tr>
<td>FMCC</td>
<td>1.55</td>
<td>-0.00</td>
<td>-0.29%</td>
</tr>
<tr>
<td>DBK</td>
<td>9.78</td>
<td>-0.08</td>
<td>-0.85%</td>
</tr>
</tbody>
</table>

To contact the authors of this story:
Martin F Hellwig at hellwig@coll.mpg.de
Anat R Admati at admati_anat@gsb.stanford.edu

To contact the editor responsible for this story:
Paula Dwyer at pdwyer11@bloomberg.net

Terms of Service
Trademarks Privacy Policy
©2018 Bloomberg L.P. All Rights Reserved
Careers Made in NYC Advertise Ad Choices Contact Us Help