Letter

Higher equity level for banks not such a bitter pill

SEPTEMBER 16, 2013

From Prof Anat Admati.

Sir, In your Analysis article on the Lehman legacy, Patrick Jenkins worries that investors would not “put up” with the return on equity that banks would generate if their ability to juice up average returns by borrowing is constrained (“Five bitter pills”, September 13).

Invoking return on equity to argue about leverage is fallacious. First, with more equity, ROE is actually higher (less negative) if a bank incurs losses. Second, return comparisons are meaningless without adjusting for risk, and more leveraged equity is riskier. When bankers chase target returns, they may harm shareholders by putting them at risk without sufficient compensation for bearing it. Worse, excessive borrowing reduces the efficiency of lending, adds fragility to the system and increases the likelihood of financial crises, all this without generating any benefits to society.

Mr Jenkins also wonders whether the cost of credit would increase if banks had to use more equity funding. But increases in banks’ funding costs would only be due to a reduction in the government subsidies they enjoy when borrowing and not when using equity. Encouraging and subsidising banks to borrow excessively is as paradoxical as subsidising a dye producer to pollute when there is a clean alternative that is equally costly except for the subsidies. Implicit guarantees enjoyed by too-big-to-fail banks create perverse incentives for banks to become even larger and more dangerous and inefficient.

If banking shrinks because some banks are not viable at a level of 30 per cent equity, the economy stands to benefit. Lending is only a small part of the largest banks’ investments. Lending suffers when banks are weak, and bankers use subsidised funding to boost their ROE in derivative and other markets.

In the same piece, Daniel Schäfer finds appealing the “bitter pill” of making banks into partnerships with unlimited liability. If bank owners were liable for paying banks’ debts from their personal fortunes, they would probably do better controlling risks than do banks’ boards and CEOs. Many of the problems of accountability and responsibility in banking would be addressed.

When banks were organised as partnerships in the 19th century, they had 50 per cent equity and no government guarantees. They were small. Would there be enough bank owners willing to expose their personal wealth to risk in banking today?

Regulation must ensure that institutions whose distress and default is harmful should rely much more on equity. Otherwise, expect intense cycles of boom, bust, and bailout to continue.

Anat Admati, George G C Parker Professor of Finance and Economics, Stanford University, US

Co-author of *The Bankers' New Clothes: What's Wrong with Banking and What to Do About It*