View

Must Financial Reform Await Another Crisis?

By Martin F Hellwig and Anat R. Admati
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We have argued that if banks had much more equity, the financial system would be safer, healthier and less distorted. From society's perspective, the benefits are large and the costs are hard to find; there are virtually no trade-offs.

The claim is often made, however, that this reform would be costly. Higher equity requirements, goes the argument, would reduce bank lending and harm the economy, which hasn't yet recovered from the sharp downturn of 2008.

In fact, it is best for the financial system and for the economy if problems in banking are addressed quickly and forcefully. If bank equity is low, it is important to rebuild it quickly even when the economy is weak.

It is also important to recognize hidden losses and to close zombie banks -- those with large losses that, if acknowledged, would wipe out the banks' equity. If the losses aren't acknowledged, these weak banks continue to operate, but their decisions are likely to be harmful.

Delays can be costly. In Japan in the 1990s, the authorities failed to force banks to recognize losses from bad loans. The banks continued to lend to distressed borrowers while reducing their lending to new firms. As a result, economic growth stalled. The Japanese crisis lasted for more than a decade. In the U.S. in recent years, banks have also been slow to recognize losses while cutting new lending.

Weak Banks

Weak banks don't serve the economy well. They may continue to roll over loans to distressed or insolvent clients and even provide them with additional funds to avoid having to acknowledge losses. Such behavior, however, hurts the economy by maintaining unsuccessful old firms and restricting funding for potential new ones. Distressed or insolvent banks also tend to take excessive risks to gamble for survival. Yet authorities in most countries have been reluctant to address the continued weakness of many banks.

The easiest way to increase the health and stability of the financial system is to ban banks from making cash payouts, such as dividends, to their shareholders, and to require banks to retain their earnings until they have significantly more equity. These measures would bring immediate benefits and have no harmful side effects on the economy.

If banks didn't pay their shareholders, they could lend using their retained earnings rather than with new borrowing. Successful companies use retained earnings all the time to fund new investments. In fact, retained earnings are the most popular source of funding for corporations.

Shareholders in fast-growing companies, such as Apple Inc., are usually happy if earnings are retained. They expect their money to be invested productively so that the share price will rise.

By contrast, if a corporation might default on its debts, shareholders may prefer that money be paid out to them rather than benefiting creditors in a bankruptcy. In this case, a ban on payouts might hurt some shareholders, but it would benefit creditors and, in the case of banks, the deposit-insurance fund and possibly taxpayers. Society as a whole, including most bank shareholders, would benefit because the bank and the financial system would be safer from distress or failure. Safer, less-indebted banks are in a better position to support the economy.

In 2007 and 2008, U.S. regulators allowed banks to make large dividend payments, even after the subprime crisis broke into the open in August 2007. The payouts weakened banks significantly. The amounts the largest banks paid their shareholders equaled about half what the U.S. government provided them subsequently through the Troubled Asset Relief Program. Had the banks not made those payouts, there would have been less need for government support.

Raise Equity

Since 2011, the Federal Reserve and authorities elsewhere have allowed most banks to make cash payments to shareholders, even though banks are still weak and some still haven't reached the level of equity required under the new international rules for banking regulation, known as Basel III.

Because of warnings that stricter equity requirements would reduce bank lending and harm economic growth, Basel III won't take full effect until 2019. Yet it makes no sense to allow such a delay on the grounds that banks need time to adjust, and at the same time allow payouts that deplete the equity and make the adjustment slower. Allowing the payouts before the new equity levels have been reached benefits the banks while harming the public.

Healthy banks don't need to wait for equity to be built internally through retained earnings. Such banks could immediately become safer by raising new equity from investors, and regulators can require them to do so. If banks are required to raise their equity by specified amounts, there is no reason for them to make fewer loans.

If a bank is unable to raise new equity because it has no profits to retain or can't sell shares, there is reason to suspect that the bank is highly distressed. In such a case, supervisors should step in, examine the loans and other assets one by one, and close the bank if it is insolvent. Hidden insolvencies are highly inefficient and must not be allowed to persist.

In addition to the unnecessarily long transition period, Basel III's equity requirements are far too low. When the agreement was announced in September 2010, Martin Wolf, the Financial Times columnist, wrote that the tripling of requirements "sounds tough, but only if one fails to realize that tripling almost nothing does not give one very much."

The requirement for common equity was indeed raised from 2 percent to 7 percent. However, this ratio relates the bank's equity to its so-called risk-weighted assets, a measure that tries to account for the risk of assets. Referring to risk-weighted rather than total assets weakens equity requirements significantly.

For example, the roughly 55 billion euros ($74 billion) in equity that Deutsche Bank AG had on its balance sheet at the end of 2011 represented more than 14 percent of the bank's risk-weighted assets -- far more than required by Basel III -- but only 2.5 percent of the bank's total assets. When equity is 2.5 percent of a bank's total assets, a 2.5 percent decline in the value of assets is enough to wipe out the equity and make the bank insolvent.

Since 2007, several large banks became insolvent from relatively small losses -- or would have become insolvent if they hadn't been bailed out with taxpayer money. In some cases, the losses came from assets that had been treated as riskless by regulators and therefore weren't backed by equity at all. Empirical research indicates that the ability of banks to withstand the recent crisis depended on the ratio of equity to their total assets rather than their risk-weighted assets.

The idea of risk weighting is that safer assets are given less weight and therefore require less backing by equity. In practice, the system of risk weights has encouraged banks to invest in assets that are treated as safe by regulators even though they are risky, such as AAA rated mortgage-backed securities or Greek sovereign debt. The system also allows banks to manipulate their own equity requirements by using their own risk models to determine risk weights.

Basel III also proposes a so-called leverage-ratio regulation, which will set a minimum level for equity relative to total assets. Basel III fixed this minimum at 3 percent. This number is outrageously low. If bank equity is so low, we must be prepared for more bank failures and crises, with large costs to taxpayers and significant economic damage.

There is no legitimate reason for the proposed Basel III requirements to be so low. These requirements reflect the political impact that the banks have had on the policy debate and the flawed and misleading claims that are made in discussions about banking regulation.

Fictional Costs

Requiring that bank equity be on the order of 20 percent to 30 percent of total assets would make the financial system much safer. At those levels, most banks would be able to cope on their own and would require no more than occasional liquidity support.

Instead, the approach taken by regulators has been based on the misplaced notion that there are significant trade-offs for society associated with higher equity. The research that has been offered in support of Basel III understates the benefits and makes up fictional costs of equity to society.

For example, practically all of the studies assume that there is a cost to society when banks issue new equity, without properly explaining why. They also fail to distinguish between the cost to banks and the cost to society; the two differ if risks to creditors, taxpayers and the economy increase when banks use less equity and borrow more.

With more equity and lower indebtedness, banks' reactions to losses would also be less intense and less destabilizing. When losses wipe out much of a bank's equity, distressed-asset sales might depress market prices, as happened in 2007 and 2008. If banks were less indebted, they would also have more confidence in each other, which is important because banks routinely borrow from and lend to one another to smooth fluctuations in funding due to customer transactions.

The banking system has become ever more fragile since the 1970s. Increased competition in financial markets has lowered banks' ability to withstand shocks. The high degree of interconnectedness in the system that came with financial innovation and globalization has magnified the potential fallout from the failure of an individual institution. Finally, some shocks to the overall economy, to which all financial institutions tend to be exposed, have become more pronounced, which makes it more likely that many institutions will run into trouble at the same time.

Given this increased fragility, bank-equity levels from the recent past don't provide appropriate guidance for the equity levels that would make for a healthy system today. Equity levels of 20 percent to 30 percent, or even more, were typical before the development of government safety nets, even without capital regulation. Such levels provide a more appropriate benchmark.

Reducing Fragility

If banks are less able to use subsidized borrowing, the banking sector might shrink, but this shouldn't cause concern. The current size of the banking sector may well be too large.

The proper size of any industry should be determined in markets, as different businesses compete for resources, including people. In banking, however, the normal market mechanism has been distorted by guarantees, bailouts and cheap bank borrowing at the expense of taxpayers. Such distortions are highly inefficient. Excessive borrowing exposes the public to unnecessary risk of financial instability and crises while producing no benefit.

Bankers don't have proper incentives on their own to make their banks safe. Current public policy and regulation give them strong incentives to borrow too much and to take excessive risks with their investments, both of which are in direct conflict with the public interest in a stable financial system.

The public continues to be harmed by a dangerous and distorted financial system that doesn't support the economy as well as it should. Efforts to reform the system have so far been weak and misdirected. Much can be done at little cost to have a better banking system. The critical ingredient to financial reform -- still missing -- is political will.

(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 last 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. Read Part 1 <http://www.bloomberg.com/news/2013-02-03/emperors-of-banking-have-no-clothes.html> and Part 2 <http://www.bloomberg.com/news/2013-02-04/bankers-arguments-on-capital-are-fundamentally-flawed.html> .)

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