Project Syndicate

The Great Bank Escape

Dec 31, 2012 | **ANAT ADMATI**

STANFORD – This year has proven to be yet another replete with futile efforts to manage the outsize grip that banks and bankers have on the world economy. The global financial system remains distorted and dangerous.
Since the 1980's, "shareholder value" has increasingly become the focus of corporate governance. Managers and board members often receive stock-based compensation, which gives them equity ownership rights and, in turn, creates a powerful incentive to maximize the market value of their companies' shares.

But actions taken in the name of shareholder value often benefit only those whose wealth is closely tied to the company's profits, and may actually be harmful to many shareholders. Despite their claims that they are pursuing shareholder value, the actions of top managers, in particular, often reflect only their own interests, rather than those of shareholders who often hold the great majority of the shares.

This discrepancy can be seen clearly in the banking sector. Before 2007, banks enjoyed high returns and soaring stock prices. But excessive indebtedness and losses on the risky investments that had been made triggered the global financial crisis and led to the failure, or near-failure, of many major financial institutions.

Banks with substantial overhanging debt reduced lending, and, despite the massive intervention of governments and central banks, the crisis dragged down the global economy. As a result, since 2008, shareholders have lost substantially on their investments in banks. The crisis – together with the prolonged economic downturn that followed – caused diversified shareholders to lose on their other investments, too.

Furthermore, many bank shareholders have suffered from the disruption in lending, either directly or via their businesses or employers. Some have even lost their jobs. And, along with other taxpayers, they incurred some of the cost of the bailouts.
And yet, despite large losses on their holdings in 2007-2008, top bankers fared significantly better than most of their shareholders did in 2000-2008. Even

executives of the failed investment banks Bear Stearns and Lehman Brothers walked away with hundreds of millions of dollars in compensation, while the companies' shareholders, who received some dividends along the way, fared much worse – not even considering their other crisis-related losses.

To safeguard their interests, bankers have lobbied relentlessly against regulations that would require them to rely less on borrowing and more on retained earnings or new equity to fund their lending and investments. They cite the need to deliver high returns for shareholders, implying that tighter regulations undermine shareholders' interests.

But safer, less indebted banks are better able to continue lending without becoming distressed or needing support. As a result, they are less likely to destabilize the global financial system or impose harm on most shareholders and the public.

Bankers also claim that higher equity requirements would restrict credit and hinder economic growth. But their arguments are flawed and misleading. For example, they use return on equity as their primary measure of profitability, but neglect to distinguish between ROE and shareholder value. In fact, in the single-minded quest for higher returns, bankers might expose shareholders to excessive risk, without compensating them adequately. And bankers neglect to acknowledge the role of government guarantees and subsidies in making so much borrowing possible and attractive.

Contrary to bankers' claims, increasing equity requirements significantly, and thus safeguarding the financial system's stability, is in the public interest – including the interest of most shareholders. By contrast, preserving the *status quo*, or implementing inadequate regulation, would allow bankers to continue to profit at the expense of others.

Small shareholders cannot easily influence banks' decisions, especially on complex risk-related issues. And banks' boards of directors, which wield ultimate control, are not legally required to consider the broader impact of their actions on others. Instead, their narrow perspective – which tends to coincide with executives' preferences even at the expense of other shareholders – dictates their decision-making.

Even from banks' narrow standpoint, higher equity requirements would cost less than other proposed regulations. And such requirements would reduce the likelihood that strong banks would be called upon to finance the resolution of failed institutions. (Of course, these considerations are less relevant if bankers expect to succeed in blocking *all* regulation aimed at reducing excessive risk-taking, and to be bailed out in a crisis.)

As matters stand, bankers continue to benefit fully from the upside of their investments, while sharing the downside with creditors and taxpayers – and sometimes with shareholders. Although some progress has been made in improving regulation and enforcement, industry lobbies have largely succeeded in delaying essential reforms needed to ensure global financial stability.

JPMorgan Chase's CEO Jamie Dimon reportedly told his daughter that a financial crisis "happens every five to seven years." Last month, the bank paid $1.1 billion in dividends, reducing its ability to absorb future losses on its investments. If policymakers and regulators do not strengthen their reform efforts, taxpayers and shareholders – not bankers like Dimon – will be the ones who suffer the consequences of the next crisis as well.

ANAT ADMATI

Writing for PS since **2012**
2 Commentaries

Anat Admati, Professor of Finance and Economics at the Stanford Graduate School of Business, is co-author (with Martin Hellwig) of *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It*.

http://prosyn.org/oGfWxVY;