# BankThink Too Much Equity? If Anything, Brown-Vitter Asks Too Little

By Anat Admati
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In a recent column William Isaac warns that the Brown-Vitter bill "will do far more harm than good." The bill, introduced by Senators Sherrod Brown, D-Ohio, and David Vitter, R-La., would require the largest banks to maintain higher equity levels than current or proposed regulations demand. Mr. Isaac actually agrees with the intent and with key parts of Brown-Vitter, but he recommends a substantial long-term debt requirement in lieu of the additional equity that Brown-Vitter requires for megabanks with assets over $500 billion.

Long-term debt is a poor substitute for equity, particularly for the largest banks. If anything, Brown-Vitter does not go far enough in raising equity levels. Requiring even more would enable banks to absorb more losses without becoming distressed, failing, or needing taxpayer support. Better yet, having more equity would improve the banks' ability to perform all their useful functions, including deposit-taking and lending. Requiring more equity is the simplest and most effective way to reduce the large distortions associated with the banks' high indebtedness and to prevent instability and crises.

Isaac recognizes the benefits of requiring more equity. He recommends requiring 8% tangible equity relative to total assets, significantly more than current regulations require and the same as Brown-Vitter mandates for banks between $50 billion and $500 billion in assets. Also like Brown-Vitter, Isaac's proposal avoids relying on the complex, distortive and manipulable system of risk weights used in the Basel standards to determine capital requirements.

The only difference: Mr. Isaac's 12% long-term debt requirements would replace the additional 7% tangible equity that Brown-Vitter requires for banks with assets above $500 billion, currently just the largest six.

Isaac claims that higher equity requirements would harm credit and growth. This claim rings hollow, since a system of better capitalized institutions is more resilient to downturns and less prone to crises. The 2008 financial crisis resulted in the largest decline in output since the Great Depression and in a credit freeze that led the U.S. government and the Federal Reserve to provide unprecedented support to banks. These events were not due to banks having "too much equity," but rather to their distress as a result of heavy borrowing and subsequent losses. Mervyn King, the outgoing governor of the Bank of England, said recently: "Those who argue that requiring higher levels of capital will necessarily restrict lending are wrong. The reverse is true. It is insufficient capital that restricts lending."

Excessive borrowing generates inefficiencies. This dark side of borrowing is a key reason it is rare for healthy companies to become heavily indebted, even though there is no regulation preventing it and the corporate tax code encourages debt over equity funding. Nothing about banking makes equity levels below 25% essential, unavoidable or efficient. In fact, it was common for banks to maintain such levels or even higher ones before they had access to so many safety nets. The banks' depositors and other creditors insisted that banks have more equity, just like prudent banks, acting as creditors, require from those they lend to.

The claim that more equity would harm lending is rarely challenged, but why would it be true? For example, since the large banks are currently profitable, why can't they retain their earnings and make loans? They can take a cue from Warren Buffett, whose Berkshire Hathaway always retains its earnings and invests. Retained earnings are a key source of funding and growth for most companies, one that does not require borrowing.

Lending is actually only a part of what large banks do. JPMorgan Chase (JPM), for example, has at least $300 billion of "excess deposits," some of which were invested in derivatives in London. Loans make up less than a third of JPMorgan's assets under generally accepted accounting principles. The problem if banks don't lend is not the lack of funds or an inability to increase equity; rather, it is the bankers' lack of incentives or desire to lend or to raise equity, and their preferences for other investments and for continuing to rely on borrowing.

Borrowing creates conflicts of interest between borrowers and creditors, and these conflicts distort investment decisions. Heavy borrowers may avoid investments that benefit the creditors at the borrowers' expense, and they might be biased towards risky investments that benefit themselves at the expense of creditors. Distressed homeowners, for example, might not invest in maintenance or home improvement. Taking out a second mortgage exposes the lender that wrote the first mortgage to increased risk of default and foreclosure  just like the payment of dividends by a highly indebted corporation puts its creditors at higher risk.

Since they rely on so much borrowing, banks are strongly influenced by such incentives. Making a boring but worthy business loans might be unattractive to bankers, particularly those working for the largest banks. Investments in traded assets or derivatives that have more upside and are more easily "scaleable" are likely to be more attractive, particularly if bonuses depend on short-term profit measures. Deposit insurance and guarantees greatly exacerbate the distorted incentives, enabling banks to continue to borrow repeatedly and take risk without complaints from their existing creditors. The deposit insurers or taxpayers are harmed  including by the business loans that are not made. In a crisis, the harm can be larger.

The only way to alleviate these conflicts is to require more common equity. Any borrowing, including long-term debt, maintains the conflicts and exacerbates the inefficiencies of debt overhang.

Another problem with long-term debt relative to equity is its dubious capacity to absorb losses, especially in the case of the largest banks. The failure of a global megabank in the U.S. would entail the Federal Deposit Insurance Corp. exercising its yet-untested new resolution authority. But the FDIC lacks jurisdiction outside the U.S. Despite some progress with U.K. authorities, legal differences across countries will pose enormous challenges should a global bank fail.

Moreover, imposing losses or expenses from the resolution process on a bank's creditors or on surviving institutions, which themselves might be systemically important and likely to be weak at the same time, might further destabilize the economy in a crisis. Despite the Dodd-Frank Act reforms, we are likely to see taxpayer-funded bailouts again if policymakers view the alternative as worse. Even in the best scenario, a resolution process would be disruptive and costly. Equity, by contrast, absorbs losses without such complications.

The notions that "excessive" equity will hurt the economy, that debt funding is "cheaper" or better than equity in any way that is relevant to the policy debate, or that it is a policy objective to make sure "our banks" succeed in global competition, are among the claims that my colleague Martin Hellwig and I have debunked in our book "The Bankers' New Clothes: What's Wrong with Banking and What to Do about It" and in a subsequent summary document . I hope those who make such claims or believe them to be true will take the time to consider our arguments. The public deserves a safer and healthier financial system that supports the economy without exposing us to as much risk, distortions and harm.

*Anat Admati is a professor of finance and economics at Stanford University's Graduate School of Business.*

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