By

S. L. Mintz /

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6 Fallacies, Myths and Irrelevant Facts Bankers Want You to Believe

Before your banker rails against stiffer capital requirements, arm yourself with countervailing facts. Three co-authors at **Stanford University's** Graduate School of Business and a colleague at the Max Planck Institute for Research on Collective Goods, in Bonn, Germany, marshal evidence that contrary to a party line, higher equity capital standards will not imperil banks - unless you are a banker counting on a huge bonus.

"Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive," shoots down the argument that higher equity requirements cripple credit markets. **J.P. Morgan Chase** CEO Jaime Dimon and other bankers can insist otherwise, but more equity on bank balance sheets should stoke no fears of scarcer loans or higher interest rates. That's a big fat misconception, insists co-author Anat R. Admati, the George G.C. Parker Professor of Finance and Economics at the Graduate School of Business, Stanford University.

In her letter this week in Risk Magazine and published on the **Huffington Post**, Admati tutors J.P. Morgan Chase directors on a matter you'd expect they understand already: Despite all the advertising, capital requirements cause no funds to sit idly in reserve.

Double Standard
Capital requirements do not constrain bank lending any more than the mix of debt and equity constrains any corporate balance sheet. Investors own the debt and the equity. Companies put that capital to its best use. But where banks slap restrictive covenants on you Mr. Corporate Borrower if your debt exceeds, say, 50% of capital, bankers insist they are hamstrung unless their risk-adjusted debt can nudge past 90% of capital. Razor thin equity turbocharges compensation tied to return on equity, but it exposes banks to giant systemic risk.

Admati and her Stanford colleagues **Peter DeMarzo** and **Martin Hellwig**, and **Paul Pfleiderer** at the Planck Institute debunk six claims with mythical significance for borrowers and policy-makers.

Myth No. 1: Increased equity requirements would prevent banks from operating at the optimal scale.

The real deal: Not true. Equity can be added to the balance sheet without changing the bank's core business. Because it is false, it does not furnish any incentives to resist increased capital requirements.

Myth No. 2: Increased equity requirements reduce the average ROE (Return on Equity) for banks.

The real deal: True. Bankers may see paychecks suffer if their compensation is tied to ROE. But there managers part ways with shareholders and taxpayers. Far from impairing value creation, additional equity reinforces balance sheets so that banks can ride out frequent economic turmoil. More lenient leverage should not hijack public policy.

Myth No. 3: Increased equity requirements would increase banks' total funding costs, because banks would be forced to use more equity, which has a higher required rate of return.

The real deal: False again. Changing the bank's capital structure changes how risk is distributed but not the overall cost of funding. Fallacies cannot justify opposition to increased capital requirements - much less play a part in setting policy aimed at easing systemic risk.

Myth No. 4: Increased equity requirements would decrease the size of the interest tax shields banks can obtain through debt financing.

The real deal: True, tax makes debt cheaper than equity. Favorable tax treatment that beefs up bottom lines may benefit shareholders. But those advantages pale next to risks that too much bank debt imposes on society. It makes no sense to subsidize excessive leverage. One only need review the recent financial crisis to see why.

Myth No. 5: Increased equity requirements reduce banks' ability to use cheap debt financing that is subsidized by implicit government guarantees.

The real deal: This statement is true and will mobilize bankers when compensation is tied to equity value. Cheap debt also benefits shareholders. But again, guarantees that subsidize over reliance on bank debt serve nobody in the long run. Instead, subsidies encourage short-sighted, self-serving practices - a.k.a. moral hazard -that make bad credit decisions more likely.

Myth No. 6: Increased equity requirements would reduce managerial discipline and thus interfere with effective governance.
The real deal: The recent financial crisis says otherwise. Where was effective governance when banks were leveraged to the hilt? Nor should shareholders resist increased capital requirements to foster tighter management. There are ways to improve governance without piling on big risks.

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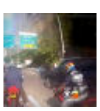
- 
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