Institutional Investor

Five Questions: Anat Admati Says More Bank Equity Is Needed

19 APR 2012 - S.L. MINTZ

Many bankers insist that more equity on bank balance sheets would crimp their ability to lend. Sure, they will impose rigorous covenants on nonfinancial corporate borrowers that operate with less than 40 percent equity, but 13 percent for the banks' own looks more than ample to JPMorgan Chase chairman Jamie Dimon. Of the extra cushion, he says, "this is capital that we don't need."

Nonsense, says Anat Admati, the George G.C. Parker professor of finance and economics at Stanford University. Who are bankers kidding? It is high leverage, flawed regulation and compensation structures in banking — not more equity — that curtails lending capacity.

Admati is a co-author of "Debt Overhang and Capital Regulation" with Stanford University colleagues Peter DeMarzo and Paul Pfleiderer and Martin Hellwig from the Max Planck Institute in Bonn, Germany. They published the research paper in March, a sequel to earlier research. Their recent conclusion: "High equity requirements for banks bring about large benefits at essentially no relevant social cost. Banks funded with much more equity would be able to serve the economy better, without subjecting it to excessive risks and costs."

Institutional Investor contributor Steven Mintz spoke recently with Professor Admati about the case for more equity on bank balance sheets.

What persuades you and your co-authors that higher equity requirements would

be so beneficial?

Three key reasons. One, better capitalized banks can absorb losses without creating system-wide financial instability. Second, banks with more equity are less burdened by debt overhang so they can raise funds more easily for new loans. And three, higher equity requirements might give pause to banks before they embark on riskier investments that fueled the financial crisis. In addition to requiring too little equity, flawed current regulations use a system of risk weights to specify the equity requirements. The risk tier weighting system favors marketable securities and other structured investment and derivatives over lending to productive companies in the real economy that can help the economy grow.

What about market consequences if banks must add equity to their balance sheets?

It sounds counterintuitive. Shareholders and managers of highly leveraged banks, those whose investments are concentrated in the banks, resist leverage reduction even if the bank's total value might increase. High leverage works for bankers whose bonuses are pegged to return on equity, but not for the rest of us. Reducing leverage benefits existing creditors and taxpayers who ultimately guarantee the debt. When high leverage rewards bank managers but exposes third parties to risk, or externalities, you get social inefficiencies. That's because most shareholders own bank stocks in diversified portfolios and they pay taxes. If undercapitalized banks trigger another financial crisis, the vast majority of shareholders are likely net losers.

What about other adverse consequences that bankers predict?

Banks say their costs will go up, but they give fallacious reasons, never mentioning that the key reason for any such cost reduction is that their borrowing is subsidized through guarantees and tax savings. There is simply no shred of a valid reason banks should not be funded with 20 percent to 30 percent equity. It would not hurt their ability to do anything for the economy, while bringing great benefits.

Bankers cloud the issue. Equity is not idle cash. Equity is held by shareholders and invested in loans and other investments. Safer banks with more equity would add incentives to write sound loans and reduce reason to favor risky investments that increase bankers' compensation but make the financial system more fragile.

Why don't rule makers hear your message?

There is a combination of confusion and a form of capture around the world. The crisis revealed failings of regulations and enforcements, but it seems difficult to get effective change. Flawed risk weights have allowed a huge buildup of systemic risk. Banks, especially in Europe, failed on investments considered safe by regulators. The politics is complex. Many industries lobby, but no one as much as the banking industry, and they seem to have an impact.

Regulators have some idea of the problem but they are afraid of the industry. Models lull them and can be used as a cover. They let banks pay dividends which deplete equity unnecessarily and do not examine the issues sufficiently. On the outside everything works so long as risk weightings and accounting tricks conceal risk. But this remains a highly dangerous system.

How do you propose banks build equity when stock prices are low?

The best way to increase equity is to stop payouts through dividends or share buybacks. I'd happily give up my dividends to build up capital and a more stable banking system.