BANKING & FINANCE

Regulating Banks by Regulating Capital

Instead of trying to block banks' ability to make foolish decisions, regulators should require that they have ample capital to pay off their creditors.

BY MICHAEL L. DAVIS

Oscar Wilde once observed: "Moderation is a fatal thing. ... Nothing succeeds like excess." Way too many regulators take this observation to heart. They seem to think that if a little bit of regulation is necessary, more must be better. But the inevitable fact is that while regulations may or may not create benefits, they come with considerable costs. And so a balancing of costs and benefits—a certain moderation—is an essential adjunct to the modern regulatory state.

Or maybe not.

It turns out that one particular type of regulation may provide substantial benefits with almost no costs. For the past 10 years or so—at least since last decade's financial crisis—a number of respected experts in economics and finance have argued that simply requiring banks to maintain much higher levels of capital can solve many of the problems of systemic risk without imposing serious costs on the banks. In other words, they think we can trash most of the expensive, complex, and clunky rules that now govern banks and substitute a much simpler rule: "Rely on more capital and issue less debt." And by "more capital" they mean levels that—in the world of modern finance—seem like crazy, excessive, immoderate amounts.

If these academics are correct, this is a really big deal. Everyone agrees that our current system of bank regulation, headlined by the Dodd–Frank Act, is very, very costly. Almost no one believes that this system has done all that much to prevent future crises. Replacing Dodd–Frank with rules demanding that banks limit their debt and rely more on equity just might give us a much safer financial system at a much lower cost.

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These ideas have now been advanced into legislation. Specifically, the proposed Financial Choice Act, currently approved by the House and awaiting action in the Senate, allows banks the opportunity to avoid certain types of regulation by increasing their capital.

PROTECTING "FOOLS" AND THEIR MONEY

Figuring out whether this idea can really work is, admittedly, both technical and tedious. It is also important. The Great Recession cost the economy at least $22 trillion. Even if you don't think the failures in the financial sector "caused" the downturn, you must accept that financial failures made it much worse. Effective and efficient policies that prevent such failures in the future would be most welcome. So how can changing the rules on capital transform the messy world of bank regulations?

Bank capital / Capital is most easily measured by a borrower's "equity ratio," which is the proportion of the value of assets not owed to the people who loaned the borrower money. If you have a $200,000 house but you owe the bank $100,000, your equity ratio is 50%. In other words, capital is just the part of the business that can be claimed by the owners of the firm. It's what's left over after all the debt holders get paid. And, by corollary, the higher the ratio, the more confidence creditors will have that they will be repaid.

This calculation is confusing for banks because there are all kinds of ways to count the value of a bank's assets. By any measure, banks have ridiculously low equity ratios given the risks they face. Back in the 1800s, they tended to look like many other sorts of businesses, with equity ratios of about 50%. Beginning about 100 years ago, though, that ratio began to shrink. At the start of last decade's financial crisis, bank equity ratios averaged about

4%. They've gone up some since 2008, but most banks still have a ratio of 8% or less. By comparison, the equity ratio across all U.S. corporations averages around 64%. Even more telling, some of the most dynamic and successful firms in the country—firms like Apple and Google—have no debt at all, meaning their equity ratios are 100%.

Capital and financial decisions / Before the financial crisis, some banks and other financial institutions made some very foolish decisions, like assuming that housing market prices would never stop rising, and loading up on complex financial instruments they didn't understand. Unfortunately, requiring higher equity ratios won't magically stop such decisions. Foolishness (or, to speak more charitably, "optimism bias" or "herd mentality") is part of the human condition, even for bankers and finance wizards. However, increasing capital means that the right people—namely, bank shareholders and their top managers—will have to pay for such decisions.

When some Wolf-of-Wall Street wannabe goes to work for a bank trading derivatives he doesn't understand, a 4% equity ratio can disappear very quickly. When that happens, the bank's debt holders—who also tend to be a clueless lot—take a hit. And when they don't get paid back as quickly as they expected, they can't in turn pay back their own debt holders. If things really get crazy, the whole system unravels until we get—well, exactly what we got in 2008: a frozen financial system followed by a miserable recession. But higher equity ratios would mean that the owners of the firm will be positioned to absorb a big hit without then passing that hit onto their creditors and the rest of the financial sector and the broader economy.

Why protect debt holders? / Much of the public—meaning much of the consumer base that drives this economy—holds debt. If you have a bank account, you are a debt holder—the bank invests your deposits in order to earn a little interest. This is true even of your checking account; when you make a deposit, you're making the bank a loan—and not just any kind of loan, but a loan that you can demand to be repaid at a moment's notice.

Did you do a credit check on your bank? Did you look at its financial statements for the past 10 years and carefully evaluate

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the audit letter? Admit it: you have no idea what exactly your bank is doing with your money. For all you know, they're investing it in grape jelly futures and don't have a chance of paying you back. But since your account is fully insured by the Federal Deposit Insurance Corporation, you don't worry about what the bank is doing with your money because you're guaranteed to get it back.

Deposit insurance is something almost everyone believes is right, just, and good. No one in the mainstream is seriously proposing that we run the system without the backstop of deposit insurance. Bank runs—the mass withdrawal of deposits by suddenly fearful depositors, which can shutter even the most responsible banks—are bad and we can't trust the little depositors to do the kind of careful risk management that would prevent runs. (Most libertarians will tell you that such insurance doesn't need government support and that if the FDIC closed, private deposit insurance would be offered. They're probably right, but feel free to ignore them; everyone else does.)

The problem is that the government doesn't just see to it that the small-fry depositors and debt holders get their money back. It guarantees that pretty much all the debt holders will get their money back—even large financial entities that have the ability to do due diligence. Interestingly, almost no one in government will admit this. All the stern and serious people in the Treasury and Federal Reserve claim that if a bank starts to go under, the big-shot financiers who loaned the bank money will just have to go down with the ship. But when a crisis actually happens, they bail them out along with the rest of the debt holders. Every. Single. Time.

This creates some very bad incentives for banks and other financial actors. Not only do debt holders have no reason to monitor their banks, but the fact that their debt either comes with the explicit guarantee of deposit insurance or the implicit guarantee of a government bailout means that banks can borrow money very cheaply. Quite rationally, they want to load up on as much debt as they can because that lets them make more loans and thus earn more interest. And that is exactly what they do.

Think for a moment about how weird this is. Alphabet, the parent company of Google, is a great company with solid earnings and fantastic growth prospects, yet it would probably pay more to borrow money than a broken-down bank in Atlantic City.

A COSTLY LECTURE

This behavior can't be rectified with a stern lecture from officials and some government-mandated bank "stress tests." But those are basically all that Dodd–Frank does. It lays out a long list of bank do's and don'ts that stretches across some 2,300 pages of legislation and countless volumes of semi-official interpretations and guidances, but they provide little more protection against banker foolishness than the physical paper they're written on. The legislation also requires banks to suffer all manner of examinations, including the dreaded "stress test."

Complying with all this is terribly expensive, but we don't really know just how costly it is. Several of the largest banks report that complex regulations require them to hire thousands of compliance officers at a cost of over $100 million per year. The smaller community banks, which often have the hardest time complying with the rules, have seen their market shares decline by over 12% since 2008. This decline isn't all due to Dodd–Frank, but it is a contributor.

WHY EQUITY REQUIREMENTS ARE BETTER

Instead of such a costly and questionable regulatory effort, an equity requirement would create a financial system where these debt holders—or depositors or whatever you want to call them—are at little risk of not being paid back.

In an ideal world, no government intervention would be necessary. In such a world, the small depositors would be protected by private deposit insurance and the uninsured debt holders—the big guys—would act like grownups and be careful about where they put their money. But that's not the world we live in. In the real world all the debt holders know government will see to it that they get their money back, so they care little about the financial risks they take with their money. This means the banks can borrow cheaply and so they load up on debt.

This leaves us with two choices: we can deal with this risk-taking by either micromanaging banks by imposing all sorts of regulations to make sure they almost never fail, or we can require banks to have high equity ratios so that when they do fail the debt holders will be unharmed.

The "micromanage banks" approach is what we're doing now. It's why Dodd–Frank is so complicated and costly. The "make banks have high equity ratios" approach is just implementing principles from Finance 101: if a bank has a high equity ratio, the value of the assets can decline a lot before the debt holders are threatened. On the other hand, if the equity ratio continues to remain at the low levels it's been for the past century, relatively small problems will continue to fall on the shoulders of the debt holders. Capital would thus protect debt holders from the sad consequences of bad management and a crazy economy.

Hurting the banks? / Earlier in this article I claimed that forcing banks to hold more capital wouldn't really hurt them economically. This seems false; if banks hold more capital, they surely would have less money to lend out. And that, in turn, would hurt individuals and small businesses because they would be less able to borrow money, expand their consumption or inventories, purchase equipment or other long-lived goods, use higher-skilled labor, and so forth. Indeed, whenever someone proposes requiring banks to raise their equity ratios, bank officials recite this parade of horribles.

But these scary stories shouldn't dissuade us. Capital—primarily bank shareholders' money—is a *source* of funds, not a *use* of funds. Banks can and do treat the money they raise from the equity holders the same way they treat the money they get from the debt holders: they use some of it to pay the bills and lend out

the rest. Depending on equity instead of debt didn't stop Apple from growing and it won't stop a good bank from lending.

Bankers would likely object to this theory, claiming that if they have to raise equity ratios, it will be more expensive for them to raise money. But in an ideal world—a world where the financial markets operate without government interventions—changing the equity ratio wouldn't have any effect at all on the cost of capital. This insight comes from the famous work of Franco Modigliani and Merton Miller, who argued more than a half-century ago that a firm's value is determined by its earning power and the risk of its assets, and is independent of how it finances its investments or distributes its investments.

Of course, banks don't operate in that world. The fundamental problem—and I can't stress this enough—is that government guarantees bank debt. That means banks are able to borrow from the debt holders at a rate much lower than they'd have to pay if they got money from shareholders. And so, yes, if we force banks to raise more money from the shareholders, this would make it more expensive for banks to raise money.

But that's a good thing for two reasons. First, the government's guarantee is not free. It costs all of us to provide this backstop that reduces banks' and depositors' need to do due diligence. That cost probably is very high, though it's not easy to calculate. If banks raise funds by issuing less debt and more equity, the guarantee will be irrelevant and those costs will go away.

Second, if banks have higher equity ratios, they don't need as much scrutiny and supervision. Remember, all the expensive bits of Dodd–Frank are there to protect the debt holders, not the owners of banks. If the debt holders are protected because the banks are holding lots of capital, banks don't need as many compliance officers and the government doesn't have to do as many of those expensive examinations.

When you think about the cost of the financial system, you can't just think about banks' cost of capital. All of those regulatory costs—especially the cost of the implicit loan guarantees—matter. So yes, if banks have to maintain higher equity ratios, their cost of capital will go up. But the overall cost of running the system will go down—maybe by several billion dollars.

THE FINANCIAL CHOICE ACT

There is broad agreement among banking and finance scholars that forcing banks to increase equity ratios would make banks safer. But some people worry that this would lead banks to reduce their lending. In other words, they think the advocates of more capital don't fully appreciate how much this rule would increase a bank's cost of funds.

These skeptics have some respectable theory and evidence to support their views, but they've also made some useful suggestions about how to deal with the problem. Specifically, they would prefer that the capital requirements be raised slowly so as to give banks a chance to adjust. They've also made some intriguing suggestions about encouraging banks to use some forms of convertible debt that is not guaranteed.

The proposed Financial Choice Act would also give banks a choice: they could raise lots of capital and thus not be bound by some of the current Dodd–Frank rules, or they could continue with the status quo: depend mostly on debt and then endure the tight scrutiny of the regulators. If it turns out that maintaining a higher equity ratio really does destroy a bank's ability to do business, then banks that chose that option could revert back to the status quo and dealing with the regulators.

Congressional bungling / Of course, Congress could ultimately adopt a version of the Financial Choice Act that is loaded up with fine print and details that undermine the virtues of higher equity. For instance, lawmakers could adopt an insufficiently low equity ratio for the banks.

The cost of the financial system involves more than the banks' cost of capital. If banks have to maintain higher equity ratios, their cost of capital will go up, but the overall cost of running the system will go down.

Right now they are talking about a ratio of 10%. There is some academic research suggesting that might be enough, but the evidence is ambiguous. Stanford finance professor Anat Adamati and Max Planck Institute economist Martin Helwig argue for equity ratios of 20–30%. Former University of Chicago finance professor and now Hoover Institution senior fellow and Cato adjunct John Cochrane likes to say that capital requirements should be "enough so that it doesn't make any difference"—that is, so high that there's no worry whether they're high enough.

Adamati, Helwig, and Cochrane are taking the Oscar Wilde stance: success through excess. Even if you don't want to go that far, we should err on the side of requiring a bit too much capital, rather than too little. The one thing we can't have is an unregulated banking system that still doesn't have enough capital to prevent systemic risk.

People also worry that if the capital requirements are changed, some other financial institutions will arise to do some of what the banks have been doing. If these institutions don't have to obey the rules and they become big enough to matter—if they create "systemic risk"—then we still have a problem. We saw something

like this in the financial crises with the so-called "shadow banks."

This is a real concern but it is also one we can solve. The term "shadow banks" is misleading; these institutions aren't really "in the shadows" because anybody who was paying attention to the world of finance knew they were there. If we see this kind of regulatory arbitrage—new arrangements developing to take advantage of loopholes in the law—we should be able to close the loophole.

If lawmakers make this policy choice, they also need to get the technical details right, most importantly the proper definition of bank capital. Accountants and financial types are particularly good at creating different ways to define what is and is not capital. With all regulation, complexity creates opportunities for evasion. Columbia University finance professor Charles Calomiris makes a persuasive case that the standards need to be based on market values of equity, not book value. (See "Handicapping Financial Reform," p. 32.) Bankers may not like that, but forcing them to respond to market signals seems like an obviously good idea.

Of course, it's hard to predict whether the proposed Financial Choice Act will become law and, if it does, in what form. But it is a serious, intelligent idea that is being debated and discussed by serious, intelligent people. And that—in the current political climate—is a surprisingly good thing. *R*

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