Fixing Banking – Part II

Banks are junk. How do we fix that? Part II of this Series provides dramatic proposals that nevertheless remain "inside the box" of conventional thinking. (Suggested sub-title / deck)

As in Part I of this Series, we divide proposals for "fixing banking" into three categories: "Nibble the Edges;" "Dramatic Change Inside the Box;" and "Banking Re-Boot into Safe Mode." All three have advantages and disadvantages. As we describe in Part I, the first option is easiest to implement and is the current course of global governments and regulators. Unlike this first option, the second proposal would be highly effective. While straightforward to implement, this option #2 is controversial and requires an old-fashioned political battle that could go either way. In this Part II, we discuss only this second alternative.

Option #2: Dramatic Change Inside the Box

Anat Admati and Martin Hellwig propose that governments and regulators should require much higher capital levels for banks. (See *The Bankers' New Clothes: What's Wrong with Banking and What to Do About It*, Princeton University Press, 2013.) Stripping away worthwhile discussion on the nature of bank regulation, conflicts of interest, and deliberate and accidental confusion, the Admati-Hellwig thesis is easy to state: banks should hold common equity equal to 20-30% of total assets – where "assets" consist of both balance sheet and off-balance sheet exposures. This proposal is far more stringent than Basel III since it references *total assets* rather than *risk-weighted assets* and since Basel III does not require common equity of more than roughly 10% of risk-weighted assets. Since risk-weighted assets are typically 30-60% of total assets (see figure 5 of V. Le Leslé and S. Avramova, "Revisiting Risk-Weighted Assets," *IMF Working Paper* WP/12/90, 2012), the Admati-Hellwig capital proposal of 20-30% of *total* assets provokes debate and disagreement. (See M. Folpmers, "The Big 'Capital' Debate: Economists vs. Bankers," *Global Association of Risk Professionals* FRM Corner, June 12, 2014.)

An immediate, simple, and valid criticism of Admati-Hellwig is that the quantitative specification of 20-30% of total assets is contrived. There is no derivation or argument for this broad range other than appeal to history with the claim that this 20-30% level is typical of banks at the beginning of the twentieth century. Since banking and the global economy *now* differ greatly from those of earlier centuries, historical precedent is not persuasive.

Our view is that the Admati-Hellwig proposal does lack foundation, but the larger point remains valid. The best argument, unfortunately, is criticism of the *status quo*. To put it informally, bankers and bank regulators claim that a proper bank equity level is 3% of total assets. (See section 4.1 of M. Auer and G. von Pfoestl, "Basel III Handbook," *Accenture*, 2012, and discussion of the minimum equity ratio of 3% becoming a discretionary rule of the regulators.) Yet this result is absurd and offends one's common sense. Banks with such thin equity survive from year to year due primarily to the perception of government support. Since the purpose of bank reform is to eliminate or, at least greatly reduce, government support, banks should have sufficient equity for stand-alone survival.

Thus, even though the 20-30% specification is arbitrary, we consider the Admati-Hellwig capital requirement to be far more appropriate than those of the Basel III "nibble the edges" approach we described in Part I. This higher capital level *feels* right and we expect that bank stand-alone credit strength would improve markedly. Bank regulators and bankers argue in response that banks' funding costs will increase and, therefore, there will be fewer loans and higher yields for the banks' borrowers. In other words, the regulators and bankers claim that raising the capital requirement for banks will hurt the banks, the borrowers, and – by extension – the entire economy. (See, for example, P. Angelini *et al*, "Basel III: Long-term impact on economic performance and fluctuations," *BIS Working Paper* No 338, February 2011.)

Ultimately, we concur with the Admati-Hellwig view that the cost of increasing bank capital to the economy is minimal relative to the benefit of establishing much safer banks. Unlike Admati-Hellwig, we do not consider the trade-off to be a "free lunch" in which bankers' and regulators' fear and

concern for impact on bank lending is baseless. Though not necessary in theory, some banks may well reduce lending, rather than raise equity, to meet the elevated capital standard. Bank shareholders may choose not to reduce their return targets wholly in line with reduced risk. (See, for example, M. Baker and J. Wurgler, "Do Strict Capital Requirements Raise the Cost of Capital? Bank Regulation and the Low Risk Anomaly," August 2013. According to this study, the result of bank shareholders "not reduc[ing] their return targets" is merely a drop in market value of bank equity. While negative for the shareholders, this "regulatory risk" is inherent to all investments in bank equity.) Bank creditors are unlikely to demand precisely the lower yields that theory might imply. All in, we do expect borrowers will find somewhat higher yields on bank loans when the banks have much lower leverage. Yet not only is this cost reasonable, it is also appropriate. Governments and bank regulators should not seek to subsidize or otherwise control banks' lending rates.

For our "Dramatic Change Inside the Box" option, we also stipulate a large increase in the bank reserve requirement. For example, instead of requiring reserves of 10% of demand deposit liabilities in the U.S. or 1% in the Eurozone, banks should hold 30-40% reserves. Our only basis for this otherwise arbitrary range is Walter Bagehot's statement that the Bank of England held 30-50% in reserves in 1870. (See chapter 2 of W. Bagehot, *Lombard Street – a Description of the Money Market*, Public Domain book, *circa* 1870.) Reserve levels are much lower than 30-40% in the modern banking era due to the existence of (government) deposit insurance and central bank lending. To lessen the dependence of banks on government, then, it is sensible for banks to hold reserves in sufficient quantity to give the perception and reality that government support is not necessary.

The disadvantage of this proposal to increase the minimum capital and reserve requirements in such large steps is simply that the paradigm remains unchanged. Banks would still be *part of government* since deposit insurance, central bank lending, bailouts, and extensive regulation and control are still present. Taxpayers remain at risk. While the banks are no

longer "junk" under this option, there is no true quantification of the level of direct and indirect expected loss of the government support.

Yet these disadvantages – that nothing changes except for two simple criteria pertaining to capital and liquidity (reserves) – also provide an advantage. It is politically conceivable that this option could win support. Gaining approval for drastic change is always challenging. Yet this option would leave in place the roles and responsibilities of all institutions and people. This proposal ruffles feathers without plucking them. Bankers and regulators will fight these inside-the-box capital and liquidity amendments, but they will not fight to the death.

In the future Part III of this Series, we will describe the "Safe Mode" alternative to "Nibble the Edges" (Part I) and "Dramatic Change Inside the Box" (this Part II). In "Safe Mode," we will explain the calls of Kotlikoff, Wolf, Kay, and many others for stark reinvention of "fractional reserve banking."

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