Comments on Bank Capital

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What is "Capital" and What is the Debate?

- Capital requirements are about *funding, leverage*.
- "Hold" capital, "capital set aside/held in reserve" is unfortunate and confusing language. Implies passivity and costs. ("A dollar in capital is dollar not put into the economy.")
- High leverage introduces fragility, systemic risk, increases probability and cost of crises.
- **Is fragility inherent in banking?**

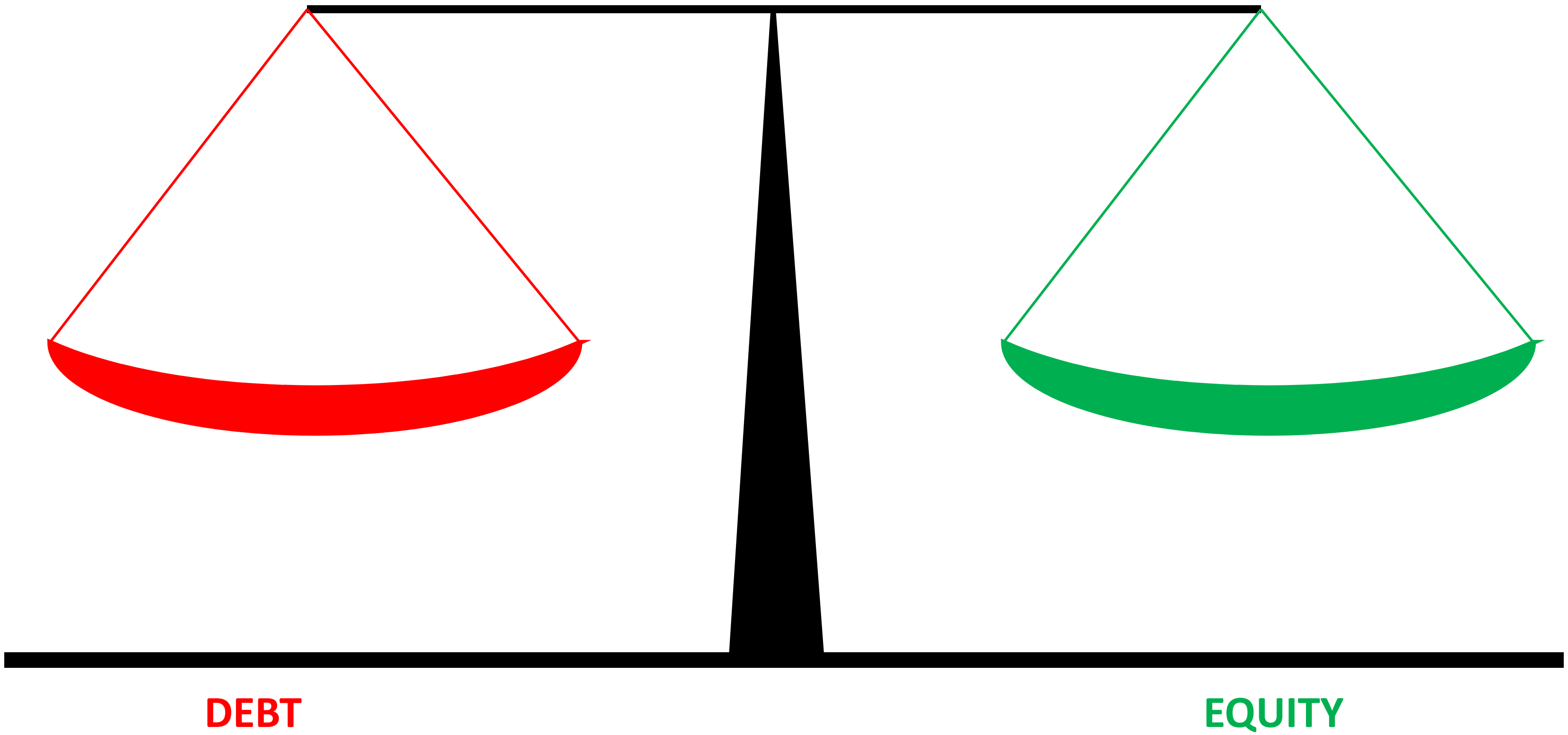
M&M and Banking, a 50+ years Debate

- Modigliani and Miller's result does NOT imply that banks, or capital structure, are irrelevant.
- *In a well functioning market, average return is related to risk*.
  - The cost of equity ***cannot*** be constant as leverage changes; it decreases with less leverage.
- *The impact of a change in funding mix must be examined through its effect on frictions, i.e., how the funding mix changes the total cash available.*
  - This principle applies to banks and non-banks.
  - Denying this is akin to denying gravity.

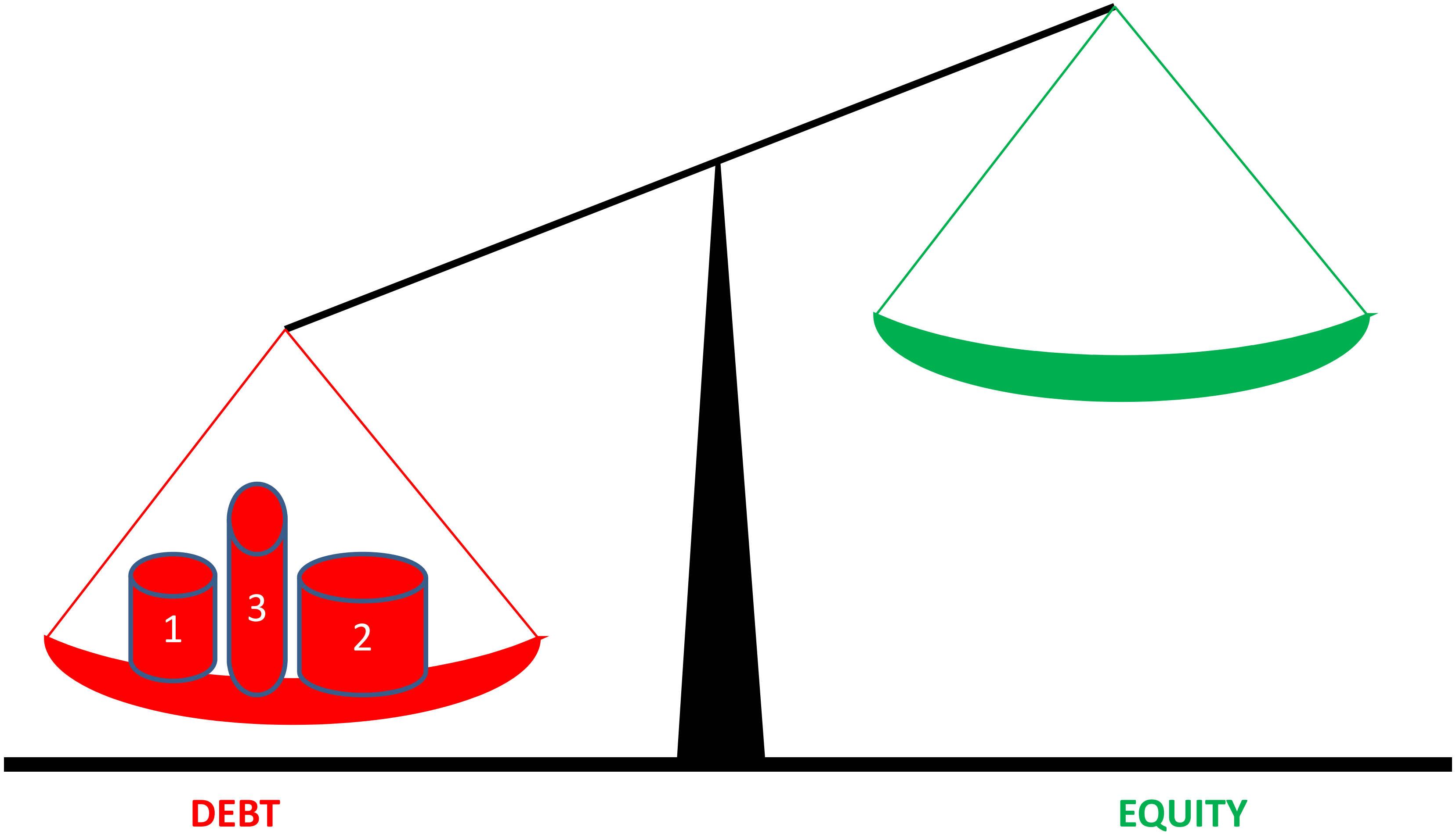
Why the Focus on ROE in Banking?

- **ROE is meaningless for measuring value unless leverage and risk are fixed!**
- Leverage always magnifies risk and average return/ROE.
- ROE fixation reflects love of leverage and related subsidies.
- ROE-based compensation encourages focus on returns and “spreads” and ignorance of the risks that brings them about.
- Competitive ROEs should be lower with more equity
  – but profitability would decline mainly through lost subsidies.
- Will higher requirements be a “nail on banks’ coffin”?
  – Do banks have a viable business model without subsidies?

Equity vs. (non-deposit) Debt

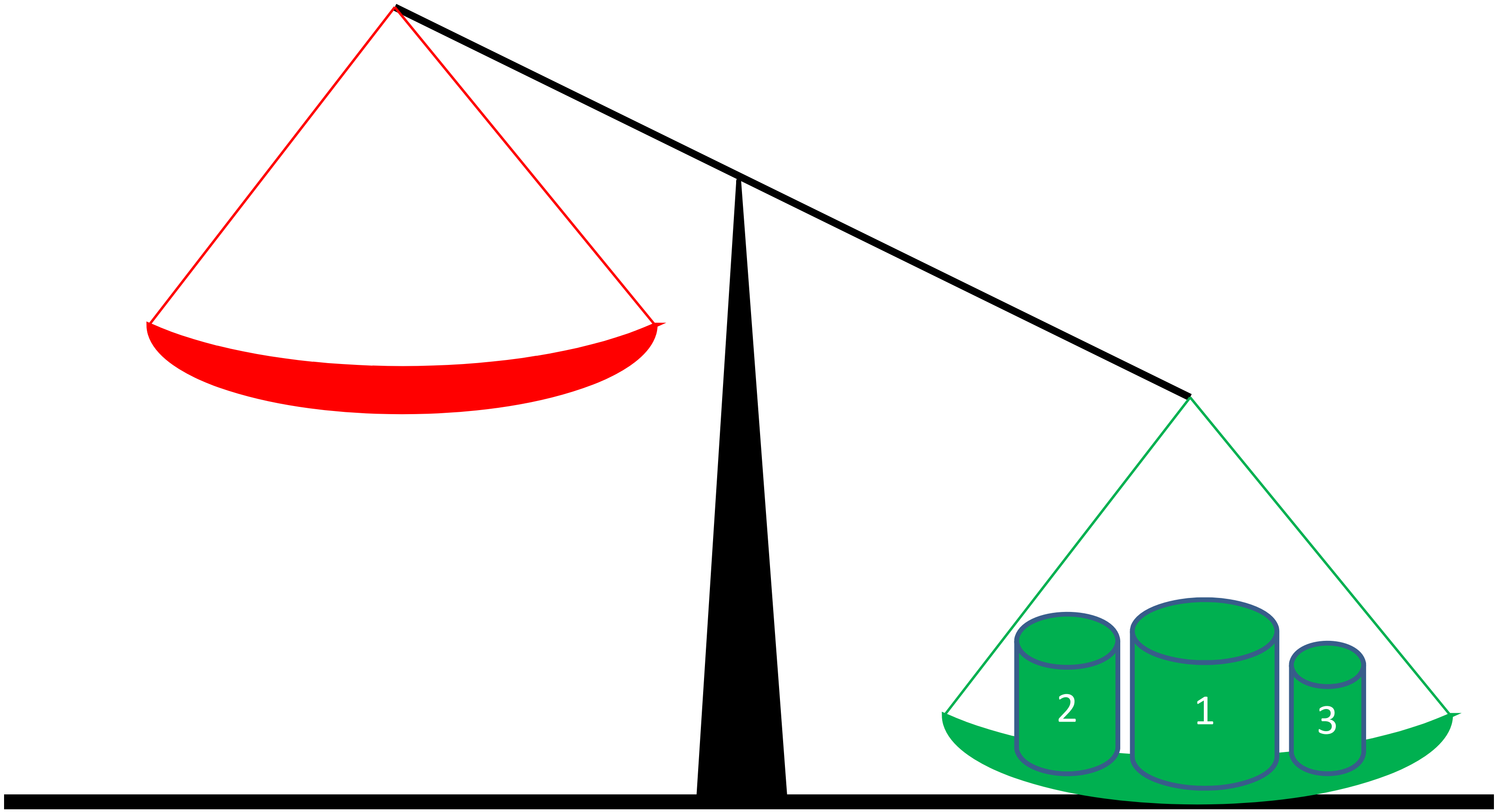


Equity vs. (non-deposit) Debt: Private Benefits



1. Tax advantages make it cheap
2. Implicit guarantees make it cheap
3. ROE fixation

Equity vs. (non-deposit) Debt: Social Benefits



DEBT

1. ~~Tax advantages make it cheap~~
2. ~~Implicit guarantees make it cheap~~
3. ~~ROE fixation~~

EQUITY

1. Reduces systemic risk
2. Reduces incentives for excessive risk-taking
3. Reduces deadweight costs associated with bailouts

Concluding Remarks

- Public policy should not encourage bank leverage.
- *High* leverage is not inherent to the business of banking.
  - Equity requirement should be *a range* (with regulatory action within the buffer), and *much* higher.
  - why not 15%-25%? Regulators should help in transition.
- *Subsidies are distortive.*
  - Tricky to remove or price guarantees.
  - Cannot and should not commit not to bail out.
  - Subsidies prevent efficient resource allocation by markets
  - Equity is like “self insurance” through private markets.
- International harmonization/cooperation
  - Critical for resolution mechanisms.
  - Highly desirable but not essential for capital regulation: e.g., require independent subsidiaries.