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The More Bank Capital, the Safer the Bank

We need buffers to protect taxpayers and the financial system.

By JOHN H. COCHRANE

The battle over bank capital requirements is coming to a head. On its outcome hangs who will pay for the next crisis, and even whether there will be a crisis.

The new Basel III agreement calls for 7% capital, up from 3%. The Federal Reserve wants another 3% for "systemically important" banks, and the Fed's Dan Tarullo proposes even more, 14%.

The banking lobby is furious, as evidenced by recent House testimony and an open letter to federal regulators from the Clearing House association of banks. They claim that lending will decline, banks will move abroad, jobs will be lost, and growth will suffer.

These claims are nonsense, as many academics such as Stanford's Anat Admati point out. Even substantially higher capital requirements would have essentially no social cost but would greatly reduce the chances of another crisis. Better capitalized banks mean a safer, more stable banking system.

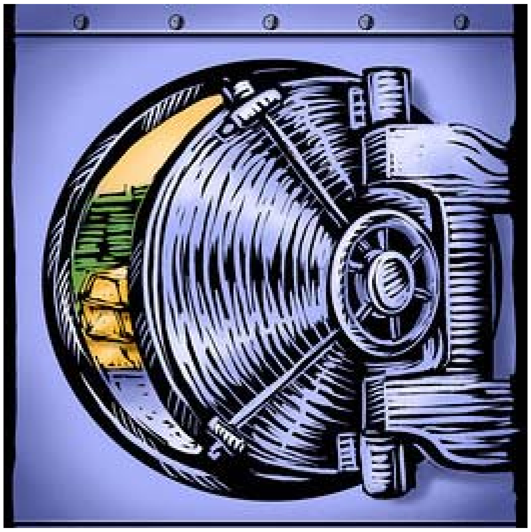
Suppose a bank wants to lend $100. To get the money it issues stock, borrows from other banks and money-market funds, takes deposits, or sells bonds. Under the old rules, a bank had to sell $3 of equity, and then it could borrow the remaining $97.

If the bank gets 6% interest on its loans, and pays 1% to its creditors, then the equity investors get $5 back for their $3 investment—a nice return. There's a risk of course: If some borrowers default and the loans only pay $97, the shareholders are wiped out.

But what if the loans only pay $90? Answer: Taxpayers fill the gap. The government guarantees deposits. Normally, the other bank creditors would split up the $90 in bankruptcy, but big banks are too big to fail these days.

Now you know why banks love leverage. High leverage maximizes the value of government guarantees, effectively letting banks borrow at subsidized rates. It's also a tax dodge. The bank's interest payments are tax deductible; its dividend payments are not.

Clearly, a bank with more capital is safer, for the simple reason that the value of its loans can fall further before it faces bankruptcy or bailout. A bank with more capital also has more incentive to manage its risks. Once my example bank loses $3, it doesn't care whether it loses $10, $20 or everything. "Bet-the-farm" mortgage-backed securities look enticing.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So why not require more—lots more—capital? Banks claim that more capital means less lending. This claim confuses capital with reserves. Capital is part of a bank's funding (where it gets money)—it is not part of a bank's investment (how it uses the money). Capital is not "set aside," placed in "reserve," or subtracted from lending. With a 10% capital requirement, the bank in my example still needs to raise no more than $100. It needs to borrow $7 less as it sells $7 more stock.

Banks claim that issuing equity is hard. But the proposed requirements phase in slowly. Banks can get additional capital by retaining earnings rather than paying them out as dividends. And banks routinely issue additional equity when needed.

Banks today are sitting on a trillion and a half dollars of reserves beyond what they are legally required to hold. They are paying dividends, and some are buying back shares. So are banks anxious to lend, as some claim, but pesky regulators forbid it because banks just don't have enough capital? Not on this planet. Lending is anemic, but not because of capital requirements.

Banks claim more capital will raise their cost of funds, which they will have to pass on to borrowers. Since equity bears more risk than debt, banks must offer a greater return to equity holders than to lenders. But better-capitalized banks will be safer, so shareholders will not require as high a rate of return.

The banks deny this, claiming that investors require the same high return no matter how leveraged or safe the bank. But any investor who holds bonds, money-market funds or bank deposits along with his bank stock is already lowering his risk and return. Even if a hypothetical investor only holds bank stock and demands the high risk and return of a highly leveraged bank, he can add the leverage himself by purchasing the stock on margin.

Now, banks will have to pay a bit more for funds overall, but for a different reason. With more capital and less debt, the value of banks' tax deductions and government guarantees will be lower. But the taxpayer gains exactly what the bank loses.

The most hilarious argument is that under Dodd-Frank regulation, our banks aren't risky anymore. Under the watchful eye of regulators, the story goes, the banks will never lose money again, and the law's new resolution authority—which allows the Federal Deposit Insurance Corp. to close "systemically important" financial institutions—means there won't be any more bailouts.

Sure. The bureaucracy that didn't see the risks of subprime mortgages, and then Greek debt, is now going to remove all the risk from J.P. Morgan's balance sheet? The Dodd-Frank resolution authority guarantees bank-creditor bailouts: If "systemically important" means anything, it means the government wants to protect creditors who would normally take losses in bankruptcy court.

More capital is no panacea. The whole Dodd-Frank/Basel structure is flawed in many ways. Financial engineers will quickly circumvent the new "risk weights," which define how much capital the bank must issue for each investment, just as they got around the old ones. The capital requirements need to look more than one step ahead. Once the bank loses money, it needs time and a plan to replace capital, rather than frantically dumping assets or trying to raise more capital overnight. Both of these are additional good reasons to set very high capital requirements, not aim for some absolute minimum.

Free-market nirvana is a long way away. As long as our government subsidizes debt and will bail out the creditors of any large financial institution, we need large capital buffers to protect the taxpayer and the financial system. Even the Fed's 10% is timid. We should demand much more.

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