Healthy banking system is the goal, not profitable banks

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From Prof Anat Admati and others.

Sir, **Basel III bank regulation proposals that Group of 20 leaders will discuss** fail to eliminate key structural flaws in the current system.

Banks' high leverage and the resulting fragility and systemic risk contributed to the near collapse of the financial system. Basel III is far from sufficient to protect the system from recurring crises. If a much larger fraction, at least 15 per cent, of banks' total, non-risk-weighted, assets were funded by equity, the social benefits would be substantial. And the social costs would be minimal, if any.

Some claim that requiring more equity lowers the banks' return on equity and increases their overall funding costs. This claim reflects a basic fallacy. Using more equity changes how risk and reward are divided between equity holders and debt holders, but does not by itself affect funding costs.

Tax codes that provide advantages to debt financing over equity encourage banks to borrow too much. It is paradoxical to subsidise debt that generates systemic risk and then regulate to try to limit debt. Debt and equity should at least compete on even terms.

Proposals to impose a bank tax to pay for guarantees are problematic. High leverage encourages excessive risk taking and any guarantees exacerbate this problem. If banks use significantly more equity funding, there will be less risk-taking at the expense of creditors or governments.

Debt that converts to equity, so-called "contingent capital", is complex to design and tricky to implement. Increasing equity requirements is simpler and more effective.

The Basel accords determine required equity levels through a system of risk weights. This system encourages "innovations" to economise on equity, which undermine capital regulation and often add to systemic risk. The proliferation of synthetic AAA securities before the crisis is an example.

Bankers warn that increased equity requirements would restrict lending and impede growth. These warnings are misplaced. First, it is easier for better-capitalised banks, with fewer prior debt commitments hanging over them, to raise funds for new loans. Second, removing biases created by the current risk-weighting system that favour marketable securities would increase banks' incentives to fund traditional loans. Third, the recent subprime mortgage experience shows that some lending can be bad for welfare and growth. Lending decisions would be improved by higher and more appropriate equity requirements.

If handled properly, the transition to much higher equity requirements could be implemented quickly and would not have adverse effects on the economy. Temporarily restricting bank dividends is an obvious place to start.

Many bankers oppose increased equity requirements, possibly because of a vested interest in the current systems of subsidies and compensation. But the policy goal must be a healthier banking system, rather than high returns for banks' shareholders and managers, with taxpayers picking up losses and economies suffering the fall-out.

Ensuring that banks are funded with significantly more equity should be a key

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