FINANCIAL TIMES

August 2, 2011 3:04 am

Greenspan's reasoning on 'excessive' equity is misleading

From Prof Anat R. Admati and others.

Sir, Alan Greenspan's article "Regulators must risk more to push growth" (July 27) involves false characterisations and inappropriate analogies. Therefore, it is misleading about capital requirements and their costs.

If banks hold excessive liquid asset reserves, as Mr Greenspan asserts, this has little to do with capital regulation. The reserve levels are the result of banks' own choices, presumably coloured by the experience of wholesale markets drying up after Lehman's insolvency. Is Mr Greenspan second-guessing market participants?

Mr Greenspan writes that "excess bank equity capital ... would constitute a buffer that is not otherwise available to finance productivity-enhancing capital investment". This, and the mixing of liquidity reserves with the capital regulation debate, is an example of the pervasive fallacy that capital regulation forces banks to "hold" idle funds. Capital requirements do not constrain how banks invest their funds. They merely require them to use less debt and more equity funding for these investments.

Mr Greenspan compares safety measures in financial systems to the use of expensive building materials for "earthquake flexibility". This is a false comparison. Seismic safety requires real investment. Replacing debt with equity does not. Moreover, changing the funding mix imposes few, if any, costs on the economy, while its benefits extend beyond safety to better incentives to manage risk and fewer refinancing problems due to overhanging debt. The main impact of higher equity requirements on banks' funding costs is due to lost tax advantages and subsidies, particularly the highly distortive too-big-to-fail guarantees that he despises.

Contrary to Mr Greenspan's suggestion, financial crises, which are often caused or exacerbated by flawed policies, are not like natural disasters. As Mr Greenspan recognises, adequate equity-to-asset ratios would probably have kept problems in US mortgages from leading to a global crisis, a prolonged recession and bail-outs. Unless the fragility of the financial system is reduced, financial disasters can recur frequently. Protection against such disasters through increased equity requirements, unlike protection against natural disasters, does not entail high social costs.

Some claim that equity requirements substantially higher than Basel would be "excessive" without offering an explanation. In the 19th century, a time that Mr Greenspan extols and one without government bail-outs, banks funded their assets with as much as 40 per cent equity. Banks themselves frequently require borrowers to contribute equity in excess of 25 per cent. It is low equity requirements and manipulable risk-weighting systems that allow the build-up of systemic risk and put us in danger, not "excessive" equity.

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