Running on Empty

Banks should raise more capital, carry less debt—and never need a bailout again

By JOHN H. COCHRANE

Four and a half years ago, the large commercial banks nearly failed, inaugurating our great recession. They were saved by the Troubled Asset Relief Program, Federal Reserve lending and other government support. If you think all that was bad, imagine the ATMs going dark. What has been done to avoid a repetition of these events? Sadly, and despite all the noise you hear about bank regulation, not much.

The central problem, at the core of Anat Admati and Martin Hellwig's "The Bankers' New Clothes," is capital. In order to make $100 of loans, a typical bank borrows $97—from depositors, from money-market funds, from other banks, or from bondholders—and sells $3 of stock, its "capital." So if only 4% of the bank's loans fail, the shareholders are wiped out, and the bank cannot pay its debts. Worse, if there is a rumor that some loans are in trouble, creditors may "run," each trying to get his money out first, and force a needless bankruptcy. Think of Jimmy Stewart in "It's a Wonderful Life."

When banks are on the brink, all sorts of other pathologies emerge. Bankers and their regulators may try to keep zombie loans on the books, hoping things will turn around. Or bankers may bet the farm on very risky loans that either save the bank or impose larger losses on creditors and the government. Ms. Admati and Mr. Hellwig explain all this nicely in their first few chapters.

The solution seems pretty obvious, no? Banks should fund their investments by selling a heck of a lot more stock and borrowing a heck of a lot less, especially in the form of run-prone short-term debt, as most other companies do.

Far more value was lost in the 2000 tech bust, for instance, than in the subprime mortgages that sparked the 2008 crisis, but the tech bust did not cause a financial crisis. Why? Tech companies were funded by stocks, not short-term debt. Worried
shareholders can drive down the price of a stock, but they have no right to demand that the company redeem shares at yesterday's price, so they can't drive the company to bankruptcy in a run. Depositors and other short-term creditors have a fixed-value, first-come-first-serve promise from a bank—they can run.

More capital and less debt would stabilize the financial system in many ways. If a bank wants to rebuild its ratio of capital to assets from 1% to 2% by selling assets, it has to sell half of its assets. Doing so can spark a fire sale, especially if all the other banks are doing the same thing. If the same bank wants to rebuild capital from 49% to 50% of assets, it only has to sell 2% of its assets. That bank will also have a far easier time issuing more stock, rather than selling assets, which is a better way to build equity in the first place.

The U.S. government has instead addressed the risks of banking crises by guaranteeing bank debt. Guaranteeing debts creates perverse incentives, so our government tries to regulate the banks from taking excessive risks: "OK, cousin Louie, I'll cosign the loan for your Las Vegas trip, but no poker this time, and be in bed by 10."

Ms. Admati and Mr. Hellwig show how this approach has failed, repeatedly, over the course of many years—in the 1984 Continental Illinois rescue; in the Latin American debt crisis and savings-and-loan crisis in the 1980s; in the Asian-currency crisis and the collapse of Long-Term Capital Management in the 1990s; and in the recent financial crisis. Each time, our government bailed out more and more creditors in a wider array of institutions. Each time, our government wrote reams of new rules that banks quickly got around.

Now pretty much all of the big banks' debt is guaranteed, explicitly or implicitly through the widely held expectation that a big bank's creditors will be bailed out. But our regulators promise that next time, trust them, they really will spot trouble ahead and do something to stop it—even though our massive bank-regulation machinery failed to notice that subprime mortgages might be a bit risky in 2006 and even though, as Ms. Admati and Mr. Hellwig note, Europe's regulators still consider Greek government bonds to be risk-free assets.

Most basically, Ms. Admati and Mr. Hellwig point out that current regulation is focused on a bank's assets: the loans, securities and other investments that bring money in (and sometimes don't). They want us to focus instead on the bank's liabilities: the ways banks get money and the promises banks make to depositors and investors. Bank assets are not particularly risky or illiquid. Apple's profits from selling iPhones or a mutual fund's portfolio of stocks are far riskier than any bank's portfolio of loans and mortgage-backed securities, or even their much-disparaged trading books. Bank liabilities—too much debt and too much short-term debt—are the central problem that causes financial crises.

What about those "tough" new capital regulations that you keep reading about? They are not nearly as tough as you think. At best, the new Basel III international bank regulation agreement calls for a 7% ratio of capital to assets by a leisurely 2019 deadline. But that is the ratio of capital to "risk-weighted" assets. Risk-weighting is a
complex system in which some assets count less against capital requirements than others. A dollar of mortgage assets might count as 50 cents, but it might count as 10 cents or less if it is a complex mortgage-backed security, and zero if it is government debt. When Ms. Admati and Mr. Hellwig unravel those "risk weights," we're still talking about 2% to 3% actual capital.

Foreseeing the usual risk-weighting games, Basel III requires a backstop 3% ratio of equity to all assets. "If this number looks outrageously low," Ms. Admati and Mr. Hellwig write, "it is because the number is outrageously low." Indeed.

This simple truth has been met by howls of protest and layers of obfuscation and derision by bankers, their consultants and many of their regulators. "Oh, you just don't understand the complexities of banking" is the basic attitude. "Go away and let the experts fix this." Well, Ms. Admati and Mr. Hellwig, top-notch academic financial economists, do understand the complexities of banking, and they helpfully slice through the bankers' self-serving nonsense. Demolishing these fallacies is the central point of "The Bankers' New Clothes."

No, they write, it was not always thus. In the 19th century, banks funded themselves with 40% to 50% capital. Depositors wouldn't lend to banks unless the banks had a lot of skin in the game. Without a government debt guarantee—and, early on, without limited liability—shareholders wanted less risk as well.

"Capital" is not "reserves," and requiring more capital does not reduce funds available for lending. Capital is a source of money, not a use of money. When, as Ms. Admati and Mr. Hellwig gleefully note, the British Bankers' Association complained in 2010 about regulations that would require banks to "hold"—the wrong verb—"an extra $600 billion of capital that might otherwise have been deployed as loans to businesses or households," it made an argument both "nonsensical and false," contradicting basic facts of a bank balance sheet. Requiring more capital does not require banks to raise one cent more money in order to make a loan. For every extra dollar of stock the bank must issue, it need borrow one dollar less.

Capital is not an inherently more expensive source of funds than debt. Banks have to promise stockholders high returns only because bank stock is risky. If banks issued much more stock, the authors patiently explain, banks' stock would be much less risky and their cost of capital lower. "Stocks" with bond-like risk need pay only bond-like returns. Investors who desire higher risk and returns can do their own leveraging—without government guarantees, thank you very much—to buy such stocks.

Nothing inherent in banking requires banks to borrow money rather than issue equity. Banks could also raise capital by retaining earnings and forgoing dividends, just as Microsoft did for years. Every dividend drains capital from banks and removes a layer of protection between us taxpayers and the next bailout. Ms. Admati and Mr. Hellwig are at their best in decrying U.S. regulators' decision to let banks pay dividends in 2007-08—amounting to half the TARP bailouts—and to let big banks begin paying out dividends again in 2011.
Why do banks and protective regulators howl so loudly at these simple suggestions? As Ms. Admati and Mr. Hellwig detail in their chapter "Sweet Subsidies," it's because bank debt is highly subsidized, and leverage increases the value of the subsidies to management and shareholders. To borrow without the government guarantees and expected bailouts, a bank with 3% capital would have to offer very high interest rates—rates that would make equity look cheap. Equity is expensive to banks only because it dilutes the subsidies they get from the government. That's exactly why increasing bank equity would be cheap for taxpayers and the economy, to say nothing of removing the costs of occasional crises.

And, in an all-too-short chapter on "The Politics of Banking," they show us how politicians and regulators like the cozy cronyism of the current system. Banks are, of course, "where the money is," and governments around the world use regulation to direct funds to politically favored businesses, to preferred industries, to homeowners and to the government itself. Politicians want to subsidize and protect their piggy bank. Regulators commonly become sympathetic to the interests of the industry they regulate, which advances their careers in government or back in industry. Last week's news coverage of Treasury Secretary Jack Lew's interesting career is only the most recent reminder.

Part of me wishes that Ms. Admati and Mr. Hellwig had been more specific in their criticisms: naming more names and quoting more nonsense, writing a gripping exposé dripping with their justified outrage. But their restraint is wise: Too much exposé would detract from the clarity of their ideas. So readers will have to recognize the arguments and add their own outrage.

Ms. Admati and Mr. Hellwig do not offer a detailed regulatory plan. They don't even advocate a precise number for bank capital, beyond a parenthetical suggestion that banks could get to 20% or 30% quickly by cutting dividend payments. (I would go further: Their ideas justify 50% or even 100%: When you swipe your ATM card, you could just sell $50 of bank stock.)

But this apparent omission, too, is a strength. A long, detailed regulatory proposal would simply distract us from the clear, central argument of "The Bankers' New Clothes": More capital and less debt, especially short-term debt, equals fewer crises, and common contrary arguments are nonsense. More capital would be far more effective at preventing crises than the tens of thousands of pages of Dodd-Frank regulations and its army of regulators, burrowed deep in the financial system, on a hopeless quest to keep highly leveraged and subsidized too-big-to-fail banks from taking too much risk. Once the rest of us accept this central idea, the details fill in naturally.

How much capital should banks issue? Enough so that it doesn't matter! Enough so that we never, ever hear again the cry that "banks need to be recapitalized" (at taxpayer expense)!

—Mr. Cochrane is a professor of finance at the University of Chicago Booth School of Business, senior fellow of the Hoover Institution, and adjunct scholar of the Cato Institute.