I. Introduction

Good afternoon. It’s a great pleasure to be part of this book launch and I want to thank Adam Posen and the Institute for inviting me.

I won’t hold you in suspense about my overall evaluation of this book. It is a stunning achievement. Indeed, I regard The Bankers’ New Clothes as the most important contribution to the analysis of banking regulation in the past twenty five years. One has to go back to the late 1980s and to the work of Benston and Kaufman on structured intervention, bank resolution, and prompt correction action – work that subsequently led to led to the overhaul of US banking regulation in the 1991 FDICIA legislation – to find a comparable tour de force.

This book should be required reading for bank regulators, bankers, and legislators; it should also do a lot to demystify banking for the concerned public. It is beautifully written and forcefully argued. Anat and Martin are not the first scholars to argue for much higher and simpler bank capital requirements, but they make the case for that reform more clearly, more comprehensively, and more persuasively than anybody else. In so doing, they also expose the claim that the banking industry has long been peddling about the dire economy-wide consequences of much higher equity requirements for banks for what is, namely, nonsense. Hopefully, The Bankers New Clothes will ultimately lead both to a strengthened Basel international agreement on bank capital and an enhanced Dodd-Frank law – the centerpiece of which ought to be a minimum unweighted leverage requirement for banks that is much closer to 20-30 percent than to 3 percent.

Given time constraints, I want in my remarks to emphasize ten summary points from the book that merit a prominent place in the ongoing debate about bank capital standards.
First, if you evaluate the proposed reform of much higher bank capital requirements on the right metrics – that is, on a comparison of social benefits and costs rather than private ones, and if you focus on the appropriate measure of capital, namely, common equity as a share of unweighted total bank assets, then the benefit-cost calculus is not a close call; it rather points strongly to the desirability of requiring a much higher minimum leverage ratio. The minimum leverage ratio of 3 percent in Basel III is way too low. Likewise, the actual leverage ratios currently maintained by banks in the advanced economies are way too low. For example, the October 2012 Global Financial Stability Report of the IMF indicates an average leverage ratio for Euro Area banks of around 2 percent.

Neither the empirical evidence nor economic theory supports the banking industry’s claim that much higher equity requirements would have serious adverse effects on bank financing costs, on bank loan growth, or on economic growth. The time series evidence draws on a hundred years or more of data in both the United States and United Kingdom, including long sub-periods in which ratios of bank equity to total bank assets were much higher by a factor of five or more than they are today. In this time series data, there is no statistically significant link between higher equity and higher spreads on bank lending relative to reference interest rates. Similarly, there are no obvious links in the time-series evidence between higher bank equity and either lower loan volumes or lower economic growth. Bank credit crunches typically come when banks have very low levels of equity – not healthy ones. The cross-section evidence is similarly unkind to the claims of the banking industry. Non-financial firms in the United States have average equity ratios closer to 50 percent than to 5 percent, and yet these non-financial firms exhibit no difficulty making investments, or maintaining adequate returns, or raising new equity. Indeed, some of most successful corporations in America – like Apple, fund themselves exclusively with equity. It just doesn’t make sense to conclude that relying so heavily on debt is a secret funding formula for success that only banks know about.

Empirical studies that point to large adverse macroeconomic effects of higher bank equity—often carried out by the banking industry -- typically suffer from
major methodological flaws. One such major misstep is failure to recognize that higher equity reduces the riskiness of both equity and debt and thereby lowers the required rate of return, blunting any sizeable increase in overall financing costs. Treating the required rate of return on equity as independent of the mix of equity and debt and failing to acknowledge that ROE can be manipulated by higher borrowing, have also led the banking industry astray in relying on return on equity as a preferred indicator of bank performance. Over a two or three year period, there are unlikely to be any adverse macroeconomic costs of higher bank equity – particularly if higher equity is financed by retained earnings and a temporary suspension of dividend payments and if higher regulatory minima for bank equity are mandated to come from the numerator rather than the denominator of the capital ratio.

When you put all this material together, you do not find that the increased taxpayer protection against bank distress and bank insolvency provided by much higher bank equity must be paid for or “traded off” against higher financing costs and slower growth for the macro-economy. This alleged big trade-off – so frequently emphasized by bankers – is a myth. And since there is little downside to higher bank equity, we can and should ask for minimum leverage requirements that are in the neighborhood of 20-30 percent – not say, 4-7 percent.

Second, contrary to what you often hear, banks that were distressed and or required government assistance to avoid insolvency during the global financial crisis of 2007-2009 had, on average, quite low levels of equity relative to total assets. Further, simple leverage ratios did a better job of predicting which banks would get into trouble during that crisis than did more complicated measures of bank capital based on risk-weighted assets.

Third, the dilution argument against much higher equity requirements is much overstated. As Anat and Martin put it, with increased equity issuance, the shareholder gets a smaller piece of a bigger pie versus a larger piece of smaller pie prior to dilution. There can be no assurance that the former combination will make the shareholder worse off than the latter; it depends instead on what returns the
bank earns using the new financing relative to borrowing costs. Banks that are profitable usually do not find it difficult to raise new equity.

Fourth, banks are different than non-financial firms but not in ways that repeal the basic tenets of finance. Yes, bank failures carry higher contagion risks than failures of non-financial firms. But excessive borrowing carries increased risks for banks just as it does for non-financial firms. Higher borrowing by banks relative to non-financial corporations is not easy to explain with reference to the intrinsic features of banking; instead, it better explained in terms of subsidies extended to the banking industry — and especially to too-big-to-fail banks — by the official safety net, by the large amount of lobbying that the banking industry does to deter tougher rule making, and by the conflicts between shareholders and creditors that occur when there is a large debt overhang.

Fifth, the wider national interest is not well served in the longer-term by lax regulation that promotes banking fragility. Ask yourself: are the US, UK, and EU banking systems now more “competitive” or better off because of the low leverage ratios that they were permitted to maintain prior to the global financial and economic crisis?

Sixth, there should be no presumption that the existing size of the financial industry is necessarily the right one — especially in an environment where the banking industry is the recipient of very considerable subsidies from the official safety net. By the same token and contrary to the claims of the banking industry, it would not necessarily be a national tragedy if some of the highly trained specialists currently employed in the banking industry relocated to the fields of medicine, mathematics, the hard sciences, and teaching after a reduction in such subsidies.

Seventh, there is little evidence from the global financial and economic crisis that either short-term debt or subordinated debt exerts effective discipline upon bank managers.

Eighth, common equity is likely to provide better loss absorption in a crisis than contingent, convertible bonds, and without the thorny manipulation and threshold definition issues associated with such bonds.
Ninth, the existence of a large shadow banking system is not a good reason not to raise significantly bank equity standards. Instead, the appropriate policy is to require suitable capital standards for all institutions that offer banking services to the public and to ensure that all financial institutions – bank or non-bank --whose failure would have systemic consequences have enough equity.

And tenth and finally, if we were able to agree on and to implement a much higher minimum leverage requirement for banks, we could simplify considerably the broader bank regulatory regime. More specifically, with much more self insurance, one would not need to be as concerned about activity restrictions – be they of the Volcker, Vickers, or Liikanen variety. Similarly, we would not need to reach a judgment on size limits for large banks. And with risk weights no longer relevant for calculating regulatory capital, we would not need to be concerned about banks gaming these weights via their internal models, or about the regulatory implications of errors by the credit rating agencies. But it seems to me that the inverse of this tenth proposition also holds. If we are not able to agree on much higher capital requirements for banks, then lack of adequate self insurance will require a host of other more complex initiatives to limit the prospective size of a systemic bank failure and/or to place more of the financing burden for such a failure on creditors.

To sum up, this is a terrific book. It took courage, a deep understanding of banking and finance, and first-rate expository skills to write it. My congratulations go to the authors. I hope it is widely read and that its message is taken to heart by those who can change the status quo in banking. Real reform is long overdue.