

Banks need to generate investor value without subsidies

Text of letter from Anat R. Admati, Financial Times, February 9, 2011

Eric Grubelich (Letters, February 3) argues that substantially raising bank capital ratios would make it difficult for banks to maintain a “competitive return on equity”. This is not a valid concern. ROE comparisons are meaningless unless leverage and risk are fixed, and competitive ROEs would be lower if banks are better capitalized. Except through the possible loss of distortive government subsidies, changes in ROEs brought about by changes in bank leverage are not indicative of higher or lower value for shareholders.

In any setting, and this includes banking, leverage amplifies both risk and average returns. With high leverage, if things go well, realized ROE can be very high indeed. Leverage is wonderful in those scenarios. On the downside, however, ROE can quickly become negative; and the higher the leverage, the more negative the ROE becomes in those scenarios. Investors require return that, on average, compensates them for risks they bear. That is why the required returns on stocks are generally much higher than those on triple-A rated debt. Buying stocks on margin immediately creates leverage for investors and automatically increases the ROE of their investment. Shareholders do not need companies to take on leverage for them unless this leverage creates benefits such as taxes or other subsidies.

The ROE-based argument against capital requirement relies on the notion that equity investors don’t care about risk, they just need to achieve a fixed ROE. This goes against everything we know about well-functioning financial markets. Any company in any industry can achieve high average ROEs by taking on substantial leverage, yet that is not something most choose to do. The ROE fixation in banking is due to the fact that high leverage allows banks to increase the value of government subsidies in the form of taxes and especially underpriced guarantees.

Competition in banking has become competition for creative ways to take on leverage. Unfortunately, this generates systemic risk and fragility for the system, and it is based on taking advantage of government subsidies, not on generating true value.

The business of banking should focus on making good loans and on creating liquidity in a responsible way. Banks should compete to generate value for shareholders without relying on subsidies. If governments choose to subsidize banks or credit markets, alternative ways to deliver subsidies, not through encouraging bank leverage, must be found.

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