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# Dividends can wait until banks are stronger

By Anat Admati

Corrupting subsidies associated with guarantees are best handled by high equity needs, writes Anat Admati

American banks, encouraged by good earnings, are itching to “return capital” to shareholders. The US Federal Reserve is expected to allow dividend increases for many banks soon.

This action is misguided. It puts the needs of bankers and their shareholders ahead of those of the economy.

US banks paid large dividends leading up to the financial crisis, continuing even while credit was restricted and capital seemed scarce. Had they withheld some of the dividends they paid in 2007 and 2008, the government would have needed to provide significantly less support under the troubled asset relief programme.

Paying dividends helps banks maintain excessive leverage. A typical bank funds over 95 per cent of its investments with debt and less than 5 per cent with equity. A small drop in asset values can lead to distress and possible insolvency. We have seen that furious “deleveraging” by any highly leveraged and interconnected bank can start a crisis.

The average non-financial listed company in the US funds itself with 70 per cent equity. Many successful businesses, including Apple, Gap and Yahoo, are essentially 100 per cent equity financed. Given their intermediation function, banks cannot be funded entirely with equity. But there is no compelling reason for them to rely on it so little. Our financial system would work better if banks funded 15 per cent or even 30 per cent of their assets with equity.

The Basel III reforms agreed last year set minimum bank equity between 4.5 per cent and 7 per cent of “risk-weighted assets”, which are significantly smaller than total assets for most banks. Triple A-rated assets require little or no equity capital. The system of risk weights established by Basel II, which distorts banks’ investments towards favourably treated assets, was mostly maintained. Under Basel III, the ratio of equity to total assets can be as low as 3 per cent.

These equity requirements are dangerously low. Significantly increasing banks’ equity funding would provide many benefits to the economy, at little social cost.

Switzerland already requires that equity represents at least 10 per cent of risk-weighted assets for banks. Mervyn King, the Bank of England governor, has argued for more equity requirements. The US should strive to lead the world in setting prudent standards for banks.

The easiest and quickest path to better capitalisation is to require that banks temporarily withhold equity payouts. Even taking Basel III as the benchmark requirements, delaying adherence by allowing dividends now makes no sense.

The tax advantage of debt is one reason banks choose high leverage. Proposals to reform the US corporate tax code by a 2005 commission appointed by President George W. Bush and recently from the Hamilton Project and the Centre for American Progress think-tanks try to correct the tax penalty of equity. This would be helpful for bank regulation.

The corrupting subsidies associated with “too big to fail” guarantees are best handled by high equity requirements, which force banks to face the full consequences of their decisions.

Alternatives such as bail-in procedures, which involve regulators converting debt to equity ahead of taxpayers’ support, are unlikely to

work as well. Regulators are required by this mechanism first to determine exactly when large banks, with illiquid assets around the world and complex structures on and off balance sheets, would be insolvent without debt conversion. Then they must be politically able to pull triggers, telling some creditors that their debt is converted to equity. Ahead of such a situation, market participants, including governments, are likely to exert pressure on regulators. Equity requirements are simpler and more reliable.

If banks don't pay shareholders, and if no valuable loans can be made with the "surplus capital", banks can retire debt or invest in marketable securities, earning appropriate market returns. Whatever banks do, except for wasting funds in perks, the riskiness of their debt would be reduced, and profits still belong to shareholders. Shareholders can generate cash for themselves by selling some shares.

Effective capital regulation requires us to resolve who should be regulated and how to track the true leverage and risk of relevant institutions. These challenges can be met. The focus must be on the simplest and most direct approaches, and should involve serious attempts to reduce excessive leverage.

Banks must obviously pay back their equity investors at some point. But prudent regulation requires that dividends should wait until banks have significantly more equity capital.

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