Letter

Easing capital rules would lead banks away from vital lending

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From Prof Anat R. Admati.

Sir, In his excellent comment "Star traders, rip-offs and old-style bankers" (August 19), John Plender observes that universal banks take excessive risks in their various trading activities. Excess risk-taking is due to a flawed focus in banking on raw return-on-equity measures and is greatly encouraged by government guarantees that allow bankers to benefit from the upside of their investments without fully bearing downside risk.

Much of the substantial decline in bank stock prices recently is due to past risky investments that have turned out badly. Some of these, like triple A-rated subprime mortgage securities and sovereign debt, required no equity backing or "skin in the game" from the banks. Exposures to European sovereign debt and non-performing loans, mounting litigation and problems related to mortgage documentation that go back to the housing crisis, are still hanging over banks in Europe and in the US.

Some have suggested (for example, Patrick Jenkins in "For their health, banks need a holiday away from Basel", August 9) that regulators should "ease off" banks and that capital and liquidity regulation should be loosened. Regulatory forbearance might be useful if it can achieve such goals as improving lending and growth, and promoting economic recovery but there is no reason to believe that easing capital rules at this time would produce any such positive outcome. In fact, doing so would be dangerous, because banks' incentives would continue to lead them into investments and actions that they find more attractive and away from much of the lending that the economy needs. Regulatory forbearance, and the "gambling for resurrection" that followed, failed miserably in the US savings and loans crisis in the 1980s and it will not save us today.

A significant problem is that current and proposed capital regulations rely on a complex system of risk weights that discourages traditional lending. Given this, bankers' return-on-equity focus and government guarantees, we can expect banks to find that investing in start-ups in China and commodity trading is more attractive than local business loans. Banks may even, as they have done in the US recently, pay high dividends instead of lending if this would benefit their shareholders. Trust in the banks, which is essential to their ability to refinance, will only be harmed by loosening capital regulation. All of this will increase fragility without helping recovery and growth.

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