

Business

Fed Runs Scared With Boost to Bank Dividends: Anat R. Admati

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People become scared when ex-regulators or bankers warn that growth might be hurt or that the recovery would be slowed if we fail to do something. The Federal Reserve seems scared, too, or maybe captured, since it is about to allow increased dividends from banks.

The Fed should know better. Allowing high payouts to shareholders raises financial institutions' leverage and that is bad for the economy.

One of those warning that growth will suffer is William Isaac, head of the Federal Deposit Insurance Corp. from 1981 to 1985 and now chairman of Fifth Third Bancorp. Writing in the Financial Times on Feb. 9, he said that unless banks increase dividends they will have a harder time raising equity in the future, thus hurting the economy. This is similar to the flawed assertions made by bankers who are lobbying against increased capital requirements.

We have seen self-serving statements like this before. In 1994, the Financial Accounting Standards Board wanted executive stock options to be expensed to reflect their actual cost. Industry opponents threatened that doing so would prevent entrepreneurial firms from obtaining financing, impede growth and reduce U.S. competitiveness.

Massive lobbying forced the board to back off. A decade later, after WorldCom Inc., Enron Corp. and other corporate scandals, the political atmosphere was different, and the FASB finally changed the rules. Since 2006, all companies must treat executive options as an expense. And the doom and gloom we were promised? There is no evidence that expensing options had any negative economic consequences.

'Rainy Day'

Confusing language often obscures the discussion of capital regulation and makes it more difficult to evaluate such threats. Banks often are said to "hold in reserve" or "set aside" capital; capital is described as a "rainy day" fund, and we are told "a dollar in capital is a dollar not put into the economy." These descriptions portray capital as a pile of money sitting idle and not being used productively. This is nonsense.

Capital is simply equity, the value of shareholders' ownership claims in banks; and it represents a way for banks to fund their investments without undertaking debt commitments that they might not be able to meet and which add to systemic risk. Bankers are fiercely resisting the suggestion that they use more equity and less debt in funding, even though this would reduce their dangerous degree of leverage.

Severe Consequences

Like homeowners who took a mortgage with little down payments, when banks are highly leveraged, their equity can be easily wiped out by small declines in asset values. If 95 percent of a bank's assets are funded with debt, even a 3 percent decline in the asset value raises concerns about solvency and can lead to disruption, the need to "deleverage" by liquidating inefficiently, and possible contagion through the interconnected system. As we have seen, this can have severe consequences for the economy.

While equity is used extensively to fund productive business, bankers hate to use it. With more equity, banks have to "own" not only the upside but also more of the downside of the risks they take. They have to provide a cushion at their own expense to reduce the risk of default, rather than rely on insurers and eventually taxpayers to protect them and their creditors if things don't work out.

Fixation with return on equity also contributes to bankers' love of leverage because higher leverage mechanically increases ROE, whether or not true value is generated. This is because higher leverage increases the risk of equity, and thus its required return. Focus on ROE is also a reason bankers find hybrid securities, such as debt that converts to equity under some conditions, more attractive than equity.

Distorted Decisions

Isaac is right to point out that the structure of current capital requirements distorts banks' decisions. The structure, which is focused on the ratio of equity to so-called risk-weighted assets, might induce banks to choose investments in securities over lending, because securities with high credit ratings require less capital and thus allow more debt funding.

These failures of the system of risk weights, however, have nothing to do with the overall level of capital. Allowing banks to pay dividends and maintain high leverage isn't the solution to this problem. Instead, better ways to monitor the true leverage and risk of financial institutions should be found.

Isaac says he favors high capital requirements, but he says that paying dividends now is important for banks' ability to raise equity later. As prominent academics explained in a letter responding to his column, his arguments for allowing dividends are weak.

False Hopes

The muddled debate on capital regulation has left us with only minor tweaks to flawed regulations, even after banks' catastrophic failure in the crisis and the lasting consequences for the economy. The proposed solutions that regulators in the U.S. are focused on, such as resolution mechanisms, bail-ins, contingent capital and living wills, are based on false hopes. They can't be relied on to prevent a crisis. Increasing equity funding is simpler and better than these pie-in-the-sky ideas.

Until they build up much greater capital, banks should retain their earnings rather than make payouts to equity. Bank boards, helped by regulators, should make sure that "excess capital" isn't wasted or cause banks -- as JPMorgan Chief Executive Officer Jamie Dimon said -- to do "stupid things." And empty, self-interested threats shouldn't win another round of implicit subsidies if we are to prevent another crisis.

(Anat R. Admati is a professor of finance and economics at Stanford University and the coauthor of "Fallacies, Irrelevant Facts and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Expensive." The opinions expressed are her own.)

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