

Letter**Highly leveraged lenders inflict great suffering on society**DECEMBER 1, 2010

From Prof Anat Admati.

Sir, David Miles' Comment article ("[Banks fail to convince crying foul over Basel reforms](#)", November 24) and his [follow-up letter](#) (November 30) in response to letters by [Richard Barwell](#), [Simon Gleeson](#) and [Simon Samuels](#) on November 29 are refreshing, particularly following Citigroup chief executive Vikram Pandit's previous comment "[We must rethink Basel, or growth will suffer](#)" (November 11). Unlike Mr Pandit and the November 29 correspondents, Prof Miles focuses on the logical arguments.

Mr Samuels uses a quote by baseball star Yogi Berra to dismiss Prof Miles' arguments as theoretical and inapplicable to practice. But Berra is also famous for instructing a waiter to cut his pizza into six slices because he was "not hungry enough for eight slices". This is funny precisely because the size of a given pie doesn't depend on how many slices it is cut into, an exact analogue to Modigliani and Miller's result. This is true in theory and no less true in practice. The reason high leverage lowers banks' funding costs is that the more debt banks use relative to equity in their funding, the smaller is the slice the government takes in taxes, and the higher is the value of the implicit or explicit guarantees the government provides to their debt. Highly leveraged banks, particularly those too important to fail, have strong incentives to take on excessive risk, enjoying the upside without having to worry about the downside of their bets. Given the fragility and systemic risk that high bank leverage entails in our interconnected financial system, society suffers greatly when banks are highly leveraged, even as banks and their managers benefit. When it comes to banks and their leverage, there are no practical considerations associated with bank funding that provide any reason for the public to allow banks to be anywhere near as highly leveraged as they would like to be.

Messrs Pandit, Barwell, Gleeson and Samuels must do more than dismiss arguments as theoretical and raise vague and unsubstantiated threats to global growth and the economy. They must explain precisely what forces should lead society away from imposing high equity requirements on banks and how such an effect comes about. Unless and until they do so, it is their arguments that should be dismissed, not those of Prof Miles.

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