

Letter

More bank equity serves us all better

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From Prof Anat R. Admati and Mr Neil M. Barofsky.

Sir, Bankers say whatever serves their interests. William Isaac, chair of Fifth Third Bankcorp, and Richard Kovacevich, former Wells Fargo chief executive, [repeat standard and flawed arguments](#) against what they call “breathtaking” levels of equity such as 9 per cent (Comment, March 2). [Many others argue](#) that equity levels of 15 per cent or more relative to total assets for banks would provide substantial benefits to the economy without inflicting any relevant costs (Letters, November 9). Who’s right?

The warning that more equity will harm growth is self-serving and empty. In fact, banks’ high leverage has a polluting and distorting effect on the economy, by increasing the risk and fragility of the financial system and its reliance on public support. Bankers find more equity “expensive” because it transfers to them downside risk that would otherwise be borne by creditors or taxpayers. For the economy, more equity for banks is a great bargain, creating a safer and less distorted system that serves us all better.

Mr Isaac and Mr Kovacevich complain that more equity would reduce banks’ “return on equity”. Should we care? With more equity, each dollar invested in the equity is subjected to less risk. In a well-functioning financial market, this means that equity requires less compensation for risk. In banking as elsewhere, raw return on equity, unadjusted for risk, [measures nothing relevant](#), not even shareholder value. Targeting high returns by choosing little equity may increase bankers’ bonuses and the value of their government subsidies, but does not serve the public good.

Mr Isaac and Mr Kovacevich propose using subordinated debt to absorb losses, and that bail-ins be organised by the Federal Deposit Insurance Corporation for insolvent banks. But the FDIC does not have jurisdiction outside the US. Legal differences across countries were a major problem in the Lehman bankruptcy. Subsequently, governments avoided bail-ins even for hybrid securities that had been designed to absorb losses and treated as “capital” by regulators. Equity, by contrast, absorbs losses without triggering costly resolution procedures.

Does debt provide “market discipline”? Certainly no such “discipline” was evident in the run-up to the crisis, when banks relied on enormous amounts of debt and little equity. Most non-bank companies are funded with 70 per cent or more equity, without resorting to high leverage as a form of governance. Perhaps bankers can learn from them how to be more disciplined. After all, even

with all of their debt and subsidised funding, the banks haven't done so well for their shareholders recently, and certainly not for the economy.

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