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An open letter to JPMorgan Chase Board of Directors

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Anat Admati

Dear JPMorgan Chase Directors,

I own some JPMorgan Chase (JPM) shares through mutual funds in my retirement account. I have read Mr. Dimon's recent letter to shareholders and some of his public comments. I write to urge you to reconsider JPM's actions related to capital regulation. For the overall economy, as well as for JPM, these actions are misguided.

Why I am writing

The economic pain from the financial crisis was substantial and is still being felt. A major cause of the crisis was the excessive leverage used and the risky investments made by many financial entities. The resulting distress of large institutions was extremely costly and disruptive to the economy.

Bank debt involves legally-binding promises. Shareholders, by contrast, do not have fixed claims but are entitled to the residual after debt is paid, the "spread." A drop in the value of the bank's assets can lead to difficulties in fulfilling its debt obligations. The more debt is used relative to equity, i.e., the higher the leverage, the more likely this is to happen.

High leverage makes the financial system fragile. One institution's distress can have severe implications for the entire system, causing market freezes, runs and lending contraction.

Requiring banks to operate with much-reduced leverage, using significantly more equity to fund their investments even beyond currently proposed regulation, is likely the most straightforward and cost-effective approach to improving the health and stability of the financial system and preventing future crises. It must be the key ingredient in any meaningful financial reform and can reduce the need for other, more costly measures. This would greatly benefit the economy and JPM.

Flawed reasoning

Mr. Dimon claims that higher capital requirements would increase JPM's cost, but his reasoning is flawed.

It is critical first to distinguish capital and liquidity requirements. Capital requirements are not about what banks "hold." They do not mandate that banks passively "set aside," or "hold in reserve" funds, not putting them to productive uses. Banks' investments are not constrained by capital requirements. Capital requirements refer only to how banks fund themselves. It is investors, not the banks, who hold the debt and equity (so-called "capital") claims that banks issue. Liquidity requirements, by contrast, do constrain the types of assets banks hold, and they can be costly. Capital and liquidity requirements refer to different sides of the balance sheet.

A flaw in Mr. Dimon's argument concerns the "market-demanded return on capital" that he claims banks must earn. In a well-functioning financial market, investments in Treasury bills "demand" a lower return than investments in risky mortgages. The required return on capital depends on the risk to which it is exposed. When funding with a mix of debt and equity, the lower the leverage, the lower the riskiness of equity per dollar invested, and therefore the lower the return investors require as compensation for bearing the equity risk.

According to Mr. Dimon, the reduction in the required return on equity as a result of reduced leverage is "not likely to be materially significant." Is he suggesting that sophisticated investors who can value complex derivatives and other securities are unable to value JPM's equity properly? This is hard to believe. JPM's overall funding costs, averaging the required return on the various debt claims it issues (some of which might decline if JPM is better capitalized) and the required return on equity, need not change just because more equity is used.

Mr. Dimon's letter displays JPM's return on equity (ROE). ROE does not measure shareholder value because it is affected, through the market, by leverage and risk. Reaching a target ROE can be helped by leverage and risk without benefitting shareholders. Thus, if increased capital requirements lead to lower average ROE, this need not mean lower value, because it reflects the reduced riskiness of equity.

Subsidized debt funding

JPM's overall funding costs will likely increase somewhat if it reduces its leverage, but the key reason for this is that government subsidies make debt more attractive than equity as a source of funding.

First, using more debt can save on corporate taxes because interest payments are tax deductible.

Another source of subsidy for debt relative to equity is due to underpriced explicit and implicit government guarantees. Such guarantees allow JPM to borrow at rates that do not fully reflect the riskiness of its assets. Mr. Dimon argues that JPM does not benefit from subsidized guarantees, but credit rating agencies such as Moody's explicitly state that government support is built into the debt ratings of large US banks, including JPM.

Does this system make sense?

Since high leverage increases systemic risk, subsidizing debt funding and leverage is paradoxical and distortive. This is akin to providing subsidies to a polluting input (high leverage) when there is an otherwise equally costly "clean" input (more equity) for producing the same product (funds). It makes no sense to subsidize pollution when there are cheap alternatives.

Removing the preferential tax treatment of debt relative to equity, and even giving incentive for better capitalization would make for a healthier system. For the US economy, however, if JPM's pays more taxes, this is not a true cost. Any additional taxes JPM pays can be redirected to the economy, possibly reducing taxes elsewhere.

The "safety net" of the financial system, created to maintain stability and prevent inefficient panics and runs, has broadened since the crisis. It is widely believed that a "systemic" institution will likely receive government support in a crisis. Excessive guarantees create significant and corrupting distortions, including unnatural growth, distorted competition, and reduced incentives to manage risk properly.

It is difficult to remove implicit guarantees, since it might be better in a crisis to provide support. Increased reliance on equity creates more "self insurance" through the private markets, properly placing more downside risk with shareholders who benefit from the upside. It is the most direct approach to addressing the "too-big-to-fail" problem and the moral hazard it creates.

Capital regulation under Basel III

Basel III requires that, in normal times, equity represents at least seven percent of "risk-weighted assets." Capital ratios measured this way, which ignored AAA-rated securities (effectively pretending they were cash), provided little clue of looming problems leading to the crisis. Many banks, including Lehman Brothers just prior to its default, appeared reasonably well capitalized. When off-balance sheet items, contingent claims and the real market value of holdings were included, many banks turned out to have only one to three percent equity relative to total assets.

Basel III mandates a minimal leverage ratio of three percent equity relative to total assets. Contrary to Mr. Dimon's claims, Basel III requirements are dangerously low and allow the financial system to remain excessively fragile.

JPM "fortress balance sheet" has about eight to nine percent equity, depending on whether the book or market value of equity is used. Behind and "off" the simple-looking balance sheet is a massively complex set of assets with trillions of dollars in notional amount. A major shock that would reduce JPM's assets significantly, possibly stemming from difficulties its counterparties realize, can create distress even for a relatively well-positioned bank such as JPM.

Policy bottom line

The overriding policy objective in the United States must be a stable and healthy financial system that supports the American economy without imposing unnecessary risks and costs on its citizens. Insisting that banks are better capitalized is among the best approach towards this goal. Banks can perform all of their functions and support the economy, earning economically appropriate profits, with 20 percent or more equity funding. High leverage is not inherent to banking.

The recent financial crisis exposed the flawed design and poor enforcement of prior capital regulations. Basel III is insufficient. It also maintains a problematic system of risk weights. US regulators should advocate re-examining Basel III; meanwhile, US banks should withhold equity payouts.

Removing distortive tax incentives for financial institutions to choose high leverage that hurts the economy is critical. If banks remain highly leveraged, additional approaches must be found to address "too-big-to-fail" distortions.

Many provisions in Dodd-Frank focus on how to handle crisis situations rather than on prevention and ongoing system health. Resolving a large global institution would remain disruptive and costly. If multiple institutions are distressed, the economy may again suffer severe consequences. Prevention must be the key.

Bottom line for JPM

In his letter, Mr. Dimon proposes that surviving banks should pay to resolve a fellow bank to avoid using public funds. This has some merit, but since JPM is a relatively strong bank, it would expose JPM shareholders to the risk of having to cover the resolution costs of "dumb banks" (to use Mr. Dimon's language). Requiring that all banks be better capitalized would serve the interests of the economy and also those of JPM.

Relative to other proposed regulations that can be truly costly to JPM and possibly to the economy, increased equity requirements do not entail significant costs. If the tax effect is neutralized and implicit guarantees are insignificant, as Mr. Dimon claims, JPM funding costs will be essentially unchanged, and with lower leverage, there may be less need for onerous liquidity requirements or breaking up banks.

JPM should support, and should even encourage, well-designed regulation that further reduces leverage in the financial system and should urge regulators to enforce it effectively. JPM should advocate changes in the tax system to remove the advantage of debt over equity. Doing so would provide JPM and Mr. Dimon the opportunity to help lead the debate on capital regulation to a conclusion that will strengthen JPM, the banking system and the economy.

Sincerely,

Anat Admati

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