

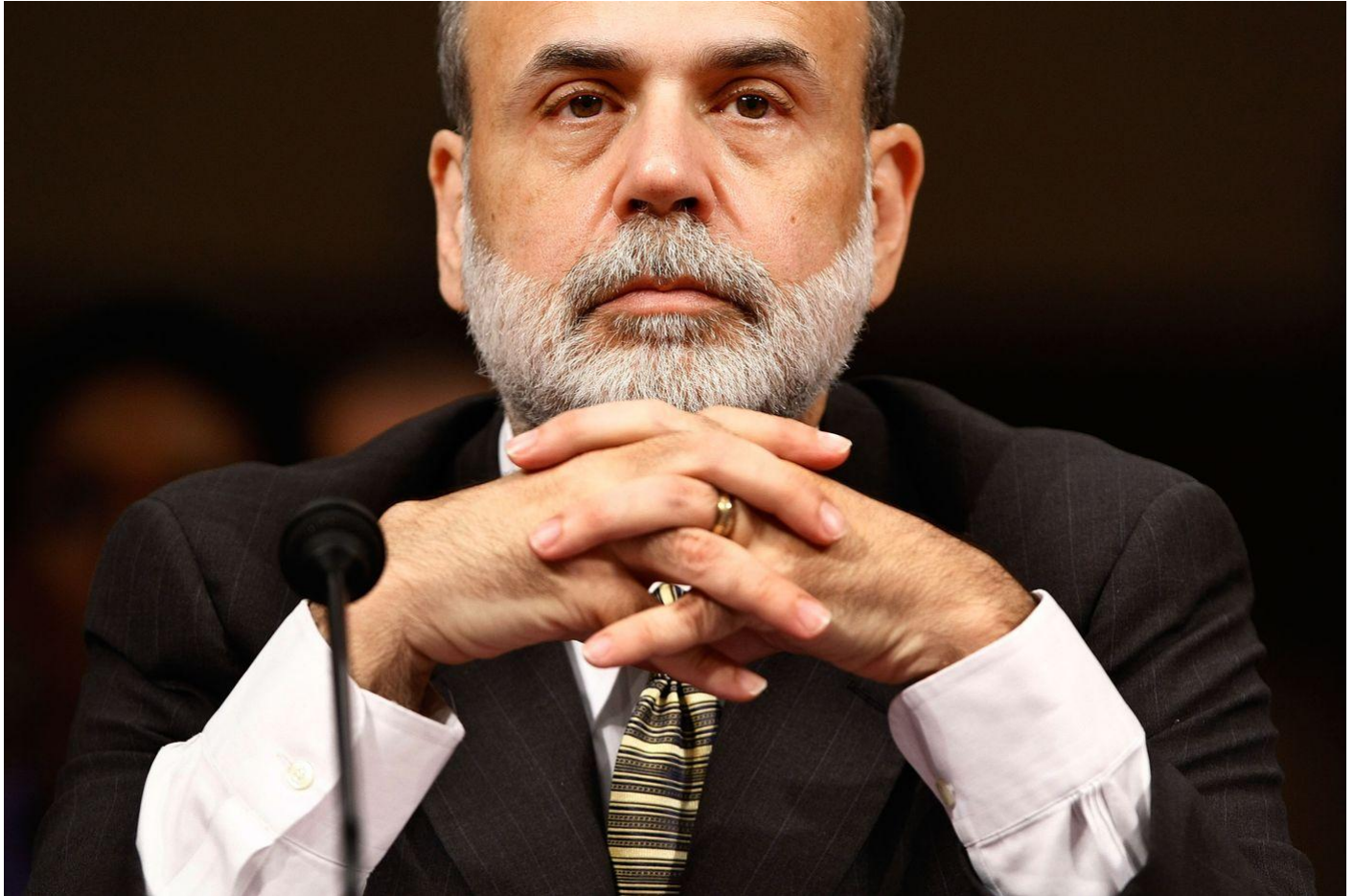
Economics

Where's the Courage to Act on Banks?

Ben Bernanke and the Fed seem to have missed a key lesson of the financial crisis.

By [Anat R. Admati](#)

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One kind of courage. *Photographer: Chip Somodevilla/Getty Images*

In his new book, "The Courage to Act," Ben Bernanke makes a strong case that the U.S. Federal Reserve, under his leadership, acted as necessary in 2008 to pull the country back from the brink of another Great Depression. Unfortunately, he and the Fed also appear to have missed some important lessons from that terrible episode.

QuickTake Capital Requirements

Consider the excessive reliance on debt in banking. Bernanke recognizes the importance of equity capital in protecting the economy from financial shocks.

Equity is money from investors who share in losses and have an incentive to monitor executives' behavior -- as opposed to depositors and secured creditors, who impose little discipline. Most importantly, as Bernanke puts it, equity allows the banking system to "withstand significant

losses and continue to extend credit to households and businesses." He also recognizes that regulatory measures of capital can be deceiving: What seemed ample ahead of the crisis proved to be woefully inadequate.

As the crisis was unfolding, the Fed did too little to ensure that the large institutions it supervised were prepared for the losses they could face. Even after the summer of 2007, when the demise of two Bear Stearns hedge funds had already triggered broader distress, regulators including the Fed allowed banks to keep making dividend payouts to shareholders. These payouts depleted the banks' equity precisely at the time when they needed it most. The largest 19 institutions paid out nearly \$80 billion through 2008, close to half of the amount the government subsequently invested in them through the Troubled Asset Relief Program.

A clear lesson is that banks need much more capital, specifically in the form of equity. In this area, the reforms engendered by the crisis have fallen far short. Regulators focus on "risk-weighted" and accounting-based capital ratios that, among their many flaws, rely on banks to assess the riskiness of their assets. Using off-balance-sheet accounting, derivatives and other tools, banks have become adept at manipulating these ratios. Annual stress tests aren't much better: They employ the same flawed measures and cannot reliably predict how an actual crisis, which may come from an unexpected direction, would play out in an opaque and interconnected financial system.

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Regulators have put in place a simpler leverage ratio, which measures equity as a percent of total assets. But banks are constantly finding ways to fiddle with the denominator, and the numerator is much too low. The international minimum is 3 percent, and the U.S. minimum is 5 percent. Many have argued that much more equity, even 20 or 30 percent of total assets, would bring great benefits at little if any relevant cost to society. Beyond making the system safer, it would reduce the too-big-to-fail subsidy, which allows the largest banks to borrow on more

favorable terms than they otherwise would, thanks to creditors' assumption that the government will come to their rescue in an emergency. Also, if banks had ample equity, there would be less need for complex and burdensome regulations.

After such a major trauma, we want to believe all is well again. But the reality in banking is different and stark. As Joris Luyendijk, an author who conducted hundreds of interviews with finance professionals, recently concluded: "Seven years after the collapse of Lehman Brothers, it is often said that nothing was learned from the crash. This is too optimistic. The big banks have surely drawn a lesson from the crash and its aftermath: that there is very little they will not get away with."

Bernanke deserves a great deal of credit for helping prevent a collapse of the U.S. financial system. But in his book he is too sanguine about the progress regulators have made. Policy makers will need courage of a different kind to stand up to the narrow interests of the financial industry and refocus the messy effort at regulatory reform.

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