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Despite their ‘flawed claims’, banks need more equity

Last year’s bank failures have not weakened the view that greater equity requirements are an impediment to growth, write Anat Admati and Martin Hellwig

by **Anat Admati** and **Martin Hellwig**

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Events in March last year showed that the financial system remains much too fragile and that bailouts persist despite promises that new rules would end them. Yet authorities failed to address the underlying problems. Flawed narratives continue to drive policies that enable bankers to benefit at the expense of society and prevent us from having a healthier system.

When Silicon Valley Bank failed, the most shocking fact was not the deposit run or the role of social media but the supervisors’ failure to recognise the bank’s technical insolvency months earlier. Even today, official narratives ignore the solvency problems that eventually caused the run and the flaws in the rules that allowed these problems to remain hidden.

Until the run, SVB was deemed “well capitalised” because accounting rules allowed it to avoid recognising losses in the market values of securities it classified as “held to maturity”. Already by September 2022, however, these losses exceeded SVB’s equity. Meanwhile, beginning in March 2022, depositors left SVB to benefit from higher interest rates in the market. On March 8, the bank proposed to raise new equity in order to compensate for losses on securities sales. The announcement revealed not only the losses but also that, to meet those withdrawals, SVB had almost exhausted its non-HTM assets and would shortly have to sell HTM securities. If that happened, a declaration of insolvency would be imminent. Prior to that announcement, the authorities had looked on without intervening.

After SVB’s failure, US authorities again kicked the can down the road. They bailed out all depositors in SVB and other failing banks, and offered liquidity support to the many banks that were in a similar situation to SVB and also had hidden losses. Providing liquidity without addressing solvency issues can delay the reckoning but not prevent it. Meanwhile, the crisis in commercial real estate exacerbates the problems.

Following the SVB collapse, in March 2023 there was also a run on global bank Credit Suisse, which ended its existence. The run reflected investors' wondering whether management was up to the situation as the bank had been making huge losses, including losses from investment banking scandals, and the proposed restructuring programs were obviously insufficient. Remarkably, the Swiss authorities did not trust the mechanisms for dealing with failures of large banks that had been created after 2008 and instead used executive orders under emergency law to facilitate a takeover by rival UBS while expropriating certain bondholders and preventing shareholders from voting on the transaction. Earlier promises that resolution and “bail-in” would prevent the need for bailouts were forgotten.

Contrary to many narratives, the March 2023 crisis could have been prevented if equity requirements had been much more strict. Such requirements would have provided authorities with the opportunity and the obligation to intervene much earlier than they did.

Banks resist more strict equity requirements and threaten that such requirements would limit their ability to provide loans. The current US debate about the Basel endgame is an example. In fact, banks could lend more if they raised additional equity by retaining profits or issuing new shares. Bankers hide this fact by making equity appear as a kind of cash held in a rainy-day fund, which cannot be used for lending. In fact, equity is a mode of funding, and the more there is the more funds are available for lending.

The true reason for banks’ resistance is that the additional equity would reduce the private benefits they enjoy from the subsidies to borrowing inherent in explicit and implicit government guarantees and support. In industries without such subsidies to debt, responding only to market forces, no healthy corporation uses anywhere near as little equity funding as do banks.

The bankers’ flawed narrative is rarely challenged. Banks have symbiotic relationships with many in politics, the media and academia, who cultivate banks, seeing them as sources of funds and prestige rather than as sources of risks to society, despite the crises we have experienced. The rest of the public is intimidated by threats, impenetrable jargon and the complexity of the issues. Flawed claims can therefore persist and keep affecting policy.

While such claims dominate in public discourse, the financial system will remain unhealthy and dangerous.

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