Making banks safe

Calling to accounts

The final article in our series on the financial crisis examines the best way to make banks safer without killing lending

Oct 5th 2013 | From the print edition

-
-

BANKS are a perplexing mix. The special institutions at the heart of capitalism, they provide an easy link between savers and borrowers: granting loans to those with the ideas and ambition to use them while at the same time providing peace of mind to squirrels who want to lock their cash away safely. Yet banks have a dark side too: they exist to manage risk, but often simply stockpile it. When they go bad they scythe away wealth and strangle economies. There is little argument that it was the banks that started the crisis five years ago. There is huge disagreement about how to put things right.

To see why banks are so vital, start with the finances of a typical household or firm. Their debts—mainly mortgages on homes, offices or factories—have fixed terms; they often have fixed interest rates too. In what is owed there is a lot of certainty. But firms' and families' financial assets are not bound by such rigid terms: deposits can be withdrawn with little notice, bonds and equity can be sold quickly if cash is needed or if investment tastes change. This combination of fixed-term debts and flexible assets is a comfortable set-up.

Related topics

- Business
- Financial Trading
- Financial markets
- Paul Volcker
- Europe

But one party's asset is another's liability. This means that corporate and personal finances have a mirror image in the balance-sheets of banks, where assets (the loans a bank has made) cannot be adjusted but where debts (its customers' deposits) can be called in overnight. That mix is risky: a rush of depositors demanding their money back can force cut-price asset sales. If debts are called in more quickly than assets can be sold, insolvency looms. Managing that risk is what banks do: by holding a risky balance-sheet they allow households and firms to have safe ones.

Since the maturities of their assets and liabilities do not match up, banks tend to give themselves some margin for error. They build resilience into their finances in two ways. Liquid assets—things like cash and government bonds that can be sold quickly and at relatively certain prices—are a safety valve. If investors suddenly shun a bank's bonds or depositors withdraw large sums, it can sell them. That allows the bank's balance-sheet to shrink safely, in line with creditors' demands.

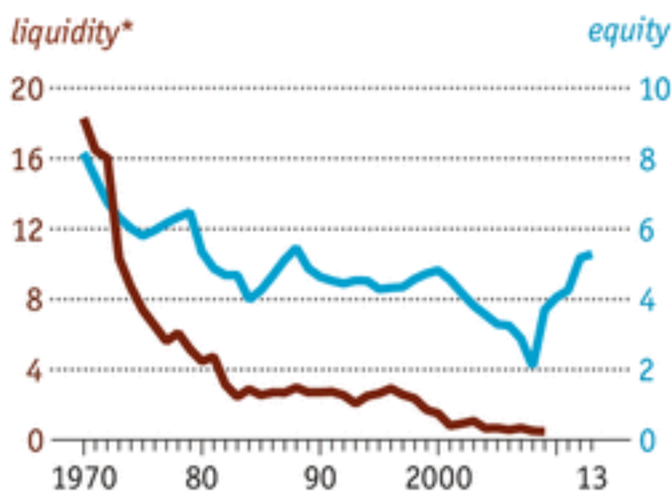
But balance-sheets can shrink for other reasons too. The value of a bank's riskier assets—mortgages, bonds, loans to companies—can drop sharply if the prospects of the borrowers sour. The danger is that the value of the bank's assets could fall below its liabilities: with more owing than is owned, the bank would be bust. To forestall such failures banks maintain equity. This represents the money a bank's owners have invested in it. Equity takes the first hit when asset values drop. Since the bank's owners absorb the loss, its creditors—bondholders and depositors—can rest assured that they will not have to.

But a bank is not a charity, and the two shock-absorbers are costly. Some rough rules of thumb show why: the return on cash is zero, with liquid assets like government bonds yielding a measly 2-3%. In contrast, mortgages might generate 5% and unsecured lending closer to 10%. Picking safe assets lowers returns. In addition equity investors expect a return (via dividends or capital gains on their shareholding) of around 12%, compared with the 4% or so demanded by bondholders.

This sets up a tension between stability and profitability which banks' bosses must manage. Their failure to do so lies at the heart of the crisis. One simple equation explains their dire performance:
Return on equity (RoE) = Return on assets (RoA) x Leverage

The idea is straightforward. A bank's equity-holders gain when the return on its assets rises. Maximising RoE means holding fewer safe assets, like cash or government bonds, since these provide low returns. When returns on all asset classes fall, as in the early 2000s, banks have another way to boost RoE: leverage (the ratio of their assets to their equity). Banks can increase their leverage by borrowing more from depositors or debt markets and lending or investing the proceeds. That gives them more income-generating holdings relative to the same pool of equity. In the short run, shareholders gain.

Risk on



Of course, skimping on safety mechanisms makes banks more risky. Yet the RoE formula is hard-wired into banking, familiar to every chief executive and shareholder. A 2011 report by the Bank of England showed that Britain's biggest banks all rewarded their senior staff based on RoE targets. Bosses duly maximised short-term profits, allowing liquid assets and equity to fall to historic lows (see chart 1).

By the mid-2000s leverage was out of control. Consider the Royal Bank of Scotland (RBS) and Citi, respectively the biggest banks in Britain and America in 2007 (RBS was also the biggest in the world). Official reports show that these lenders had leverage ratios of around 50 when the crisis hit: they could absorb only $2 in losses on each $100 of assets. That helps explain why the American subprime market, although only a small fraction of global finance, could cause such trouble. Top-heavy, with brittle accounts, the banks were riding for a fall.

The main regulatory response has been a revision of international banking regulations first agreed in Basel in 1989. Basel III, as the latest version is known, is more stringent than its predecessors on four basic measures of safety: it requires banks to hold more equity and liquid assets, to leverage themselves less (the maximum ratio is now 33) and to rely less on short-term funding. In countries where bank bail-outs during the crisis caused outrage, however, or where the financial sector's liabilities are much bigger than the economy (making bail-outs ruinous), regulators are determined to go further.

The most radical option is to carve up lenders deemed "too big to fail". Splitting them into smaller and simpler banks would make oversight easier, and prevent a bankruptcy from upending the local economy or the government's finances. But unravelling and reapportioning assets and liabilities might be impossibly tricky.

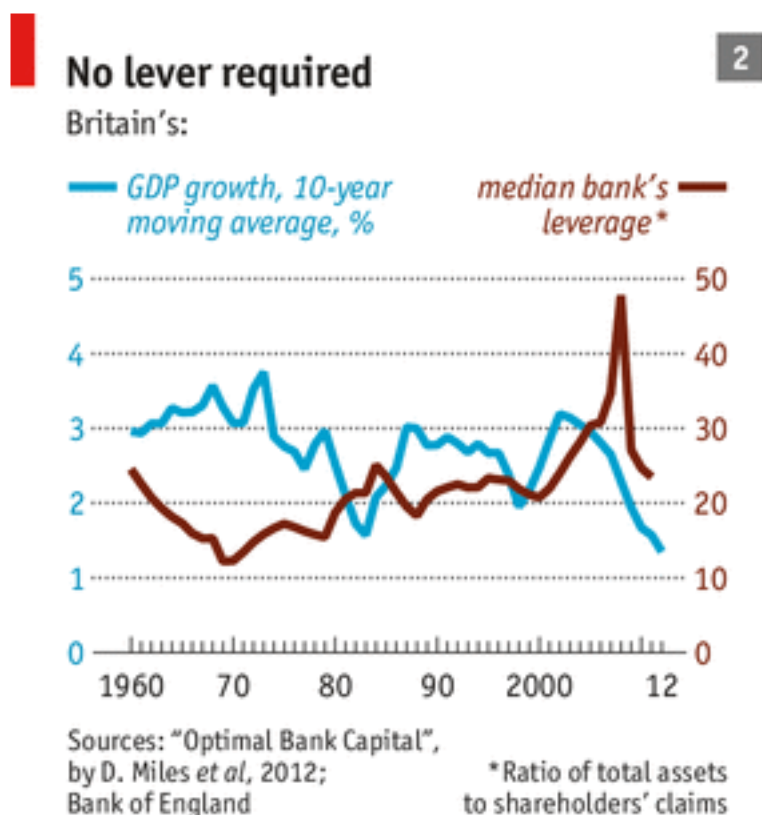
An alternative is to ban banks from the riskiest activities. In America, a rule proposed by Paul Volcker, a former head of the Federal Reserve, will soon prevent deposit-taking banks from engaging in "proprietary trading" (in essence, investing in stocks, bonds and derivatives using its customers' money). In theory, the "Volcker rule" will shield deposits from traders' losses. In practice, it is difficult to distinguish between trading conducted with a view to serving customers and that done solely for the bank's benefit.

Regulators in Europe are taking a different tack. In both Britain and the euro zone, they have proposed "ring-fences" that will separate customer deposits from banks' other liabilities. Against them, banks would only be allowed to hold assets like cash, government bonds and loans to individuals and firms. Activities deemed riskier, such as trading in shares and derivatives and underwriting companies' bond issuance, would sit outside the ring-fence, backed by a separate stash of capital.

But even once the new ring-fences are in place, banks will still grant mortgages. That is a risky business. Take British commercial-property lending (loans on offices and shopping centres). It is a large part of the mortgage market, over 20% of GDP at its peak. It is also volatile: commercial-property prices fell by almost 45% between 2007 and 2009. In America the share of even the best "prime" mortgages in arrears topped 7% in early 2010. None of this risk would be outside the ring-fence, or blocked by the Volcker rule.

That is one reason some argue that banks should hold significantly more equity than the new rules require. In a recent book, Anat Admati of Stanford University and Martin Hellwig of the Max Planck Institute maintain that the cost of holding extra equity is overstated. For one thing, bigger buffers make banks safer, so the cost of other forms of funding (like bonds) should fall. In a related paper, David Miles, a member of the committee at the Bank of England that sets interest rates, estimates both the costs and benefits of increasing equity. The two are equal, he concludes, when equity is about 16-20% of banks' risk-adjusted assets—even higher than the Basel III rules require.

Bank bosses (most notably Jamie Dimon of JPMorgan Chase) regard that as far too high. Their concern is that banks are being forced to hold redundant equity. That would have two effects. First, it might reduce lending, since existing buffers would only be enough to cover a smaller stock of loans. Second, higher equity means lower leverage, which could reduce RoE below investors' expectations. That would make it hard to raise the equity regulators are demanding and—if sustained—prompt a gradual wind-up of the banks as investors opt to put their money elsewhere. The only alternative would be to raise RoA by charging borrowers much higher interest.



There is some truth on both sides. The academics are right to say that higher equity need not kill off lending. After all, equity is a source of funds, not a use for them. Historically much lower leverage ratios have been associated with strong growth in lending and GDP (see chart 2). Yet it is also true that

without leverage to boost returns, banks might need to squeeze more from their assets: the cost of credit could rise.

There may be a third way. Some researchers think a better balance between equity and debt can be struck by using funding that has some of the attributes of both. They want banks to sell more “contingent capital” to investors. These IOUs act like bonds in normal times, paying a return and requiring full payback when they mature. But in bad times they change from debt into loss-absorbing equity.

Such ideas are attractive not just because they provide a clever solution to the debt v equity puzzle. Regulators are also pushing them for a related reason: they should encourage a bank’s creditors to provide more oversight. Knowing that their bonds could be converted into risky equity, the theory runs, big investors like insurers and pension funds would go through banks’ books with a fine-tooth comb, spotting any leverage-pumping activities on the part of profit-hungry CEOs. How cheap contingent capital will prove is uncertain: investors will presumably demand a higher return than for debt, particularly from risky-looking banks.

That might actually be a good thing: ideally markets as well as regulators would encourage banks to act prudently. In a 2010 paper Andrew Haldane of the Bank of England argued that banks’ borrowing costs are distorted. Since investors assume the biggest ones will be bailed out in times of crisis, they accept relatively low rates of interest on the bonds they issue. That, in turn, distorts the banks’ decisions: since such funding is cheap it is hardly surprising that profit-maximising bank bosses gorge on it.

Rigging and milking

All this turns banks from champions of capitalism into affronts to it, reliant on rigged markets and taxpayer subsidies. Regulators are working to change that. In a 2012 joint paper the Bank of England and the FDIC, the agency that insures bank deposits in America, set out their approach. When the next bank big enough to threaten the entire financial system fails, regulators plan to use “living wills” that explain how to unwind its holdings. They will take control, replacing a bank’s managers and doling out losses to bondholders as well as equity investors.

The message is clear: regulators are not trying to prevent failures, but to prepare for them. They hope this will make managers react by holding enough capital and liquid assets to keep banks out of trouble. Yet some banks remain too sprawling and opaque to liquidate in an orderly manner and too big to let fail. Their state support, implicit or explicit, seems likely to remain. Newly cautious by obligation but not by choice, the world’s biggest banks remain a perplexing mix of freewheeling capitalism, subsidies and regulation.