Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive

by A. Admati, P. DeMarzo, M. Hellwig & P. Pfleiderer
Discussion by Henri Pagès
Banque de France, Research Department

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Overview

- Thrust of argument is music to the ears of a CB
- Discussion of Capital Regulation: Kashyap, Rajan & Stein (2008)
- Benefits and costs of controversy:
  - Banks have mounted a campaign against increasing K requirements
  - Insightful, challenging, fun to read, comprehensive

To overthrow—that means to him: to prove... Full of solemn jesters is the market place (Nietsche, SSZ)

- Critique and recommendations
  - Are higher E requirements necessary? Yes, but to which extent?
  - Are they sufficient? Probably not

Two types of comments

APMP (Anat, Peter, Martin, Paul) have *many* (neat) arguments.
Bottomline :MM theory

- Begging the question?
  Disproving arguments about high cost of E is easier than proving large E requirements justified:
  - Arguments against higher E may be oberlooked
  - E is cheap when banks already well-capitalized
- Paved with good intentions?
  Natural to consider more equity funding but:
  - Net social benefits of higher E may be overstated
  - Should D/E be main focus of K regulation?

Begging the question (1)

Some overlooked arguments

Leverage increases ROE but so does risk borne by equity holders

- Policy reaction is endogenous: Return of risky projects depends on policy reaction fn
  - Refusing to adopt risky balance sheet can lower ROE (Farhi Tirole 2010)
  - Implications for macroprudential rather than microprudential regulation
- Cost of capital is endogenous: Multiple equilibria generated by markets' beliefs about banks' value
  - Tight MP triggers 'credit crunch', even with high equity capital requirements (Bolton Freixas 2006)
  - Large uncertainty about impact of bank capital on cost of E, credit and activity

Begging the question (2)

Debt insensitivity, market discipline and debt overhang improved with well-capitalized banks

- Information insensitivity: Optimality of debt **with** crisis (Dang, Gorton &Holmström, 2010). Debt minimizes adverse selection, increases trade
- Market discipline enhanced with high E
  - Excessive risk taking is primary governance problem: Evidence can be reinterpreted as looting, financial market fraud, or situations in which E is **never** positively valued (Akerlof & Romer, 1993)
  - Fragility as discipline mechanim: Optimality of debt **with** fragility (Diamond &Rajan, 2000): In multiperiod setting, high E can impair banks' ability to extract repayment (longer horizons)
- Debt overhang: Disentangling ST and LT debt overhang important (Diamond & He, 2010): LT debt gives maintenance incentives in bad times, ST debt desirable in good times

Paved with good intentions (1)

Net social benefits overstated

“If public policy reduces leverage, and subsidies are set in socially responsible way, banks will make loans leading to growth and prosperity”

- What would be a satisfactory level for core E requirements? Basel III from 2,5% to 7% and still too low?
- Capital regulation as means to reduce fragility
  - Goal of regulation ill-defined, systemic dimension ignored (Hellwig, 2009)
  - K regulation as buffer against systemic risk: Reducing P(financial crisis) is reductive approach

Paved with good intentions (2)

Should regulation focus on D/E mix?

- Highly mixed predictions regarding effects of solvency regulation on asset risk and overall safety (VanHoose, 2007)
  - Limiting leverage is a blunt instrument to discourage risk taking (Freixas & Parigi, 2008)
  - Recent evidence on bank leverage: Berger & Bonaccorsi (2005), Ferguson & Stevenson (2007)
- Contingent capital more efficient than buffers: Too complicated? (Bolton, Santos & Scheinkman, 2009, 2011)
- Shadow-banking system: Holding loans is no longer profitable, focusing on balance sheets is tricky.
  - "Banks supervisors have the tools to deal regulatory arbitrage"
  - ST borrowing: Minimum haircuts against ABS tranches
  - Moral hazard: Capital requirements, performance-related compensation & liquidity management not regulated separately.

Conclusion

- Thought-provoking paper, useful antidote to industry's aggressive lobbying
- Main message well-taken: Claims about high cost of E requirements often rest on weak foundations
- But so does reliance on MM theory in the context of bank capital regulation
- Given these uncertainties, step-by-step approach of Basel Committee (significant increases over eight-year period) seems warranted
- Spend more time on issues not addressed in the paper: prudential regulation, PCA, liquidity management, holdbacks on executive compensation, etc.