

CHAPTER 2:

A Simple Proposal to Recapitalize the U.S. Banking System

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Proposals to reform the banking system generally fall into two types. The first type are proposals for more regulation—such as that entailed by the Basel accords and the Dodd–Frank Act. However, these “solutions” are costly and never work as intended. The second type can be described as idealistic: These propose idealized radical solutions based on an underlying theory of the way banking is, or is not, supposed to work. These vary in merit from the ridiculous to the sublime. Whatever their intrinsic merits, getting such reforms implemented is a major uphill battle if for no other reason than that they are commonly regarded as politically unthinkable.

There may, however, be a third way: Do not propose ever more regulation, but do not propose to dismantle existing regulatory structures either. Instead, offer banks the choice of opting out of the regulatory system. Such an opt-out has considerable attractions. It is simple, easily implemented, and avoids more regulation, more complexity, and higher compliance costs. It offers more choice rather than more compulsion, and allows bankers to ignore it if they prefer, a feature that also makes it difficult for the banking lobby to mount a credible objection. Most of all, it offers the potential to set in motion a virtuous-circle dynamic that could be not just beneficial, but transformative.

This chapter proposes a regulatory off-ramp in which banks be allowed to opt out of any requirements to comply with federal prudential regulation on the condition that they

provide strong and credible reassurance of their financial robustness. This reassurance would take the form of a binding commitment to maintain a much higher minimum-capital ratio than any major banks currently maintain. The type of capital ratio referred to here is in the traditional pre-Basel sense—a ratio of core capital to total assets, or a similar measure.¹ To use more contemporary terminology, the proposal uses a high minimum-required-leverage ratio.

An intuitive way to think about this proposal is as follows. The purpose of prudential regulation is—so it is claimed—to ensure that the banks are safe; but the purpose of a high-capital/leverage ratio is also to ensure that banks are safe. Prudential regulation and higher capital are substitutes for each other toward the same end. The former can therefore be dispensed with, provided that banks

commit to the latter. However, these substitutes differ in that prudential regulation is very costly and often ineffective, whereas high capital involves near-zero cost and is highly effective. In the current system, the banks are compelled to go the former route, but the latter has considerable upsides and no discernible downside.

This proposal is very much in the spirit of “second-best” economics. In an ideal world—free of government interventions that encourage and subsidize excessive risk-taking—there would be no capital-adequacy issue and no need for any capital adequacy regulation. In such a world, banks’ capital ratios would be decided by the bankers themselves, like any business policy decision, such as how much to lend, to whom to lend, and the reserve ratios they should maintain. Competition among the banks would then help them determine their “optimal” capital ratios. If a bank maintained a very high capital ratio, it would face pressure from shareholders wanting higher returns on their equity. If it maintained a very low capital ratio, it would struggle to reassure depositors that it could withstand a major loss and still be able to pay depositors in full. In the latter case, it would face the danger of being run out of business. There would be no market failure and no case for a regulator to impose minimum (or maximum) capital requirements.

To state the obvious, this ideal world is not the current one. Instead, today’s world features a range of government-sponsored interventions in the banking system that create moral hazards that encourage banks to take greater risks than they otherwise would, had they to bear the downsides themselves. These interventions include, most notably, the “lender of last resort” function, government-deposit insurance, and too-big-to-fail support. One might even say that these moral hazards create a race for the bottom as far as capital adequacy is concerned. In particular, they encourage banks to seek higher returns on their equity, and the easiest way to boost these returns is to substitute debt for equity and run down their capital. The best solution

is to get rid of these interventions, but good luck on that. However, if one accepts for the sake of argument that all these pre-existing interventions are not going to go away any time soon, or would require an immense effort to get them even within the Overton Window²—there remains the question of what to do about undercapitalized banks. There is thus a second-best argument for some form of capital-adequacy regulation to counter the excessive risk-taking created by these pre-existing state interventions.

A natural response would be that systems of capital-adequacy regulation already exist for this reason, most obviously the Basel system. However, Basel is highly inadequate to this task and has been a repeated failure. Apart from anything else, Basel is hugely costly and proved to be of no use in ensuring that the banking system was strong enough to avert the costly bank failures that occurred in the global financial crisis. Indeed, one can argue that the weaknesses of the Basel system—its reliance on useless risk weights, its dependence on the discredited Value-at-Risk risk measure, and its dependence on unreliable risk models—greatly contributed to the severity of the crisis.³ Existing systems of capital-adequacy regulation are therefore not the solution, but part of the problem.

U.S. BANKS’ CAPITAL INADEQUACY

The traditional measure of capital adequacy is a bank’s capital ratio, which is the ratio of core capital to its total assets. In the 19th century, U.S. banks often had capital ratios of between 40 percent and 50 percent. By 1914, the year the Fed came into operation, average capital ratios in the U.S. were 16.5 percent.⁴ They fell a little by 1929, then more than halved in the decade after federal deposit insurance was established in 1934, and have remained in single digits ever since.

So the next question is what should this ratio be. There is no magic number, but a minimum capital ratio should be high enough to remove the overwhelming part of the moral hazard that currently infects the banking

system, and high enough to ensure that banks will never be bailed out again. In this context, many experts have recommended minimum capital-to-total-asset ratios that are much greater than those called for under current Basel rules. In an important letter (“Healthy Banking System Is the Goal, Not Profitable Banks”) to the *Financial Times* in 2010, no less than 20 renowned experts recommended a minimum ratio of equity-to-total-assets of at least 15 percent—five times larger than required under Basel III. Some of these experts wanted minimum requirements that are much higher still. To quote their letter:

Banks’ high leverage, and the resulting fragility and systemic risk, contributed to the near collapse of the financial system. Basel III is far from sufficient to protect the system from recurring crises. If a much larger fraction, at least 15%, of banks’ total, non-risk-weighted, assets were funded by equity, the social benefits would be substantial. And the social costs would be minimal, if any....

If handled properly, the transition to much higher equity requirements can be implemented quickly and would not have adverse effects on the economy. Temporarily restricting bank dividends is an obvious place to start.

Many bankers oppose increased equity requirements, possibly because of a vested interest in the current systems of subsidies and compensation. But the policy goal must be a healthier banking system, rather than high returns for banks’ shareholders and managers, with taxpayers picking up losses and economies suffering the fallout.

Ensuring that banks are funded with significantly more equity should be a key element of effective bank regulatory reform. Much more equity funding would permit banks to perform

all their useful functions and support growth without endangering the financial system by systemic fragility. It would give banks incentives to take better account of risks they take and reduce their incentives to game the system. And it would sharply reduce the likelihood of crises.⁵

Overall, various experts have called for minimum capital-to-asset ratios ranging from as low as 15 percent to as high as 50 percent.⁶ In short, there is a big gap between U.S. banks’ current capital ratios and any reasonable sense of what they should be; that is, U.S. banks have a big capital-adequacy problem.

FALLACIOUS OBJECTIONS TO HIGHER CAPITAL STANDARDS

The banking lobby has campaigned vigorously against higher capital levels. However, its main arguments are demonstrably fallacious, and its real reasons for opposing higher capital requirements are based on naked self-interest, that is, keeping risk-taking subsidies because they are profitable. These arguments are the bankers’ new clothes, to quote the title of Anat Admati and Martin Hellwig’s wonderful book.

The first of these fallacious arguments is that higher capital requirements would increase banks’ costs. However, if this argument were correct, it would apply to non-bank corporations too, and we would expect them to be equally highly leveraged in order to take advantage of the “cheapness” of debt. Instead, most non-bank corporations have capital ratios of over 50 percent and some do not borrow at all. In reality, equity *helps* to reduce the costs associated with potential distress and bankruptcy, and the same benefits apply to banks as to other corporations.

There is, nonetheless, one case where higher equity capital is costly—at least to bank shareholders. When the government intervenes to cover banks’ downside risk, capital becomes expensive to the banks’ shareholders: The higher the banks’ capital level, the more of the risk subsidy they

forgo, because higher capital reduces the cost to third parties of their risk-taking excesses. When bankers complain that capital is expensive, they consider only the costs to shareholders and themselves, and do not take into account the costs of their excessive risk-taking to other parties, including the taxpayers who are then called upon to bail out the banks when the combination of excessive risk-taking and run-down capital leads their banks to fail.

In fact, the social cost of higher equity can be *zero* when the costs of systemic risks are accounted for. To quote Admati and Hellwig:

A bank exposing the public to risks is similar to an oil tanker going close to the coast or a chemical company exposing the environment to the risk that toxic fluid might contaminate the soil and groundwater or an adjacent river. Like oil companies or chemical companies that take too much risk, banks that are far too fragile endanger and potentially harm the public.

But unlike the case of safety risks posed by oil or chemical companies, higher bank safety standards can be achieved at little social cost merely by requiring that banks increase their capital, which they can do by issuing more equity in the capital markets.⁷

A second argument is that high minimum capital requirements would restrict bank lending and hinder economic growth. For example, Josef Ackermann, then-CEO of Deutsche Bank, claimed in 2009 that higher capital requirements “would restrict [banks’] ability to provide loans to the rest of the economy” and that “this reduces growth and has negative effects for all.”⁸ The nonsense of such claims can be seen merely by noting that they imply that further increasing banks’ leverage must be a good thing, notwithstanding the fact that excessive leverage was a key contributing factor to the financial crisis, and that ongoing bank

weakness—weakness associated with too much leverage—is still impeding economic recovery.

One also encounters claims that higher capital requirements would restrict bank lending that are based on a confusion of capital with reserves. This is the capital-is-a-rainy-day-fund fallacy that mixes up the two sides of a bank’s balance sheet. An example by Wane Abernathy:

Think of [capital] as an expanded rainy day fund. When used efficiently, a dollar of capital on reserve allows a bank to put ten dollars to work as expanded economic activity. The new Basel rules would demand that banks would maintain more dollars on reserve for the same amount of business, or more capital for no new economic work.⁹

Alan Greenspan claimed that “[a]ny excess bank equity capital also would constitute a buffer that is not available to finance productivity-enhancing capital investment.”¹⁰

These statements come from experts who should know better. Such statements would be correct if they applied to requirements for higher cash reserves, but are false since they apply to requirements for higher equity capital. Capital requirements constrain how banks obtain their funds but do not constrain how they use them, whereas reserve requirements constrain how banks use their funds but do not constrain how they obtain them.

In fact, evidence suggests that high levels of capital *support* lending. To quote former Bank of England Governor Mervyn King:

Those who argue that requiring higher levels of capital will necessarily restrict lending are wrong. The reverse is true. It is insufficient capital that restricts lending. That is why some of our weaker banks are shrinking their balance sheets. Capital supports lending and provides resilience. And, without a resilient banking system, it will be difficult to sustain a recovery.¹¹

In principle, there is no reason why a higher capital ratio should restrict bank lending at all. On the contrary, if a bank has good lending opportunities, it can raise funds to finance them by issuing more shares, and the only constraint that matters is the willingness of investors to buy those shares.

A REGULATORY OFF-RAMP

Taking all the above into consideration, this chapter offers the following proposal: Any bank operating in the U.S. should be given the choice to opt out of federal prudential regulation provided it commits to maintain a minimum core-capital-to-total-exposure ratio of at least 20 percent.

The regulations from which the bank would be exempted would include all prudential regulation by any federal body, including the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the prudential regulations of Dodd–Frank. Implicitly, such banks would also be exempt from Basel III requirements and compliance with Federal Reserve stress tests. However, the proposal does not suggest any such bank be exempted from *all* federal regulation. Under this proposal, regulations concerned with anti-money-laundering, know-your-customer conduct, and health and safety regulations would still apply. Whether those regulations should be changed is another issue best left aside for present purposes. Policymakers should also structure the opt-out to allow banks to exit the federal deposit insurance corporation (FDIC) system. In this case, banks would free themselves of FDIC supervision as well as of the obligation to pay deposit insurance premiums at the cost of foregoing FDIC deposit insurance.

There is no doubt that the suggested minimum leverage ratio of 20 percent is an arbitrary one. The exact number—15 percent, 20 percent, 25 percent, or whatever else—is not so important. What matters most is that the minimum should be broadly in line with the consensus expert advice outlined earlier—that is, it should be much higher than existing leverage ratios. The underlying principles

here are that the bank should be sufficiently well capitalized to reassure depositors and other stakeholders that it can withstand major losses and still be viable, and that it has sufficient “skin in the game” to reassure those stakeholders that it has a strong incentive to rein in excessive risk-taking.

Naturally, the numerator and denominator in this capital ratio would need to be specified. In the U.S. context, the simplest solution—though not the theoretically best one, by any means—is to take the core capital numerator to be common equity Tier 1 capital (CET1), and to take the denominator to be the Basel III Leverage Exposure measure.¹² The advantage of these measures is that they are the best currently available in the absence of major reforms to accounting standards or Basel III metrics. The drawback is that both measures have major biases—CET1 capital overstates true core capital, and the Leverage Exposure measure understates the true amount at risk—that combine to produce a measure of the leverage ratio that is biased downward.¹³

A hint at the extent of this bias can be gleaned from banks’ price-to-book valuations, which reflect the market’s perception of the true values of the banks, taking into account the information available to the market and not reflected in banks’ book valuations. Given the scale of the discrepancies between banks’ market and book values, one might even make a case that the numerator should simply be market capitalization. On the other hand, banks’ share prices tend to oscillate excessively, whereas their book values do not, and one should think twice about building a capital-adequacy regime on excessively volatile metrics. Additionally, many depository institutions’ shares are not publicly traded. Thus, on balance, the ratio of (book-value) CET1 capital to Leverage Exposure is probably the best that can be achieved without major reforms in other areas.

One last loose end: To give the proposal teeth, there would also have to be some penalty against backsliding. There needs to be some contingency in the event that a bank

signs up for the opt-out, but then falls below the required minimum standard. The simplest solution would be to prohibit dividend and bonus payments should a bank's leverage ratio fall below the minimum standard. A bank would then have to bring its capital ratio back up above the minimum before such payments could be resumed.

THE REGULATORY OFF-RAMP: COULD TRANSFORM THE BANKING SYSTEM

The banks would now have a choice. They could choose to carry on as before and remain subject to all the existing prudential regulation, including the deposit insurance system, or they could choose to opt out of it all and recapitalize to the proposed minimum standard.

How the banks would respond would depend on their future profit prospects. Imagine a sound bank whose management were confident of its future prospects. Such a bank would now have the opportunity not just to reduce but to eliminate its prudential regulatory compliance costs. This is a *big* benefit. The cost of the bank getting free of all that regulatory compliance burden is the obligation to recapitalize to the required minimum standard, and this cost is negligible. So why would such a bank not jump at the opportunity? I would therefore expect such a bank to respond by going to the stock market and recapitalizing quickly. The key here is that the bank is able to persuade potential shareholders that its prospects are good. Indeed, there is no rational reason for a sound bank *not* to want to go this route. Substantial benefits + minimal costs = no brainer. You could even say that it offers a free lunch.

Naturally, I am presupposing that the bank's existing clients would be willing to accept the bank going this route—otherwise they would take their business elsewhere—but there is every reason to think they would. Existing borrowers would hardly have cause for concern, as their bank would be stronger. The same applies to depositors, too. Before federal deposit insurance existed, evidence indicates that depositors and noteholders in the United States

cared about the financial condition of their banks and carefully scrutinized bank balance sheets. Arthur Rolnick and his colleagues at the Federal Reserve Bank of Minneapolis have shown that this clearly happened before the Civil War. Thomas Huertas and his colleagues at Citicorp have demonstrated the importance of bank capital to depositors by noting that Citibank in its earlier days prospered in periods of general financial distress by maintaining higher-than-average capital ratios and providing depositors with a relatively safe haven.¹⁴

Now consider a bank that does not have good prospects. Such a bank would be unable to recapitalize via the stock market, because it would be unable to persuade potential investors that its equity was a good investment, and would have no choice but to remain under the regulatory status quo. Its failure to recapitalize would then provide a clear signal of its true state. Stakeholders would be asking why the bank was not taking advantage of the “free lunch” provided by the opt-out, and the bank management would be unable to provide a convincing response. The bank would then self-advertise as a zombie that cannot get out of government rehab, and there would be pressure on the bank to improve its capital position and on the regulators to resolve the bank one way or the other, either by recapitalizing it themselves or (my preferred solution) by putting it into bankruptcy.

So, the good banks would escape the regulatory system and rapidly recapitalize, and the zombies would be exposed. The former would then gain a major competitive advantage: being strongly capitalized, free of their former compliance burdens, and having good prospects, they would be well placed to increase their market share at the expense of the zombies still in the state system, which would have none of these advantages. In addition, it would be much easier for new banks to enter the market and further increase competition, thereby providing the maximum scope for, for instance, disruptive FinTech innovators or old-fashioned bankers of the George Bailey mould. Over time, the good banks—new and

old—would gradually displace the bad ones and eventually drive them out of business. In the process, the whole prudential regulatory apparatus would wither on the vine, and the

U.S. banking system would once again become strong, stable and highly competitive. A simple opt-out might just be the key to sort out the banking mess.

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ENDNOTES

1. The term “capital ratio” is not used in the sense in which that term is now commonly used, that is, to refer to the ratio of capital to so-called risk-weighted assets (RWAs). The RWA is a discredited risk measure. See, for instance, A. G. Haldane, “Constraining Discretion in Bank Regulation,” April 9, 2013, speech at the Federal Reserve Bank of Atlanta Conference on “Maintaining Financial Stability: Holding a Tiger by the Tail(s),” Federal Reserve Bank of Atlanta, 2013, <https://www.frbatlanta.org/news/conferences/2013/130408-fmc/agenda> (accessed October 3, 2016), and Kevin Dowd, “Math Gone Mad: Regulatory Risk Modeling by the Federal Reserve,” Cato Institute *Policy Analysis* No. 754, September 3, 2014, <http://www.cato.org/publications/policy-analysis/math-gone-mad> (accessed October 3, 2016).
2. Also known as the window of discourse, meaning the range of ideas the public will accept.
3. For more on these issues, see, Kevin Dowd, Martin Hutchinson, Jimi Hinchliffe, and Simon Ashby, “Capital Inadequacies: The Dismal Failure of the Basel System of Capital Adequacy Regulation,” Cato Institute *Policy Analysis* No. 681, July 29, 2011, <http://www.cato.org/publications/policy-analysis/capital-inadequacies-dismal-failure-basel-regime-bank-capital-regulation> (accessed October 3, 2016).
4. R. M. Salsman, *Breaking the Banks: Central Banking Problems and Free Banking Solutions* (Great Barrington, MA: American Institute for Economic Research, 1990); Eugene White, “To Establish a More Effective Supervision of Banking: How the Birth of the Fed Altered Bank Supervision,” NBER *Working Paper* No. 16825, February 2011, <http://www.nber.org/papers/w16825.pdf> (accessed October 3, 2016); and Howard Bodenhorn, “Double Liability at Early American Banks,” NBER *Working Paper* No. 21494, August, 2015, <http://www.nber.org/papers/w21494.pdf> (accessed October 3, 2016).
5. Anat Admati et al., “Healthy Banking System Is the Goal, Not Profitable Banks,” *Financial Times*, November 8, 2010, <https://www.ft.com/content/63fa6b9e-eb8e-11df-bbb5-00144feab49a> (accessed October 3, 2016).
6. John Allison, “Market Discipline Beats Regulatory Discipline,” *Cato Journal*, Vol. 34, No. 2 (2014), pp. 345–352; Alan Meltzer, “Banks Need More Capital, Not More Rules,” *The Wall Street Journal*, May 16, 2012; Anat Admati and Martin Hellwig, *The Bankers’ New Clothes: What’s Wrong with Banking and What to Do About It* (Princeton, NJ: Princeton University Press, 2013), pp. 179, 308, and 311; and Simon Johnson, “Eugene Fama: ‘Too Big To Fail’ Perverts Activities and Incentives,” Baseline Scenario, June 2, 2010, <https://baselinescenario.com/2010/06/02/eugene-fama-too-big-to-fail-perverts-activities-and-incentives/> (accessed October 3, 2016).
7. Admati and Hellwig, *The Bankers’ New Clothes*, p. 130.
8. *Ibid.*, p. 5.
9. Wayne Abernathy, “Shrinking Banks Will Drag Down the Economy,” *American Banker*, August 27, 2012, <http://www.americanbanker.com/bankthink/shrinking-banks-will-drag-down-the-economy-1052148-1.html> (accessed October 3, 2016).
10. Alan Greenspan, “Regulators Must Risk More to Push Growth,” *Financial Times*, July 28, 2011, <http://www.ftchinese.com/story/001039834/en/?print=y> (accessed October 3, 2016).
11. Mervyn King, “A Governor Looks Back—and Forward,” speech at the Lord Mayor’s Banquet for Bankers and Merchants of the City of London, June 19, 2013, <http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech670.pdf> (accessed October 3, 2016).
12. Common equity Tier 1 capital is defined in Title 12, CFR 3.20(b), and leverage exposure is defined in Title 12, CFR 3.10(c)(4)(ii)(A) through (H).
13. For a discussion of the weaknesses of these measures, see Kevin Dowd, “The Average Leverage Ratio Across the UK Banking System: 2007 vs. Now,” Adam Smith Institute blog, June 3, 2016, <http://www.adamsmith.org/average-leverage-ratio/> (accessed October 3, 2016), and Kevin Dowd, *No Stress II: The Flaws in the Bank of England’s Stress Testing Programme* (London: Adam Smith Institute, 2015), <http://www.adamsmith.org/research/no-stress-ii-the-flaws-in-the-bank-of-englands-stress-testing-programme> (accessed October 3, 2016).
14. George Kaufman, “The Truth About Bank Runs,” Federal Reserve Bank of Chicago *Staff Memorandum* No. 87-3, 1987, pp. 15–16.