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Die Märchen der Banker (The Fairy Tales Bankers Tell)

Translation

Having more equity does not cause banks to go under, write Anat Admati and Martin Hellwig. To the contrary. A book that debunks many lobbying claims

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If banks have to hold more equity, that necessarily implies fewer loans the real economy, higher loan rates, less financial innovation, less growth, lower employment, and finally a lower standard of living for the man on the street. This is what the banking lobby is telling us. But the opposite is true: Better capitalized banks reduce the risk of bank failure, reduce the risk of (systemic) contagion, reduce the risk that government bailouts may be needed, and thus provide more safety for taxpayers, savers and citizens, that is, for society and for the economy as a whole. “The Bankers’ New Clothes” by Anat Admati and Martin Hellwig picks up one aspect only, but the most important one, of the reform of banking regulation, the equity that is required for a bank to be robust and healthy.

The finance specialist in Stanford and the director of the Max Planck Institute for Research on Collective Goods ask that equity requirements be raised dramatically, to a level of 20 to 30 percent of the entire (unweighted) assets that a bank has in its books.

In Andersen’s tale the emperor is naked.

With this proposal, the authors are right on the mark because currently, under Basel III, the real capital requirement (“leverage”) stands only at 3%. On this requirement the authors write: “If this number looks outrageously low, it is because the number *is* outrageously low. “ Right. And this is where the book’s title comes in.

In Hans Christian Andersen’s tale “The emperor’s new clothes”, the emperor parades proudly in his splendid clothes until a child debunks them as being nonexistent and all his subjects suddenly realize that he is completely naked.

According to the authors, the objections of the banking lobby against a tightening of regulation in general and a tightening of equity requirements, in particular, are just like the emperor’s new clothes: An airy nothing. One only must realize that even a mantra like repetition cannot weave an airy nothing into a splendid garment or into a serious chain of arguments.

Admati and Hellwig explain extensively what is the point of high indebtedness of banks, why a lack of equity greatly magnifies the leverage effect of gains and losses, and why bankers are addicted to borrowing the funds they need for their investments instead of funding a greater part of their business with equity.

An example: With equity equal to 3 percent of total assets, a 3 percent increase in the value of assets provides for a return on equity of 100 percent - a miracle! Wow! With that return, the banker is sure to get his bonus, he will be told “go on like this!” But if the assets decrease in value by the same rate of 3 percent, then all the equity is lost and the bank is insolvent. Never mind, the banker goes to the government, opens his hand and asks for bailout money. And the government will (have to) pay this bailout money if the bank is systemically important – with funds from the taxpayer. And we had to observe exactly this sequence in the years before and then after the financial crisis broke out.

However if a bank has equity equal to 30 percent of total assets, as demanded by the authors, the calculation looks very different. If assets increase in value by 3 percent, the return on equity is no longer 100 but only 10 percent – no super bonus for that! If assets decrease in value by 3 percent, equity goes down as well, but is still almost 28% of total assets. The bank continues to be robust and solvent and there are no systemic risks emanating from it.

A higher equity requirement thus reduces the potential return on equity – and that is something the bankers shy away from like the devil shies away from blessed water. However, a higher equity requirement also dramatically reduces the probability of a need for government rescue measures. We should learn the lessons from the crisis and its aftermath, and therefore all people with political and supervisory responsibility should promote such substantially higher equity requirements. But they don’t. Why not?

The reason is the “new clothes”, the arguments brought forward by the banking lobby in its own interest, which appear splendid and plausible, but which upon a closer look are only an airy nothing. Therefore the authors want to induce the public to be more critical and the people in charge of regulation to be more responsible to the public because all too often these people act like the courtiers of the emperor. The also tell the tale of the “new clothes”. There are different reasons for this, for example, the need for government finance, the fear of adverse propaganda from banks, political contributions and campaign contributions, individual career concerns, ignorance, etc. And therefore, the last sentence of the book says succinctly: What is missing is the political will.

How can the banking system be made safer?

The authors’ message and arguments are strong and convincing, but the text might have benefit from some shortening. Readers who want to enter into the subject more deeply find many suggestions in the 170 pages of notes, unfortunately without a glossary. This is a book for those who ask themselves how the banking system can be made safer, what is behind the arguments of the banking lobby, whether their splendid clothes are for real or fake, and whether it isn’t time to join the authors in shouting: the bankers are naked!

Susanne Schmidt has for a long time worked as a banker, analyst and financial journalist in the City of London. Her book “Markt ohne Moral” (Market without Morals, 2010) earned her the Deutscher Wirtschaftsbuchpreis (German Economics Book Award). In 2012, she published the book “Das Gesetz der Krise: Wie die Banken die POlitik regieren” (The Law of the Crisis: How the Banks Rule over Politics).