The 20% solution

Stuff bank balance sheets with equity, say the authors of a new book – it's the only way to prevent another debt crisis. Andrew Sawers meets **Anat Admati** and **Martin Hellwig**

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It seems so simple, really. Back in the mists of time, back when the current, never-ending financial crisis seemed to be known as a 'debt crisis', it was fairly obvious that the problem was too much debt. Bad debt, packaged debt, sliced and diced debt - but at the end of the day, too much debt.

When it all started to whiplash, the banks had so much debt and so little equity they couldn't carry the burden and were either forced into a shotgun marriage, bailed out by taxpayers or allowed to fail.

So the idea that academics Anat Admati (Stanford) and Martin Hellwig (Max Planck Institute) came up with is that banks should have equity worth between 20% and 30% of their total assets.

Let's put that in context: Basel III says the figure should be 3% (or 7% of risk-weighted assets). UK banks, Admati says, are running with between 3% and 4% equity: "Those numbers are missing a digit," she argues.

Admati and Hellwig have written a new book, *The Bankers' New Clothes: What's wrong with banks and what to do about it*. It seems certain to enlighten, demystify, infuriate and bemuse in not quite equal measure. "[We decided] we must write the book, not just for regulators and the same old crowd but for the general public," explains Hellwig.

With a mission statement like that, it has been written in about as plain English as it is possible to be.

The title comes from the bunkum that the authors say the industry spouts - the myths, nonsense and falsehoods that are designed to deflect criticism and to put a cork in regulation. In one example, the authors specifically cite a 2010 comment by the British Bankers' Association that new regulations would require UK banks to "hold an extra £600bn of capital that might otherwise have been deployed as loans to businesses or households".

Admati and Hellwig write that this argument may look plausible, but is, in fact, "nonsensical and false". Capital regulation "does not tell banks what to do with their funds or what they should hold. It tells banks only what proportion of the funds they use must be unborrowed [ie, equity]," says their book.

Another plank of their platform is, "don't dabble in details". "We want the bigger picture," Admati adds.

"Much of the debate has been about structure," continues Hellwig. "Retail versus investment [banking]. Should we separate them? Should we ring-fence?" It's clear they believe Lehman Brothers' collapse would probably have happened under the imminent regulatory regime.

And don't get them started on risk-weighted assets: Dexia, they point out, failed with a portfolio of Greek government bonds, seen at the time as top-quality, zero risk-weighted assets.

> "Much of the debate has been about structure. Retail Vs investment – should they be separated?"
>
> **Martin Hellwig** is director of Max Planck Institute

Take their 20%-30% band as a broad - but stiff - brush approach to capital adequacy: they side-step some of the details, such as whether the ratio relates to bank balance sheets prepared under IFRS or US GAAP, which can make a huge difference.

"We have this sort of conservation buffer concept, of not regulating to a number," Admati says. The idea is that equity should be about 30% in the good times but, if the equity takes a hit, it can absorb considerable amounts of loss - to the point where it is about 20% of total assets - without causing a default or a crippling deleveraging of the balance sheet. Then rebuild the balance sheet with retained earnings.

LOOKING FOR NIRVANA

But isn't equity expensive? What would be the impact on the cost of borrowing from equity-laden banks? They point to studies where lending spreads are unaffected by a bank's gearing ratios. Their book makes the 'Modigliani and Miller' point that the funding mix doesn't affect the funding cost because a less-geared bank has less risk, and hence a lower equity cost.

More controversially perhaps, Admati says that the cost of borrowing may go up, but that would be because they would also scrap the implicit subsidy of taxpayer support for failing banks, which holds down banks' cost of debt: "There is plenty of evidence that the actual downside that's really on banks' balance sheets is not priced, is not in the market," Admati says. "Maybe this will bring the cost [of borrowing from a bank] to the right economic cost."

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> **Anat Admati** is a professor at Stanford

So - a better bank balance sheet, a better pattern of bank lending, at the true economic cost, with no threat to the public purse. Sounds like financial nirvana, but how to get from here to there? And is there enough equity?

But even as the question is asked, the answer becomes obvious: don't just raise equity, shrink the assets. The Admati-Hellwig recipe includes recognising losses, cutting out zombie banks, restructuring, reprivatising. "That's the point where you get equity because the new shareholders will know that [if you have done] the restructuring properly you [will] have a market structure where they can earn money."

It's compelling - radical, but compelling. Is anyone listening? What do the people who can do something about this say to Admati and Hellwig? "They usually don't talk to us!" says Admati, though it's not convincing. "I have yet to meet someone who can acknowledge that they can do something about this," Hellwig says, more plausibly. One can sense the shrug of the shoulders from those on high who are still in denial.

After our interview, Admati and Hellwig spoke at the London Business School. They were joined on the platform by Professor David Miles, who sits on the Bank of England's Monetary Policy Committee, and Sir Win Bischoff, chairman of Lloyds Banking Group, who had no shortage of praise for the book. So some people are listening.

In the Q&A, *FS Focus* asked Sir Win if it were possible for a single, hypothetical bank to compete in the industry and in the capital markets with an equity-rich balance sheet like the one the authors propound. One half-expected him to reply that it required global regulation - a level playing field, and all that. He didn't. "It can be done, I believe," he said. "I believe there is equity, there is capital around - at a price, but you'd have to have a proposition as a management which could convince investors that this, ultimately, can in fact meet its cost of capital."

So if it can work for one hypothetical bank, why not all the real ones? Perhaps it will take the dawning realisation that Basel III (known to the authors as Basel 2.01) couldn't, can't, won't prevent another financial crisis for *The Bankers' New Clothes* to be embraced as the model for Basel IV.

The Bankers' New Clothes: What's wrong with banks and what to do about it

Anat Admati and Martin Hellwig

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