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Bloated business of banking

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The Australian Prudential Regulation Authority is mulling over imposing tougher standards for the big four banks. Picture: Brad Hunter Source: TheAustralian

LABOR leader Ben Chifley's quixotic 1947 plan to nationalise Australia's banks ended his political career, but in a perverse way his dream came true.

Australia's big four banks have become so enormous and so indebted that they are public when they make losses and private companies when they don't, whatever the government or law may say.

They, and their massive counterparts overseas, neither requested nor were formally granted this bizarre arrangement. But as governments - and thereby their capacity to bail out banks - expanded inexorably since World War II, the probability grew that hapless taxpayers would be forced to insulate large, highly interconnected and politically significant banks from failure, and with it banks' incentive to take advantage of the artificially cheap debt such assurance fostered.

In Australia that probability is now 100 per cent. Standard & Poor's, a ratings agency, gives Australia's biggest four banks a AA rating explicitly because taxpayers will provide "extraordinary support" to their creditors in any crisis, an implicit guarantee worth more than one-quarter of the four's annual profits.

Since 1995, the big four Australian banks' assets, reflecting a global trend, have ballooned from 94 per cent of Australia's national income to $2.86 trillion, or 190 per cent.

"The question of too big to fail might eventually turn into a question of too big to save," say Patrick Bramer and Horst Gischer, whose analysis in the latest Australian Economic Review found Westpac to be the most "systemically important" Australian bank, followed by the Commonwealth Bank, National Australia Bank and ANZ.

"With the exception of the UK and Ireland, no other national banking system in major economies has

experienced a comparable expansion of banks' importance," they add.

Australia's big four won't grant a mortgage for more than 80 per cent of the value of a house without insisting the borrower buys insurance, but they don't hold themselves to such prudent standards: less than 5c of shareholders' equity stands behind every dollar of the big four banks' assets; the rest is debt. Put differently, their assets need fall only a few per cent before they are practically insolvent and taxpayers are on the hook for their borrowings.

"If such ratios look outrageously low that's because they are," says Anat Admati, a professor of finance at Stanford University, and part of a growing chorus of eminent economists and regulators arguing banks should be forced to reduce their reliance on debt to protect taxpayers from bailouts and economies from financial crises.

The more a company relies on debt rather than equity - also known as capital - to fund its assets, the more vulnerable it is to bankruptcy if its business sours.

"A highly indebted bank is like an unstable, shoddily constructed building," Admati says.

The global financial crisis showed how losses on even a tiny fraction of US mortgages suddenly made banks worldwide extremely reluctant to lend to each other, a reasonable fear given their absurdly thin capital buffers; Swiss banking giant UBS had a capital ratio of less than 1.8 per cent in late 2007. Naturally, banks have relatively high levels of debt compared with other large companies because taking deposits is their core business.

EQUITY as % of TOTAL ASSETS

Bank	Pre-GFC	2013
ANZ	4.4	4.7
WBC	3.9	5.0
NAB	4.2	4.9
CBA	3.9	4.6
Other companies	*Equity %*	*Assets $bn*
David Jones	63	1.2
Fairfax	51	4
Harvey Norman	57	4
Qantas	28	21.2
Rio Tinto	49	117.6
Telstra	33	38.5
Woolworths	39	21.6

Source: Macquarie Bank; author's calculations

Source: TheAustralian

But discredited global bank regulations - first rolled out in the late 1980s and known as the Basel rules - allowed banks' capital ratios to fall to dangerous and historic lows.

Deposits are less than 65 per cent of banks' borrowings, the rest short and long-term borrowing from other foreign and Australian banks - an interconnectedness that increases the risk of financial contagion.

"Very smart people can make decisions that are quite dumb in retrospect," Simon Johnson, professor of economics at Massachusetts Institute of Technology, tells The Weekend Australian, pointing out how the regulations' misguided focus on so-called "risk-weighted capital ratios" blinded them to the real risk burdens.

Risk-weighted measures encourage banks to favour assets that regulators believe are less risky - such as government bonds or mortgages - and artificially swell the "risk-weighted" capital ratios of the Australian majors, which are heavily exposed to "safe" home loans. Since 1990, this system has helped the stock of Australian business loans shrivel from 270 per cent of the value of housing lending to 57 per cent.

"Risk-weightings are like asking a convict what sort of sentence he'd like," Citigroup's distinguished global chief economist Willem Buiter says.

Chastened by the financial crisis, the still pusillanimous post-GFC version of the Basel rules has imposed a minimum ratio of 3 per cent - "ludicrously low", says Johnson.

Regulators in the US, Britain and Switzerland are planning to impose much tougher capital standards, potentially up to 10 per cent.

The local bank regulator, the Australian Prudential Regulation Authority, is itself mulling over imposing tougher prudential standards for Australia's big four banks, which may include a higher minimum capital ratio.

Michael Wiblin, head of Australian banks at Macquarie, notes that our big four banks are in the top quarter of global banks ranked by leverage (a measure of indebtedness). "If foreign jurisdictions opt for tougher rules,

the market itself might force the majors to hold more capital because they borrow a lot from the UK and the US," Wiblin says.

Benjamin Franklin's dictum that an ounce of prevention is worth a pound of cure isn't resonating with bankers, however, here or overseas. They argue that forcing them to hold more capital is inefficient, will boost their cost of funding, lift lending rates for households and retard economic growth.

But their arguments are false or vastly exaggerated. "We have a system with nothing to recommend it except bank managers like it that way," Admati says.

First, lifting minimum capital ratios does not require banks to "hold" or "have" more capital or cash, as lazy reporting suggests, limiting their ability to make loans.

Higher capital ratios imply nothing about the type or quality of banks' assets; they simply specify the fraction that is backed by shareholders - the bank's money - rather than creditors. They specify how much a bank's assets can fall in value before taxpayers are called in.

David Miles, professor of economics at Imperial College London and a member of the Bank of England's monetary policy committee, says: "The idea banks must shrink lending to satisfy higher equity funding requirements is a classic non sequitur.

"While leverage in banking has risen steadily for 100 years, average economic growth and investment have shown no obvious trend," he says, pointing out the gap between mortgage lending rates in Britain and the US and official rates were not obviously higher when banks used vastly more capital than now.

Certainly, Australian, British and American banks once had capital ratios above 20 per cent, more than four times their present level.

Even Buiter, chief economist of a leading US bank, says he hasn't seen a bank yet that shouldn't have more. "Banks can live with whatever capital ratio," he says, pointing to Modigliani-Miller theorem that shows a company's cost of finance is independent or unaffected by its chosen mix of debt and equity.

"Absent a tax bias towards debt, the notion equity is more expensive is wrong."

Of course many tax systems, including Australia's, do have a bias towards debt because interest payments are tax deductible but dividends are not.

Miles estimates a doubling of capital ratios would lift lending rates by only somewhere between 0.1 and 0.4 percentage points.

"It is absolutely not self-evident that requiring banks to use more equity has to substantially increase their cost of funds and cause them to change more on loans," he says.

The big Australian banks' huge profits are as much a symptom of sickness as financial health. Any business that leverages itself massively will generate a high return on its sliver of equity, as the big four routinely do.

"Bank executives are typically remunerated according to a measure of return on equity that is unadjusted for risk so they happily accept more risk," Johnson says.

That Australia avoided much of the GFC says nothing about the likelihood of enduring another one in the future.

"Simply because you haven't had one does not mean your system is structurally healthy," Admati warns.

She suggests the kind of basic mortgage lending Australia's big banks specialise in is historically as risky as superficially more complex investment banking.

Admati and Johnson point to Australia's exposure to the inscrutably dynamic Chinese economy, volatile global resources prices and bank regulators' ubiquitous hubris.

Politicians and regulators have wilfully or naively turned a blind eye to banks' absurd low levels of leverage, Admati argues.

"After all, banks are where the money is," she says.

Johnson says: "Public policy shouldn't care about bank profits for their own sake. If you want to subsidise

banks, fine, but do it transparently on the government's balance sheet."

Banking is inherently risky and financial crises occur frequently in rich and poor countries alike; Australia has had three. They devastate economies with costs typically ranging from 10 per cent to 50 per cent of national income, up to $700 billion in Australia's context.

If big industrial companies want to leverage themselves to the hilt, as large banks typically do, good luck to them. But when banks do it, ordinary taxpayers and economic prosperity are at risk, aside from the serious distortion to the economy. Financial services, a middle-man industry that undertakes no research and innovates little, is a bigger share of Australia's national production than any other industry, having outstripped mining, farming, education and even spiralling health services in the decade from 2000.

Mounting international evidence suggests it is has grown far too large, here and overseas.

"Banking is a massively bloated industry that routinely exaggerates its importance in its own interest," Admati says.

Australian banks should be prevented from paying out dividends until their level of shareholders' equity exceeds a specified dollar amount at least twice the current level (specifying a ratio would be naive, prompting banks to sell curb lending to meet the ratio).

Higher capital ratios, by weakening the relevance of the implicit taxpayer guarantee big lenders enjoy would help smaller banks compete. They also would lessen the need for a supervising bureaucracy and the failed "risk-weighting" system because the buffer protecting taxpayers from a fall in asset prices would be so much larger.

Free lunches are meant to be a myth, but requiring banks to lend more of their own money looks like a banquet.