THE AUSTRALIAN

Bank capital and other fallacies

ADAM CREIGHTON THE AUSTRALIAN DECEMBER 06, 2013 12:00AM

FALLACIES wouldn't have a name were they not so common and stubborn. Ad hominem -- attacking the person rather than the argument -- and appeals to authority and emotion are probably the most common in general public commentary.

The UN says humans are responsible for climate change so it must be true. Children from broken homes with poor prospects are struggling at school so taxpayers must spend a further $5 billion a year on public education.

Economics has a class of its own. The eminent US economist Deidre McCloskey was railing against some of them in Sydney earlier this week. The idea government could protect particular industries from foreign takeovers or competition, without harming the greater good, was probably the oldest in the book, she said. A close second was the idea that economic prosperity depended on spending, which led to the Keynesian "demand management" fallacy that the government -- despite all its inherent foibles -- could "manage" the economic cycle to improve the general welfare.

Thankfully, a small but skilled bevy of commentators routinely pull these fallacies apart, so non-economists at least are vaguely aware of them. But those in the more specialised financial press get less attention. The biggest, and one that hinders good policy formation, is in relation to the structure of banks: the insidious little refrain of bank reportage: "hold more capital".

Since the global financial crisis it became gobsmackingly obvious that most of the world's banks were hopelessly undercapitalised. Put another way, far too great a share of their assets was backed by borrowed money -- from depositors or other banks -- rather than their own money: equity, or shareholders' funds. That meant any problems that emerged with banks' assets soon exhausted what precious little shareholders' money was sloshing around, leaving taxpayers' on the hook to bail out banks' creditors, who (quite naturally) said the world's financial system would collapse if they were not repaid.

Since then, embarrassed regulators have started rolling out higher mandatory "capital ratios" -- shareholders' funds as a share of total assets -- for banks. Yet practically every financial journalist, including once this one, has reported this as banks having to "hold" or "set aside" more capital. Consider these lines taken from stories in The Australian Financial Review this year: "The financial crisis prompted regulators to demand banks set aside more capital" and "regulations are designed to make the financial system safer, including by forcing banks to hold more capital and more liquid assets". One from The Australian referred to "concerns the Australian banks would have to hold more capital if they are forced to reduce leverage".

If banks or companies hold anything, they hold assets, not liabilities. Capital is a liability: the amount shareholders have tipped into a company and are on the hook for. It is not a "reserve" of cash. Lifting mandatory capital ratios has absolutely nothing whatsoever to do with banks' assets, let alone setting any of them aside. A well-capitalised bank could have all its assets in safe "liquid" form or all of them invested in highly risky derivatives. Capital ratios say nothing about how risky its assets are, but they say a lot about the size of the likelihood of taxpayers having to bail banks out.

Practically by definition, if capital ratios are higher, then leverage is lower. Leverage is typically specified as the ratio of debt to equity: a company with debt worth twice the value of its own funds is three times leveraged. Banks are typically more than 20 times leveraged, which means small changes in the value of their assets have a massive impact on their rates of return on equity. A first-home buyer taking a mortgage worth 99 per cent of the house makes a killing if the house appreciates, but they are quickly wiped out if it falls in value.

Too many have forgotten the basic high school accounting equation "assets = liabilities + shareholders' funds" applies to banks too, except in the latter case the shareholders' funds are typically called "capital".

Pedantry is not the motivation here. The phrase leads ineluctably to the idea that if banks are "holding" more capital, then they must be "holding" less of something else, namely mortgages or business loans that contribute to economic activity.

As US Stanford economics professor Anat Admati wrote recently in her new book The Bankers' New Clothes: "The confusion is insidious because it biases the debate, suggesting costs and trade-offs that do not actually exist."

Higher capital ratios do not inhibit bank lending because they do not, as mentioned, impinge on what banks do with their assets. They can even raise more equity and choose to lend that out if they want. Indeed, banks throughout history have had capital ratios about four times what they are today and evidently society coped and even prospered. But higher ratios may harm banks' profitability because interest payments are tax-deductible for businesses while dividends are not, creating an inherent and potentially highly damaging bias in the economy to borrow rather than fund projects internally.

To be sure, "hold more capital" is a neat phrase, but should always be replaced with "better capitalised" or "less leveraged".

Precision should trump elegance in financial reporting.