KEY POINTS

- Banking regulations are too lenient. Banks should be required to hold much higher capital.
- The current system results in excessive risk of loss to taxpayers.

Author Andrew Smithers

Why banks' regulatory capital requirements need to be raised

Andrew Smithers argues the case for tighter banking regulation in light of the credit crunch.

There is general agreement that regulations governing banks need to be changed. One key question is whether the current capital requirements are adequate. During the past 20 years there have been banking crises in the US, Japan and Europe. These have often led to considerable cost for the taxpayer and, in the case of Japan, made a major contribution to a long period of economic malaise.

Difficulties in banking can spread quickly beyond the original troubled institution and become, or threaten to become, crises. Business consists of taking risk and no one can tell, other than with hindsight, which risks are justified. If Northern Rock were a hedge fund rather than a bank, it would be noted that the management had made a bet which went wrong. That would or should be the end of the story. But banks are different. In practice, even if not in theory, their deposits are guaranteed by taxpayers. This means that banks can borrow as much as they want at close to the same rate as governments, however badly they are managed. In return for this guarantee, governments regulate banks. One aim is to stop them going bankrupt and imposing costs on the taxpayer in consequence; the experience of the past 20 years is that this aim has not been achieved.

Successful regulation is very difficult because managements like risk. Managements do not have the same interest as the owners of companies, let alone those of taxpayers. This is known to economists as the agent/principal problem. Managements are inclined to take greater risks than shareholders should want them to do. Financial markets are not perfectly efficient, and extreme events happen much more frequently than they would otherwise be expected to do. Ninety per cent of the time, returns are better and conditions smoother than they are on average, but ten per cent of the time returns are negative and conditions turbulent.

From the shareholders' viewpoint, caution makes sense in the good times, so that disaster can be avoided in the bad. But this is not in the interests of management. If they are cautious in the good times, they will not look clever and will not reap fat bonuses and may lose their jobs. In the bad times they will lose their jobs but not their capital. A lost job can be replaced, lost capital can't. So, the balance of risk and reward means that management is inherently driven to take more risks than shareholders really want them to do. This problem has been made worse in recent years by the massive increase in the proportion of managements' remuneration which is tied to the results of the business.

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This is a general problem for business. It can set off big swings in stock markets, other financial assets and property and, when these come down to earth, it makes the management of the real economy very difficult. But it is a very serious problem for banks because, when they go bankrupt, the taxpayer picks up the tab and the repercussions on the real economy are particularly acute.

The regulation of banks needs to change to reduce these risks. Regulations have so far failed to do this effectively and current data suggest that further failures are likely. The current return on banks' equity capital in Europe and America is a multiple of the long-term average return on corporate equity but, as banking is a competitive industry, it must have a very similar average return in the long run.

An increase in the ratio of equity capital to loans and other risk assets will smooth out returns on equity, bringing down the peak returns but raising the returns in bad years. The long-term average returns on bank equity should, through normal competitive pressures, be much the same as for businesses in general and would thus not be affected by the requirement to hold higher equity ratios. Tougher regulations should not therefore make banks less profitable in the long run than they are today, but it will reduce the likely cost to taxpayers that comes from guaranteeing deposits. This guarantee provides a subsidy to banks, and it is only reasonable that regulations should seek to minimise its cost.

One test of good regulation is therefore that the average return on equity in good times should not be too far above the equilibrium return. Otherwise, the return in bad times will tend to be so low that bankruptcies will occur and a heavy cost may fall on taxpayers. As current returns are so high, we know that this test is not currently being met. Banking regulations today are thus too lax, as banks are allowed to run their businesses on too little capital. ■

Biog box

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