

Viewpoint: Get Level with Capital

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By Raymond Natter¹

Recent legislation and regulatory initiatives make it clearer than ever: capital is king. The Dodd-Frank Act repeatedly states that the regulators are to set stricter capital requirements, especially for systemically important banks. Likewise, the proposed new capital framework, Basel III, would impose higher capital mandates for all internationally active banks.

There is no question that capital serves important purposes. Capital represents the shareholders' equity investment in a financial institution. Capital provides a source of funds to absorb unexpected losses. It provides a buffer to protect the federal deposit insurance fund. And as capital puts investors' funds at risk, it reduces the moral hazard created when institutions invest other people's money and none of their own.

Yet capital is a two-edged sword. While insufficient capital requirements increase the risk that a financial institution will fail, excessive capital requirements are harmful to both the institution and the economy.

An inappropriately high capital requirement adversely affects financial institutions in several ways: it discourages equity investments, it enables competing institutions in less-regulated sectors to gain market share and it encourages the financial institution to raise prices and fees. It also can harm the economy by reducing lending capacity.

Investors prefer companies that provide the most value for each dollar invested. In making this determination, investors will look at both risk and expected return. For companies that are viewed as presenting more risk, the expected return has to be higher than for companies considered to be less risky. One way of reducing risk is to hold sufficiently high capital. That is why a company with higher capital ratios can typically borrow funds at a lower rate than a similar company with less capital.

If a company is required to hold capital that is higher than necessary to offset its risk profile, the capital requirement no longer is viewed as a benefit, but can actually be a detriment to further investment. An inappropriately high capital requirement means that there must be more investment dollars backing each earning asset than is economically necessary. Because an institution's earnings are divided among all of the

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outstanding shares, the higher the capital requirement, the lower the earnings per share. Investment in financial companies with inappropriately high capital will be less attractive, since the amount of earnings per share is reduced. As a result, investments will flow to companies that are perceived as having sufficient capital but not excessive amounts of capital. If this occurs, investments in less-regulated companies will be more attractive than investments in highly regulated banks.

Second, it is important to recognize that capital represents a cost of doing business. For a company that is not subject to regulatory capital requirements, the markets determine the amount of capital that is necessary and sufficient. If regulated companies are required to hold excessive levels of capital, the less-regulated company will be able to offer its products at a lower price. This could hurt the regulated sector and drive consumers to use providers that are not subject to these regulations. The less-regulated company will have a government-provided pricing advantage.

Third, a financial company with inappropriately high capital standards will be motivated to offset these competitive disparities by increasing its earnings. Typically, this means either increasing prices (charging higher rates and fees for financial products) or making riskier loans and investments that provide a higher return for each dollar of capital allocated to that investment.

A risk-based capital system should limit the ability of companies to make riskier investments without having to hold additional capital. However, some of the proposed capital standards do not vary based on risk. One example is the idea of imposing an "equity to debt" capital standard that would not be risk-adjusted. If this standard is imposed and becomes a binding constraint, some financial companies would be motivated to offset this capital requirement by making riskier investments.

It should be noted that high capital requirements can result in decreased lending activity at a time when credit availability is necessary for economic recovery. Capital is a ratio between the shareholders' equity and the amount of assets held by a financial institution. For banks, the primary assets are loans. If capital requirements are increased, some banks will attempt to comply with the new requirement by reducing assets. As loans are paid off, the bank will reduce the number and amount of new loans being made, thereby shrinking the denominator and increasing the bank's capital ratio.

The reduction in lending would not be limited to subprime, but would affect the availability of credit for every sector. This will make economic recovery harder, as the availability of credit is essential to the growth of large and small businesses alike.

Appropriate capital levels are important for many reasons. Yet it is unrealistic to say that capital alone can prevent failures. Bank failures are primarily caused by making bad loans and investments. Years later, when these investments go bad, capital levels will take the hit, but the mistakes were made years before. High capital will not prevent an institution from making bad investments that seemed like good investments when made. Better underwriting standards, internal controls and even economic forecasting are more important in preventing failures than capital.

Some argue that high capital levels will protect the financial institution from mistakes in loan underwriting or investment decisions. The problem is that to provide sufficient protection to withstand the type of turmoil we have seen in the past two years, the capital levels would have had to be set so high as to be incompatible with the role of financial institutions to provide credit to our economy. To make them fail-safe, we would have to impose capital levels that would significantly limit their ability to lend or invest, dramatically reducing credit availability.

Attempts to make financial intermediaries "risk free" through excessive capital requirements will impede economic recovery and prove to be a grave miscalculation.