Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Should Capital Be King?*

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One fact of life is now clearer than ever in the world of regulated financial institutions: "capital is king." The Dodd-Frank Wall Street Reform and Consumer Protection Act repeats in section after section that the regulators are to set more stringent capital requirements on systemically significant financial companies. The emphasis on increased capital is also found in the stringent proposals emanating from abroad, in the form of a new "Basel III" that would impose significantly higher capital mandates for all internationally active banks, and in the U.S., some of these requirements could possibly be imposed on even community banks.

The renewed emphasis on capital is understandable. The country has undergone a wrenching financial upheaval, and politicians, the press and the public have put the blame squarely on the shoulders of the banking and finance industry. Congress, the Administration, and pundits of all stripes quickly concluded that "excessive leverage," another word for inadequate capital levels, was one of the fundamental causes for the crisis.

There is no question that capital serves critically 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 creditors and the FDIC insurance funds and potentially Government resources during downturns. And since capital puts investors' funds at risk, it reduces the moral hazard created when institutions invest other people's money and none of their own.

However, as with other regulatory requirements, capital is a two-edged sword. Insufficient capital requirements increase the risk that a financial institution will fail, that it will not be able to survive unexpected losses or downturns in the economy, and that it will undertake aggressive and speculative growth. Capital requirements that are excessive when compared

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to the underlying risks of a company's activities are counterproductive for the institution and the American economy.

This is not to argue that mandatory capital requirements are not necessary for companies that are perceived as being too big to fail, or that have the benefit of Government guarantees, such as deposit insurance. Regulatory capital standards are necessary for these institutions since the markets will consider the Government backing as mitigating their risks in funding these companies. However, it is important that mandated capital ratios are reasonable and balanced. Higher is not always better.

I. Risks Inherent in Capital Requirements Set Too High

An inappropriately high capital requirement adversely affects banks and other 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 bank or other financial institution to raise prices and fees. It can also adversely impact the economy by reducing lending capacity which will slow economic growth.

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 reducing risk is to hold sufficient capital to offset the perceived risk of the company's investments and other activities. That is why, for example, 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 by Government mandates 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 necessary for the risk inherent in that investment. Since an institution's return on assets (earnings) are divided among all of the shareholders, the higher the capital requirement the lower the earnings per share of equity. A rational investor will be attracted to invest in a company that provides a higher distribution of earnings per share than a lower amount. Therefore, investment in financial companies with inappropriately high capital will be less attractive, and funds will flow to companies that are perceived as having sufficient capital in light of its risk profile, and are not required by statute or regulations to hold excessive capital. This is counterproductive to the goal of having a healthy and robust regulated financial services industry that attracts funds that can be loaned to others. In addition, it will provide advantages to the less regulated or unregulated sector that is not subject to these capital mandates.

Second, it is important to recognize that capital represents a cost of doing business. In order to obtain funding and investment, an unregulated financial company will hold capital that the markets determine necessary and sufficient. If regulated companies are required to hold excessive levels of capital, the less regulated or unregulated company will be able to offer its products and services at a lower price than the regulated company. This will disadvantage the regulated sector and drive consumers and to use providers that are not subject to these regulations. In effect, the unregulated company will have a Government provided pricing advantage over the regulated sector.

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 capital standards under discussion would not vary based on risk. One example is the idea of imposing an "equity to debt" capital standard that would not consider the risk presented by the company's assets. If this type of non-risk adjusted standard is in fact imposed and becomes a binding constraint, some financial companies would be motivated to offset this capital requirement by making riskier investments. This would not conducive to the ultimate goal of making our financial system less risky.

Finally, it should be noted that high capital requirements can result in decreased lending activity for all types of loans 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, including small business. This will make economic recovery harder, as the availability of credit is essential to the growth of both large and small businesses.

II. Does Capital Prevent Failures?

As noted at the beginning of this paper, appropriate capital levels are important for many reasons. Capital provides a buffer to absorb unexpected losses and mitigates the effects of economic downturns. It also ensures that the shareholders have their own funds as risk in the operations of the company. But it is unrealistic to say that capital alone can prevent failures. Bank and financial institution failures are primarily caused by making bad loans and investments. When these loans and investments are made, there is no change in a bank's capital ratios. Years later, when these investments go bad, capital levels will take the hit, but the mistakes were typically made years before. High capital will not prevent an institution from making bad loans or bad investments that seemed like good investments at the time they were made. Good underwriting standards, internal controls, and even economic forecasting are more important in preventing failures than capital. That is why capital is generally viewed as a "lagging indicator" of a problem in the bank or financial company. The cause of the distress in the company is not the decrease in capital, but rather the cause was the investment decision made when capital levels were high. The decrease in capital is a result of past mistakes that are embedded in the institution's balance sheet.

Some may argue that if capital levels are set high enough, it will protect the financial company 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 financial institutions "fail safe," we would have to impose capital levels that would significantly limit the ability of financial institutions to lend or invest. As a result, credit availability would decrease dramatically, and the economy would suffer a terrible blow. Banking and related financial services involve some inherent risks, and over the course of hundreds of years we have come to recognize that the benefits of having a modern banking system outweigh the risks. Attempts to make banks and other financial intermediaries "risk free" through excessive capital requirements will undermine these benefits, impede our economic recovery, and ultimately prove to be a grave miscalculation.

III. Conclusion

Minimum regulatory capital requirements are both necessary and important. However, inappropriately excessive capital mandates reduce profitability, limit growth, and raise the cost of loans and other financial products, and in some instances could even encourage the booking of riskier loans and investments. Inappropriately high capital standards will provide competitive advantages to the less regulated or unregulated sector, and drive business away from regulated financial companies. Regulatory capital standards need to be established with these concerns in mind. Capital is an important tool to enhance bank safety, and along with appropriate macro-economic policies can reduce the potential for future crises and mitigate their consequences when they occur, but it must be used carefully to avoid unintended consequences that would be harmful to safety and soundness and hinder economic recovery.

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