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Why be Afraid of Higher Bank Capital Requirements?

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There is much debate, and resistance from the banking sector, about the merits of higher required bank capital ratios. Both in theory and in practice there is little reason to justify such concern.

Under the Basel Accord, banks in most countries are subject to minimum regulatory capital requirements, generally expressed as a proportion of risk weighted assets. Currently there is discussion about increasing the minimum capital requirements (as well as making changes to the way it is calculated, what counts as eligible capital etc.)

While there was general support for higher capital ratios in the immediate aftermath of the Global Financial Crisis, the passage of time is seeing strong pushback from banks on the case for imposing higher capital ratios. Many of the arguments are unfounded and it should be asked whether the costs of higher capital ratios are significant and would outweigh the benefits.

In addressing this question, the first point to note is that the risks inherent in bank asset portfolios must be borne by stakeholders (shareholders, debt-holders, depositors and government – as an explicit or implicit guarantor) in the banks. In providing funds to the bank, they will (or should) demand a risk premium for bearing that risk. In this regard, all that higher capital ratios do is to change the mix of bank funding (and risk bearing) towards more equity and less deposits or debt.

In theory (absent tax distortions and financial “safety net” effects) this would not change the overall (average) cost of funding to banks. Indeed, to the extent that potential financial distress costs are reflected in the cost of funding, a lower risk of bank failure should in principle reduce the average cost of funding.

While reality differs from that world of theory, some of the conclusions highlight real world implications. In particular, lower bank leverage won’t necessarily lead bank depositors and debt holders to accept lower promised interest returns - because perceptions of government support for banks mean that they disregard or discount bank risk of failure.

If that is a cause of increased bank cost of funding due to higher capital requirements, they should not necessarily be seen as involving a social cost. Rather, they involve a “corrective” mechanism which limits bank access to this implicit subsidy and partially redresses competitive imbalance with non-bank financing which the subsidy induces.

An alternative cause of increased bank funding cost could be the tax effects. In a classical tax system the “double taxation of dividends” makes high leverage attractive. And while Australia’s dividend imputation tax system reduces that effect, it may still have some relevance.

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But again, it should be asked how much leverage should be permitted in pursuit of such tax benefits. Australian (and international) banks have leverage ratios (assets/equity) in the order of 20, compared to non-financial companies for which the average is around 2.

Non-financial companies can't lever up to that extent because shareholders and creditors get nervous and demand much higher rates of return. Banks escape that market discipline, perhaps partly because they have less risky activities – the GFC notwithstanding, but because of perceptions of government support and oversight (prudential supervision). If market discipline inadequately constrains excessive leverage for these reasons, explicit constraints can be justified.

For these types of reasons, it may be argued that a consequence of higher bank capital requirements will be a higher cost of bank funding, which will have adverse effects upon economic activity through consequently higher loan interest rates. But how significant is this claimed effect. Consider the case where a bank currently funds its assets with 5 per cent equity capital with a required rate of return of 15 per cent, and 95 per cent by deposits with an interest cost of 5 per cent. With no change in these rates of return, increasing the equity funding to 6 per cent means that the average cost of funding increases from 5.50 per cent to 5.60 per cent, ie 10 basis points (or an increase in funding costs of around 2 per cent).

Of course, banks may not be able to pass on the higher funding costs to borrowers, such that the return payable to shareholders is reduced. And because of the high leverage, that would be significant – at the new leverage ratio an average cost of funds of 5.50 per cent means that the compatible return on equity drops to around 13.5 per cent.

Ultimately, whether banks would be able to pass on the higher cost of funding in loan rates, or whether the cost of deposit funds would decline and offset the effect, depends upon how the Reserve Bank adjusted monetary policy. But even if there were no change in monetary policy, the effect upon real activity is unlikely to be substantial, given the relative interest inelasticity of demand¹, and thus not a strong argument for opposing (at least modest) increases in required bank capital ratios.

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¹ For example, the IMF recently estimated that a 100 basis point increase in interest rates would reduce residential housing investment in Australia by around 2.5 per cent. *World Economic Outlook* (April 2008, Chapter 3), <http://www.imf.org/external/pubs/ft/weo/2008/01/pdf/text.pdf>