Review of:

The Bankers' New Clothes, by Anat Admati and Martin Hellwig, Princeton University Press, Princeton, pp xv+398

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This polemical book has one key message - banks should be required to operate with a much higher proportion of equity financing relative to debt and deposits. And that message applies even after allowing for the higher minimum capital requirements being gradually implemented worldwide under Basel 3 regulations. Of course, the book does more than make that single argument. In particular, it stresses the political economy nature of the process by which banking regulation evolves, and focuses upon a number of fallacious arguments, rhetoric, and tactics used by bankers to prevent regulatory change of the sort advocated by the authors. Hence the title of "The Banker's New Clothes". Naked self-interest and logical inconsistencies in banker opposition to regulatory change is hidden from the general populace by the mystique associated with banking, and which the authors aim to strip away.

Such a book would be controversial even in normal times, but is particularly timely given the (still) recent financial and economic disruption of the global financial crisis which the authors argue (correctly in my view) demonstrated the faults of a financial system built upon highly levered banks. And while regulators have responded to that experience with increased capital requirements (and other measures), they are too little and implementation is too slow (facilitating "pushback" by bankers). As the authors also argue, those changes are perpetuating the illusion of scientific fine tuning given by complexity and reliance on internal risk modelling by large banks in the Basel regulatory approach, which an increasing number of researchers are sceptical of.

The authors are (rightly) scathing of the commonly heard arguments which claim that the cost of "holding" more capital is costly for banks and threatens lending, and thus, economic growth. First, as any student of banking should know, capital is on the liability side of bank balance sheets. It is not "held", it is a source of funding. This could be dismissed as a matter of semantics, but the rhetoric suggests that banks would have less lending capacity because they are required to "hold" more of something else. That is not the case. The implication is that the mix of funding sources is different - involving more equity capital and less debt and deposits.

Why are bankers averse to having more equity financing? A common argument is that equity is a more costly form of financing than the alternatives. But is it, and if so why? One valid argument is taxation - in most tax systems company tax is reduced by using debt rather than equity financing. But, first, this applies in all industries, and no others have leverage ratios even vaguely close to those of banking (where equity/asset ratios were often around 2-3 per cent prior to the crisis). And, second, the same argument is heard from Australian banks where dividend imputation removes most (if not all) of that tax advantage.

More generally, bankers argue that the required return of shareholders (cost of equity) is much higher than the cost of debt or deposits, because of the higher risk of equity. The counter-argument is that with lower leverage, the risk of equity is reduced and the resulting lower cost of equity offsets the greater reliance on this rather than on debt. While this argument has impeccable theoretical foundations, the fact that the cost of equity is not directly observable makes it hard to produce evidence to debunk doubters or those arguing from positions of self interest.

So the answer needs to be sought elsewhere, and the authors focus on the existence of implicit and explicit government guarantees of banks. Creditors (bond holders and depositors) would normally demand higher promised rates of interest when default risk is increased by higher leverage, in order to maintain expected returns (after allowing for default risk) at least constant. But the view that governments will bail out (particularly large) banks (a view reinforced by policy responses to the financial crisis) means that creditors do not demand appropriately higher returns as bank risk increases. Consequently, bankers have an incentive to increase leverage. Shareholders get the upside from risk taking, while governments and taxpayers bear the downside.

The authors expose a range of other doubtful arguments and areas where bank risk taking creates costs for society. While other post crisis regulatory initiatives, such as liquidity requirements, retail bank ring fencing, restrictions on activities are mentioned, the authors are resolute in their view that higher capital requirements are a necessary condition for achieving stability in banking.

In their wide ranging discussion they are also particularly critical of bankers' rhetoric. "Unintended consequences" is one of the bugbears they note as being a common argument raised against almost any proposed regulatory change. Yes, they can occur and are relevant in examining ex post outcomes, but ex ante arguments against policy change rarely articulate what unintended consequences are envisaged. The "unripeness of time" (yes / maybe, but not yet) is another common bugbear whose use by opponents of change the authors illustrate in the text and comprehensive endnotes.

The book is written for a lay audience, but the authors attempt to cater for the demands of specialists. Of the near 400 pages, end notes and references take up around 40 per cent. The end notes provide examples of "banker talk", information on relevant events, and references to academic research. While they provide a valuable supporting framework for the text, I found this to be one of two less satisfactory features of the book. In essence, the end notes provide too much information, are not well structured, overkill - almost, and the reader is probably well advised to initially read the text without reference to the end notes to avoid losing the plot. The text is well written and structured, and there is a good index to help the reader find the detail in both the text and the endnotes.

The other problem I had with the book, reflects the fact that it is not written for trained economics, business, or finance, students or graduates as the target audience. The focus is on non-specialists. Consequently, the authors include a number of early chapters which discuss the role of leverage and risk-taking using examples of individual financial decision making, in order to explain concepts relevant to the subsequent discussion of banks.

Whether that works for that audience is an open question, but it means that specialists may find it takes some way into the book before interest is stimulated.

Despite being a bank shareholder, I have also previously argued that higher bank capital requirements are desirable from a social perspective, and that any resulting private costs on banks and their shareholders are essentially a warranted transfer of existing hidden costs on government and taxpayers. Consequently, I find myself in considerable sympathy with the thesis of the authors. And substantially higher capital requirements might enable a retreat from the increasingly mind numbing complexity of bank regulatory requirements which give the illusion of scientific "fine tuning".

But whether the authors can win the debate on these matters against the rhetoric and lobbying of vested interests in the financial sector is subject to doubt. Most of the general populace at whom this book is aimed are unlikely to have the incentive to read and understand the arguments, despite the book being well written and persuasive. But as valuable contribution to debate and counterweight to opposing arguments it is certainly most welcome.

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18 July 2013