Higher Bank Capital: What's Wrong with That?

Suggestions from the IMF for Australian banks to increase their capital have elicited the usual negative response from that sector. Unnecessary, unfair, undesirable (for economic growth) are the sorts of reactions one gets used to hearing. But really, what does the social cost/benefit ratio look like?

It is important to realise that, in essence, bank capital requirements are no more than restrictions on the funding mix used by a bank. Higher capital requirements mean more use of equity and less of deposits and debt to fund a given level of lending and investments. Why might regulators want more capital, and why do bankers oppose this?

The call for higher capital is based on the fact that shareholders then bear more of the risk associated with bank activities, with their equity investment providing a buffer to protect depositors and debt holders from losses. That is good for financial stability and for taxpayers (if governments compensate depositors when banks fail), and the call is premised on a view that bankers will choose a level of capital which is too low on a social cost-benefit analysis.

Bankers economize on equity capital funding because of the view that deposits and debt funding is cheaper. Using other people's money to make profits for shareholders is the name of the game, and the more of others' money and less of shareholder money the better.

But are deposits and debt cheaper, and if so why? At face value the interest cost looks lower than the rate of return demanded by shareholders, but that is only part of the story. Increasing leverage (deposits and debt relative to equity) increases the risk (variability of returns) faced by shareholders causing them to demand a higher rate of return.

Taking this implicit cost of higher leverage into account, there should be no reduction in the average cost of funding unless there are some other relevant market imperfections (as Nobel prize-winning economists Modigliani and Miller pointed out many years ago). And, of course, there are such imperfections which are worth examining in more detail.

One is that depositors and debtors, who also face greater risk (from bank failure) of increased leverage, do not adequately increase the interest rates they demand from banks to compensate for that risk. And that will be the case if they believe that governments will protect them from losses, either explicitly via arrangements such as the Financial Claims Scheme, or implicitly by bailing out failing banks.

Thus banks, acting in the interests of shareholders, have a private incentive for higher leverage than is socially optimal because of an implicit taxpayer subsidy.

But maybe current regulatory capital requirements mean that Australian bank leverage is sufficiently constrained, such that risk of failure is so small as to be negligible and the taxpayer subsidy of minimal or no import. That may be so, but then the question arises of what is the cost of a higher capital ratio which decreases leverage, shareholder risk, and the required return of shareholders.

Not much is the answer, particularly under the Australian dividend imputation tax system where debt (deposit) financing has no (or little) tax advantage. The average cost of bank funds may increase by 5 to 10 basis points for each 1 percentage point increase in equity capital/assets – or not at all if shareholders act as proponents of efficient financial markets theory should suggest and reduce their required rates of return.

Of course, any higher bank funding costs mean higher costs for borrowers – but this can be offset by Reserve Bank interest rate policy. The main risk would be that banks respond to higher requirements not by raising new equity capital, but by reducing the scale and risk-weighting of their balance sheets.

The current unsettled global financial climate may be an inopportune time for banks to raise equity. But offsetting this is the ongoing wall of money flowing into Australian superfunds, including self managed super funds, with much of that looking to be invested in (particularly blue chip) Australian equities.

Whether higher bank capital ratios than current are needed or desirable can be debated, but that debate (like those over other regulatory changes) needs more attention paid to social cost/benefit analysis than has occurred to date.

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