AMERICANS FOR FINANCIAL REFORM
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More Bank Capital Will Improve Financial Stability Without Harming the Economy

Excessive, uncontrolled borrowing by big banks was a major driver of the 2008 financial crisis. By the time of the crash, the ten largest bank holding companies had over $40 in borrowed money for each dollar of secure capital. When the value of the banks' asset collateral dropped and lenders began to demand their money back, the need to unwind these loans drove the financial system and then the wider economy over the brink. As it became clear that banks could not make good on their debt, Congress acted to provide a taxpayer bailout.

Requiring more bank capital is vital to shifting the risks of bank activity from the public back to private sector investors, where it belongs. Capital refers to the equity or risk capital that private investors have pledged to a bank. Capital requirements mean that banks are required to raise more equity from private investors. Unlike those who simply lend money to a bank, equity holders have agreed to take the risk of bank losses as well as reap the upside benefits of bank profits. If there is an unexpected economic downturn, capital holders can absorb a loss without the need for a big bank to run the risk of a possibly catastrophic bankruptcy.

Regulators are now moving to strengthen capital requirements for big banks. The new international Basel III requirements would require banks to raise more private capital, and more reforms may be coming. But financial industry interests are working to prevent sufficient change, with lobbyists pushing back hard against requirements to raise additional capital. AFR recently held a policy event featuring presentations by scholars from Stanford University, the Brookings Institution, and the University of Massachusetts to discuss the benefits and costs of capital requirements. Tomorrow, the Senate Banking Committee will also be holding a hearing on debt and capital requirements in the financial sector.

Limiting Big Bank Borrowing Would Make The Economy More Stable And More Fair

Bank capital acts as a "buffer zone" in the financial system, allowing banks to take losses without having to go bankrupt or pressure government for support. This improves financial stability. Before the crisis, this "buffer zone" was too small. Our financial system was like a highway crowded with speeding cars – even a small mishap could spiral into a major crash. Now regulators want to raise capital standards so that there is more safety in the system.

Capital also improves financial stability by limiting the total amount of leverage in the system. Excessive leverage multiplies financial returns, but it also multiplies losses. Because lenders to banks (unlike capital holders) have not agreed to take any risk of losing principal, banks need to sell assets quickly to raise money if there is any threat that they might be unable to pay off their debts in full. This creates "fire sales" that drive down asset prices. It also increases the chance of panic-driven bank runs as creditors race to withdraw their money.

Besides improving stability, higher capital standards for the largest banks would improve fairness as well. The largest banks have an unfair market advantage because lenders may still believe they are "too big to fail" and will be bailed out in an emergency. By requiring that big banks in particular raise more capital, new requirements will force them to compete fairly on the basis of their business performance. They will have to find private investors willing to take on their risks, rather than depending on the possibility of a taxpayer bailout. This is a major reason that community bankers support higher capital requirements for the largest banks.

Raising More Capital Will Not Harm The Wider Economy

Bank-funded studies and testimony have claimed that a higher capital requirement will restrict lending and create economic harm. But experts at the AFR event concluded that the actual impact of capital requirements will range from no economic effect at all to possibly a very minor effect (perhaps a 20 basis point increase in interest rates, and no impact on credit availability).

This is because – contrary to some false impressions that have appeared in the press and lobbyist testimony – bank capital rules do not require banks to "reserve" or "set aside" any funds from lending. Capital requirements don't affect banks' ability to lend their own funds at all. Instead, they refer only to the method used by banks to raise funds. Capital rules require that banks raise a specified percentage of their funds as equity or risk capital, instead of debt. So new capital rules simply require banks to borrow less and raise more capital from private equity investors.

Taxpayer Subsidies Give Banks Incentives To Lobby For More Borrowing

If bank capital rules don't cause significant economic harm and help financial stability, why do banks lobby against them? The reason is that banks get special benefits from taxpayers when they borrow. The subsidies they receive make banks prefer borrowing to raising equity.

- **Tax subsidies to borrowing:** The interest paid on borrowed funds is exempt from taxation. This means that bank borrowing gets special subsidies through the tax system, while equity capital does not. These subsidies benefit banks, but they are a direct cost to taxpayers – they do not benefit the economy as a whole.

- **Implicit public guarantees make borrowing cheaper for big banks:** Until the new resolution authority provisions under the Dodd-Frank Act are tested, or other changes to make the banking system safer are fully implemented, investors will continue to believe that the government could bail out "too big to fail" banks. Bank bailouts typically guarantee lenders to big banks against any loss, while allowing holders of equity to take losses. For example, all of Citibank's lenders were paid off in full after the crisis thanks to government guarantees, but Citibank stock has lost 90 percent of its value since 2007. As long as the possibility of bailout exists, lenders will be willing to lend to big banks at a lower interest rate than other borrowers in the economy.

Both of these factors mean that banks can earn higher profits when they borrow more, and give them an incentive to lobby for less capital. But that's not because borrowing is actually better for the economy. Instead, borrowing is cheaper because it is subsidized by taxpayers and the public.