How Much Bank Capital Is Enough?

William R. Cline says new international norms developed after the crisis fall short of optimal levels of bank capital, but US financial institutions are already fairly close to where they need to be.

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Pedro Da Costa: I am Pedro da Costa. editorial fellow here at the Peterson Institute for International Economics, and I am joined by Bill Cline to talk about bank capital, which seems to be an evergreen subject in the evolving world of financial regulation.

Now, you recently wrote a working paper for us called, Benefits and Costs of Higher Capital Requirements for Banks, which pushes back a little bit on the notion that, the capital requirements don't have any cost to the broader economy. Could you speak to that a little bit?

Bill Cline: Well, I mean the Basel III reform, of course, did increase the capital requirements, but there are some academics out there who are saying, "Way too little, we need much more capital". So this examines that and the academic argument is based on a couple of Noble prize winning economists, Modigliani and Miller who in the 1950's said, "Well, whether you borrow or use equity doesn't make any difference." Because if you have more equity you will be safer, and so the unit cost of equity will go down. People will have a willingness to provide you equity capital at a cheaper rate.

Well the previous paper I did last year tested that hypothesis for the banks and then found out that that so-called offset is only about one-half. There are a lot of special features of banks, for example, their product isn't debt, it's deposits. But without going into that, my conclusion is that bank capital is not cost free to the economy because the banks have to pay more if they use more equity and they raise their interest rates that causes the cost of investment to go up. That means less capital in the long-term and lower GDP in the long-term.

Pedro da Costa: And so where does that leave the current for US banks, in particular, where does your research line-up compared to where regulators are falling into their standards? Are they too tight? Or too loose?

Bill Cline: Let me tell you how I get there. I mean the bottom line is that they are holding more capital than they are supposed to or than they have too according to Basel III. They are holding about 7%, 8% of their total assets as capital, they only have to hold 5%. And if you have used the so-called risk weighted assets, these numbers are almost twice as high.

Pedro da Costa: When you say hold, it doesn't prevent them from lending. It's just equity versus debt, right?

Bill Cline: Right. So if you compare their common, tangible equity against their total assets, it's about 7%. It turns out that that's at the bottom end of the range that I identify as optimal, which is 7% to 8% of total assets. And it's considerably above the Basel III minimum of 5%. So I conclude that Basel III does not have a high enough target and it is true that the actual practice of the US banks it's pretty close to the optimal that I identified. But, I would still feel more comfortable if the target were moved up somewhat.

But I think another major point is that this is far or less than some of these academic studies call for. They call for a capital of like 25% of assets. If you look at the bottom line in my study, you will see that the benefits of crisis avoided are on this top line here. The costs are this straight line going up. And some of these other advocates say or analysts say that we should be way out here at the 25% capital to assets. Instead, I say it's optimal level 70%, that's where the extra benefits, which is crisis avoidance equal the extra cost which is the fact that you don't form as much capital and have lower GDP from holding more bank capital.

Pedro da Costa: Let me push you a little bit on the cost. The title of your working paper is Benefits in Cost of Higher Capital Requirements for Banks and our viewers can download it at www.piie.com. But, with the issue of benefits and cost having just come out of -- or at least, a few years out from a massive financial crisis, isn't there a sense that there are intangible costs beyond what you can quantify in the sense that, the long-term unemployment and the underutilization of resources that you have had over say, a seven-year period. People even referred to the US as having lost significant economic ground not to mention other places like, Europe and --

Bill Cline: In the topsy-turvy way that this is analyzed, that speaks to the benefits of capital because the benefit is the avoidance of the loss of output and the unemployment and all that. My number for that is a banking crisis imposes an economic loss to the economy that's worth about 2/3rds of one year's full GDP. That will be like 11 trillion dollars. That's a huge number. And accounts ongoing effects for many years now.

Some estimates are even higher than that because they assume these effects last absolutely forever. But I think those estimates forget that nothing lasts forever. The capital that you would have created during that period would have its own amortization life and so forth. But, yes you are definitely right that the intuition that these damages from these banking crises are really huge is right. And that's already included in my calculation.

It's also true if you take a look at the relationship of the probability of a crisis to the amount of the capital banks hold. It's a very sharp curve. The risk drops off quite a quickly as you get close to filling that gap from what might be the nasty shock in which you actually hold. I am already taking account of the large benefits, which is a terrible loss avoided from a higher bank capital.

Pedro da Costa: Is it fair to say that basically there is a general agreement that capital was too low before the crisis. The crisis in itself proves it, but is it fair to say that you want to fight against the pendulum swinging too far in the other direction, is that kind of where you're headed? What are you think the best regulators are?

Bill Cline: My basic position is that we could benefit from still some further move and make the Basel III target what the actual banks are doing in the US now, at least. But that the desirable level is not these extremely high capital ratios because the consequence of that you wouldn't get a much further reduction in the probability of crisis but you'd have just a straight line, further additional cost of reduced capital formation for the economy.

Pedro da Costa: Thank you so much, Bill. I appreciate it.

Bill Cline: My pleasure.