

Banking without Foundation: Observations from the Dutch Discussion

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2 BANKING WITHOUT FOUNDATION: OBSERVATIONS FROM THE DUTCH DISCUSSION¹

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Fundamental uncertainty remains with regard to the sustainability of the financial system. As clearly demonstrated by the credit crisis, banks are essential to the economy at large. At the same time, the crisis has revealed the impotence of the supervisory authorities and the invisibility of politicians. Like policymakers, and perhaps the supervisory authorities, the parliament assumed that everything was fine, relying on the adage that ‘ten million bankers cannot be wrong’. We know better now: the banking sector is too important to be left to bankers. The credit crisis has also revealed the difficulty of reaching consensus among bankers with regard to several fundamental insights concerning the operations of their own sector. There appears to be considerable confusion. A hearing that was held in the Dutch parliament in 2013 (on the crisis) placed bankers in sharp opposition to academics. What should politicians make of this? The problem facing politicians has to do with the complexity. In addition to the extreme complexity of the financial sector itself, the interconnectedness between the financial sector and society renders the situation even less comprehensible. Although measures could obviously be taken to reduce complexity, the situation will never become simple. Interconnectedness with society is a persistent characteristic of the financial sector. This sector does not develop in isolation. Instead, it branches out through the entire society. This is why the credit crisis had such major consequences.

This article develops a conceptual framework with the goal of reaching consensus amongst all parties involved (i.e. bankers, politicians and academics). The results indicate that today’s dynamic society demands a banking system with much higher risk-bearing capital (equity) than it currently has. This message is extremely unpopular amongst bankers. For this reason, it is important to engage in substantive discussion concerning the inevitability of additional risk-bearing equity. This will ultimately make banking interesting for bankers once again, too. In a world with such an improved level of capitalization, common sense and judgement would once again prevail over naive trust in models and box-checking. Banking would include a notion of entrepreneurship instead of continuing to follow a path that inevitably leads to a dead end in the shape of increasing regulation and further bureaucratization of the banking profession. Bankers must once again be able to function as professionals, and they must once again be able to profit from their own judgement.

One concern can certainly be eliminated, as we will demonstrate, capital is available. All banks in the Netherlands should therefore elevate their level of capital. An increase in bank equity would have an exceptionally beneficial effect on the Dutch economy.

The proposed conceptual framework offers a number of basic principles and insights. A sound understanding of these elements is essential in order to arrive at solutions for

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all parties involved in the future of our banks. The first point concerns what should be understood as capital in banks.

2.1 UNDERSTANDING CAPITAL

Capital is the risk-bearing funding of banks that is intended to absorb losses. It thus consists of equity, and not of debt, given the fixed payments associated with debt and the requirement to repay it or face bankruptcy. Parties within the banking sector often get confused by this fundamental logic. The confusion is even embedded in regulations, particularly those regarding minimum capital, as designed by the BIS in Basel. Complex definitions of Core Tier 1 capital, Tier 1 capital and Tier 2 capital made it possible to circumvent minimum-capital requirements by allowing the inclusion of funding sources that essentially amount to debt as part of the capital. This is strange, given that capital is intended to absorb losses, as is the case with equity in regular enterprises. Debt cannot do this. Another feature of capital is its permanent availability; it cannot simply disappear. With the exception of perpetuals (which have no end date), debt must be refinanced at some point. If investors do not wish to refinance, insurmountable problems can occur at that point. Debt, as a form of funding, may therefore not always be available when it is needed. This also helps to explain discussions concerning the need to improve the 'quality of capital', which can seem somewhat odd to outsiders. Paradoxically, 'capital' in banks was not what it was promised to be. The new capital guidelines that have been enacted recently (i.e. those included in the document known as Basel III) provide for this and seek to strictly limit capital to common equity.

Left versus right on the balance sheet

One statement that is frequently heard in discussions, as in the recent House hearings on the future of banks in the Netherlands, is that higher capital requirements 'would obviously mean more dead money and fewer loans for SMEs'. This suggests that capital remains unused 'on the shelf'. However, capital is not dead money. Capital is neither an asset nor an exposure of a bank, as is the case with SME loans that banks extend, or with 'dead money' that they keep on reserve and do not lend. Capital is a way in which the bank finances itself. It is thus a source of funding for the bank. Although the confusing term 'capital' calls to mind a kind of asset, capital does not consist of assets. It is a funding method of the bank, and it appears squarely on the right-hand side of the balance sheet. Left and right on the balance sheet are thus confused with each other, with the exposures (e.g. SME loans) appearing on the left hand side and their funding on the right hand side.

2.2 WHY CAPITAL SEEMS EXPENSIVE

Capital is often seen as a more expensive way of funding, leading to the conclusion that there should be as little of it as possible. Capital (equity), however has other benefits, with shareholders assuming a portion of the risk associated with the bank's exposures. Creditors and depositors must be paid even in unfavorable times, while shareholders do not. On the other hand, they receive more in favorable times. This is how risk sharing works. In addition to funding, shareholders actually provide at least a partial insurance product. Although this is obviously accompanied by a cost, it is compensated by the insurance against bankruptcy it provides. If this insurance product is weighed against market prices, capital is no longer expensive. Indeed, if we were to live in a frictionless world, it would make no difference in terms of funding costs whether exposures were financed with debt or with equity. This insight forms the foundation for Modigliani-Miller's famous proposition, which holds that the capital structure and funding costs are independent of each other. In practice, not all of the conditions of this proposition are met. Inasmuch as it consists of deposits in current accounts, the debt of banks serves a liquidity function, for example. However, the basic principle remains the same. In practice, better capitalized banks have even been shown to have a competitive advantage. More capital is therefore a blessing.

More capital is lower costs

A further misconception is that attracting additional equity leads to higher costs. This is a fundamental misunderstanding as well: banks incur risk through their exposures on the balance sheet. This does not change with the amount of equity. If there is more equity, the same risk is distributed over a broader base, thus reducing the risk per unit, such that the cost of equity goes down, and not up. Mismatch risk on the balance sheet is also easier to absorb when the capital base is larger, and more capital makes capital less risky per unit. Debt also becomes less expensive when there is more equity; the bank's distance to default increases, leading debt holders to decrease the risk surcharges to be paid by the bank. Access to long-term debt thus becomes easier (and less expensive). This increases the effectiveness of bail-in mechanisms. A bail-in mechanism is intended for investors from the financial market, including providers of long-term debt. In contrast to savers, these investors make risk-return considerations. The price of the long-term debt will be acceptable: the greater equity minimizes the likelihood of bail-in, thus also minimizing its price-increasing effect. Bail-in becomes easier, but less necessary. This also provides greater protection for savings and deposits. In this way, banks can use additional equity to set a virtuous circle in motion.

2.3 RISK-WEIGHTED CAPITAL VERSUS LEVERAGE RATIO

The Basel II standards that were introduced in 2008 consider only risk-weighted assets (exposures). Abbreviated to RWA, risk-weighted assets are calculated through a series of complex models, specifying a measure of assets that discount assets with little risk. It

sets a specified minimum percentage of these RWA that must be financed with equity rather than with debt. The underlying idea appears to be essentially defensible for exposures that are not accompanied by risk, and thus do not require the absorption of any losses (and hence require no equity). In practice, however, it has the wrong effects. The calculation of RWA has proven an impossible task; even worse, it is vulnerable to manipulation. In a recent study, the BIS asked a large group of banks to calculate the RWA for identical portfolios of exposures. The differences between the various models used by the various banks were dramatic, amounting to a factor of 8, according to the *Financial Times*.

ABN AMRO has recently reported that it already meets the new capital requirements of Basel III, not through profit withholdings or additional capital from its shareholders, but by using a more optimistic model in the classification of its loans to companies. Additional problems have resulted from the political undesirability of classifying government bonds as risky, even if this is obviously the case, as with Greece.

Throughout Europe, regulators and politicians are placing excessive emphasis on RWA, with an exclusive focus on the proportionate relationship between equity and RWA. The result is that banks, instead of obtaining more capital on the market, are working on the denominator rather than the numerator of the capital ratio, increasingly fleeing from SME loans and investing more in government bonds. The result is that business loans are decreasing throughout Europe, while the toxic interconnectedness of banks and governments is increasing. This is improving the capital ratios, but in the wrong way.

In the United States, it has been demonstrated that another way is possible. In 2009, the largest American banks were told flatly that they would have to obtain \$179 billion on the capital market. This involved a fixed amount in dollars, thus eliminating the possibility of manipulating the denominator. It took place amidst the crisis, thus eliminating any possibility of using a flight from business lending as an escape route. And indeed, this did not happen there. Since the introduction of this Supervisory Capital Assessment Program by then Treasury Secretary Lawrence Summers, bank loans to the commercial sector have increased again, in contrast to the situation in Europe.

Simple capital ratio needed

The RWA approach is clearly problematic. The model-based approach has deficiencies. Under Basel III, the RWA approach has therefore been supplemented by a simple capital ratio based on the balance sheet (also known as the 'leverage ratio'). The leverage ratio is the capital scaled by the entire left side of the balance sheet, including all exposures, regardless of their risk. The imposition of stricter requirements on the leverage ratio thus does not lead to the avoidance of financing for SMEs in favor of financing governments. A pure leverage ratio obviously has disadvantages as well, given that it makes no distinction between extremely risky assets and less adventurous investments, even though the risk profiles of these two categories are quite different. For this reason, the Basel III plan to use them both for the time being is a good idea.

Once the leverage ratio has experienced a fundamental increase, the disadvantages will decrease accordingly. Risks will then be internalized, and there will be less

opportunity for manipulation. In this regard, it would be desirable to identify a solution for the temporary ‘parking’ of deposits. Parties in the market often make deposits in order to store them briefly without risk. These deposits are not investments, and are not intended to be used as a source of funding for the bank. The problem is that a sudden deposit (e.g. €100 million) would mean that the bank would then have a corresponding amount (i.e. €100 million) of debt, as a result of which the capital ratio would worsen: the proportion of equity to debt would then be less favorable. A ‘storage facility’ from the ECB could offer a solution. Such a storage facility could resolve this problem for banks in the same way that trust accounts are isolated from the ups and downs of a civil-law notary.

Another disadvantage of the RWA approach involves the sensitivity of the RWA to business cycles. In boom periods, risks seem smaller, and the RWA declines for a stated balance-sheet total. The capital requirements of banks thus become less binding and hence their lending capacity increases precisely when the economy is booming, with the reverse occurring during a dip in the business cycle. This problem is less prominent with a leverage ratio. The newest variant of the BIS regulatory framework (Basel III) also includes an anti-cyclic buffer, which must be supplemented in good times and which may be emptied in bad times.

2.4 ENFORCEMENT NEEDED

One key insight from modern finance theory is that a surplus of debt – debt overhang – poses an additional obstacle to raising equity. Although this seems paradoxical, it is easy to understand. Attracting new capital (e.g. by issuing new shares) is advantageous to the providers of debt (or the government, if it issues a guarantee, as is the case in the banking sector), as it improves their position. A larger amount of debt (leverage) makes their position risky, while a larger amount of equity (and thus less leverage) strengthens their position. This windfall gain is paid for by someone else – i.e. the existing shareholders – and the share price declines after such an allocation.

This is the greatest gap in knowledge for politicians, banks and the public. A lower share price is not detrimental to the solidity of a bank or to society. New shares reinforce a bank’s buffer capital and protect taxpayers. This explains why the share price decreases with the expansion of share capital. The bank now has an artificial subsidy from the government, given that it provides assistance if the bank should encounter problems. New share capital reduces the value of these subsidies. The bank is less likely to need an injection, because the greater amount of share capital is able to absorb more losses before the government needs to intervene. The lower share price can thus be explained by the risk falling to the shareholders rather than to the providers of debt or to the government. This is also good news for shareholders. Once there is sufficient equity, it becomes predictable in terms of risk, thus making lower returns acceptable.

Dilemma for the government

Another problem is that the government has its own interest in this struggle. The Ministry of Finance is pleased with the annual dividend that it receives from ‘its’ bank

ABN AMRO. This dividend, however, serves to erode the bank's equity. Yet the ministry's dilemma is even more serious: it would like to achieve the greatest possible revenue in the upcoming public offering of ABN AMRO.

The quest to achieve high proceeds, however, is contrary to the interests of Dutch society. The interest of society would be for ABN AMRO to be forced to achieve the fundamental reinforcement of its equity, as other banks must do. Only then can a bank fulfill its social role, freeing taxpayers from instability. An increase in bank equity is indeed possible. The bank could issue new shares during the public offering, using the proceeds to reinforce its own balance sheet. This is different from selling the ownership of the government's existing shares, which would amount to no more than shuffling, with the government disappearing from the stage. However, the Ministry of Finance is hesitant in this regard.

2.5 MISUNDERSTANDING THE AVAILABILITY OF CAPITAL

Another misunderstanding is that there is no longer any capital to be had. We have already refuted this misunderstanding for ABN AMRO: if this bank is able to enter the market for an IPO, it should also be able to issue new shares. ING could do this as well, as it is listed. SNS Bank also has no problem: that bank should be sold, with the requirement that its capital must be strengthened. To be sure, as with ABN AMRO, this will suppress the sales price, but it is in society's interest to have a greater distance to default for the taxpayer. The implicit subsidy should be eliminated, and it should therefore also be removed from the sales price.

This leaves Rabobank. As a mutual, it cannot simply enter the market, and sale is not an option. Rabobank can nevertheless issue certificates resembling shares. Even though these are not shares, they do yield price gains when things are going well, and they can absorb losses when problems occur. This is similar to the member certificates that Rabobank will now be trading on the exchange. An important innovation is still possible, however. Although the current certificates are permanent, the payments to investors take place by means of interest (often high) to be paid, as is the case with debt. The latter implies that Rabobank is required to pay out a great deal of money. An innovation is possible by means of which these certificates could profit from intrinsic capital gains, which would allow a reduction in the interest to be paid. This would make it much easier for Rabobank to reinforce its capital through retaining internal profits.

2.6 FINAL CONSIDERATIONS

Politicians should understand that only with sufficient capital, banks can fulfill their critical role in society without banks shifting risks to the state. If insufficient equity is available, the government will encounter major risks, and the attempt to keep banking under control through a myriad of rules should not be surprising. The motto should therefore be: 'more equity'. This would make it possible to reduce regulatory pressure and stifling rules. If the distance to default is increased, the government does not need to be as

closely involved. If they have more equity, banks will be less likely to seek undue risks and be better able to absorb losses when they would nevertheless occur, thus lessening the risk to society while allowing ordinary business owners easier access to the banks than is currently the case. Politicians should therefore demand more equity in banks, thereby setting a virtuous circle in motion towards economic recovery and a more stable society.