Does MM Apply to Banks?

Healthy industrial corporations typically operate with debt ratios of around 35%. Most financial managers would not be too concerned if that ratio was a few percentage points higher or lower, and would probably find it difficult to put a precise figure on the optimal debt ratio. As we pointed out in Chapter 1, shareholder value is largely created by the company's choice of real assets, not by its financial structure.

This is not so for bankers. Banks operate with very high debt ratios. For example, just before the financial crisis many major banks, such as Barclays, UBS, and Deutsche Bank had book debt to asset ratios of about 97 to 98%. So it needed only a 2-3% fall in the value of their assets to wipe out the total value of the equity. With this sort of leverage, it is not surprising that banks often get into difficulties. This does not mean that banks could, or should, operate with the levels of debt that are typical in industrial companies, for a central part of their business is the issue of debt in the form of customer deposits. However, banks could issue substantially more equity than they do without needing to reduce their deposits or increase their assets.

Bank regulators meeting in Basel have established limits on the amount of leverage that banks should be allowed to have. Following the crisis these limits were revised downwards in the Basel III Accord. Several countries have imposed even lower limits on the amount of leverage that their banks can undertake.

These moves to make banks issue more equity capital have been vigorously opposed by bankers, who have argued that higher capital ratios would add considerably to their costs. One complaint is that a reduction in leverage would reduce their return on equity. This may be true, but it is beside the point. Increased capital would lower the expected return on equity, but MM would note that it would also reduce the risk of the equity and the return that shareholders require. In a perfect world these two effects would cancel out, so that lower leverage would not increase the cost of capital for banks and would not make shareholders any worse off.

Does bankers' opposition to higher capital requirements simply reflect a failure to understand MM's arguments or are there other more valid reasons for their views? One possibility is tax.

As we point out in Section 17-4, debt interest carries with it a tax shield which may be important to a financial institution that operates on relatively fine margins. But that raises a further question: Does it make sense for the government to offer a subsidy that encourages banks to borrow if the effect of that borrowing is to cause periodic banking crises?[1] Would it be better for the government to offer the same tax advantage to banks if they issue extra equity?

[1] For a discussion of these issues by four proponents of higher bank capital requirements, see A.R. Admati, P.M. DeMarzo, M.F. Hellwig, and P. Pfleiderer, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive," August 2010, *Rock Center for Corporate Governance at Stanford University Working Paper No. 86, Stanford Graduate School of Business Research Paper No. 2065.*