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Democracy Dies in Darkness

Opinion Ignore the bank lobby, regulators. It's high time for banking reform.

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Banks are at it again.

Less than a year ago, runs on regional banks led to the second-, third- and fourth-largest bank failures in U.S. history — First Republic, Silicon Valley Bank and Signature Bank. Yet the powerful banking lobby is once again aggressively resisting reforms that would make the financial system both safer and more efficient.

This time, U.S. authorities must resist and enact their modest proposals for reform without compromise.

The primary debate is over regulators' call to raise capital requirements — that is, increase the fraction of banks' funding that comes from shareholders (equity) rather than from depositors or bondholders (borrowing). Bank advocates argue that this equity is somehow idle, so any increase in required capital wastes resources and depresses lending, reducing the ability of households and businesses to finance essential activities.

This is wrong.

The truth is that capital is *never* a wasted resource. It is a source of funds that the bank uses to provide loans. A well-capitalized bank has more resources to supply credit, not fewer.

Banks (accurately) view equity capital as a costly source of funding, as the owners providing it demand a higher return than the interest rate the banks pay depositors. They would prefer to fund far less of their activity with equity (or retained earnings) and borrow more through deposits or issuing bonds. That is, the banks seek more leverage.

But the banks' preference for financing themselves largely reflects distortions created by public policy. First, though interest payments lower a bank's taxes, payments (dividends) to investors who provide equity do not. Second, the shareholders of a bank with little equity enjoy an enormous upside when the bank turns a profit, while the creditors (ultimately including taxpayers) bear the risk of bankruptcy when there are losses. Third, for large banks that are perceived as too big to fail, the cost of borrowing is further reduced by the presence of implicit government guarantees. As a result of these distortions, the shareholders and bank managers strongly prefer to borrow.

From the public's perspective, none of these distortions is relevant. Hence, the *social* costs of more bank capital are far lower than the *private* costs. In fact, by countering the factors that distort banks' preferences, more capital funding can even *reduce* social costs.

How do higher bank capital requirements make the financial system safer? By creating a buffer against bank insolvency when adverse events lower the value of bank assets. A hefty capital buffer reduces the incentive for uninsured depositors to run — as they did when rising interest rates depressed the value of the assets of First Republic, Silicon Valley Bank and Signature Bank.

Higher bank capital requirements also make the financial system more efficient. Since banks have more "skin in the game," they have greater incentive to scrutinize the use of funds. As a result, they are less likely to lend to unprofitable and highly indebted — sometimes called zombie — firms that can survive only if someone is willing to provide them even more credit.

Granted, a few details of the current proposal, known as the Basel III Endgame, might merit review. For example, the computation of operational risk capital — the owner's net worth that provides a buffer in the event of errors, theft, technology failures and the like — should reflect the lack of correlation among the risks. But these issues are minor compared with the broad thrust of the reform.

Importantly, the regulators' proposal to raise capital requirements directly affects fewer than 40 of the more than 4,500 U.S. banks. Though these targeted banks account for a large share of activity, the reform limits costs and complexity for the rest.

That said, the proposal does extend higher requirements to the large regional banks, such as those that failed so recklessly last year. This is critical: A lasting lesson of the 2023 episode is that banks that will receive generous regulatory treatment in a crisis need a higher level of *self-insurance*. Banks that know the authorities will bail them out have greater incentive to take risks today, making a future crisis more likely. The solution is to compel any bank whose failure puts the financial system at risk to directly bear the broad risks it poses.

Experience with raising U.S. capital requirements is quite favorable. In the years following the financial crisis of 2007-2009, policymakers raised capital requirements significantly. What ensued was the longest business-cycle expansion in U.S. history, supported by increased bank lending. While critics argue that domestic rules will be stricter than those overseas, U.S. banks continue to outperform their international peers. Put simply, being well-capitalized offers an enduring competitive advantage, because depositors, investors and borrowers prefer sound banks.

One frequent objection to higher bank capital requirements is that some risky lending and trading activities will migrate to nonbanks — such as brokers, mutual funds and insurers — without making the financial system safer. However, not all these activities are best funded by bank deposits that are subject to runs and panics, so some of these shifts do make the overall system safer. Moreover, U.S. regulators should aim to treat risks taken by banks and nonbanks in the same way. For example, they can impose minimum down-payment requirements on government-insured mortgages regardless of the lender. Allowing banks to act unsafely is surely *not* the way to address the possibility of risks migrating elsewhere.

U.S. banking regulators — and their congressional overseers — should resist the bank lobby's appeals. Ensuring a stable, efficient financial system starts with safe and sound banks — and that means high levels of capital funding.