The other King's Speech – l-l-l-l-less leverage

Governor Mervyn King says banks should be forced to hold significantly more capital. Banks complain the costs are prohibitive and destabilising. Prof PHILIP MOLYNEUX predicts 'a game of brinkmanship' with the regulators.

Bank of England Governor Mervyn King, used October's Bagehot Lecture in New York to outline his vision for UK bank regulation. He put substantial emphasis on the increased risk-taking features of banking, inadequate capital and liquidity to back these risks and concerns over the greater recent incidence of banking crises.

A key feature related to excessive leverage in the banking sector and ways to alleviate this problem. While banking is a naturally leveraged business, there is much discussion about the optimal level of capital that a financial firm should hold.

The Governor's view (and that of colleagues such as David Miles and Anat Admati) is that banks should be forced to hold significantly more capital. The argument is that much greater solvency

is needed to shore up banks and minimise the likelihood of failure and crises.

In addition, John Vickers, Chair of the Independent Banking Commission, has been talking-up Glass-Steagall type bank break-ups, splitting the retail and investment arms of UK banks and also boosting their capital at the same time.

All this seems laudable: it aims to strengthen the UK banking system where, as King noted, the assets of the top 10 institutions amount to 450 per cent of GDP and the new Basel 3 international capital regulation guidelines will not come fully into force until 2019, far too late to be of use – many think!

So banks need more capital and there are two schools of thought on the impact of major capital raising by them. The first, following the well-known Nobel prize-winning Modigliani-Miller theorem, is that, under certain assumptions, the combination of equity to debt in firm financing has no influence on the cost of financing.

Intuitively this seems strange. We all know that equity capital costs more than debt because it is riskier. However, if a bank increases its equity relative to its debt, this reduces the riskiness of equity as operational and other risks are spread more evenly throughout the bank. A decline in leverage should also reduce the riskiness of debt as there is a larger cushion of equity to cover debt-holders.

Taking these factors together, Mervyn King and other advocates of capital raising argue that forcing UK banks to raise massive amounts of new capital should not adversely impact their cost of capital and financing in general.

Theory, of course, may be wrong. Regulations, such as Basel 2 and Basel 3, distort the relationship between capital and its costs, and make both debt and equity less risky than in a free market. Investors may just not believe greater equity capital makes the system less risky. Finally, competition may be limited so there may be little link between bank returns and the cost of capital.

Typically bankers and analysts would take the latter view – that there's no unlimited demand for bank capital. A UBS Investment Report last November playfully simulated the amount of capital UK banks would have to raise if they were to reach a Bank of England 'preferred' leverage ratio of 6 – Barclays would have to raise an additional £204bn, RBS £171bn and HSBC £164bn.

These are staggering amounts that, in practice, could never be soaked up by the markets. Also, a standard hedge fund strategy has been to short any bank rights issue to gain from significant price falls around the issue date. Any major capital issuing planned by UK banks would be targeted by the global shorting industry! However, the UBS examples may be rather extreme and much more modest capital injections would be a possibility (although still subject to speculation, of course).

> **"THEORY MAY BE WRONG**. INVESTORS MAY JUST NOT BELIEVE THAT GREATER EQUITY CAPITAL MAKES THE SYSTEM LESS RISKY."

All in all it looks like a game of brinkmanship will continue between banks and regulators. The latter will push for more capital for safety purposes and the former will say that costs are prohibitive and destabilising. Possibly some compromise can be arrived at before September 2011 when the Independent Banking Commission plans to report.

If not, a radical restructuring may be advocated with forced major reductions in leverage on the retail side complemented with high (extortionate) capital cost investment banking on the other. We won't have long to wait to see what happens!

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