Increased Capital and Financial Stability

Some Doubts

Lawrence H. Summers

May 2017

*Related to Sarin, Natasha, and Lawrence H. Summers. BPEA 2017.

"Understanding Bank Risk through Market Measures."

Regulatory community asserts system is safer today

- "The capital requirements of our largest banks are now ten times higher than before the crisis...This substantial capital and huge liquidity gives banks the flexibility they need to continue to lend to UK businesses and households, even during challenging times."
  - Mark Carney, 2016
- "We have put into place numerous steps...that will strengthen these institutions, force them to hold a great deal of additional capital, and reduce their odds of failure. There will be much lower odds that a so-called systemic firm will fail..."
  - Janet Yellen, 2014

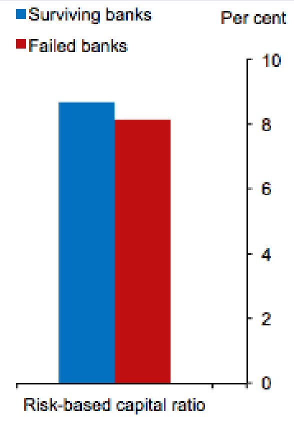
How predictive is measured capital?

Capital ratio has little predictive power for distress

- "Whether used singly or along with credit, higher capital ratios are associated, if anything, with a higher probability of a crisis....In fact, as we know from recent experience, banking systems may appear to be well capitalised on the eve of crises."
  Jorda et al. (2017)

- No statistically significant difference between levels of regulatory capital of banks that failed and those that survived [during the Recession].
  Haldane and Madouros (2012)

Global Banks' Capital Ratios, end-2006



Haldane and Madouros (2012)

Reduced leverage does not show up in market volatility measures

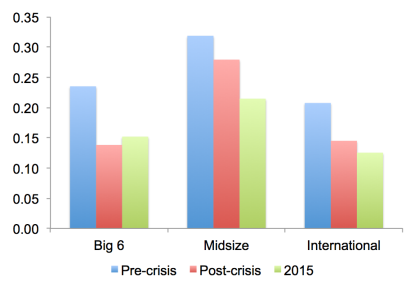
Data for Big 6 US Financial Institutions

Measure	Pre–crisis average	Post–crisis average	2015 average
Volatility	24.70	33.47	20.67
Implied volatility	22.90	30.77	22.96
Option delta	0.036	0.074	0.046
Beta	1.18	1.61	1.23
CDS spread	31.85	140.63	93.58
PE/market PE	0.67	1.22	0.68
Preferred stock price	24.97	20.25	20.74

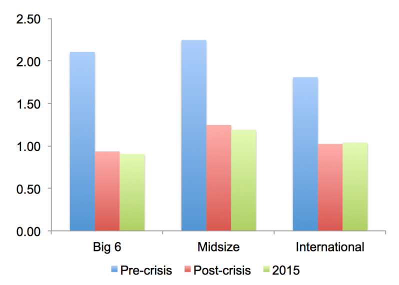
Big 6 firms are Bank of America, Citigroup, Goldman Sachs, JP Morgan, Morgan Stanley, Wells Fargo

Market measures of equity capital suggest limited improvement

Average MVE/Risk-Adjusted Assets



Average Price/Book



Possible explanations

- Market error: Markets underestimated risk pre-crisis and have adjusted their views.
- Bank capital mismeasurement: Regulatory capital measures may be flawed, and may have become even more flawed over time.
- Declining franchise value: Even though banks less levered than previously, declines in market valuation of banks have been so large that measured on a market basis they have less equity relative to assets than they did previously.
  - We find this hypothesis most plausible and important for explaining our findings.

What does this imply for policy?

- Must take dynamic view of capital
- Destruction of franchise value is destruction of capital
- Need prompt capital raising when things turn down (crucial 2008 failure)
- Beware of insolvency without illiquidity