

# The Parade of the Bankers' New Clothes Continues: 44 Flawed Claims Debunked

Finance Working Paper N° 951/2024

February 2024

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## Abstract

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This version February 5, 2024

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# **The Parade of the Bankers' New Clothes Continues: 44 Flawed Claims Debunked\***

Anat Admati and Martin Hellwig

January 4, 2024

## **Introduction**

Since the early 1990s, the development of bank regulation has been dominated by flawed and misleading claims. Flawed and misleading claims provided the basis for the poor design of bank regulation that contributed greatly to the financial crisis of 2007-2009, the buildup of risks before the crisis and the contagion processes in the crisis. Flawed and misleading claims also caused post-crisis regulatory reform to be very timid so that financial institutions and the overall financial system remain unconscionably fragile.<sup>1</sup> The fragility was in evidence in the spring of 2023, when several US banks and Swiss megabank Credit Suisse collapsed. Whereas the Federal Reserve has remained sanguine about the situation, the US Office of Financial Research (OFR) has warned that “banking conditions remain fragile and uncertain.”<sup>2</sup>

In our book *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It*, first published in 2013, we discussed and debunked many of the flawed claims. We refer to these claims as the Bankers' New Clothes and show that they have as much substance as *The Emperor's New Clothes* in Hans-Christian Andersen's tale. However, the debunking has not deterred the bankers, lobbyists, policymakers, academics, and others from continuing to make these flawed claims, as well as some new ones. Such claims still dominate policy discussion, including the ongoing debate about the so-called Basel Endgame, an effort to eliminate some of the worst abuses of existing regulation. Many of the people making these claims do not care whether they are true but employ them strategically in order to gain the allegiance of certain target audiences and to win the legislative debate about bank regulation.

We discuss these developments in detail in a new edition of our book (Admati and Hellwig, 2024). This new edition retains the earlier text and adds a discussion of events between 2013 and May 2023. It also explains in some detail the role of central banks in supporting fragile financial

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\*This document is a new revision of a document that was first posted in 2013 and has been revised and expanded several times since. This version adds more claims and discussion and organizes the list according to the specific nature of flaws the claims involve. We are grateful to Peter Conti-Brown and Kim Schoenholtz for comments on earlier versions, and especially to Paul Pfleiderer for useful conversations and comments on earlier versions as well as this document.

<sup>1</sup> Admati et al. (2013), first published in 2010, had classified many of the claims we take on as “fallacies, irrelevant facts, and myths.”

<sup>2</sup> The report was posted on December 2023. It mentions that rating agencies have downgraded several banks and warns of potential problems to the system. It also identifies banks that are highly distressed and likely insolvent because of recent losses and low levels of equity. See <https://www.financialresearch.gov/briefs/files/OFRBrief-23-04-two-new-metrics-bank-securities-portfolio-risk.pdf>

institutions, the persistence of bailouts, and the failure of the vaunted post-crisis mechanisms for dealing with insolvent banks. In addition, we discuss the position of financial institutions in our political and legal systems and argue that the outsized influence of banks and their leaders undermines democracy and the rule of law.

Shortly after the first edition of our book came out in 2013, we prepared a document listing 23 flawed claims with brief rebuttals and references to more detailed arguments in our book and elsewhere. Over the years, we updated the document several times as new claims were added to the list. This document presents another update, now with 44 flawed claims.<sup>3</sup>

Some of the flawed claims involve confusion about basic terminology and ignorance about basic mechanisms of corporate funding. Others involve special pleading, with exaggerated accounts of why banks are different from all other corporations and why certain traditions in banking cannot be abandoned. Many flawed claims involve a confusion between private costs to bankers and social costs to all of us. Deliberate neglect of damage and risks for others, including taxpayers, is pervasive.

Like our book, the document reflects our view that the enormous reliance of banks on funding by debt is a result of distorted incentives and badly designed rules. Excessive debt funding of banks imposes undue risks on the rest of us. It also distorts the banks' decisions on lending and other investments, as well as their ability to provide consistent liquidity without supports from governments or central banks. The funding decisions we criticize are not mandated by the necessities of the business of banking, and the decisions should be restrained by properly designed and enforced rules so that the harm they cause to society is minimized.

The persistence of flawed and misleading claims in the debate and the persistence of flawed rules reflect the politics of banking. Politicians have incentives to give banks and bankers special treatment because banks are a source of funding and are also viewed as such by voters. Threats that regulation may prevent banks from providing voters with whatever goodies they are hoping for are very effective. By contrast, risks of harm to society from flawed bank strategies receive less attention in public debate, despite the experience of the financial crisis of 2007-2009. In public debate, the lobby is joined by many enablers, while others have few incentives to challenge the flawed claims.<sup>4</sup>

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<sup>3</sup> The new edition of our book refers to Admati and Hellwig (2023) with 38 flawed claims. The current document, completed in January 2024, discusses 44 flawed claims.

<sup>4</sup> Economist John Cochrane acknowledged this issue in the context of the debate on capital regulation in his blog by saying: "The rest of us read the gobbledygook in the newspapers, chuckle at the faculty lunch – "Ha ha, xyz is CEO of a huge bank and has never heard of Modigliani-Miller! Ha Ha -- pdq is a senior regulator and doesn't know the difference between capital and reserves!" -- and then we go about our business." See "The banker's new clothes -- review," John Cochrane, *The Grumpy Economist*, March 1, 2013 <https://johnhcochrane.blogspot.com/2013/03/the-bankers-new-clothes-review.html> See also our discussion of Claim 44.

The policy debate since 2010 has led us to be deeply concerned about the ability of our democracies to deal with powerful corporations and their ability to corrupt public debate with claims that they maintain even after they have been shown to be false, confident that many in the audience will not be able to tell the difference and that those who are able to tell it will not bother to object.<sup>5</sup> Public debate should be based on the principle that it matters whether something is true or not. If something is shown not to be true, the responsible parties should stop spreading the falsehood and, if they refuse, they should suffer damage to their public reputation.

To ensure that it matters in public debate whether something is true or not, enough people must overcome the temptation described by Margaret Heffernan when she wrote: “We turn a blind eye in order to feel safe, to avoid conflict, to reduce anxiety, and to protect prestige.”<sup>6</sup> With this document, as with our book, we hope to contribute to overcoming willful blindness in the debate about bank regulation.

This document is organized as follows. We first provide a full list of the flawed claims, divided into seven groups by type and topic. For each group of claims, we provide a brief introduction before going through the claims one by one, explaining what is wrong with them. Throughout the document, chapter references refer to the new edition of our book, Admati and Hellwig (2024). In this new edition, Chapters 1-13 are unchanged from the original edition. Chapters 14-17 are new.<sup>7</sup>

## Flawed Claims Debunked

### Basics about Bank Capital and Bank Funding

Flawed claims 1-6 reflect basic confusions and fallacies about the literal meaning of words, the economics of corporate funding, and the rationale for regulating the mix of debt and equity in bank funding.

**Flawed Claim 1:** Bank capital is something that banks *hold*.

**What’s wrong with this claim?** The word “hold” suggests that bank capital is an asset. As discussed in Chapters 1 and 6, however, bank capital is a source of funding, provided in return for ownership titles or shares. For other corporations this source of funding is called equity. Debt is another source of funding, provided in exchange for promises of payments for interest and

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<sup>5</sup> Proctor and Schiebinger, eds (2008) refer to “the making of ignorance” as. “agnotology” and it can be seen in other areas, such as denials of the harm from tobacco and of climate change. See our discussion in Chapter 17 of Admati and Hellwig (2024).

<sup>6</sup> See Heffernan (2012). Admati (2017) and Chapter 17 of Admati and Hellwig (2024) discuss the motivation of many participants, including academics, who produce flawed narratives or serve as enablers.

<sup>7</sup> The Table of Contents, preface, Chapter 1 and index are available by clicking “look inside” <https://press.princeton.edu/books/paperback/9780691251707/the-bankers-new-clothes>

repayment of principal.<sup>8</sup> Banks use the funds they obtain by issuing equity and debt to acquire assets, to hold cash, to buy securities and to make loans.

The confusion between capital as an asset and capital as a source of funding is due to the fact that the word “capital” has multiple meanings in economics. When economists talk about producing goods with capital and labor, the word “capital” refers to machines and the like, which are indeed assets. However, when accountants or finance experts refer to borrowed capital (debt) versus own capital (equity), they refer to the *funding* that is used to invest and acquire assets. Funding is not something that anyone “holds,” especially not the corporation that obtains the funding. *Investors who provide the funding to a corporation hold shares and debt titles of the corporation* and expect to receive dividends or interest from the corporation. The corporation makes these payments out of the returns it earns on the assets it has purchased with the funding it obtained. In the case of banks, these investors include depositors, who are creditors of the banks.

What banks *do hold* are *reserves* of central bank money, i.e., cash and deposits in the central bank. Those funds are actually set aside and not used to make loans that may benefit the real economy. Banks may in fact find it more beneficial to hold deposits in the central bank, especially if the central bank pay generous interest on those deposits (just as individuals like interest-bearing deposits in their banks). According to the Wall Street Journal, in late 2023 and early 2024, the Federal Reserve paid even higher interest on the deposits of commercial banks than it charged on the loans it offered banks under the emergency Bank Term Funding Program (BTFP) created in the aftermath of Silicon Valley Bank collapse on March 12, 2023. Perversely, it thus provided a windfall opportunity for banks at the expense of taxpayers.<sup>9</sup>

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<sup>8</sup> Some kinds of debt have features that are characteristic of equity. For example, the obligation to make interest payments may be made to dependent on whether the bank earns positive returns. Or the nominal value of the debt, which forms the basis for determining the interest and principal that the debt must pay, may be written down in certain situations. Bank regulation treats some of these hybrid forms of funding as a kind of equity. This treatment reflects industry lobbying under the mantra “anything but equity.” We are skeptical of this treatment because, at least when they are issued, the hybrid forms of funding come with payment obligations that do not depend on the bank’s success in its markets and usually they share the feature of debt in having priority over equity. In the financial crisis of 2007-2009, holders of hybrid debt were not made to share in losses; governments bailed them out along with the holders of ordinary debt because they were afraid of making the crisis worse. We discuss the issues and the experience in Chapters 11, 14, and 16. More recently, the complete write-down of AT1-Securities, contingent-convertible debt, of Credit Suisse, even as shareholders received some money, took most people by surprise and led to strong negative reactions by investors and by bank supervisors outside of Switzerland. On investors’ reactions, see for example Swiss Federal Department of Finance, *The Need for Reform after the Demise of Credit Suisse: Report of the Expert Group on Banking Stability 2023*. On the reaction of regulators and supervisors outside of Switzerland, see for example the March 20 statement of EU authorities, *SRB, EBA and ECB Banking Supervision statement on the announcement on 19 March 2023 by Swiss authorities*, <https://www.srb.europa.eu/en/content/srb-eba-and-ecb-banking-supervision-statement-announcement-19-march-2023-swiss-authorities>

<sup>9</sup> See “The Fed Launched a Bank Rescue Program Last Year. Now, Banks Are Gaming It.” David Benoit and Eric Wallerstein, *Wall Street Journal*, January 10, 2024. At the time, the BTFP charged banks 4.89% for a loan (compared with 5.5% rate at the short-term discount window), and paying 5.4% interest on reserve, thus banks earned a 0.51% spread, entirely risk-free. See “The Fed Decision Markets Need to Pay More Attention to,” Karen Petrou, *Financial Times*, January 11, 2024. By early February 2024, possibly as a result of such publicity, the rates on BTFP were set

**Flawed Claim 2:** By forcing banks to “hold” more capital than they want and more than is good for the economy, capital requirements prevent banks from making worthwhile loans.<sup>10</sup>

**What’s wrong with this claim?** This claim involves the very confusion between capital as an asset and capital as a source of funding (equity) that we discussed in the context of Flawed Claim 1. The claim suggests *falsely* that bank capital is something like a cash reserve, which provides banks with a rainy-day fund that they can draw on when they need it, for example to meet withdrawals of deposits. In fact, bank capital is *not* a cash reserve, and capital requirements must not be confused with minimum reserve requirements. Capital requirements concern the mix of debt and equity that banks use for funding, minimum reserve requirements concern the amount of cash and of deposits that that banks must hold with their central bank.<sup>11</sup>

In a hearing of the US Senate Committee on Banking, Housing, and Urban Affairs on December 6, 2023, Ranking Member Tim Scott (R-S.C.) falsely “translated” the terminology around capital regulations “for the average American sitting at home” by stating that proposed rules about bank capital are about “simply requiring more capital on the sidelines, which then means fewer dollars to lend to small businesses, first-time homebuyers, car loans.” He continued to claim that “the actual impact of a higher regulatory standard is fewer dollars to lend to Americans who need desperately to be engaged in the process of achieving the American Dream that is typically defined by having access to capital.” In this “explanation,” the cash banks are required to put “on the sidelines” is preventing Americans from obtaining “capital” (i.e., funding) to fulfill the American Dream.<sup>12</sup> This view of equity requirements is nonsensical and false, and it

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equal to the interest on reserves, 5.4%. By contrast, since 2019, the European Central Bank’s deposit facility has paid interest at half a percentage point (50 basis point) below the main refinancing rate at which the ECB lends to commercial banks, currently 4% versus 4.5%. The ECB has never set the rate at which it lends to banks below the rate it pays on the banks’ deposits.

<sup>10</sup> This fallacy about the meaning of capital regulations or requirement, is pervasive and insidious. Tim Pawlenty, then president of the Financial Services Roundtable, was quoted in *Wall Street Journal* on July 20, 2015 (“Fed Lifts Capital Requirements for Banks,” by Ryan Tracy, Victoria McGrane and Justin Bear) claiming that “this rule will keep billions of dollars out of the economy.” In “How to Solve the Bank Capital Goldilocks Question,” *Fortune*, May 6, 2013, Cyrus Sanati falsely claims that capital requirements ask banks to “hold some cash on the sidelines.” The comparison of capital to “a rainy day fund” has also been used in Andrew Ross Sorkin, “Easing of Rules for Banks Acknowledges Reality” *New York Times*, January 7, 2013, and in Gretchen Morgenson, “Trying to Slam the Bailout Door,” *New York Times*, April 27, 2013. In early 2019, Gary Cohn, who was at the time White House National Economic Council Director said “Banks are forced to hoard money because they are forced to hoard capital, and they can’t take any risks.” (See “Dodd-Frank Do-Over a Win for Banks: Trump Advisor Gary Cohn, Henry Fernandez, Fox Business, March 30, 2017.”) By contrast, “A Simple Rule to Stop the Next Financial Crisis,” Pat Ragnier, CNN Money, September 15, 2014, and “Bank Rules Debate, Capital Matters – and Words Too,” Peter Coy, *Bloomberg BusinessWeek*, September 18, 2014 help clarify the terminology.

<sup>11</sup> The new Chapter 15 gives a detailed account of the role of the central bank, particularly in relation to commercial banks.

<sup>12</sup> Similarly, in the 2010 discussion about increased regulatory reform after the global financial crisis, the British Bankers’ Association proclaimed that proposed reforms would require British banks to have 700 billion pounds more capital and that meant 700 billion less in lending to private households and to firms. The claim would have been correct, if this had been 700 billion pounds set aside in accounts with the Bank of England. In fact, British banks could have responded to the reform by raising 700 billion pounds in additional equity and that could have meant 700 billion more in lending to private households and to firms.

does not become true because others also maintain it.<sup>13</sup> As Chair Sherrod Brown (D-OH) stated correctly, speaking to bank CEOs who testified in the same December 6, 2023 hearing: “Let’s be clear: Absolutely nothing in these rules would stop your banks from making loans to working families and small businesses. Absolutely nothing.”<sup>14</sup> Yet, a January 18, 2024 *New York Time* story about the Basel Endgame debate falsely “explained” that capital is “cash-like assets.”<sup>15</sup>

**Flawed Claim 3:** Requiring banks to “hold” capital equal to 15% or more of their assets would not make them much safer and therefore even such high capital requirement would not address the key problems in banking.<sup>16</sup>

**What’s wrong with this claim?** Funding by equity allows banks to absorb losses without defaulting on their creditors. The claim is false because additional equity allows a bank to absorb more losses without becoming distressed or insolvent and without needing support. Currently internationally agreed regulations allow banks to have equity funding amounting to only 3% of their total assets.<sup>17</sup> At that level of equity funding, a loss of more than 3% on its assets makes a bank insolvent. Silicon Valley Bank’s had unacknowledged losses amounted to more than 8% of their assets and more than their equity so the bank was in fact insolvent. Requiring equity funding of at least 15% of assets would make banks *significantly* safer.

Whereas banks typically fund much less than 10% of their investments by equity, it is rare for any healthy non-financial company to have less than 25% in equity, and many successful companies borrow little or nothing, although there is no regulation that prevents them from borrowing as much as they would like. Banks get away with much less equity funding because their creditors are less organized than the creditors of most non-financial companies. This failure in the governance of banks creates many distortions.<sup>18</sup>

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<sup>13</sup> See examples in footnote 10.

<sup>14</sup> See [https://www.banking.senate.gov/imo/media/doc/brown\\_statement\\_12-6-23.pdf](https://www.banking.senate.gov/imo/media/doc/brown_statement_12-6-23.pdf). The Bank Policy Institute (BPI), a lobbying organization, labeled Senator Brown’s statement a “false claim” (<https://bpi.com/bpinsights-december-23-2023/>). The BPI did not take a stand on Senator Scott’s nonsense but presented claims of its own, which echo Flawed Claims 13-21 below.

<sup>15</sup> See “Why Big Banks (and Some Odd Allies) Oppose a Plan to Protect Banks,” Emily Flitter, *New York Times*, January 18, 2024. The story referred to some of the comment letters from bank lobbies and from non-profit organizations favoring the rules, but did not link to Anat Admati’s comment, Admati (2024a), which included also Admati (2016) on the “missed opportunity” of Basel reforms and a version of the current document dated January 4, 2024. See <https://gsb-faculty.stanford.edu/anat-r-admati/files/2024/01/Admati-Comment-Basel-Endgame.pdf>

<sup>16</sup> Cyrus Sanati, cited in Footnote 10, criticized the higher capital requirements proposed in 2013 by Senators Sherrod Brown (D-OH) and David Vitter (R-LA) that would have required 15% equity for the largest banks and, falsely referred to the proposal as if it concerned cash reserves. About the Brown-Vitter proposal, which never was discussed in the Senate, see <https://www.brown.senate.gov/newsroom/press/release/brown-vitter-leverage-ratio-standards-represent-major-step-forward-but-congress-must-pass-legislation-ending-too-big-to-fail>

<sup>17</sup> This is the so-called leverage ratio under Basel III, an international accord that was concluded in 2010. The accord sets minimum requirements for bank regulation. US banks that are regulated by the FDIC have actually been subjected to a stricter requirement.

<sup>18</sup> See Chapter 6, Admati et al. (2013, Section 2), Admati (2014), Admati and Hellwig (2019).

The flawed claim may reflect the confusion between equity requirements and minimum reserve requirements discussed in the Context of Flawed Claims 1 and 2. Importantly, *a reserve of cash or deposits with the central bank does not contribute to the ability of a bank to absorb losses without defaulting on its debt*. For example, if a bank has \$97 billion in deposits and \$3 billion in equity funding, a cash reserve of \$15 billion will not help it to survive if it loses \$4 billion on its loans and other investments. After the loss, it has \$96 billion in assets, less than the \$97 billion it owes, and is insolvent, just as a homeowner is “under water” if the mortgage is larger than the value of the house.

If instead the bank had \$85 billion in deposits and \$15 billion in equity funding, it would easily withstand the \$4 billion loss and even a much larger loss without becoming distressed or insolvent. After a loss of \$4 billion, the bank’s equity would still amount to \$11 billion. Ordinarily, this amount should be sufficient to give depositors and other creditors the confidence that they need to continue lending to the bank or to provide further funding if some investors wish to liquidate their positions. For a bank with assets of \$96 billion and equity of \$11 billion, it may also not be difficult to raise additional funds by issuing equity for \$4 billion and using the proceeds to buy new assets.

**Flawed Claim 4:** Equity funding is expensive. Therefore, equity requirements must not force banks to have too much equity.<sup>19</sup>

**What’s wrong with this claim?** The claim rests on the observation that shareholders usually require higher rates of return than creditors. For existing shareholders, it therefore seems cheaper to raise additional funds by borrowing than by issuing new equity. However, as we explain in some detail in Chapter 7 and in the context of Flawed Claim 15 below, the returns that shareholders require depend on the funding mix, and required returns change when the funding mix changes. Shareholders require higher returns per dollar invested than creditors, at least on average, because the returns to shareholders are riskier. Whereas creditors only bear risks related to the bank’s failing, shareholders bear all the other risks to the corporation’s returns. With a greater share of equity funding, however, the risks to shareholders are more widely spread and therefore the risk per dollar invested in equity is lower. Therefore, the excess of expected returns per dollar invested over creditors’ returns that shareholders require is also lower.

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<sup>19</sup> This claim dominates the discussion about bank regulation. See Chapter 6, as well as Admati et al. (2013). Recent instances involve Schütz’s (2023) discussion of the demise of Credit Suisse and the US Bank Policy Institute’s labelling of reform proposals as “Basel’s Universal Tax on Every Bank Borrower and Intermediation Activity”, <https://bpi.com/about-excessive-calibration-of-capital-requirements-for-operational-risk/> The “explainer” of “How Capital Works” <https://stopbaselendgame.com/capital-101/> posted on the website of the same lobbying organization also uses this false logic.

*It is fallacious to talk about “costs of equity funding” in isolation. It only makes sense to talk about the overall funding cost for a given funding mix, taking account of the impact of the mix on the corporation’s returns and the risks borne by shareholders and creditors.*

More equity funding in the mix means that the bank is using more of the “more expensive” kind of funding, but the per unit “cost” in terms of required returns is lower because the per-dollar risk to shareholders is lower. The question is which of the two effects dominates and why. Under some circumstances, it so happens that the two effects just cancel each other out and the overall funding cost is independent of the funding mix.<sup>20</sup> These circumstances hardly ever occur in the real world, but the underlying analysis provides a basis for studying how changes in circumstances can make equity expensive for bankers. The analysis also shows that what is expensive for bankers can be costless for society. Unless one believes that only the bankers’ interests count, *the difference between private and social costs of different funding mixes calls for having regulation in the form of equity requirements, in order to prevent bankers from choosing funding strategies that impose undue harm on others.*<sup>21</sup>

A major reason why banks and other corporations consider equity to be expensive involves a bias in the tax system that favors debt funding over equity funding of corporations. We discuss this bias in Chapters 9 and 14. Corporate profits, which benefit shareholders, are subject to corporate income taxation while interest on debt is exempt. Because of this tax subsidy, the use of debt can lower the funding costs of a corporation. From the perspective of society however, this tax advantage is a private benefit to banks; it comes at the expense of others, taxpayers and citizens, who enjoy fewer public services or must pay more taxes, depending on whether the difference in government revenue causes public services to be lower or other taxes to be higher.<sup>22</sup>

Whereas the tax subsidy to debt is available to all corporations, another distortion concerns mainly banks. Banks’ depositors and possibly other creditors benefit from explicit and implicit guarantees that the government will reimburse them for the damage they might suffer if their banks fail. The guarantees make them willing to lend to banks at artificially low rates of interest, so borrowing costs do not reflect the default risks implied by the banks’ decisions, in funding as well as investments.

Finally, shareholders – and managers – are likely to prefer additional borrowing over a new equity issue because some of the benefits from new equity issue provide a windfall gain to creditors or taxpayers at the expense of shareholders. The funds raised by a new equity issue can be used to buy back debt or to buy additional assets. In either case, default and insolvency become less likely,

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<sup>20</sup> This is known as the Modigliani-Miller theorem. As we explain in discussing the following claim, the interest of the theorem is not so much in the conclusion of the theorem itself but in the development of a conceptual framework for analyzing real-world deviations from the conclusion.

<sup>21</sup> Chapters 7-9 and 14 provide detailed discussions of the arguments and their implications for bank regulation. See also Admati et al. (2013, 2018) and Admati and Hellwig (2019).

<sup>22</sup> This concern is neglected in many contributions claiming that equity funding of banks is expensive. For example, French et al. (2010), a policy document written by fifteen prominent academics, make this claim without considering the impact of tax subsidies and guarantees and the distinction between private and social costs.



which makes the (remaining) outstanding debt becomes safer. As default and insolvency become less likely, the right that shareholders have to stop paying creditors when the bank fails becomes less valuable. By contrast, new borrowing may make it more likely that the bank cannot meet its obligations so the shareholders' right to stop payments when the bank fails becomes more valuable. This benefit to shareholders from increasing indebtedness comes at the expense of existing creditors and possibly taxpayers.<sup>23</sup>

If managers' bonuses are tied to shareholders' returns or to the stock price, their assessments will take these effects of new funding decisions on shareholders into account so they will also be biased in favor of debt funding over equity funding. Some bonus schemes make managers even more eager to avoid new equity issues than the existing shareholders themselves.<sup>24</sup>

In addition to the private costs to shareholders and managers, any policy assessment of banks' funding decisions must also take account of the costs that the banks' decisions impose on others, particularly the banks' existing creditors and taxpayers. The fact that banks consider funding by equity to be expensive reflects the fact that they are not taking into account the effects of their decisions on others. If one considers the *social costs* of bank funding decisions that include the costs to others, rather than merely the private costs to banks and their managers and shareholders, the claim that equity is expensive is not true.

Further considerations would also take account of the damage from systemic effects of bank defaults and bank failures of the kind that we saw after the Lehman Brothers bankruptcy (discussed in Chapter 5 under the heading "banking dominos"). Once all effects are considered, the conclusion that equity is *not socially expensive* emerges more strongly. From the perspective of the overall economy, instead, having more equity in the funding mix of banks is actually *cheap* and excessive bank borrowing is expensive. Borrowing merely appears cheap to the banks because it enables them to impose risks and costs on others.

**Flawed Claim 5:** Theoretical arguments from corporate finance are irrelevant for assessing bank capital requirements because their assumptions are unrealistic.<sup>25</sup>

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<sup>23</sup> The discussion here concerns the so-called default option shareholders have because of limited liability. Whereas the effects of tax subsidies and guarantees had been known for a long time, Admati et al. (2018) explain that the effect of debt overhang on new funding decisions creates a ratchet mechanism that tend to make debt go up over time, not because this is efficient but because outstanding debt causes new funding decisions to be biased. In principle, this effect is relevant for all corporations, but, as we discuss in the context of Flawed Claim 7 below, as well as Admati and Hellwig (2019), it is particularly strong in banking because the bank's creditors are highly fragmented and unable to impose and enforce contracts that would prevent it.

<sup>24</sup> Chapter 8 shows that many bonus schemes make managers even more prone than shareholders to take risks at the expense of others; the arguments given there apply to risks from additional borrowing as well as risks from investments.

<sup>25</sup> For example, Barclays Credit Research, "The Costs of a Safer Financial System," March 25, 2013, The Clearing House, "Vanquishing TBTF," March 26, 2013, Oxford Economics (2013), Elliott (2013) and Cline (2017).

**What’s wrong with this claim?** The preceding discussion of the claim that bank equity is expensive rests entirely on two observations whose real-world relevance is beyond doubt: First, funding costs depend on the entire funding mix, and it makes no sense to talk about costs of equity in isolation. Second, banks’ assessments of their own private costs of different funding mixes are not a good guide for policy because these assessments neglect the costs banks impose on the rest of society.

The presumption that the funding mix does not matter for the cost of funding is empirically false, not only for banks but also for other corporations. However, the two observations that a corporation’s funding costs depend on the entire funding mix and that private cost assessments do not provide a good measure of social costs are universally valid, for banks as well as for other corporations. The arguments we gave show that, when considering the social costs of bank funding, bank decision making is biased in favor of debt and against equity. Once these biases are properly taken into account, one sees that there are large social benefits and virtually no social costs to banks having significantly more equity in the funding mix than they would like and that current rules allow them to get away with.<sup>26</sup>

**Flawed Claim 6:** Equity requirements must be calibrated to the risks that banks take, so that a bank with very risky activities must use more equity funding than a bank with safer activities.<sup>27</sup>

**What’s wrong with this claim?** The claim refers to the practice of determining a bank’s required equity in relation to its so-called risk-weighted assets, rather than its total assets. Whereas the claim suggests that risk-weighting should be used to raise equity if the bank takes large risks, this rarely happens.<sup>28</sup> Most of the time, risk-weighting is a device to *reduce* required equity. The people who put the claim forward really mean that a bank that *claims* to be pursuing a safe strategy should be allowed to get away with a lower requirement, sometimes almost no equity funding at all.

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<sup>26</sup> Whereas Chapter 7 discusses the corporate finance analysis summarized in the context of Flawed Claim 4, Chapter 9 discusses distortions from tax subsidies and guarantees, Chapter 8 discusses incentives to take excessive risks that are created by debt overhang and compensation structures in banking. Taking on additional debt even though indebtedness is already high is one form of excessive risk taking, a sort of “addiction” to borrowing. The resulting leverage ratchet effect is studied in detail in Admati et al. (2018). Chapter 10 and Admati and Hellwig (2019) show that the fact that banks provide liquidity services through some of their borrowing generally leads to excessive and inefficient, rather than appropriate levels of indebtedness and risk. We elaborate on the distortions associated with the tax subsidy of debt in Chapter 14 and discuss bailouts extensively in Chapter 15 and 16. See also Flawed Claims 34-38 below.

<sup>27</sup> The “risk-based approach” is baked into all discussions of capital regulations, see, for example, the latest proposal from the Federal Reserve <https://www.federalregister.gov/documents/2023/11/27/2023-23911/regulatory-capital-rules-risk-based-capital-requirements-for-depository-institution-holding>

<sup>28</sup> An exception that proves the rule involves the treatment of crypto assets, particularly cryptocurrencies like Bitcoin. Banks that invest in crypto currencies assets must fund these investments fully (100%) with equity, much more than the 8% required equity for standard loans; See BCBS (2022). We suspect that this rule was in part motivated by fears that growth of crypto currencies would undermine traditional banks and money altogether.

This situation is dangerous because it allows banks to take enormous gambles with hardly any equity to absorb losses. If the risk weight of an asset is zero, no equity funding is required at all. If it is close to zero, a small amount of equity can support a huge gamble. In the runup to the crisis of 2007-2009, many large banks had equity funding of 2% of assets or even less. For securities and other assets in the so-called trading book, equity funding was around 1%.<sup>29</sup> Assets were deemed to be almost riskless, but then, in the crisis, even AAA-rated securities lost enormously in value.

The claim pretends that risks can be defined and measured in some objective way. The industry also pretends that the banks' own risk modelers are experts for such measurements. Such pretenses are useful for lobbying but have little to do with the reality of risk measurement and risk management in banking. Allowing required equity to depend on the risk weights attached to banks' assets creates significant conflicts of interest, not only in relations between banks and supervisors but also in relations between investment units and risk control units of banks.<sup>30</sup>

Empirical research has shown that the ability of banks to withstand losses in the financial crisis was highly correlated with how much equity they had relative to their total assets; in contrast, equity relative to their risk-weighted assets seemed to be irrelevant.<sup>31</sup> Despite the skepticism that this experience generated, the Basel III accord basically stuck to the system of calibrating bank equity requirements to the banks' risks as assessed by the banks themselves. However, as we discuss in Chapter 14, in the mid-2010s, the supervisors found that different banks come to very different assessments of the same risk of the assets they were asked to consider, so there is nothing objective about the resulting risk weights. Under the guise of "finalizing" the Basel III agreement of 2010, the supervisors then proposed to limit the extent to which the banks can use their own quantitative risk assessments in determining the amount of equity funding they are required to use. The industry has been fighting this "Basel III endgame" quite furiously, arguing that risk-based regulation is necessary, and that any deviation will harm bank lending.<sup>32</sup>

The reference to bank lending, particularly to small and medium enterprises, is disingenuous because risk-weighting of assets in the assessment of equity requirement works against lending and in favor of securities. Risk weighting is particularly important for assets in the

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<sup>29</sup> FSA (2010).

<sup>30</sup> For examples, see UBS Report to Shareholders on UBS's Write-downs and Behn et al. (2022). We discuss the issue in Chapters 11 and 14.

<sup>31</sup> Demirgüç-Kunt et al. (2010), Brealey et al. (2011).

<sup>32</sup> See, for example, the claims by bankers in this recent debate <https://www.brookings.edu/events/requiring-banks-to-hold-more-capital-benefits-and-costs/>. The Bank Policy Institute started a website and a major advertisement campaign under the slogan "Stop Basel Endgame" (see <https://stopbaselendgame.com/>) and has mobilized a number of comments to regulators based on the threats that specific individuals and organizations, particularly minorities, local governments and small businesses, will have difficulty funding their consumptions and investment. These claims ignore the fact that the cheap funding provided to banks is based on subsidies that can be given directly to those who need them most, as well as the banks' own admission that they will make investments on behalf of their shareholders, which may well not include reasonably priced loans to small businesses or needy individuals. Nothing in the rules guarantees that banks will make the investments they threaten to withhold or that they will make them at attractive prices.

trading book, where risk weights are more easily manipulated. Thus, before 2007, banks used risk-weighting based on their own risk models to claim that equity equal to 1% of assets provided sufficient loss absorption capacity. Flawed risk weights introduce biases into banks' investment decisions, and these biases tend to go *against lending*.

## **“Banks are Special”**

Whereas our discussion of Flawed Claims 1-6 has used basic concepts of corporate finance to debunk claims about bank “capital,” Flawed claims 7-12 involve the view that “banks are special” and should therefore be given a special treatment.

The view that banks are special rests on the observation that, in contrast to other corporations, banks take deposits and make loans. For certain megabanks, however, this characterization is an anachronism because, in addition to taking deposits and making loans, these institutions also raise funds in wholesale markets, invest in securities and have a large derivatives business so that one might think of them as large hedge funds with a side business in traditional banking and the government guarantees that come with this side business. Even so, the view that banks are special pervades much of the debate about bank regulation.

Arguments for this view take many forms. Some argue that banks are special because deposits are a form of money, created by a bank in the act of lending. Some argue that banks are special because they “create liquidity,” i.e., they enable their depositors and other short-term lenders to liquidate their investments quickly and predictably. Finally, banks are said to be special because their lending is crucial for the viability of non-financial firms, especially small and medium enterprises.

Every lobbyist claims that the business he or she represents is special. A lobbyist for a high-tech company might argue that the company is essential for innovation and growth and therefore should be given special treatment, e.g., through a reduction of corporate income taxes on retained earnings that might fund further investments and further growth. The claim that a business is special must therefore be treated with some skepticism. Thus, in his first review of our book, Martin Wolf of the *Financial Times* wrote: “Banks are not special, except for what they are allowed to get away with.”<sup>33</sup>

The rules of the market economy presume that nobody receives privileges because he or she is “special.” Differential treatments of some firms and industries may be called for if these

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<sup>33</sup> See Martin Wolf, “Why Bankers are Intellectually Naked,” *Financial Times*, March 17, 2013. In the book we also discuss how banks get away with breaking laws and recklessness more broadly, quoting Joris Luyendijk, “How the Banks Ignored the Lessons of the Crash,” *The Guardian*, September 30, 2017 saying that large banks learned from the financial crisis that “in the end there is very little they will not get away with.” Admati (2016) also includes a discussion of the “specialness” of banks and the flaws of Basel III.

firms and industries benefit or harm others, including society as a whole. In this respect, banks have a history of being special in causing financial and economic crises and in being bailed out by governments and taxpayers. Moreover, bankers' incentives are biased in the direction of borrowing and risk taking at the expense of others.

**Flawed Claim 7:** The key insights from corporate finance are not relevant for banks because the economics of funding for banks is entirely different from that of other companies.<sup>34</sup>

**What's wrong with this claim?** The claim is false. Although the economics of funding for banks is somewhat different from that of other companies, key insights from corporate finance are highly relevant for banks and the appropriate banking regulation.

Most references to banks being special are motivated by the observation that investors value bank deposits for their liquidity and for the associated payment services. Because of these benefits, depositors are willing to accept lower interest rates on bank deposits than on other forms of debt.<sup>35</sup> However, the fact that bank depositors care about liquidity benefits and payment services as well as the monetary returns they receive does not invalidate the key insight that equity and debt have different risk characteristics and that the per-dollar risks to shareholders and to debt holders – including depositors – are the larger, the more the borrower is indebted. For banks, as for all other borrowers, debt is a legal promise to pay, and a heavily indebted borrower is more likely to become distressed or insolvent. When investments turn out badly, someone must bear the losses; if there is too little equity, the losses must be borne by the bank's creditors, including depositors, or by taxpayers.

This observation gives another spin to the message that “banks are special.” The threat, and even more so the actual occurrence, of bank distress and insolvency are likely to *impair* the liquidity of uninsured deposits and other short-term bank debt. Depositors worried about this risk will require much higher interest or withdraw their funds altogether. *The notion that deposits are cheap presupposes that banks have sufficient equity funding to stave off default – or that they are*

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<sup>34</sup> See, for example, Oxford Economics (2013), and Barclays Credit Research, referenced in Footnote 25, and “Safety in Numbers,” *The Economist*, April 11, 2013. DeAngelo and Stulz (2015), mis-characterize our arguments as relying only on the irrelevance result of Modigliani and Miller, discussed in the context of Flawed Claim 4, and proceed to develop a model of liquidity benefits from deposits in a model that assumes no uncertainty, which is hardly suited for discussing the notion of “liquidity.” The DeAngelo and Stulz analysis involves assumptions about pricing and the appropriation of consumer surplus by banks that are incompatible with market equilibrium, which they never actually study. Cline (2017) also criticizes the application of the irrelevance result which in fact does not describe reality as such, yet ignores the actual reasons equity appears expensive to bankers.

<sup>35</sup> By contrast, standard analyses in corporate finance, as considered in the discussion of Flawed Claims 4 and 5, assume that investors only care about monetary returns.

*protected by taxpayers.* Increasing indebtedness (leverage) and raising the probability of bank failure put these liquidity benefits of deposits at risk; their loss would be a *social cost*.<sup>36</sup>

Do banks take this effect into account? As we discuss in Admati et al. (2018) and Admati and Hellwig (2019), the answer to this question is usually No. Banks are not only special because deposits provide liquidity benefits. They are also special in that their own creditors are highly fragmented and unable to coordinate on imposing and enforcing covenants that would limit bank leverage. In decentralized contracting with multiple creditors, the contracting parties have incentives to engage in excessive debt funding because the impact of the higher debt on the default probability is partly borne by those creditors who are not present in the negotiation. Admati et al. (2018) show that this effect is present even incumbent creditors are protected by seniority clauses. The effect is reinforced if the government steps in to protect banks' creditors through deposit insurance and other forms of explicit or implicit guarantees. Such government protection—which exacerbates the conflicts of interest and distortions associated with heavy borrowing—may well be what is really special about banks.

For bank borrowing in wholesale markets and bond markets, insights from corporate finance are also applicable. In these markets, banks interact with the same investors that buy shares and bonds of other corporations, and like for other firms, the risk they take must be borne by all investors (unless it is borne by taxpayers). Investors value banks' shares and bonds in the context of their overall portfolio and use the same criteria for all investments. The same considerations apply to the borrowing by banks from other financial institutions.<sup>37</sup> For large banks, this observation is important because typically more than half of their debt funding comes from markets rather than depositors.

Importantly, like other firms, *banks can choose how much equity to use for funding and how much to borrow.* And banks are also more likely to become distressed or insolvent when they have little equity and borrow heavily. The issues discussed in Chapter 3, entitled “The dark side of borrowing” and again in Chapters 9-10 and 14-16, including the strong conflicts of interest between borrowers and creditors, and the distortions and inefficiencies of high indebtedness and particularly of distress and insolvency, apply to banks. Because of these distortions, the dynamics of leverage are characterized by an excessive growth of debt, which again exacerbates the distortions, as discussed in Admati et al. (2018). These distortions and inefficiencies can spill over

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<sup>36</sup> We discuss this issue in Chapter 10. DeAngelo and Stulz (2015) miss out on this effect because they assume that there is no uncertainty. They also miss out on the possibility that, because of debt overhang effects, ongoing funding choices may not be value maximizing let alone socially efficient, see Admati et al. (2018) and Admati and Hellwig (2019). Gorton and Winton (2017) allow for this effect in principle but then impose special assumptions that eliminate it again, namely, either there are no assets outside of banks or equity is raised at a time when the incidence of risk is already known.

<sup>37</sup> In some of the academic literature on banking, the statement “MM does not apply to banks” is used to postulate frictions that, under the assumptions of the models, might be addressed by borrowing, while conveniently ignoring the enormous frictions and collateral damage on the system that borrowing creates, which we discuss in Chapters 3, 6, 8 and 9. See also Pflleiderer (2015) and Admati and Hellwig (2013).

to taxpayers and the public, something that those who seek to justify the banks' choice of funding mix as efficient often neglect.<sup>38</sup>

**Flawed Claim 8:** Banks are special because deposits are “money.”

**What’s wrong with this claim?** The notion that bank deposits are “money” is based on the fact that people regard the funds they have in a bank deposit as being similar to cash and are able to use those funds for payments, such as by checks, credit cards, and bank transfers.<sup>39</sup> Monetary economists therefore refer to people’s total holdings of cash and of deposits in the economy as the amount of “money” in the economy.<sup>40</sup>

Putting demand deposits and cash into the same macroeconomic aggregate does not mean that they are literally the same. A critical difference is that *deposits are a form of debt*.<sup>41</sup> Banks are obliged to pay the depositor when he or she asks for it. If a bank cannot repay depositors, it is in

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<sup>38</sup> The arguments of Admati and Hellwig (2019), as well as Admati et al. (2018) on the inefficiency of high leverage even from the private perspective of the bank and its investors apply here as well.

<sup>39</sup> Some (e.g., Gorton, 2010) have suggested that the use of short-term borrowing, for example through so-called repos, is a modern-day form of deposits. (See also Cyrus Sanati, referenced in footnote 10.) Repos share with deposits the very short-term nature of the lenders' claims. Unlike deposits, however, repo borrowing is not accompanied by provision of payment services. The repo lender, e.g., a money market mutual fund, might provide payment services to its own investors, but those services have nothing to do with the bank that acts as repo borrower. Repo borrowing takes place in wholesale markets with financial institutions acting as lenders. In these markets, as discussed in the context of Claim 4, the insights about the economics of funding that apply to all firms are fully relevant. The so-called shadow banking system, with money market mutual funds offering money-like claims and investing the funds they get in short-term claims on banks as well as other institutions, poses problems for monetary policy as well as prudential regulation and supervision. On the former, see Pozsar (2014), on the latter Gorton and Metrick (2010).

<sup>40</sup> This aggregate is typically larger than the amount of “high-powered money” in the economy, i.e. the money that the central bank has created. High-powered money consists of cash and of the deposits that banks hold with the central bank. Legally, these deposits are claims to cash and may therefore be regarded as equivalent to cash. “Money” in the sense of cash and deposits of non-banks exceeds central-bank money because the reserves of cash and central-bank deposits that banks hold are smaller than the banks' own customers' deposits. Under “fractional reserve banking,” banks have only a fraction of the deposits available in central bank money because they deem it unlikely that all their deposits be called at once. The phenomenon is called “money creation by commercial banks.” For a perceptive discussion of the difference between money creation by commercial banks and money creation by central banks, see Tobin (1967).

<sup>41</sup> One of the strangest statements in this context comes from John Stumpf, the CEO of Wells Fargo Bank, who reportedly said in an interview: “Because we have this substantial self-funding with consumer deposits, we don't have a lot of debt.” (See Tom Braithwaite, “Wells Chief warns Fed over Debt proposal,” *Financial Times*, June 2, 2013.) “Self-funding” ordinarily refers to equity and retained earnings. Deposits, by contrast, are a form of debt. It is false, indeed a contradiction in terms, to say that a bank that relies primarily on deposit funding does not have a lot of debt. For an extensive discussion see Hellwig (2018b).

trouble.<sup>42</sup> Cash issued by a central bank, by contrast, is nobody's debt.<sup>43</sup> (For a detailed discussion, see Chapters 10 and 15.)

The key difference between deposits and other kinds of debt is *not* that deposits are “like money” or that deposits may be created by lending (discussed below), but rather that the bank provides depositors with services such as payments through checks and credit cards or access to ATM machines that make funds available continuously. The demand for deposits depends on these services as well as the interest that the bank may offer, and it may also depend on the risk of the bank becoming insolvent or defaulting. However, as discussed in the context of the preceding claim, this special property of deposits does not invalidate the relevance of the insights of corporate finance for banks. Indeed, the finding that excessive borrowing by banks may endanger the safety and the liquidity benefits of their deposits justifies regulation limiting their indebtedness. Rather reducing the ability of banks to provide liquidity benefits such regulation *enhances* liquidity benefits by giving depositors and other short-term creditors more confidence that they can actually get at their money when they need it.

**Flawed Claim 9:** Banks do not intermediate between their depositors and other creditors and their own borrowers. Banks create their own funding: When a bank makes a loan, it creates a deposit.<sup>44</sup>

**What is wrong with this claim?** This claim is often made in opposition to the description of banks as intermediaries that raise funds through deposits, other borrowing and by equity in order to make loans (so-called “loanable funds” view of banks). The claim rests on the observation that, if a commercial bank makes a loan to a nonfinancial firm or to a private household it provides its borrowers with a claim on a deposit account. However, this fact is hardly relevant for the bank's funding policy. The nonfinancial firm or household that receives a loan from a bank will typically use the associated deposit for payments. If the recipients of the payments do not have accounts with the bank, the transfer reduces the bank's deposits and its reserves of central bank money.

The claim that banks create their own funding when they lend confuses stocks and flows. The fact that new lending involves a claim on a deposit account provides for a link between the *flow* of new lending and the *flow* of new deposits. The bank's funding problem, however, involves the *stocks* of debt and equity that it has outstanding and the *stocks* of securities, loans, and cash that it holds. When the borrower has used the funds that the bank lent him, i.e., when the borrower has drawn down the amount in the deposit account, the loan is still on the bank's book and requires funding. If this funding involves deposits, *the bank owes the depositors the full amount they*

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<sup>42</sup> For the difference between bank deposits and central bank money for the issuer, see Tobin (1967) and Hellwig (2018b).

<sup>43</sup> Deposits with the central bank usually are claims to receive cash. Since the central bank can itself create this cash, these deposits do not involve serious obligations for the central bank. We explain the workings of central banks in Chapter 15.

<sup>44</sup> See, e.g., McLeay et al. (2014). For details of the criticism, see Hellwig (2018b).



*deposited*, regardless of any losses that it might make on its loans and other operations. The logic of risks per dollar invested being increased by leverage (as discussed in Chapter 2) applies to deposits as well as any other form of borrowing, by banks or others. As explained in Chapter 15, this problem does not affect *central banks* because the banknotes they issue do not oblige them to anything and the deposits they have from commercial banks oblige them only to deliver banknotes if called upon.<sup>45</sup>

**Flawed Claim 10:** Whereas deposits might move within the banking system, once deposits are “created” by lending, they will always be somewhere in the system. Deposit funding for the banking system as a whole is reduced only when loans are repaid.<sup>46</sup>

**What is wrong with this claim?** Cash withdrawals reduce not only the deposit funding of an individual bank but also the funding that is available to the banking system as a whole. The same is true if deposits are used for transfers to other countries or for investments in treasury bills. Whereas some authors suggest that deposits are *only* created when banks lend and *only* destroyed when borrowers repay loans, depositors themselves can engage in actions that create or destroy deposits.

A standard response to these arguments is that these other modes of deposit creation and destruction do not matter. Cash is unimportant in a modern economy. Transfers of funds abroad are relatively unimportant, as are purchases of treasury bills. In normal times, this assessment may be appropriate. For example, cash may be unimportant because people find non-cash transactions much more convenient. In a crisis, however, they may want cash anyway because they deem it to be safer than bank deposits.

Cash withdrawals played a key role in the runs on US banks in the Great Depression, and they played again a key role in Greece in the spring and summer of 2015. Shifts of funds to other countries also played an important role in the euro crisis where in 2012 the banking systems of the southern periphery countries came under pressure because many investors shifted their funds to financial institutions in the northern “core countries.” Shifts of funds into treasury bills played a

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<sup>45</sup> As we explain in Chapters 10 and 15, central banks did have to worry about their own indebtedness in a previous era when banknotes were promises to pay in gold.

<sup>46</sup> The term “banking system as a hole” refers to all the institutions that have deposits with the central bank and use these deposits to make interbank payments. See McLeay et al. (2014), and Jakab and Kumhof (2015). See also Thomas Mayer, “Lasst Bankpleiten zu!” (Allow banks to fail!), *Frankfurter Allgemeine Sonntagszeitung*, January 5, 2014, Martin Wolf, “Only the Ignorant Live in Fear of Inflation,” *Financial Times* April 10, 2014, and “Strip Private Banks of Their Power to Create Money”, *Financial Times* April 24, 2014. Some even suggest that this “deposit creation through lending” is said to be the way money from the central bank gets into the economy. For a detailed discussion, see Hellwig (2018b).

key role in the runs on banks in September 2008. In all these cases, the amount of funding to the banking system as a whole imploded, with dire consequences for the economy.<sup>47</sup>

**Flawed Claim 11:** An individual bank that loses deposits can always replace the lost funding by borrowing in wholesale markets.<sup>48</sup>

**What is wrong with this claim?** First, for reasons given in our refutation of the preceding claim, funding available to a given banking system as a whole may be reduced. If that happens, some institutions will find it impossible to replace the lost funding. The effect will be reinforced if money market lenders worry about their own liquidity and become unwilling to lend to others, preferring to hold central bank money or Treasuries instead. Second, if the bank in question has insufficient collateral, or if its solvency is in doubt, uninsured depositors may withdraw their funds, as happened at Silicon Valley Bank in early March 2023, when it became obvious that the bank's insolvency would shortly be acknowledged. In such a situation, money market lenders are also likely to be unwilling to provide funding even if the funds are available. The fates of Bear Stearns and Lehman Brothers provide examples of how mistrust by lenders can induce a money market run that pulls a bank down. The weeks following the Lehman Brothers bankruptcy show how general mistrust can induce a money market freeze, leading to a severe funding shortage and liquidity crisis at many financial institutions. The shortage of cash motivated enormous fire sales, inducing dramatic declines in asset prices that in turn caused doubts about solvency and reinforced the lending freeze.

**Flawed Claim 12:** A key role of banks in the economy is to take deposits and to make loans, which facilitates real investments whose economic lifetimes are much longer than the terms for which current investors are willing to commit their funds. Exposure of banks to the risks that come with this *maturity transformation*, especially interest rate risk, is an unavoidable side effect of this role.<sup>49</sup>

**What is wrong with this claim?** The claim interprets traditional arrangements in banking as if there was no alternative. It overlooks the fact that, in the past, these arrangements caused many

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<sup>47</sup> The crisis of March 2023 in the US also involved runs, but in these runs the funds stayed inside the system as depositors moved from regional banks to the larger banks.

<sup>48</sup> In combination with Flawed Claims 9 and 10, this claim suggests that bank lending is not constrained by deposit funding. Bank lending creates deposits, these deposits move around in the banking system, and their movements can always be neutralized by interbank borrowing and lending.

<sup>49</sup> Chapters 4 and 10 provide references to such claims, routinely made by scholars who specialize in banking. In a 2014 workshop for bank supervisors where one of us presented our research, a participant claimed that "banks are special because they transform people's deposits and savings into loans." In fact, of course, *all corporations* "transform" funds raised from investors into assets. We have recently encountered this claim in discussions about the demise of Silicon Valley Bank.

banking crises. It also overlooks the fact that because of technical and institutional innovations since the 1970s, the viability of these arrangements today is doubtful.

As we discuss in Chapter 4, banks and savings institutions traditionally took deposits and made loans to nonfinancial firms and to homeowners. Depositors received promises of fixed amounts for repayment of principal and accumulated interest. Depending on the terms of their contracts, depositors could ask for their money any time (demand deposits) or after a specified term had elapsed (term deposits); the time frame of these contracts is typically much shorter than the time frame of loans.

From the perspective of the other participants, the bank or savings institution in this arrangement performs two distinct functions, not just one. First, it reconciles the short time horizons of investors with the long economic lifetimes of assets such as houses and factories. Investors can get out early, even if the assets that their deposits have helped to fund have not yet matured. This reconciliation is feasible if investors who want to liquidate their positions are easily replaced by new investors.

Second, the bank or savings institution provides investors and borrowers with protection against uncertainty about changes in the economic environment. As investors are promised fixed amounts for repayment of principal and interest, risks from lending and risks associated with replacing deposits that are withdrawn are fully assumed by the bank or savings institution. Fixed interest rates on loans and mortgages also protect the borrowers against uncertainty about changes in the intermediary's refinancing conditions.

References to *maturity transformation* as a key role of banks often lump the two functions together without any distinction. However, there is no reason why these two functions should always be linked. Moreover, as we explain in Chapters 4 and 10, the experience of the past fifty years suggests that, because of changes in institutions and technology, the traditional combination of the two aspects of maturity transformation is problematic, a sure-fire recipe for a crisis. For example, in the United States, savings and loans institutions had traditionally used fixed-rate deposits with maturities of at most seven years to fund fixed-rate mortgages with maturities of thirty or forty years. In the early 1980s, when market rates of interest were 15% per year and higher, the fair values of claims on 1960s' mortgages were substantially below the nominal mortgages' nominal values, and interest income from these mortgages was substantially below the costs of deposit funding.

There is a strong presumption that *liquidity transformation*, allowing investors to get at their funds when they wish, regardless of what is the remainder of the real assets that have been funded, is indeed a key role of financial institutions. Banks and savings institutions invest in loans and other long-term assets that cannot be traded easily. They fund these investments by issuing short-term debt and tradable securities. When the original investors leave, new investors step in to roll over the short-term debt or to buy the securities.

However, such liquidity transformation can also be performed without insuring investors against uncertainty about the payments they will receive when they get out. For example, a mortgage-granting institution can fund itself by issuing long-term bonds, using portfolios of mortgages as collateral. If there are markets for these bonds, buyers of bonds are not forced to hold on to them until they mature but can sell them at any time when the markets are open. However, investors do not have any insurance against uncertainty about the prices at which they will be able to sell their bonds.<sup>50</sup>

There is *no* presumption that the institutions involved in liquidity transformation should also provide investors with full insurance against the uncertainty about the prices at which they can get out. For example, why should a depositor with a seven-year term deposit be given a claim that is completely independent of the value of the mortgage portfolio that a savings institution holds. When the deposit matures, many mortgages in the portfolio still have many years to go. If market rates of interest at that time are high, the fair value of these mortgages will be less than their nominal values, as was the case in 1981. One might argue that risks attached to individual borrowers should stay with the mortgage lender so that the lender has appropriate incentives for creditworthiness assessments. However, this argument does not apply to the risk that changes in market rates of interest – or other macroeconomic developments – impose on the fair value of the mortgage portfolio. Many banking crises have been caused by the inability of banks and other financial intermediaries to bear such risk and withstand shocks from macro developments. Silicon Valley Bank’s succumbing to interest rate risk is the most recent example.<sup>51</sup>

## **Economic Effects of Higher Bank Equity Requirements**

Whereas Flawed Claims 6-12 involved the funding side of banks’ activities, Flawed Claims 13-26, to which we now turn, concern the implications of bank equity requirements for the banks’ lending and other investments. In 2010, the late Paul Volcker, Federal Reserve Chair from 1979 to 1987, told a US senator that “just about whatever anyone proposes, the banks will come out and claim that it will restrict credit and harm the economy. It’s all bullshit.” Underlying these claims there is also a notion that banks are special, but now this notion involves the dependence of many non-financial firms and of private households on being able to borrow from banks. This dependence provides the banking industry with a certain amount of power, which it does not hesitate to use in political lobbying.

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<sup>50</sup> As we explain in Chapter 4, this is also the logic underlying mortgage securitization. There is however an important difference between covered bonds and mortgage-backed securities: With covered bonds, the issuing bank is liable to investors, with mortgage-backed securities, liability is limited to the returns on the mortgage portfolio. With covered bonds therefore the issuing bank retains strong incentives to check the creditworthiness of the borrowers and the quality of their collateral.

<sup>51</sup> On the welfare economics of the allocation of interest rate risk, see Hellwig (1994).

**Flawed Claim 13:** Increasing equity requirements would harm economic growth.<sup>52</sup>

**What’s wrong with this claim?** Those who make this sweeping assertion do not typically provide a coherent explanation for why increased equity requirements, which amount to a reshuffling of financial claims in the economy, would have a harmful effect on growth. In the 2010s, such dire predictions about the impact of higher equity requirements under Basel III have been thoroughly refuted by experience.<sup>53</sup>

Those who make this claim also neglect the fact that the worst downturn in economic growth occurred as a result of the actions taken by highly indebted banks and other financial institutions, which led to the financial crisis in the last quarter of 2008. One reason for the severity of this crisis was the lack of equity in banks, which made banks vulnerable to the decline in US real estate markets, defaults on subprime mortgages and the collapse of the markets for asset-backed securities.

In fact, banks with more equity to absorb losses without becoming distressed are better able to sustain lending in a subsequent economic downturn, with positive effects for investment and the economy. As seen for example in Iceland and Ireland, growth can be temporary and illusionary when the boom is followed by a bust.

**Flawed Claim 14:** Increasing equity requirements would reduce banks’ ability to take people’s deposits and issue short-term claims that are liquid and can be used like money.<sup>54</sup>

**What’s wrong with this claim?** The claim falsely assumes that the amount of a bank’s equity is fixed and limited, and that none of the banks’ debt can be replaced with equity without interfering with “liquidity provision.” In fact, a bank can raise the amount of equity by retaining and reinvesting its earnings, or by issuing new shares, either in addition or instead of some of its debt. By increasing its equity, the bank could actually raise the amount of deposits it can take. If equity requirements are increased adding equity would allow the bank to keep its deposits and other “liquid” debts unchanged.

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<sup>52</sup> See, e.g., Angelini et al. (2011). Cline (2017) also claims that “an increase in capital requirement by 1 percent of total assets would reduce long-term GDP by 0.15 percentage point.”

<sup>53</sup> See Cecchetti (2015).

<sup>54</sup> Barclays Credit Research, referenced in Footnote 25, DeAngelo and Stulz (2015), *The Economist*, referenced in footnote 34, and Kling, “What Do Banks Do?” *The American*, February 26, 2013 warn of the reduction in bank deposits that, in their view, would be implied by higher equity requirements. Gorton (2012) refers to banks as “producers of debt” in the form of deposits and other short-term claims that people want because these debts are similar to money. Gorton views equity and investments as “inputs” for this debt “production.” There is actually no sense in which the bank’s equity is an input to its debt when both debt and equity entitle investors to payments from the bank, both being on the same side of the bank’s balance sheet. Indeed, it makes little sense to refer to debt promises the bank makes to its creditors as something it “produces.”

This objection to the claim is also valid if we think about deposit creation as a by-product of lending, as discussed in the context of Flawed Claim 9, rather than a result of depositors' choices. If equity were fixed and limited, equity requirements may indeed constrain the bank's ability to create new deposits through additional lending. However, nothing prevents the bank from increasing its equity and engaging in additional lending and deposit creation. The concerns we raised in the context of Flawed Claims 9-11 about maintaining funding when the beneficiaries of new loans use the newly created deposits for payments, are unaffected.

Relying on more equity would in fact *enhance* a bank's ability to maintain its deposit funding and its provision of useful liquidity because, with more equity, the bank's debt is more trustworthy. Thus, contrary to the claim, the "liquidity" or "money-like" nature of deposits and other short-term bank debt is *improved* when the bank is less highly indebted and has more equity. By making the banks' deposits and other short-term debt safer, additional equity therefore enhances the banks' ability to provide benefits to depositors without needing support from central banks or governments.

Banks may, however, be *unwilling* to increase their equity in response to higher requirements, because, in the presence of existing deposits and other debt, bank managers and shareholders have incentives to undervalue the benefits from additional equity to their depositors and to their resiliency. If the banks' managers and shareholders could have previously committed firmly to all their future funding decisions, they would have taken account of the fact that additional equity enhances the safety and the liquidity of their debt and makes their (potential) lenders willing to provide funding at more favorable terms. In the real world, however, such a commitment is impossible. Over time, banks repeatedly take new funding decisions without having made commitments to depositors and other lenders that they would avoid continuing to borrow. In these decisions, the interest rates on previously contracted debt are taken as given. Banks have no reason to take into account the fact that additional equity makes their existing debt safer whereas additional debt and the risky investments funded with this new debt make it less safe.

Debt overhang, i.e., the existence of previously contracted debts, generates a ratchet effect that makes the bank's indebtedness increase whenever new needs or opportunities call for additional borrowing, whereas there is an aversion on the part of the bank's shareholders and managers to decrease leverage because such a decrease would benefit incumbent debt holders at the shareholders expense.<sup>55</sup> The mix of debt and equity funding of banks that we see is likely to take insufficient account of the beneficial effects of additional equity for the safety and liquidity of deposits and other reforms of "money-like debt" of banks, in addition to not taking account of

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<sup>55</sup> This aversion reflects the fact, discussed in the context of Flawed Claim 4, that the shareholders' option to default on the bank's debt by allowing the bank to fail becomes less valuable as risk is shifted back from depositors or the public to the shareholders and managers who benefit from the upside.

the effects of the risks to which their actions expose the rest of the financial system and the overall economy.

Therefore, the strong reliance of banks on short-term debt that we observe cannot be presumed to be beneficial for society. Whereas this reliance is fully in line with the incentives of bank managers and shareholders, it is in conflict with the interests of other stakeholders and society as a whole. This conflict creates not only a strong rationale for equity regulation to substitute for the missing ability to pre-commit future funding decisions. It also poses challenges for the implementation of equity requirements over time, which should direct banks to retain profits or issue certain amounts of equity rather than selling assets to meet the regulatory ratios.<sup>56</sup>

**Flawed Claim 15:** Increasing equity requirements would increase the funding costs of banks because investors require higher returns when investing in equity than when investing in debt.<sup>57</sup>

**What's wrong with this claim?** First, as discussed in Chapter 7 and in the context of Flawed Claims 4 and 5, it is fallacious to suggest that using more equity in the funding mix raises funding costs because the required return on equity is higher than the required return on debt. The required return on equity, debt, or any other security depends on the entire funding mix, and the required return on equity (as well as generally on other securities, including debt) will be lower if the bank has more equity. As discussed in Chapter 9, and in the context of Flawed Claim 4, the total funding costs of banks might increase as a result of higher equity requirements, but such an increase would be due to banks' being less able to take advantage of guarantees and tax subsidies for debt, which come at the expense of taxpayers. For the policy debate, the relevant concern must be the cost and benefits *to society* of banks using different mixes of funding with different levels of equity. Because the fragility of the financial system is costly and harmful to society, a correct statement, contrary to the claim, is: *“Increasing equity requirements would reduce the cost to society of having a fragile and inefficient financial system where banks and other financial institutions borrow excessively, and thus would be highly beneficial.”*

**Flawed Claim 16:** Increasing equity requirements would lower the banks' return on equity (ROE) and thus make investors unwilling to invest in banks' stocks.

**What's wrong with this claim?** The reasoning in this claim is fallacious. As explained in Chapter 8 and in the context of Flawed Claim 4, investors' willingness to invest in banks' stocks, or in the stocks of any other firms, depends on whether they are properly compensated for the risk they

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<sup>56</sup> For more detail, see Admati et al. (2013, Sections 4.2 and 4.3) and Admati et al. (2018). The latter contains a detailed analysis of this effect as well as the method by which banks would choose to reduce leverage in response to leverage ratios requirements. This analysis and our recommendations in Chapters 11 and 14 are relevant for making leverage regulation work.

<sup>57</sup> See, for example, Oxford Economics (2013), and Barclays Credit Research (in footnote 25), *The Economist* (referenced in footnote 34), Elliott (2013) and, more recently, the “explainer” of “How Capital Works” posted on the Bank Policy Institute website <https://stopbaselendgame.com/capital-101/>.

take, not just on the stocks' expected returns.<sup>58</sup> If managers target specific ROE levels, they may harm rather than shareholders by exposing them to risk without proper compensation. Moreover, when managers borrow excessively or take excessive risks, they harm creditors and taxpayers and endanger the public, which includes most of their shareholders. *Corporations outside banking have, by the logic of this claim, too much equity even though their funding mix is not regulated.* The fixation of ROE in banking reflects the desire by banks and bankers to shift costs and risks to others and benefit from subsidies, as we discuss in Chapters 9, 15 and 16.

**Flawed Claim 17:** Profitable banks may be unable to raise their equity levels to satisfy higher equity requirements.

**What's wrong with this claim?** A profitable bank can always raise its equity by retaining and reinvesting profits. A bank that is not currently earning profits can raise equity by selling shares to investors *provided that these investors believe that they will ultimately get a return.*

When bankers claim that they cannot raise new equity in the market, they really mean that they cannot raise new equity at a price that the existing shareholders are willing to accept. A decline in the share price of the bank is merely another application of the finding, discussed in the context of Flawed Claim 4, that shareholders of a highly indebted corporation dislike the issuance of new equity because the increase in equity makes a failure of the bank less likely and therefore devalues the bank's right to cease payments to creditors when it fails.

If a bank is truly unable to raise new equity in the market, there is a strong presumption that it may be insolvent, i.e., that the fair value of its assets may amount to less than its liabilities, as was the case with Silicon Valley Bank (SVB). As we explain in Chapter 14 and in the context of Flawed Claim 30 below, the fair value of SVB's assets had been smaller than SVB's liabilities since at least September 2022, but the insolvency had been hidden because the accounting rules did not force the bank to adjust the values of securities classified as "held to maturity." The failure of the bank's attempt to raise new equity on March 8, 2023 reflected the underlying insolvency.<sup>59</sup>

If a bank is known to be solvent, i.e., to have assets whose fair values amount to more than its liabilities, it can always raise new equity in the market: The value of the bank's total equity after the new shares have been issued will not be smaller than the amount of money that the new shareholders have contributed. To get the new shareholders to come in, it suffices that the fraction of the total equity they acquire be equal to the share of the money they contribute in the bank's

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<sup>58</sup> We interpret the claim as referring to expected ROE. People who make the claim tend to lump actual ROE and expected ROE together without appreciating that investment decisions are based on expected returns. For actual ROE, the first statement is actually false; when asset returns are below the borrowing rate, actual ROE is in fact *higher* if there is more equity. See Admati et al. (2013).

<sup>59</sup> The December, 2023 OFR report mentioned in footnote 2 also confirms that the fair value of SVB losses was greater than its equity by December 2022, i.e., it was insolvent.



overall net wealth. Existing shareholders may lose a lot, but this loss is entirely due to the devaluation of the right to stop payments to debtholders if the bank fails.

Whether a bank should be regarded as solvent or insolvent may be a matter of dispute, especially since fair values of assets such as loans to households and nonfinancial firms are hard to assess in the absence of markets for these assets. However, if a bank is unable to raise new equity in the market, this fact in itself is a signal that many investors have doubts about the bank's solvency. In a very real sense, such a bank does not pass a "market-based stress test." Its failure to pass such a test should alert the bank's supervisors that they must look into the matter and perhaps initiate corrective action.<sup>60</sup>

**Flawed Claim 18:** Increasing equity requirements would force banks to reduce lending.<sup>61</sup>

**What's wrong with this claim?** In Chapters 6 and 11 and in the context of Flawed Claims 2 and 17, we noted that to comply with higher equity requirements, profitable banks can increase their equity levels by retaining earnings or by selling new shares to investors. In either case, with more equity, banks would have *more* funds and could increase their lending. Suggesting that equity requirements *force* banks to reduce lending is preposterous when they are making large payouts to shareholders in the form of dividends and share buybacks. There is nothing to prevent them from raising their equity by retaining the money they pay out and using the funds for additional loans.

If increased equity requirements cause banks to reduce their lending, the reason is that *they do not want to increase their equity*. As explained in Admati et al. (2018) and in the discussion of Flawed Claims 4 and 14, this phenomenon is due to the distorted incentives created by overhanging debt. The distorted incentives create a sort of addiction to borrowing that is reinforced and encouraged by government guarantees and by compensation structures in banking.<sup>62</sup>

The greatest downturn in lending since the Great Depression of the 1930s occurred in the fourth quarter of 2008, when losses on subprime mortgages and mortgage-backed securities threatened, and in some cases even destroyed, the solvency of banks and other financial institutions. If these institutions had had more equity funding, they would have been better able to withstand those losses, and the downturn in lending would have been much smaller.

If equity requirements are formulated in terms of a ratio for equity to some measure of assets that must be met and if banks are free to adjust their asset holdings, an increase in the

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<sup>60</sup> For detailed discussions of these issues, see Chapters 11 and 14. Chapter 14 also discusses the problem that the extreme opaqueness of banks tends to undermine investor confidence in their solvency.

<sup>61</sup> See, for example, S&P, "Brown Vitter Bill: Game-Changing Regulation for U.S. banks," April 25, 2013 and references in footnote 10. Elliott (2013) stresses that frictions in capital markets make it difficult or impossible for banks to raise new equity. As we discuss in Admati et al. (2013, Section 5) and in Chapter 11, the arguments he gives, which allude to information asymmetries, are not applicable to new equity issues through rights offerings.

<sup>62</sup> Admati et al. (2018) explores in detail the leverage ratchet effect and explains why the effect is so important in banking.

required ratio may initially lead to a reduction in lending because banks do not want to raise additional equity. However, the increased loss absorption capacity of banks that comes with a greater share of equity in funding has the effect that subsequent losses are more easily borne and a downturn in lending after such losses is much smaller.<sup>63</sup> The initial effect itself can be avoided if the equity requirement is not simply imposed in the form of a higher ratio of equity to assets, leaving banks free to reduce their assets. Instead, during the transition, the banks should have to satisfy the new requirement for the investments in place at the time the requirement was imposed.

**Flawed Claim 19:** Increasing equity requirements would harm the economy because banks would be less willing to make loans.<sup>64</sup>

**What’s wrong with this claim?** Like Flawed Claim 18, this claim focuses on the initial effect of the introduction of higher equity requirements and overlooks the fact that, subsequently, higher equity enables banks to withstand losses more easily, and without being possibly forced by their distress, reduce lending radically. More equity today generally enhances the banks’ ability and willingness to continue lending after a potential downturn in the future, such as a year or two later.<sup>65</sup>

In fact, credit crunches are primarily caused by heavy indebtedness and financial distress, with insufficient equity to absorb losses. They are *not* caused by banks funding with “too much equity.” The initial effect of higher equity requirements on lending that is due to the banks’ unwillingness to raise equity can be avoided by having special rules for the transition to more equity. Banning payouts to shareholders in the transition and specifying target *levels, rather than ratios*, for equity would mitigate the initial impact effect. To be sure, a ban on payouts is only effective if the bank earns profits. Moreover, a new equity issue may not be feasible if investors in the market do not believe that the bank is solvent. In such circumstances, however, as we discussed

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<sup>63</sup> Jordà et al. (2012).

<sup>64</sup> See references in Footnote 25 and S&P, referenced in Footnote 61. References in Footnote 6 are also relevant here, because those who present “capital” as cash being set aside also claim that more “capital” would prevent banks from lending. In the ongoing debate on capital regulation in the US, the website set up by the Bank Policy Institute to “stop Basel Endgame” (<https://stopbaselendgame.com/>) states in enormous letters “This proposal will have REAL CONSEQUENCES FOR EVERYDAY AMERICANS.” The lobbyists warn that the proposal will interfere with the “American Dream” of low-income Americans and harm small businesses. As noted in the context of Flawed Claim 1, some US senators echo these claims made in many advertisements.

<sup>65</sup> In the same spirit, King (2013) said: “Those who argue that requiring higher levels of capital will necessarily restrict lending are wrong. The reverse is true. It is insufficient capital that restricts lending. That is why some of our weaker banks are shrinking their balance sheets. Capital supports lending and provides resilience. And, without a resilient banking system, it will be difficult to sustain a recovery.” Kapan and Minoiu (2013) show that “banks with strong balance sheets were better able to maintain lending during the crisis,” and suggest that “strong bank balance sheets are key for the recovery of credit following crises.” Cole (2013) shows that bank lending to businesses suffered when banks incurred losses and that the Troubled Asset Relief Program (TARP), which did not alleviate the banks’ indebtedness, did not result in improved lending. See “Trump Cites Friends to Say Banks Aren’t Making Loans. They Are,” Zeke Faux, Yalman Onaran, and Jennifer Surane, *Bloomberg*, February 4, 2017, debunking complains by President Donald Trump that banks are not making loans because of regulations.

in the context of Flawed Claim 17, *there is a presumption that the bank may be already insolvent*. As we explain at length in Chapters 3 and 11, such a situation would call for supervisory action anyway, possibly even for closing the bank.

Even without special rules for the transition, the initial effect of higher equity requirements need not be large. Banks' lending decisions depend not only on the amount of funding available to banks but also on how attractive loans are relative to other investments. Many banks, including most of the large banks in the United States, are far from using all their funding to make loans.<sup>66</sup> For example, from late 2019 to March 2022, Silicon Valley Bank (SVB) almost quadrupled its deposits, from \$51 billion to \$198 billion. During the same period, loans went from \$33 billion to \$68 billion. Most of the increase in the bank's funding went into securities, mainly government debt, rather than loans. From late 2019 to March 2022, the bank's securities holdings rose from \$29 billion to \$127 billion. The relatively slow growth of the bank's loans was not due to a lack of funds or an inability to raise more funds, but to the banks' choices to focus on other investments instead.<sup>67</sup>

Although government debt only paid 1.5% per year in interest, SVB considered it to be more attractive than loans. To some extent, this development may have reflected the impact of the Covid pandemic on the demand for loans. It may also have reflected distortions from the risk-weighting system used in capital regulation, which we discuss in Chapters 11 and 14. As we discuss in the context of Flawed Claims 6 and 29 below, this system completely neglected (and still neglects) the risks of changes in the market values of most of the securities SVB held, and no equity backing was required for them at all. Such a bias in risk-weighting creates incentives for banks to invest in securities in the market rather than, for example, make business loans.

For the largest banks, loans to individuals and businesses actually represents a very small fraction of their investments. We point this out in discussing the balance sheet of JPMorgan Chase in Chapter 6, and the same is true today.

It is also false to presume that all lending is useful. Banks help the economy by making *appropriate* loans at *appropriate* interest rates that reflect the borrowers' risks and the cost of funds. Some loans (such as, quite clearly some subprime mortgages prior to 2008) might actually be wasteful and inappropriate; such loans are usually the result of banks counting on someone else to bear the losses. Excessive lending can also result when there are too many banks with too much capacity; in this case, banks' "gambling for survival" may offer cheap loans for a while, but their

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<sup>66</sup> See, for example, Elizabeth Dexheimer, "JPMorgan Leads U.S. Banks Lending Least Deposits in 5 Years," Bloomberg, February 20, 2013. In the same story quotes a principal at Deloitte & Touche LLP, saying that new regulations that include "holding more capital to cushion losses" would impede lending. Quite obviously, especially in the context of the story (about the low ratio of loans to deposits), this statement is fallacious and misleading. This fact may not be as obvious because of the pervasive confusion between capital and cash reserves discussed in Claim 1 above).

<sup>67</sup> Under-investment is among the distortions and inefficiencies associated with heavy borrowing, again due to a "debt overhang" effect. This problem is explained in Chapter 3.

actions may expose the economy to increased risk of a major crisis later. In fact, as already noted, credit crunch and reduced lending are due to debt overhang from excessive borrowing.

**Flawed Claim 20:** Increasing equity requirements would force banks to charge higher interest on loans, which would harm the economy.<sup>68</sup>

**What’s wrong with this claim?** The claim is disingenuous. If banks charge higher interest when equity requirements increase, the reason is that they have higher funding costs. As we explained in the context of Flawed Claim 4, such an effect of increasing equity on funding costs reflects the decrease in benefits that banks draw from tax subsidies to borrowing and from government guarantees to the banks’ creditors. Tax subsidies and government guarantees introduce a dangerous bias into bank funding, causing banks to fund more with debt and less with equity than is desirable for society.

Low equity funding raises the likelihood of a bank failure, with substantial consequences for the banks’ depositors and other creditors and possibly the rest of the economy. If the banks’ depositors and other creditors are bailed out by the government, the consequences are borne by taxpayers.<sup>69</sup> Equity requirements therefore attempt to correct the distortions and to reduce the risks from excessive bank borrowing. The increase in loss absorption capacity of banks that comes from higher equity requirements reduces the danger of a bank failure and the collateral harm it causes or a need for the government to make good on its guarantees.

As explained in the context of Claim 4, the resulting reduction of the value of government guarantees and of tax subsidies to the bank is likely to raise the banks’ per-dollar fundings costs. Therefore, banks may end up charging more for their loans. In this sense, the claim that higher equity requirements may end up burdening the banks’ borrowers is correct. However, the change would be due to the reduction of the banks’ ability to shift costs and risks to others. It might also be due to banks becoming more careful about risks in lending as they must bear the risks of losses themselves instead of having the government underwrite these risks. Such care would hurt high-

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<sup>68</sup> See, for example, Oxford Economics (2013), Elliott (2013) and Cline (2017). William Isaac, in “Better than Brown-Vitter: Make Banks Issue Long-Term Debt,” *American Banker*, June 4, 2013 warns that higher equity requirements on the largest banks would cause them “to decrease their lending dramatically and/or increase significantly the price of loans.” Anat Admati responded with “Too Much Equity? If Anything, Brown-Vitter Asks Too Little,” *American Banker*, June 24, 2013, citing the original version of this document and available here [https://gsb-faculty.stanford.edu/anat-r-admati/files/2022/04/too\\_much\\_equity\\_if\\_anything\\_brown-vitter\\_asks\\_too\\_little\\_american\\_banker.pdf](https://gsb-faculty.stanford.edu/anat-r-admati/files/2022/04/too_much_equity_if_anything_brown-vitter_asks_too_little_american_banker.pdf).

<sup>69</sup> In the case of Silicon Valley Bank, the costs are borne by the other banks, which must pay a special levy to the FDIC. In the Savings and Loans crisis of the early 1990s, the surviving institutions were too weak to bear the costs, so the government had to provide \$124 billion (out of a total bailout cost of \$153 billion). In the spring of 2023, unrealized, unacknowledged losses of US banks were estimated to amount to something like \$2 trillion, an amount that is likely to exceed the industry’s ability to pay through a levy. As of this writing, this problem is still being kicked down the road.

risk borrowers but benefit low-risk borrowers, who would profit from reduced gambling incentives of banks.

One may believe that certain activities of banks, such as lending to small firms, should be subsidized by the government because market frictions keep these activities at artificially low levels. Such subsidies, however, should be directed precisely to the targeted activities. A blanket subsidy to bank borrowing would merely provide banks with artificially cheap funding, which they can use at their discretion, making any investment they find attractive. The cheap funds may not actually go to the loans that the economy needs, and instead the borrowing itself makes banks more fragile, exposes the economy to substantial risks, and distorts banks' investment decisions, giving them incentives to take excessive risk in their investments or to under-invest in relatively safe but worthy loans because bankers do not find them to have enough upside.<sup>70</sup>

The size of the subsidies is not known but there is broad agreement that they are substantial.<sup>71</sup> Measuring their size is difficult even for explicit the explicit subsidies involved in deposit insurance. The subsidy there is inherent in the underpricing of the insurance, the amount of which depends on the likelihood and extent to which it will be needed. In fact, there is reason to believe even many academic studies under-estimate the subsidies.<sup>72</sup> For implicit guarantees,

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<sup>70</sup> For example, Levitin (2014) questions our statements that there is no social cost in reducing distortive subsidies, missing the distinction between social and private costs that is explained in detail in Admati et al. (2013, Section 4). Matt Yglesias, in "Banks Borrow Too Much," Slate, March 7, 2013, expresses concerns regarding the potential cost of withdrawing the banks' subsidies. However, in his subsequent blog post entitled "How I Learned to Stop Worrying and Love Higher Capital Requirements," March 8, 2013, he states that in our book we "in many ways end up underselling the power of [our] idea," emphasizing that, as we explain in Admati et al. (2013, Sections 2 and 9), not only would more equity make banks safer, but it will also make their lending and investment decisions more appropriate and better for society.

<sup>71</sup> For example, see Chapter 3 of IMF 2014 Financial Stability Report, yet in documents such as, "Measuring the TBTF effect on bond pricing," by Goldman Sachs Global Markets Institute, May 22, 2013, large banks argue that large banks do not benefit from a too-big-to-fail effect on their funding costs. There are a number of critical flaws in the Goldman Sachs analysis, and most are discussed in Mark Whitehouse "Too-Big-To-Fail Myths, Goldman Sachs Edition," *Bloomberg View*, May 28, 2013. (See also Christopher Cole, "Goldman's TBTF Study Used Flawed Data to Reach Flawed Conclusions," *American Banker*, May 30, 2013.) First, it compares interest rates on bonds of large banks and small banks without adjusting for differences in the risk creditors are supposedly exposed to. As discussed by Brando et al. (2013), however, too-big-to-fail banks tend to take more risks in their investments than smaller banks; unless the implicit guarantee is perfect, this would raise the interest TBTF banks have to pay. Second, the observation that creditors suffer more in failures of small banks relative to those of large itself reflects too-big-to-fail policies, including support from the Federal Reserve that has provided ample and cheap funding to banks since 2008. The Goldman Sachs paper dismisses findings of a large literature (some of which is also cited in Chapter 9) without engaging on substance, including academic studies that conclude that the value of the subsidies is in the tens of billions of dollars and particularly large in downturns. Many other industry-sponsored studies also fail to correct properly for the funding mix and other parameters of the bank borrowing that would affect the risks that their long-term creditors would be exposed to, relative to those of other companies that do not have access to safety nets.

<sup>72</sup> See Stefan Nagel, "Too Big to Fail is Larger than You Think," *Bloomberg View*, March 2, 2014. Given the opacity and complex structure of the liabilities of the largest banks, it is possible that without any guarantees, the cost of unsecured borrowing to these banks would be prohibitive. Of course, among the reasons banks are able to borrow as much using collaterals is that deposits are unsecured, and at least some assets purchased with deposits can be used as collateral for additional borrowing.

such as the too-big-to-fail treatment of uninsured depositors of Silicon Valley Bank, the subsidy is greater yet.<sup>73</sup>

**Flawed Claim 21:** If equity requirements are increased, the banking sector will have to shrink, and this will be bad for the economy.

**What's wrong with this claim?** As we discussed in the context of several preceding claims, increases in equity requirements do not force banks to shrink. Banks have a choice of whether to raise equity or to divest assets. Quite likely they will choose to divest assets rather than raise equity, but this is a matter of preference rather than necessity. Moreover, such reactions can be forestalled by introducing the new rules in such a way that, at least during the transition, the levels of equity have to be increased and not just the ratios of equity to some measure of banks' assets.

If banks are genuinely unable to raise equity, there is a presumption that they may be insolvent and the supervisors should look into the matter and possibly force the bank to leave the industry. Having the industry shrink by removing insolvent banks makes the industry healthier, which is good for the economy, contrary to the claim. Continued existence of banks with hidden insolvencies would be dangerous because such banks are likely to engage in ruinous competition, putting harmful pressure on other banks.

The existence of nonviable banks that cannot raise equity may indicate that there is excess capacity in the industry. Excess capacity in banking is to be expected if failing banks are bailed out and do not leave the industry. Even before banks fail, guarantees may contribute to excess capacity and ruinous competition by enabling the survival of banks that would not otherwise be viable. In such a situation, downsizing of the industry would be called for and would benefit the economy. The remaining banks would be viable and would have fewer incentives to gamble at the expense of their creditors, taxpayers, and the economy.<sup>74</sup>

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<sup>73</sup> For more on these issues, see Chapter 9, entitled "Sweet Subsidies," which discusses harmful effect of guarantees and subsidies, and Chapters 12 and 13. Chapter 15 discusses the role of central banks in bailouts, Chapter 16 the politics of bailouts.

<sup>74</sup> A relevant example is provided by Germany since the 1970s, where the Landesbanken benefitting from government guarantees and bailouts cannibalized wholesale banking at the expense of the large private banks. More generally, the fact Europe has been much slower than the US in consolidating banks after the crisis of 2007-2009 has contributed to keeping the profitability of European banks low and slowing down the post-crisis cleanup of bank balance sheets. We discuss problems caused by excess capacity in Chapters 11, 14 and 15.

**Flawed Claim 22:** Higher equity requirements would restrict banks' ability to provide market-making services, harm market liquidity, and prevent banks from stabilizing volatile stock markets by countering adverse price movements.<sup>75</sup>

**What's wrong with this claim?** There is no automatic connection between equity requirements and the ability of banks to provide market-making services, or to enhance market liquidity. If banks merely act on commission for their customers, their own accounts are not affected at all. If banks act as counterparties, buying securities that the customers want to sell or selling securities that the customers want to buy, the question is how these transactions fit into the bank's own asset management and portfolio decisions. As discussed in the context of Flawed Claims 18-19 about bank lending, such questions of portfolio choice do not generally depend on the bank's funding mix. To comply with higher equity requirements, banks can retain their earnings and raise more equity. With ample equity, it is moreover likely that asset choices are undistorted by excessive incentives to take risks.

From the customers' perspective, banks' professed desire to provide market making services can be a mixed blessing. In many instances in the past, banks have used their customers' dependence on such services in order to take advantage of the information provided by customers' orders, using practices such as front-running or dual-capacity trading to speculate on the basis of privileged information about their customers' orders.<sup>76</sup> Whereas banks claim that their services improve market liquidity, such practices, which are almost impossible to prevent, actually harm the customers' confidence and the liquidity of the markets.

Market liquidity captures the ability and ease of converting financial securities to cash through trading in markets and the price at which securities can be bought and sold. Liquidity is determined by the balance of reasons for trading of various market participants, namely the availability of buyers and sellers at a given time and price, the trading mechanism that determines the market price (for example, how buyers and sellers find each other, whether an intermediary or an exchange is involved, etc.), and, importantly, on the information that participants have about the value of the security, which may differ across participants. Liquidity can be reduced, or even break down, if some participants have much better information than others, creating so-called

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<sup>75</sup> For example, "Bank Capital Needs Seen Soaring on Basel Market-Risk Review," John Glover and Boris Groendahl, Bloomberg, October 20, 2015, quotes Mark Gheerbrant from the International Swaps and Derivatives Association (ISDA) saying "We're concerned about the impact [increased capital requirements] will have on market liquidity". Jürgen Fitschen, Co-CEO of Deutsche Bank claimed that, as we saw recently, banks will be less able to counter adverse market moves, with reference to the stock market declines in the summer of 2015 (see "Wenn es uns zu gut geht, machen wir Fehler" – "If we are doing too well, we make mistakes," Handelsblatt, September 3, 2015.). Duffie (2016) also argues that higher equity requirements will harm market liquidity, making the (flawed) assumption that regulators do not have tools to counter inefficient responses in a transition to higher equity requirements, such as by restricting payouts and mandating equity issuance and thus referring to "balance sheet space" as something costly that we must encourage or enable banks to use for such things as market making.

<sup>76</sup> See, for example, Pagano and Röell (1990, 1993) and Röell (1990). The debate on high-frequency trading involves similar issues. Some of the episodes in Lewis (2014) illustrate the problem and the potentially large social costs involved.

adverse selection (similar to the market for used car). Whether some financial institutions must use more equity funding for their trading does not bear directly on any of these considerations. More generally, the resilience of intermediaries is likely to enhance, rather than harm, market resilience.<sup>77</sup>

There is also no automatic connection between equity requirements and the positions banks take in stock markets, except perhaps that stock market investments might involve higher risk weights than other kinds of investments. Solvent banks can always raise additional equity if their portfolio decisions require it. Higher risk weights for stock market investments – or prohibitions of stock market investments under the Glass-Steagall Act or the Volcker Rule in the United States) – reflect the assessment that such investments may be too dangerous for banks. The banker’s promise that he will do his best to prevent stock prices from falling, if actually not empty, should raise concerns about the risks the banks are taking. When banks tried to stop and reverse a falling stock market on October 24, 1929, it only took four days for them to realize the futility of the effort and the size of the losses they had incurred.<sup>78</sup>

In this context, it is useful to note that the worldwide decline in stock market values after the Lehman Brothers bankruptcy amounted to some \$20 trillion, three or four times the decline after the burst of the tech bubble in the early 2000s. This decline was greatly exacerbated by banks’ scrambling for cash and selling assets as money markets on which they had relied for funding ceased to function. Lack of equity to absorb losses from “toxic” assets was one reason so many banks were mistrusted and were unable to roll over their short-term funding.

**Flawed Claim 23:** Higher equity requirements would cause banks to increase their “risk appetite,” which will make the system more dangerous.<sup>79</sup>

**What’s wrong with this claim?** As we discuss in Chapter 8, such a claim was made by Bob Diamond when he was CEO of Barclays. Statements like these may be empty threats, but if they are not, they raise serious concerns about governance that should trouble not only regulators and supervisors but also banks’ shareholders. If risks are worth taking on behalf of the banks’ investors, why aren’t the banks already taking them? If the risks are not worth taking, why would the banks take them when they are funded with more equity?

Contrary to what the claim suggests, having more equity funding would seem to *reduce* the shareholders’ “risk appetite.” If equity is low, a risky strategy may look attractive because taxpayers bear the losses if the strategy fails. With higher equity, this strategy may become unattractive because the threshold for losses at which taxpayers come in is higher, i.e., shareholders

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<sup>77</sup> See “Bond Market Liquidity: Should we be Worried?” Stephen G Cecchetti and Kermit Schoenholtz. Blog, August 17, 2015. Liquidity requirements, which mandate the holdings of assets within specific set, may have a direct effect on the willingness of institutions to trade in or make certain markets.

<sup>78</sup> See Galbraith (1954, pp. 105-120).

<sup>79</sup> See, for example, Bill Black, “Brown-Vitter Will not and Cannot Work but it is Criminogenic,” Naked Capitalism blog, May 11, 2013.



bear a greater part of the downside risk. By the same logic, a strategy that shareholders consider unattractive when equity is low should be even more unattractive to them when equity is higher.

The claim appears related to the flawed focus on ROE in banking that we discuss in Chapter 8 and Flawed Claim 16.<sup>80</sup> When equity is higher, the rate of return per dollar invested in equity is lower. A manager who gets a bonus of \$1 million if ROE exceeds 20% and none if ROE is less than 20% may decide that with higher equity, he must gamble in Las Vegas because otherwise he has no chance of getting an ROE above 20%. In Las Vegas, his chance of getting there may be miniscule, but at least it is not zero. However, not adjusting the bonus system to the regulatory environment is a serious flaw in corporate governance.

**Flawed Claim 24:** If equity requirements are increased, the discipline that creditors impose on bank managers will decline.<sup>81</sup>

**What's wrong with this claim?** The claim rests on the false notion that bank creditors can “discipline” bankers, or provide better governance, than shareholders, and that bankers are more disciplined when investing borrowed money than when they invest shareholders’ money.

The academic literature includes theoretical models that claim to capture the idea that “debt disciplines managers.” Some such theories are specific to banks, arguing that by threatening to withdraw their funding, depositors and short-term creditors can provide “discipline.” As we have argued in various writings, these models are a poor basis for policy advice because they lack empirical support and ignore critical elements of the real world which, if included, would reverse their conclusions.<sup>82</sup> The fact that assertions about the real world are made on the basis of theoretical

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<sup>80</sup> See also Anat Admati, “Beware of Banks’ Flawed Focus on Return on Equity,” *New York Times Dealbook*, July 25, 2011, and Anat Admati and Martin Hellwig, “The Case Against Banking’s Case for Less Capital,” Bloomberg View, February 5, 2013.

<sup>81</sup> For example, French et al. (2010) asserts, with no evidence: “Debt is valuable in a bank’s capital structure because it provides an important disciplining force for management.” Raghuram Rajan, in “Love the Bank, Hate the Banker,” *Project Syndicate*, March 27, 2013, refers to the Washington Mutual (WaMu) failure and claims that it illustrates how the threat of runs helps provide “discipline” to bank managers. In fact, the timing of the events in the WaMu is at odds with Rajan’s claim. The run on WaMu started after the Lehman Brothers bankruptcy on September 15, 2008, the bank was closed on September 24, 2008, and there is no evidence of disciplinary effects of the threat of a run before September 15. See also Rajan’s contribution to the Nobel Symposium in Stockholm 2018, (<https://www.youtube.com/watch?v=3rvUXmrv5Hk>) and Martin Hellwig’s comments at the same symposium ([https://www.youtube.com/watch?v=Mf\\_AEKpVjk](https://www.youtube.com/watch?v=Mf_AEKpVjk))

<sup>82</sup> See Admati et al. (2013, Section 5), which first appeared in 2010, and Admati and Hellwig (2013). The latter document concerns that we omitted from the book after we were told that they were of interest to academics only. In Admati and Hellwig (2013), we explain that high indebtedness in banking, and the fragility it causes, probably reflect a *lack* of discipline, as bankers have unchecked access to borrowing even if bankruptcy is already imminent. See also Pflleiderer (2018), Anat Admati “Political Economy, Blind Spots, and a Challenge to Academics,” ProMarket, November 15, 2019 and Chapters 14 and 17.

models without justifying the appropriateness of the models or addressing the critical issues we raise about their inadequacy is highly disturbing.

The experience of Silicon Valley Bank (SVB) confirms this assessment. From March 2020 until March 2022, this bank experienced enormous growth in uninsured deposits. It invested many of the additional funds in securities that paid interest on the order of 1.5% per year, fixed over many years. At a time when Federal Reserve policy kept market rates of interest near zero, depositors were pleased to avoid the hassles of recurrent money market investments and just kept their funds at SVB. The average deposit amounted to some \$4 million, so the depositors' stakes were quite substantial. Yet the depositors did not pay attention to the risks that the bank was running, let alone "discipline" the risk taken by bank's managers. With money interest rates near zero, it should have been obvious to all that, at some point, interest rates would have to go up, at which point depositors might want to move into money market investments again and, at the same time, the securities held by the bank would lose in value. When interest rates did rise in 2022, depositors did begin to move their funds out of the bank and the bank's investments did lose substantially in value so that as early as September 2020, the value of the bank's assets was less than its liabilities. However, a run only occurred when the bank's own announcement on March 8, 2023 made it clear that the bank's insolvency would be laid open shortly. Depositors did not exert any discipline when there was still time.

Perhaps, the depositors of SVB did not care about the bank's risks because they expected to be bailed out anyway, as they actually were when the bank went under. If so, the notion of creditors exerting discipline is altogether moot since bailout expectations remove any incentives to monitor.

This consideration is also relevant for long-term debt. In some of the discussion on debt funding as a disciplining device, long-term debt is proposed as an alternative to short-term debt because long-term debt does not involve much risk of a run.<sup>83</sup> Even so, however, long-term debt may still generate systemic risk. If debt holders are sufficiently important for the financial system, for example large insurance companies, it may be deemed undesirable to impose losses on them in resolution or insolvency.

Indeed, the too-big-to-fail problem is relevant for long-term debt as well as short-term debt in that the collateral damage associated with distress or insolvency may lead to bailouts. If debt holders believe they can count on being bailed out, they will not impose any discipline on the bank. We discuss this point further in the context of Claims 36 and 37 below, which concern proposals to regulate the banks' funding by loss-absorbing long-term debt, rather than equity.

Second, even if long-term creditors want to impose discipline, the scope for doing so is limited. For example, with a ten-year bond, on average one tenth of the debt is rolled over each

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<sup>83</sup> French et al. (2010), Poole (2010).

year. But discipline can only be imposed when the debt must be renewed, and investors negotiate with the bank for the conditions under which a renewal would be granted. As we have argued in the context of the possibility that deposit and short-term debt provide “discipline,” long-term debt may in fact provide the precise *opposite* of discipline: Negotiating with new short-term creditors or offering them collateral can make incumbent long-term creditors worse off (should they expect to bear losses), yet these creditors are unable to withdraw their claims until the debt expires.

**Flawed Claim 25:** Historically, banks have never had as much as 30% equity; requiring as much equity would therefore harm the business of banking.<sup>84</sup>

**What’s wrong with this claim?** The statement is false. First, references provided in our book (particularly in notes 20-27 to Chapter 2) support the claim that going back more than a century to the period before bank owners and shareholders could rely on creditors, central banks, or governments to pay their creditors, it was common for banks to have as much as 50% equity. Second, arguments based on history presume that circumstances are similar. However, since the 1970s (uninsurable) macroeconomic risks have become much larger than they had been in the preceding decades. More importantly, financial institutions worldwide have become much more interconnected; this has greatly increased systemic from contagion. In some parts of the business also competition has become much more intense; this has reduced the ability of banks to rely on margins to provide buffers against shocks.

Our proposed leverage ratios *do not only stand* on historical figures but are rather based on the economic arguments, on observations of funding mixes in other, unregulated industries, and on considerations of the social costs of banks’ choices when they borrow so excessively. As explained in details in the book and earlier in this document, the economics of debt and equity funding is not fundamentally different for banks even though some of the rewards to the banks’ debtholders are provided through services, for payments and other uses of liquidity. Quite clearly, the bankruptcy of Lehman Brothers caused significant collateral damage. As Admati et al. (2013, 2018) explain, markets may allow leverage to get socially, and even privately, excessive. Requiring investment banks, which can scale up risk and become systemic, to have 30% equity corrects this situation and produces substantial social benefits with minimal if any relevant cost.<sup>85</sup>

We are sometimes asked why we do not go to 100% equity. The reason is precisely that deposits do provide benefits that are not captured by standard corporate finance arguments.

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<sup>84</sup> Calomiris (2013) and Levitin (2014).

<sup>85</sup> Economist John Cochrane concluded his *Wall Street Journal* review of our 2013 book by the statement: “How much capital should banks issue? Enough so that it doesn't matter! Enough so that we never, ever hear again the cry that “banks need to be recapitalized” (at taxpayer expense)!” See “Running on Empty,” John Cochrane, *Wall Street Journal*, March 1, 2013, posted with an introduction at <https://johnhcochrane.blogspot.com/2013/03/the-bankers-new-clothes-review.html>. Cochrane summarizes the bottom line of his review as being “Banks should issue a lot more equity, a lot less debt, especially short-term debt, and a heck of a lot less nonsense.””

However, for many large banks today, deposits account for only a part of their funding.<sup>86</sup> The 30% ratio we propose is roughly what banks themselves impose on financial institutions, such as hedge funds or REITs, to which they lend, which have similarly diversified portfolios.

**Flawed Claim 26:** There is not enough equity around for banks to be funded with 30% equity.<sup>87</sup>

**What’s wrong with this claim?** As explained in the context of Flawed Claim 1, equity is not a cash reserve but a financial claim that banks can issue to obtain funding for their investments. Contrary to this claim, higher equity funding for banks does *not* require new savings and new inflows into capital markets. If a bank issues more equity and uses the funds it obtains to buy listed securities, capital markets will adjust so that investors who have sold the other securities will hold additional bank shares because the bank’s returns would partly reflect the returns on those other securities. No new savings and no new inflows of funds into capital markets are required. To the extent that all assets in the economy are held by, and all risks are borne ultimately by end investors and taxpayers, the effect of a reshuffling of financial claims to make sure more equity funds banks’ investments would generate less distorted, more appropriately priced investments in the economy.<sup>88</sup>

## “Bank Regulation and Supervision are Already Tough”

Bankers and policymakers repeatedly assert that regulations are tough enough, that banks are “safe enough” and that any tightening is unnecessary and costly. In fact, the “reformed” rules are not based on any serious analysis of the lessons of the financial crisis of 2007-2009 and other experiences. They rest on politics, tradition, and pseudo-science, and are not well-suited to support financial stability.

**Flawed Claim 27:** Basel III is already very tough, doubling or tripling previous requirements; banks that comply with Basel III requirements are safe enough.<sup>89</sup>

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<sup>86</sup> See Advisory Scientific Committee (2014), as well as Chapters 6 and 14.

<sup>87</sup> For example, Elliott (2013) stresses that frictions in capital markets make it difficult or impossible for banks to raise new equity. As we discuss in Chapter 11, and in Admati et al. (2018), the arguments he gives that allude to information asymmetries are not applicable to retention of earnings or to new equity issues through rights offerings.

<sup>88</sup> A more detailed discussion of this argument is offered in Sections 7 and 9 of Admati et al. (2013), as well as Admati et al. (2012). At current levels of indebtedness, individual institutions, and the banking sector as a whole, are likely to be inefficiently bloated due to excessive subsidies. See also the discussion of Flawed Claims 17 and 21.

<sup>89</sup> The term “Basel III” refers to the agreement concluded in 2010, which we discuss in Chapters 6 and 11. Claims that Basel III is tough have been made throughout, by regulators, bankers and others. However, as we discuss in Chapter 14, by the mid-2010s, regulators and supervisors became concerned about the scope for flawed assessments in risk weighting, so in 2017, they concluded a new agreement, called “Finalizing Basel III”, which proposes to limit the scope for abuses of risk-weighting somewhat (BCBS 2017). See also our discussion of Flawed Claim 6 above.

**What's wrong with this claim?** These statements use a flawed benchmark. Basel III was considered tough because previous requirements had been extremely lax. As Martin Wolf put it in the *Financial Times*, “tripling almost nothing does not give one very much.”<sup>90</sup>

The vaunted tripling of requirements refers to risk-weighted, rather than total assets. On the use of risk-weighting, see our discussion As of Flawed Claim 6. Before the crisis of 2007-2009, many important banks had used risk-weighting and *risk-weight management* to fund 98% or more of their assets by borrowing; their equity funded less than 2% of their assets. Tripling the ratio of required equity to risk-weighted assets does not have much of an effect on required equity if the risk weights are zero or almost zero.

Turning from equity relative to risk-weighted assets to equity relative to total assets, we note that Basel III allows banks to fund up to 97% of the assets on their balance sheets by borrowing, i.e., to have equity funding as low as 3%. This so-called *leverage ratio* requirement was introduced to take account of the fact that, in the crisis, risk-weighting of assets had been seen to be unreliable and that banks with very low risk weights and very low equity relative to total assets had been most vulnerable. However, equity equal to 3% of total assets is just what Lehman Brothers had shortly before going bankrupt. At this low level of equity, investors' doubts about the values that Lehman Brothers had assigned to mortgages in its portfolio, quickly became doubts about the solvency of Lehman Brothers.<sup>91</sup> These doubts triggered the collapse of the bank.

All the requirements refer to accounting measures of asset holdings and of equity. Accounting conventions can matter greatly, including how they treat off-balance-sheet exposures and derivatives.<sup>92</sup>

Accounting measures ignore many off-balance sheet commitments. They also involve significant biases towards overvaluing assets and overstating equity. Overvaluations of assets are to be expected because bank managers have strong incentives to avoid showing losses in asset value. Showing such losses will likely reduce the bonus components of their remuneration. It may also raise questions about their past strategy choices – and even about the bank's solvency. The overstatement of equity that goes along with an overvaluation of bank assets also suits the bank's managers by providing more room for borrowing.

The accountants often go along because they do not want to lose profitable clients.<sup>93</sup> Some accounting rules actually seem designed to make room for the overvaluation of assets. One

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<sup>90</sup> Martin Wolf, “Basel: The Mouse that Did not Roar,” *Financial Times*, September 14, 2010

<sup>91</sup> These mortgages were held in “warehousing”. They had been acquired for the purpose of securitization. However, as the markets for mortgage-backed securities had broken down, the bank was unable to securitize and sell them without substantial losses. Investors were concerned that the bank had not (or not much) depreciated the values of these mortgages in its accounts. On this issue, see Ball (2018), Chari (2022).

<sup>92</sup> On accounting issues and ways banks can manipulate them through securitization and derivatives, see Kerr (2011). According to Singh and Alam, 2018, off-balance-sheet funding for many banks was greater in 2016 than in 2007.

<sup>93</sup> We discuss the role of accountants and other “gatekeepers” in Chapter 17.

example involves “tax assets,” the assessed value of savings on future taxes that are expected because of past overpayments of taxes or because of a loss carry-forward that can be used to reduce taxable profits in the future. The value of these assets depends on the taxable profits one expects to earn in the future. Any self-respecting bank manager “knows” that these profits will be large. In the late summer of 2022, however, the decline of Swiss megabank Credit Suisse was much accelerated when it had to acknowledge that it was writing US tax assets of almost 4 billion Swiss francs down to zero because there was no prospect of earning enough profits to benefit from these assets.

Other examples involve valuation rules for securities that are classified as “held to maturity” and for subsidiaries. Valuations of securities that are classified as “held to maturity” are exempt from rules requiring adjustments to changes in market values. Our discussion of Flawed Claim 29 below shows that this rule enabled Silicon Valley Bank to maintain the appearance of being solvent, with an accounting value of equity on the order of 8% of total assets, even as unacknowledged losses exceeded the accounting value of equity, i.e., the bank was insolvent already. In the case of Credit Suisse, the valuations assigned to different subsidiaries and different financial reporting lines differed quite markedly between the consolidated group accounts under international reporting standards and the parent’s accounts under Swiss law. For the end of 2022, the consolidated group accounts showed equity equal to 45 billion Swiss francs, the parent’s accounts showed equity of 22 billion Swiss francs. The parent’s accounts also showed a loss of 24 billion Swiss francs, in contrast to 7 billion Swiss francs in the consolidated group accounts. Whereas the much larger loss in the parent’s account is attributed to depreciation in the value of participations, the consolidated group accounts are accompanied by the statement that a thorough examination of business prospects showed no need for any further depreciation in values attached to any line of business, as well as a statement that “internal control over financial reporting was not effective.”

Given the biases in asset valuations and equity statements, the appropriate standard for assessing equity requirements is not given by the actual equity banks used in the runup to the crisis of 2007-2009. The question is whether the requirement for reported equity is sufficient to make the bank robust against losses even when one takes account of the fact that true loss absorption capacity may be significantly smaller than is indicated by reported equity.<sup>94</sup>

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<sup>94</sup> We make this case in detail in Chapters 11 and 14. Among those providing evidence, Haldane (2011) shows that banks that needed significant bailouts (“crisis banks”) had regulatory ratios that were, if anything, stronger than banks that did not need as much supports. Singh and Alam (2018) show that off balance sheet exposures appear higher in 2017 than in 2007. Sarin and Summers (2016) show that “the ratio of the market value of common equity to assets on both a risk-adjusted and risk-unadjusted basis has declined significantly for most major institutions” (relative to pre-crisis period). Efforts to point out the poor design and inadequacy of Basel III go back to 2010. Following Admati et al. (2010, revised 2013), a letter from twenty academics in finance and banking, published in Financial Times on November 9, 2010 and available here <https://www.gsb.stanford.edu/faculty-research/excessive-leverage/healthy-banking-system-goal> states: “The Basel III proposals... fail to eliminate key structural flaws in the current system....

**Flawed Claim 28:** Basel III and its implementation in different jurisdictions, are based on reliable scientific analysis of the costs and benefits of different levels of equity requirements.<sup>95</sup>

**What’s wrong with this claim?** Basel III and its implementation in different jurisdictions are the result of politics rather than serious analysis. The same is true for the 2017 amendment to the 2010 Basel III accord, which is discussed under the label “finalization of Basel III” in the European Union and under the label “Basel Endgame” in the United States.

Originally the Basel Accord was meant to provide a set of minimal standards with the effect that the banks of any jurisdiction that satisfied these standards would be admitted to doing business in other jurisdictions while supervised by their home country authorities. When Basel III was agreed, however, the European Union chose to deviate from it, for example, by counting certain kinds of contingent debt as equity even though it was not. In the current discussion, it is going even further, loosening some of the new requirements in order “to take account of European specificities.”<sup>96</sup> At the same time, US banks are lobbying furiously against the proposed “Basel Endgame” rules. The actual legislation that emerges is determined by politics, where different jurisdictions test what they can get away with without provoking strong retaliation from others.

In the years after Basel III was introduced, the Basel Committee came to recognize that there is a problem with risk weights under the model-based approach. The Committee observed that model-based assessments of risks of the same asset portfolios exhibit an unconscionable amount of heterogeneity across banks. On the basis of this observation, it initiated another round of negotiations that led to the 2017 agreement “to finalize Basel III.” Under this new agreement, the model-based approach for computing capital requirements can only be used if risk-weighted assets under this approach are no less than 72.5 % of risk-weighted assets under the so-called standard approach.<sup>97</sup> The reform reduces the scope for manipulating capital requirements through the design of risk models, but it does not address the problem that even in the standardized approach, important risks are overlooked.

As for the “science” underlying capital requirements, in Chapters 11 and 14 we argue that the studies that supposedly support the Basel III rules are based on flawed models and their quantitative results are meaningless. For example, these studies assume that the required return

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Basel III is far from sufficient to protect the system from recurring crises. If a much larger fraction, at least 15%, of banks’ total, non-risk-weighted, assets were funded by equity, the social benefits would be substantial. And the social costs would be minimal, if any.” The letter makes briefly many of the points discussed elsewhere in this document. Hoenig (2013, 2023), Goldstein (2017), and Cecchetti and Schoenholtz (2017) also argue that capital requirements under Basel III are inadequate and problematic. We discuss the risk-based design in other claims.

<sup>95</sup> Claims that the requirements are tough and based on “science” are frequently made by regulators, bankers and others. For example, in a November 19, 2013 interview to *Die Welt*, Lloyd Blankfein, CEO of Goldman Sachs, said: “The new capital adequacy regulations under Basel III are the results of a long and meticulous process.”

<sup>96</sup> See Chapter 14 and the references given there. Even as the negotiations about the “completion of Basel III” were taking place, France, Germany and the European Commission announced that the European Union would not abide by the new rules.

<sup>97</sup> See Basel Committee on Bank Supervision BCBS (2015, 2017). We discuss this development in Chapter 14.

on equity is independent of risk; one paper purports to derive the “optimality” of Basel III without even considering the costs that bank failures impose on the rest of the financial system and the economy.<sup>98</sup> The “scientific” papers that discuss costs and benefits of different capital requirements also ignore the distinction between private and social costs, the distortions in investments associated with high leverage, and the problems with risk weights, discussed below.<sup>99</sup>

The fact that studies end up with precise numbers for “optimal” capital regulation is irrelevant if the foundations of the studies are shaky. We are not aware of any theory or model that would provide appropriate estimates of the costs and benefits to society associated with different funding mixes for banks. Despite this, we are confident in asserting that equity levels of three percent of total assets, as admitted by Basel III, are unsafe, and that a significant increase will substantially improve the health and safety of the financial system. Low levels of equity expose the banks and the economy to unnecessary risk. And allowing banks to rely as much on subsidized borrowing distorts the economy. Effective regulation to counter the banks’ tendency to choose unsafe levels of equity is essential.

**Flawed Claim 29:** Assigning risk weights to assets when determining required equity is a way of bringing serious quantitative analysis to bear on bank regulation.<sup>100</sup>

**What’s wrong with this claim?** As we discuss in Chapters 11 and 14 and above in the context for Flawed Claims 6 and 28, risk weights under the Basel approach have more to do with politics and tradition than with science. In fact, the Basel rules ignore important sources of risk altogether: Risks from sovereign debt that is funded in the currency of the country in question, risks of changes in funding conditions for medium or long-term loans, risks from the possibility that borrowers might default simultaneously because their default risks are correlated. Risk from sovereign debt that is funded in the currency of the country was in evidence in the Greek default in 2012. Funding risk for long-term loans was a key factor in the S&L crisis in the 1980s and again in the US crisis in spring 2023 involving Silicon Valley Bank (SVB) and First Republic Bank. Correlated borrower defaults were a major factor in the subprime mortgage crisis of 2006-2009.

Even if the politics of the regulation could be defused, the problem of measuring risk can hardly be solved. For example, in cross-border lending, a bank may try to eliminate the exchange rate risk by denominating the contract in its own currency. If the borrower is a bank in another country, it may also try to eliminate the exchange rate risk by denominating the contract in the

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<sup>98</sup> The paper is Angelini et al. (2011). Admati et al. (2013) discusses some of flaws in this paper as well as others produced by the Basel Committee on Bank Supervision and other members of the supervisory community.

<sup>99</sup> A recent paper, Brooke et al. (2015) still includes a flawed analysis of the tradeoffs. For a discussion of some of the flaws, see Admati (2016).

<sup>100</sup> For example, Tom Braithwaite (referenced in Footnote 41) praises the Basel risk weights system for controlling banks’ risks. Most regulators appear to take it for granted that risk weights are essential, and the Federal Reserve has proposed to adopt Basel III, including the use of risk weights, for all US banks.



currency in which it borrows. If the final borrowers are entrepreneurs, however, who earn money in the currency of their country, the mismatch between the currency in which they earn money and the currency in which they owe money may cause them to go bankrupt if their home currency is devalued. The banks that lent to these entrepreneurs may then also go bankrupt, and the international banks that lent to these banks may find that their wonderful risk management has only transformed the exchange rate risk of their loan into a credit risk.<sup>101</sup>

Such constellations, where attempts to hedge some underlying risks by suitable hedge strategies merely transform the risks into correlated counterparty credit risks, occur in many contexts. Proper measurement of the risks to which a bank is exposed would have to consider the counterparty credit risks and their correlations with the underlying risks of the banks. The scope for doing so is limited by a lack of data and by the never-ending changes in risks and correlations that occur when counterparties change their own positions.

In practice, the use of risk weights in bank regulation allows banks to be extremely highly indebted, masks important risks, and adds to the interconnectedness of the system. Whereas proponents of the system argue that it is important to require banks to have more equity funding when their assets are riskier, in fact the system allows banks to get away with *much less* equity funding when they say that their assets are less risky. A uniform ratio of required equity to total assets would provide a lower bound on the banks' leverage and would enable supervisors to intervene when the ratio is breached before it may be too late. By contrast, because some risk weights are (near) zero, the risk-weighting system allows very high leverage. Thus, banks could take large positions in assets with (close to) zero risk weights, such as Greek sovereign debt or AAA-rated toxic securities and fund them almost entirely with debt and with hardly any equity. The system also distorts banks investment decisions, typically against business lending, and is highly manipulable by the banks.<sup>102</sup>

The ability of banks to “economize on equity” is enhanced by their ability to use their own models to assess risks. The scope for manipulation they have is largest for assets in the trading book, which is why they were keen to put mortgage-backed securities and the like into the trading book, subject to mark-to-market accounting rules. Most of the losses in 2007-2009 were incurred on assets in the trading book, where equity often was as low as 1 percent of investments.<sup>103</sup>

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<sup>101</sup> The text describes the experience of international banks, Thai banks and Thai entrepreneurs in the 1997 crisis.

<sup>102</sup> See further discussion in Chapters 11 and 14. The report on JP Morgan Chase “London Whale” loss by the Senate Committee on Investigation specifically refers to attempts to manipulate models, and points to poor risk controls. See, for example, David Henry and Lauren Tara LaCapra, “JPMorgan and other banks tinker with risk models,” Reuters, March 18, 2013, and Floyd Norris, “Masked by Gibberish, the Risks Run Amok,” *New York Times*, March 21, 2013. On the flaws in the Basel approach, see also Haldane (2011, 2012, 2013), Hoenig (2013), Joe Rizzi, “Risk-Based Capital: The Good, the Bad and Mostly the Ugly,” *American Banker*, May 20, 2013, William Isaac, referenced in Footnote 68, and Robert T. Taylor, “Basel Rules Echo Missteps of S&L Era,” *American Banker*, June 19, 2013. See also a related discussion in Dowd (2015) in the context of stress test.

<sup>103</sup> FSA (2010).

Credit risk on assets in the bank book, i.e., assets that banks claimed they intended to hold to maturity, played less of a role in the crisis (except for sovereign exposures in the euro crisis). The changes in regulation (“Basel II”) that allow banks to use their own models to assess credit risk were only being introduced when the crisis unfolded. However recent empirical research has shown that the use of model-based internal ratings to assess credit risk and determine risk weights for capital regulation has gone along with a significant deterioration in the quality of these assessments: for comparable borrowers, internal ratings are better and actual risk incidence is worse than under the previously used “standard approach.”<sup>104</sup>

**Flawed Claim 30:** The fate of Silicon Valley Bank (SVB) shows that equity is unimportant for a bank’s survival; a bank’s survival depends on its liquidity, and that can vanish for no reason at all if depositors or other short-term creditors decide to run or not to roll over the bank’s debt.

**What’s wrong with this claim?** While the collapse of SVB involved a depositor run, this run did not occur “for no reason at all.” SVB’s equity had actually been negative since at least since September 2022. The fact that the bank had been insolvent during the months since then was merely hidden because of inappropriate accounting rules that allowed losses to go unrecognized. The bank’s announcements of March 8 made clear that the insolvency would shortly be laid open, and that information triggered the run.<sup>105</sup>

During the pandemic, in 2020 and 2021, while interest rates in money markets were near zero, many investors found it easier to hold their liquid assets in the form of deposits with SVB and other banks rather than in money market investments. SVB invested primarily in long-term securities, such as government bonds.<sup>106</sup> These bonds had no default risk, but they were subject to interest rate risk. The 1.5% interest on government bonds issued in 2020 and 2021 was better than the rates paid in money markets in those years, but it was worse than the rates paid in money markets in the second half of 2022 and in 2023, when these rates had risen to over 4%. rates Given the higher interest rates in the market the market prices of these low-rate long-term securities had to fall so that the rates of return on investing in them would be competitive with money market investments. This fall in securities prices caused losses for SVB. By September 2022, these losses exceeded the bank’s equity. The losses were shown in the notes accompanying SVB’s quarterly accounts but not in the accounts themselves because SVB had classified them as “held to maturity.” This classification exempted the bank from adjusting these assets’ valuations to the changes in market prices.

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<sup>104</sup> See Behn et al. (2022, first put out as a discussion paper in 2014).

<sup>105</sup> Chapter 14 discusses the SVB experience in detail, including the parallels between SVB and the experience of US savings and loan institutions in the 1980s. See also Anat Admati, Martin Hellwig and Richard Portes, “When Will they Ever Learn? The US Banking Crisis of 2023,” VoxEU, May 18, 2023.

<sup>106</sup> First Republic Bank, which also went under in the spring of 2023, provided long-term mortgages to wealthy clients.

At the same time, as market interest rates had gone up, many depositors had alternative opportunities to obtain higher rates in the market and left SVB. The bank's announcement on March 8 of losses from selling some of its government bonds showed that, because of these withdrawals, it would shortly have to start selling "held-to-maturity" securities, at which point, it would have to acknowledge the market value loss for the entire portfolio and acknowledge its insolvency. Given this information and the observation that no new equity was forthcoming, the depositors ran immediately.<sup>107</sup>

An equity requirement on the order of 20% would have restricted the bank's growth in 2020 and 2021. It would also have improved the bank's ability to absorb the market value losses on the securities it purchased. Moreover, it would have caused the authorities to intervene before the insolvency became obvious. There would have been much less of a bailout of uninsured depositors, if any at all. The other members of the industry would have been spared the extra levy needed to cover the FDIC's losses from the bailout that did occur.

**Flawed Claim 31:** For fixed-rate loans and securities that banks intend to hold until they mature (in the so-called bank book), interest rate risk does not matter, and it is appropriate that risk weights under Basel III do not take this risk into account.

**What's wrong with this claim?** Whereas the interest that banks earn on fixed-rate loans and securities is independent of market rates of interest, which can change, the same is not true for the conditions that govern bank funding. Deposits and money market borrowing have short maturities. If they are not renewed, the bank may be unable to go through with the intention of holding longer-term assets until they mature. Nonrenewal of short-term funding is most likely when market rates of interest have risen so that investors have attractive alternatives elsewhere, as happened to SVB starting in 2022. As we discuss in Chapters 4 and 14, it is also what happened to US savings and loan institutions (S&Ls) around 1980, when money market funds offered interest rates on the order of 15% for deposit-like investments, in line with the development of money market rates, while government regulations kept interest rates on saving deposits at much lower levels.

If maturities are short, a continuation of funding can be assured if banks adjust their deposit rates to changes in market rates. Thus, in the early 1980s, deregulation of deposit rates enabled the S&Ls to compete with money market funds and to maintain their deposits and even experience substantial growth in the 1980s.

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<sup>107</sup> The hidden insolvency of First Republic Bank also became apparent at this point. First Republic Bank used loans from the Federal Reserve as well as, like SVB before its failure, from the Federal Home Loan Bank of San Francisco to avert default. These loans required collateral, further depleting the assets FDIC could possess after closing them. On the Federal Home Loan Banks (FHLB), which the authors refer to "a byzantine corner of the US financial system," see Stephen Cecchetti, Kim Schoenholtz, and Lawrence White, "The Dangerous Role of America's Weird Lenders-of-Next-to-Last Resort," *Financial Times*, August 17, 2023.

However, the maintenance of bank funding by an adjustment of deposit rates does not altogether solve the problem posed by the increase in market rates of interest. In the early 1980s, after deregulation of deposit rates, the S&Ls found themselves paying 15% to depositor while earning 6% on the forty-year mortgages they had granted in 1965, which still had over twenty years to go. This mismatch caused large losses even without any changes in the reported accounting values of those mortgages from the 1960s. If reported accounting values had been adjusted, probably more than one half of the S&Ls would have been considered insolvent right away. Instead, the insolvencies remained hidden, the zombies went on to “gamble for resurrection” by taking large risks, and the industry all but collapsed around 1990, at huge costs to taxpayers.<sup>108</sup>

In 2022 and 2023, US authorities seemed intent on repeating the S&L experience. In 2022, they failed to recognize that, as market rates of interest increased, investors who had moved into bank deposits in 2020 and 2021, when market rates were near zero, would move out of deposits again to avail themselves of more attractive alternatives in the market. They also failed to recognize that the increases in market rates of interest caused the market values of fixed-rate investments to decline and that this decline was threatening the banks’ solvency. In 2023, US authorities treated the banks as if they had only liquidity problems, so after the collapse of SVB and other banks, the Federal Reserve expanded its liquidity provision to the industry. However, if liquidity is provided at 5% and securities purchased in 2020 and 2021 yield 1.5% per year, banks have a hard time even if they can avoid realizing or even acknowledging the market value losses on their assets. The profit squeeze from the mismatch between the interest banks must pay and the interest they earn on long-term assets is likely to distort their ongoing decisions, with potentially disastrous consequences for the future.

In summary, interest rate risk does matter even if banks intend to hold their assets until they mature. Neglect of this risk in Basel III is an example of tradition and politics winning out over analysis. So much for the “science” underlying Basel III!

In the euro area, supervisors have begun to take account of interest rate risk in the bank book. They do so under auspices of what is called Pillar 2, the part of Basel III that deals with the quality and professionalism of bank management, particularly risk management.<sup>109</sup> US supervisors do not as yet seem to have seen that interest rate risk in the bank book poses a problem.

**Flawed Claim 32:** Except for the effect of credit risk, the market prices of assets in the bank book, which banks intend to hold until they mature, are irrelevant to the banks’ health, and therefore

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<sup>108</sup> See the discussion in Chapter 4 and the references given there, particularly, Benston et al. (1991), Kane (1985, 1989), and White (1991) and the discussion of the previous claim, as well as Jiang et al. (2023a, 2023b) concerning unrealized losses as well as excessive risk taking by distressed or insolvent banks in 2023.

<sup>109</sup> This approach is somewhat controversial because, in principle, Pillar 2 is meant to deal with bank-specific interventions, in contrast to Pillar 1, which sets hard rules that apply to everyone. As a legal norm, Pillar 2 is weaker than Pillar 1, and interventions for infringement of Pillar 2 rules might be more easily challenged in court.

there is no need to adjust their valuation (i.e., “mark to market”) to this risk in the banks’ accounts.<sup>110</sup>

**What’s wrong with this claim?** As discussed in the context of the previous claim, the fact that a bank intends to hold assets until they mature does not mean that it will actually be able to do so. SVB did intend to hold on to the securities it had purchased in 2020 and 2021 but was unable to do so when the depositors the bank had gained in 2020 and 2021 moved back into other investments. By March 2023, it became clear that this drain would force a sale of “held to maturity” securities. Not marking these securities to market in 2022 gave a distorted picture of the health and the vulnerability of the bank. The distortion contributed much to the delay in supervisory action towards SVB.

The principle that “held to maturity” securities need not be marked to market also distorts the risk-weighting approach to assessing required equity under Basel III. Because the reported accounting values do not reflect changes in market values, risks to market values that are associated with changes in interest rates are neglected, and risk weights do not take account of these risks. Thus, SVB needed no equity to back the government debt that it claimed to be holding to maturity.

**Flawed Claim 33:** Stress tests have repeatedly shown that, by now, banks have enough equity to withstand even major shocks.

**What’s wrong with this claim?** Stress tests provide false assurances.<sup>111</sup> In many instances, banks that passed the stress tests and thus were declared safe became insolvent or required public support shortly afterwards. Well-known examples are the Irish Banks in 2010, Dexia in 2011 and Greek Banks in 2014. They suffer from a dependence on the banks’ accounting data and the banks’ own risk models. The shocks they consider are special, and there is no analysis of additional, unexpected scenarios. In some instances, the choice of scenario itself has been biased with a view

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<sup>110</sup> The need for adjustments for credit risk, i.e., the risk that the debtors’ default on promised payments is not controversial in principle, but in practice adjustments tend to involve long delays. The rules concerning such adjustments, referred to as Current Expected Credit Losses (CECL) Standard under Generally Accepted Accounting Principals in the US and IFRS 9 in Europe, were changed recently to require forward looking assessments of default probabilities rather than the actual occurrence of a credit event, much to the chagrin of some banks and supervisors. See Kim et al. (2023) and Kund and Rugilo (2023) on the impact of these changes.

<sup>111</sup> We discuss stress tests in Chapter 11. For devastating critiques, see also Vestergaard and Retana (2013), Goldstein (2017), and Dowd (2018). Goldstein (2017) and Dowd (2018) argues strongly that the tests are highly problematic and misleading. Lawrence Summers recently called the claim that the U.S. banks are well capitalized on the basis of stress tests “a comically absurd conclusion that is belied by the most elementary analysis of the beta of those major financial institutions.” He further asserted that “the fact that that assertion continues to be made has to undercut whatever credibility one would otherwise attach to the very substantial efforts that have been made to strengthen financial regulation.” (See “Larry Summers Calls Fed Bank Stress Test Results ‘Absurd’” Craig Torres and Christopher Condon, Bloomberg, September 8, 2018).

to obtaining reassuring results. Second-round effects, from fire sales of assets on asset values or from bankruptcies on further defaults and insolvencies, have not been considered.

In the case of Silicon Valley Bank, some have claimed that the bank's problems were not recognized because, following the 2018 modification of the Dodd Frank Act (so-called S.2155), only banks with total assets exceeding \$250 billion, rather than the previous \$50 billion were subject to enhanced supervision and stress tests (i.e., considered "systemic"). Being under \$250 billion in assets, SVB was no longer subject to stress testing. In fact, however, the stress tests that the Federal Reserve undertook in 2022 would not have noticed SVB's vulnerability because it did not consider the banks' robustness to a substantial interest rate shock. When the 2022 stress test scenarios were laid down in early 2022, the "severely adverse scenario" presumed hardly any change in interest rates at all.<sup>112</sup> Thus, the major risk that affected the US banking system and that forced the Federal Reserve and the FDIC to intervene quite dramatically in 2023 had not even been considered in early 2022. Yet, at that time, US inflation was already substantial, and only one month later, the Federal Reserve initiated the steep interest rate increases that ended up bankrupting SVB.

Whereas banks routinely pass stress tests, their behavior is consistent with intense debt overhang and clear evidence of the distortions explored in Admati et al. (2018) and discussed especially in Chapters 3 and 14. For example, they are anxious to make payouts to their shareholders (in the form of dividends and share buybacks), which in the U.S. they can do if they pass the stress tests. This behavior contradicts the standard "pecking order of funding," in corporate finance, by which "normal" corporations that are not distressed or insolvent use retained earnings as the most preferred source of funding. Banks also lobby furiously against any increase in equity requirements and generally seek to "economize" on equity as they make all funding and investment decisions, including in response to risk-weight based capital requirements. The pressure for payouts from banks' shareholders suggests that equity investors do not trust banks' health and prefer to shift risk and costs to others.

## **"No More Bailouts!"**

The bank bailouts in 2007-2009 created much public resentment and led bankers and policymakers to declare in public that they will reform the system so that bailouts of the financial sector are no longer needed and led bankers and policymakers to commit publicly that they will reform the system so bailouts of the financial sector are no longer needed. When he signed the Dodd-Frank Act that set out to reform financial regulations, President Obama received a lengthy

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<sup>112</sup> On the Federal Reserve's 2022 stress test, see <https://www.federalreserve.gov/supervisionreg/dfa-stress-tests-2022.htm>.

loud applause as he declared “No more bailouts. Period.”<sup>113</sup> Public officials in governments, central banks and regulatory authorities put in a lot of work on reforming the available procedures for dealing with failing banks without causing damage for the rest of the economy. They repeatedly claimed that no more bailouts would occur and no more taxpayer money engaged in bailouts. These claims are in fact false. Bailouts persist because governments, central bank, and other authorities have their own reasons for bailouts. Silicon Valley Bank and Credit Suisse provided only the most recent examples.

**Flawed Claim 34:** Governments want to avoid bailouts.

**What’s wrong with this claim?** Whereas politicians and regulators like to preach that no taxpayer money should be used to bail out banks or the creditors of banks, they typically prefer to provide supports anyway. Most recently, the uninsured depositors of Silicon Valley Bank were bailed out. Bailouts were also provided to the creditors of some of the European banks that got into trouble in the 2010s. In Chapter 16 (entitled Bailouts Forever), we give examples showing that politicians do not like to have uninsured creditors share in the losses of a failing bank because they fear the economic and political fallout. Economic fallout concerns domino effects of the bank failure imposing a loss on creditors, in the case of SVB the tech firms that had large deposits with the bank, in the case of the German Landesbanken the local savings banks that had large deposits with these institutions. Political fallout concerns voter reactions when the public gets the impression that creditors got a bad deal and the government should have bailed them out. For example, the losses imposed on holders of subordinated debt of Italian banks in 2017 contributed to the Italian government’s losing the 2018 general election. The Italian government would have liked to bail out these debt holders but could not do so because the European Commission was strict in enforcing EU rules against bailouts.

In the case of Credit Suisse in the spring of 2023, the government did impose a total loss on so-called AT1 securities, a form of subordinated, convertible debt, even as shareholders were given some payoff. This decision accords with the observation that AT1 securities holders were spread across the globe, with few of them voting in Switzerland, but Credit Suisse shares were widely held inside the country.

**Flawed Claim 35:** Bailouts that are paid for by the industry should not be considered genuine bailouts.<sup>114</sup>

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<sup>113</sup> Around minute 10:58 here <https://www.youtube.com/watch?v=bIsBFUAVxhE>

<sup>114</sup> The March 12, 2023 announcement by the Department of the Treasury, the Federal Reserve, and the regarding Silicon Valley Bank and Signature Bank that all depositors, including all uninsured depositors, will be paid in full (see <https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312b.htm>), included the claim that “No losses associated with the resolution of Silicon Valley Bank will be borne by the taxpayer” and that the same will be

**What’s wrong with this claim?** Payments by the industry are usually not voluntary. In the US, banks are *forced* by law to fund bailouts from the FDIC. In the European Union, banks are also *forced* by law to contribute to the euro area’s Special Resolution Fund. Members of the industry pay because the government *forces* them to do so. These payments are called *assessments* or *levies* but that does not make them different from a tax. Such levies are paid for by the surviving banks and ultimately their shareholders, by their creditors if the banks end up failing too, and by taxpayers if the industry’s ability to pay is exhausted. The banks and bankers who had made legal promises to repay their depositors and other creditors and were unable to fulfil these promises benefitted from magnified upside and walked away from their commitments, leaving it for others to deal with the fallout of their losses.

In the case of Silicon Valley Bank (SVB), uninsured depositors were bailed out because the authorities in Washington considered it convenient to do so. Banks that had nothing to do with SVB, except for being in the same industry and therefore part of the deposit insurance system, were forced to pay money for this purpose. Bailouts that are paid for by a levy on the industry should be considered genuine bailouts. The government used its power over these banks to obtain payments that it could use for its own purposes. The purpose itself, indemnification of uninsured depositors, had no basis in the law. Moreover, one might have expected the large depositors to invest somewhat more care in their decisions to invest their funds with SVB and to keep them with SVB months after the bank had become technically insolvent. If Circle Corporation puts \$4 billion into a bank deposit, the people in charge of Circle Corporation should not just rely on the government to bail them out. Another aspect of this claim concerns the question of what happens if industry members are unable to pay for bailing out failing banks’ creditors. This is what happened in the S&L crisis of the 1980s. Total bailout costs amounted to roughly \$153 billion, to which the industry levy contributed \$29 billion. The remainder, \$124 billion came from taxpayers.<sup>115</sup> This experience shows that the boundary between a bailout financed by an industry levy and a bailout financed by general taxes is less clearcut than the claim would seem to suggest.

**Flawed Claim 36:** To reduce the likelihood of bank failures, it is enough to have banks issue debt that converts to equity when a trigger is hit, so-called “contingent capital,” or co-co’s.<sup>116</sup>

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true for Signature Bank. The fact that other banks, particularly the large banks, must replenish the deposit insurance fund came up in the US Senate Banking Committee hearing on December 6, 2023 (see <https://www.c-span.org/video/?532146-1/oversight-wall-street-firm>), when multiple large bank CEOs, including Brian Moynihan of Bank of America argued and Jamie Dimon of JPMorgan Chase pointed out that large banks pay for FDIC bank resolutions. Mr. Dimon said that “the American public should know that the banks pay for FDIC. It is not government money,” and the CEOs seemed critical of FDIC for providing bailouts to all uninsured depositors, with Mr. Dimon expressing desire to take over FDIC himself. Chapters 9, 15 and 16 discuss the mechanics and politics of bailouts in detail. Ohlrogge (2023) provides an analysis of the history, and the increased costs in recent years, of FDIC policy of bailing out uninsured depositors.

<sup>115</sup> See Curry and Shibut (2000) and the discussion in Chapters 4, 10, and 14.

<sup>116</sup> See, for example, Calomiris (2013). Proposals to use co-cos instead of equity have been implemented in Switzerland and have been discussed in the UK (see UK Independent Commission on Banking) and the European



**What’s wrong with this claim?** As we explain in Chapter 11 (pp. 187-188), in a section entitled “Anything but Equity,” and in Admati et al. (2013, Section 8), the various proposals to use hybrids between debt and equity as a way of forcing investors rather than taxpayers to bear losses offer no advantages, and in fact have important disadvantages, relative to equity. First, like other debt, they raise the specter of domino effects or near the triggers where debt converts to equity (or is written down, depending on what the contract says). If the institutions that hold the co-cos are systemic, the consequences of a conversion to equity can be dramatic, and fear of these consequences might motivate a bailout. In 2008-2009, holders of long-term debt and other hybrid securities meant to absorb losses as Tier 2 capital were paid even as banks were bailed out with taxpayer funds.<sup>117</sup> Second, when conversion is imminent, the strategic behavior of market participants can induce dramatic changes in prices of equity and/or co-cos. Thus, co-cos do not provide reliable loss absorption and can create instability in a crisis. Third, as long as they have not been converted to equity, co-cos and other debt-like claims add distortions to banks’ lending decisions by exacerbating the effect of debt overhang and contributing to credit reductions in downturns.

There is no sense in which having banks rely on these hybrid securities is “cheaper” or better for society than relying on equity. For the purpose of regulation, using equity simply dominates these alternatives. Those who propose such alternatives as a substitute for equity have yet to give a valid reason for their proposal that is relevant for policy considerations.<sup>118</sup>

**Flawed Claim 37:** Whereas equity is needed for banks as going concerns, banks in resolution need long-term debt that can be bailed in. Total Loss-Absorbing Capacity (“TLAC”) in resolution must be large enough to permit a quick recovery.<sup>119</sup>

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Union (see Liikanen Report). A variation on the concept is Equity Recourse Notes (ERNs) proposed by Bulow and Klemperer (2014), which amount to debt whose coupon payments are made in equity when a trigger is hit.

<sup>117</sup> In March 2023, the write-down of Credit Suisse contingent capital (AT1 securities) did not have fatal effects on the holders of these securities but the Swiss government’s treating these securities worse than equity did cause substantial damage to the markets for contingent capital. See the report of the Expert Group on Banking Stability entitled “The need for reform after the demise of Credit Suisse,” September 1, 2023.

<sup>118</sup> As discussed in the context of Claim 13, compromising financial stability in order to give tax subsidies to inefficient funding by banks makes no sense. (Because they can force conversion to equity and do not confer creditors’ rights on their holders, co-cos do not qualify as debt under the US tax code. and thus do not have the tax advantage over equity in the US that they appear to have in Europe.) In trying to address the Too Big to Fail problem, Federal Reserve Bank of Minneapolis (2017) recommends dramatic increases in equity requirements” and does not include any non-equity security as a form of loss absorbing capital, and John Vickers (2017, 2018) emphasized the superiority of equity relative to substitutes. See also “FDIC’s Hoenig Questions Fed’s Debt Proposal for Big Banks On the claim that long-term debt provides better discipline than equity, see the discussion of Claim 24. Co-cos and ERNs that they are meant to convert some debt to equity ahead of insolvency and failure are better than debt that can only suffer losses within a “bail-in” process or in a resolution or bankruptcy. And they are obviously a less fragile funding source than short-term debt that is subject to runs.

<sup>119</sup> See FSB (2015). In the United States, regulators have imposed requirements for “eligible” long-term debt meant to absorb loss in resolution on “systemic” banks whose assets are larger than \$250 billion and in August 2023 in light

**What’s wrong with this claim?** The suggestion that debt that serves as TLAC (or, as the European Bank Recovery and Resolution Directive calls it, bail-in-able debt) can do something that equity cannot do is misleading. Obviously, once a bank is insolvent, there is no equity left and thus any losses must be borne by some debt holders if a bailout is to be avoided. However, the more equity there is, the more losses it can absorb *so as to avoid entry into resolution in the first place*. The total loss absorbing capacity of equity and bail-in-able debt is not increased when equity is replaced by bail-in-able debt.

To the contrary, if the authorities end up being unwilling to impose losses on debt holders, a replacement of equity by bail-in-able debt *reduces* loss absorption capacity. The arguments in the discussion of Flawed Claim 36 concerning co-cos and the likelihood that holders of co-cos might be bailed out after all apply equally to bail-in-able debt or TLAC. Legally, the holders of TLAC have stronger than those of the holders of hybrid (convertible) debt considered as regulatory Tier 2 capital before the crisis but in 2008, yet even those weaker claims were bailed out routinely and did not absorb losses. The one exception to this rule, Washington Mutual, was highly disputed inside the US Government, and the systemic effects from the bail-in of unsecured senior debt holders of Washington Mutual has convinced many that, in a systemic crisis, such bail-ins are to be avoided. These considerations are bound to be brought back if there is a question of bailing in unsecured senior debt in a situation of systemic stress. Holders of bail-in-able debt may also be small savers who have not realized that they might be called upon to absorb the banks’ losses, as happened in Spain and more recently in Italy, thus causing a political problem if losses are large or many institutions fail.<sup>120</sup>

The claim that equity absorbs losses before resolution and TLAC absorbs losses in resolution may be correct, but then it is precisely the virtue of equity that it absorbs losses *without anyone triggering a formal resolution procedure*. Systemic effects from the triggering of such a procedure may well prevent the procedure from being triggered at all, in which case any notion of loss absorption by certain debt instruments is moot.<sup>121</sup>

In the case of Credit Suisse, in March 2023, the bank had more than CHF 100 billion in reported equity, contingent capital and bail-in-able debt, but even so the authorities preferred to avoid a resolution procedure. One reason was that some of the bail-in-able debt had been issued under US and UK law, and the conversion of this debt into equity was fraught with procedural

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of the failure of SVB, Signature and First Republic Bank that were below this limit, regulators proposed imposing such requirements on smaller banks; see <https://www.fdic.gov/news/financial-institution-letters/2023/fil23045.html> In her comments on this rule (Admati, 2024b), Anat Admati quoted a December 2022 comment on an earlier proposal, co-authored by Thomas Hoenig, former FDIC vice chair as well as “Bank Resilience: Equity Capital versus Long-Term Debt,” Thomas Hoenig, FinRegRag, September 26, 2023 <https://www.finregrag.com/p/bank-resilience-equity-capital-versus>. She cited similar comments by many academics and policymakers going back to 2010. <https://gsb-faculty.stanford.edu/anat-r-admati/files/2024/01/Admati-Long-Term-Debt-Comment.pdf>

<sup>120</sup> See “Italy bank rescues spark bail-in debate as anger at Renzi grows,” James Politi, *Financial Times*, December 22, 2015.

<sup>121</sup> Persaud (2015) calls the bail-in concept “fool’s gold” as a solution to the too-big-to-fail problem.

difficulties in those countries. The notion that bail-in-able debt makes for an easy addition to loss absorption capacity was revealed to be an illusion.<sup>122</sup>

**Flawed Claim 38:** The Dodd-Frank Act in the US, or the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) in the European Union, have done away with the need to bail out banks. If a bank gets into trouble, the authority in charge of resolution will be able to resolve it without cost to taxpayers; there is therefore no need to increase equity requirements.<sup>123</sup>

**What’s wrong with this claim?** This claim is not credible. In Chapter 16, we provide a detailed account, confirming the skepticism we had previously expressed in Chapter 5.<sup>124</sup> Three major issues arise. First, to minimize the economic disruptions from having banks go into resolution, it may be necessary to maintain some important operations at least temporarily. This requires funding. Under the Dodd-Frank Act, such funding might be obtained by borrowing from the government; such borrowing puts the taxpayer at risk.<sup>125</sup> Under the BRRD in the EU, there is no provision for such funding. Thus, to avoid a default, Banco Popular Español had to be sold overnight to Banco Santander, without any attempt to see whether other bidders might be available. And the winding down of Banca Popolare di Vicenza and Veneto Banca in Italy used funding from

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<sup>122</sup> See Federal Department of Finance, The need for reform after the demise of Credit Suisse: Report of the expert group on banking stability, September 1, 2023.

<sup>123</sup> In addition to President Obama’s comment on Dodd-Frank that we quoted in the introduction to the group of claims about the need for bailouts, see, for example, the announcements of Deutsche Bundesbank on the effects of the BRRD (<https://www.bundesbank.de/en/tasks/banking-supervision/individual-aspects/recovery-and-resolution/recovery-and-resolution-623118>) and of Swiss supervisor Finma on the effects of Swiss too-big-to-fail reforms (<https://www.finma.ch/en/enforcement/recovery-and-resolution/too-big-to-fail-and-financial-stability/>). In November 2014, Mark Carney, Governor of the Bank of England and Chair of the Financial Stability Board, announced that the international agreement on requiring banks to have sufficient bail-in-able (TLAC) funding would prevent bailouts in the future. These announcements and claims were taken up by the industry in arguing that there was no need for more equity. See, for example, presentation by the Clearing House to the Board of Governors of the Federal Reserve regarding Title II of Dodd Frank Act on February 13, 2013, and their March 26, 2013, “Vanquishing TBTF.” See also William Isaac, referenced in Footnote 68.

Using these arguments to deflect calls for higher equity requirements does not prevent the industry from also fighting TLAC requirements because “TLAC is expensive.” See for example, Wells Fargo CEO Stumpf’s reactions cited in footnote 43. Discussions about proposals by the Federal Reserve to force bank holding companies to use more long-term debt (see, e.g., Governor Daniel Tarullo testimony to Senate Committee on Banking, Housing and Urban Affairs, February 6, 2014), and similar discussions by the Financial Stability Board about so-called GLAC “Gone Concern Capital Absorbing Capacity” (e.g., “Progress and Next Steps Towards Ending Too-Big-to-Fail,” Report to G-20, September 2, 2013) must be seen in this context. For the most recent proposal, see <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230829a.htm>.

<sup>124</sup> For early criticisms, see also Simon Johnson, “The Myth of a Perfect Orderly Liquidation Authority for Big Banks,” *New York Times Economix*, May 16, 2013, Simon Johnson and Marc Jarsulic, “How a Big Bank Failure Could Unfold,” *New York Times Economix*, May 23, 2013, and Anat Admati, “Too Much Equity? If Anything, Brown-Vitter Asks Too Little,” *American Banker*, June 24, 2013, linked in footnote 70. For a more recent account, see Hellwig (2021), written in response to a report on too-big-to-fail reforms by the Financial Stability Board, FSB (2021). The latter report acknowledges that mechanisms for dealing with failing banks are as yet far from satisfactory.

<sup>125</sup> The Bank Recovery and Resolution Directive in the European Union ignores the problem altogether.

Intesa Sanpaolo with taxpayer guarantees against losses.<sup>126</sup> In the case of Credit Suisse, the Swiss government preferred the takeover by UBS to a resolution procedure because that way it could reduce its own input to the provision of liquidity backstops and guarantees.

Second, whereas both the Dodd-Frank Act in the US and the BRRD in the EU rely on industry levies and on creditor bail-ins to absorb losses, in a crisis, when many banks may be weak at the same time and the financial system is at risk, the industry as a whole or the banks' creditors (which may be other financial institutions) may be too weak to perform this role. Even if the charges are spread over time, the burden of obligations they impose may be so great that the institutions involved become incapable of functioning. These concerns arise even if the debt in question is long-term or, as in Claims 36-37, subject to contingent conversion clauses. If the banks were required to rely on equity levels much higher than the low levels current regulations allow, loss absorption would be obtained without any of these disruptions.

Third, cross-border issues in the resolution of global banks, which played an important role in the Lehman Brothers bankruptcy, have hardly been addressed. If a bank with systemically important operations in different countries goes into a resolution procedure, the procedure will be handled by different authorities in the different countries in which the bank has legally independent subsidiaries; because the different authorities act independently and each authority takes care of problems in its domain, integrated operations in areas such as cash management and IT systems are no longer feasible. It may therefore be impossible to maintain, even temporarily, some of the functions which are essential for the rest of the financial system. Proposals to deal with this issue by having only one authority in charge of resolving a failing bank, so-called Single Point of Entry (SPE) resolution, are politically unacceptable and unworkable.<sup>127</sup>

## More Radical Approaches?

Our proposals are often considered radical, but others have proposed even more radical approaches that would interfere with some of the benefits banks can bring. These proposals will be more costly for society and are less likely than our approach to address the fragility of the system.

**Flawed Claim 39:** The best way to make banking safer is to require banks to put funds from deposits into reserves of central bank money or short-term Treasury Bills (so-called narrow

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<sup>126</sup> For details of the different episodes, see Hellwig (2017, 2018a, 2019).

<sup>127</sup> See Advisory Scientific Committee (2012). The Financial Stability Board's "Principles for Cross-border Effectiveness of Resolution Actions," November 3, 2015 includes an enormous wish list and recommendations that would help make cross border resolution viable, but the implementation of these recommendations cannot be expected any time soon. The June 2014 IMF document "Cross-Border Bank Resolution: Recent Developments" summarizes the key challenges. The Financial Stability Board's evaluation of 2021 acknowledges that these challenges have still not been met. For the European Reforms, see also Hellwig (2014, 2017, 2018a, 2019, 2021).

banking, also known as the Chicago Plan for 100% reserve banking).<sup>128</sup> Such a shift will give us a stable financial system and there would be less need, perhaps even no need at all, to impose equity requirements.

**What's wrong with this claim?** Requiring banks to put all funds into cash or Treasury Bills will make these narrow banks safer, but the financial system as a whole may become less efficient in allocating resources and risk and likely less safe. If final investors remain attached to banks, a lot of funding will be given to the government, likely at the expense of funding of individuals, small businesses and nonfinancial firms. The experience of southern European countries in the decades before 1990 shows such crowding out of private borrowing by government borrowing can have substantial negative effects on economic growth.<sup>129</sup>

More likely, narrow banking would lead investors to shift more investments to other institutions, for example money market funds which are “bank-like” without being subjected to the same regulation as banks. As discussed in Chapters 5, 14 and 15, such institutions can also be subject to runs and can be a major source of systemic risk. Financial instability would merely shift from banks to those “bank-like” institutions. In this context, it is useful to recall that Lehman Brothers was an investment bank, AIG was and is an insurance company and, in Europe, Dexia and Hypo Real Estate were in the covered-bond business; none of the institutions had any deposits.

**Flawed Claim 40:** The financial system would be safe if banks were subject to a 100% reserve requirement so they could take no risks with depositors' money, while non-bank financial institutions are entirely prohibited from borrowing.<sup>130</sup>

**What is wrong with this claim?** This claim ignores the benefits of using *some* debt to fund difficult-to-value investments such as loans. Moreover, having no debt in financial intermediation would not necessarily eliminate fragility and possible harm to small investors. Investors want much of their money to earn some interest and yet to be liquid so they can get it quite reliably when they need it. If banks must operate as open-end mutual funds with no debt, investors who need cash would return (or sell) their shares and get whatever the shares were worth. Determining share values would be easy if the assets held by a fund (of the fund itself) were traded daily on a public exchange, but otherwise would be problematic, and the mutual fund could suffer something

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<sup>128</sup> The so-called *sovereign-money initiative* (“Vollgeld-Initiative”) that the electorate of Switzerland voted on (and rejected by a ¾ majority) in June 2018 presented a modern variation on this scheme. In addition to the Chicago plan's 100% reserve requirement, the sovereign-money initiative called for a legal separation of deposit taking and reserve holding from other activities of banks. For a critique see Hellwig (2018b). On narrow banking more generally, see also Stephen G. Cecchetti and Kermit L. Schoenholtz, “Narrow Banks Won't Stop Bank Runs,” Money, Banking and Financial Market blog, April 28, 2014.

<sup>129</sup> See, e.g., the essays by Caminal et al., and Borges in Dermine (1990).

<sup>130</sup> See Kotlikoff (2010) and Cochrane (2014) for such proposals.

similar to runs if shareholders fear significant asset price declines returned their shares and the fund had to sell assets in a hurry.<sup>131</sup>

Trading in stock markets exposes individuals who need to trade for liquidity reasons to losses from better-informed investors. The opacity of assets consisting of hard-to-value loans would give rise incentives to those with access to better information to engage in such trading if the shares of financial institutions with 100% equity were traded on stock exchanges. The so-called *information-insensitivity* of banks' debt is valuable for liquidity provision, and the idea of requiring significant equity (such as 30%) but not as much as 100% is intended to preserve this function and strike a balance between liquidity provision and the stability of the banking system.

## Politics of Bank Regulation and Global “Competitiveness”

A favorite but flawed claim by sectors who lobby for favorable treatment, subsidies and lax rules is that it should be a national priority that they succeed when competing with corporations in other jurisdictions. The symbiotic relations between banks and governments have led to a situation in which policymakers act to help “champion” corporations even while harming their own citizens. The politics of banking is particularly challenging because politicians have incentives to view banks as a source of funding and ignore the risk and harm they cause.

**Flawed Claim 41:** Tighter regulation of banks, and in particular higher equity requirements, are undesirable because they would cause activities to move to the unregulated shadow banking system.<sup>132</sup>

**What’s wrong with this claim?** As we discuss, particularly in Chapter 13, the development of the shadow banking system and the risks it poses point to past weakness of enforcement. The most dangerous parts of the shadow banking system have developed primarily to avoid existing regulation in what is called regulatory arbitrage. Examples include the so called off-balance-sheet special purpose vehicles and money market funds, both of which played in infamous role in the 2007-2009 financial crisis. The lessons should be that we need better rules and better enforcement for all institutions, not that we should give up on rules. Dealing with regulatory arbitrage is challenging, but the challenge can be met, and it must be met if the regulation is important and

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<sup>131</sup> Gordon and Gandia (2013), for example, show that money market funds with floating value were also quite unstable at the same time that those that promised fixed net asset value were experiencing runs in 2008. Because Germany has had such experiences with open-end mutual funds for real estate investments, the German Federal Ministry of Finance proposed in July 2012 to outlaw open-end mutual funds for real estate investments.

<sup>132</sup> See, for example Kashyap et al. (2010), Hanson et al. (2011) and Elliott (2013). Such claims are made repeatedly by bankers, including in the December 6, 2023 hearing on Oversight of Wall Street Firms in the Senate Committee on Banking, Housing and Urban Affairs mentioned in the context of Flawed Claim 1.

beneficial.<sup>133</sup> Unregulated institutions that do not take deposits, including those that engage in mortgage lending, often rely on significantly more equity funding than banks.<sup>134</sup>

**Flawed Claim 42:** Since banking is a global business, it is important to maintain a “level playing field.” Therefore, banking regulation must be coordinated and harmonized worldwide.<sup>135</sup>

**What’s wrong with this claim?** The claim, discussed in Chapter 12, is false. If some countries foolishly allow their banks to pursue very risky strategies and to borrow excessively, this is not a reason why other countries should do the same. Each country should be concerned with how much of a risk from its banks it is willing to accept, just as each country has its own building codes, consumer safety standards, environmental regulations, and energy policy. We would not allow chemical companies to pollute rivers and lakes simply because the industry maintains that somewhere in the world another country is allowing these things. The search for “level playing

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<sup>133</sup> Levitin (2014, p. 2037) asserts that “Admati and Hellwig think that [dealing with the shadow banking system] is easy.” In fact, we have not claimed it is easy to enforce the regulation effectively, only that it is important and possible. In “We are Still Hostages to the Big Banks,” *New York Times*, August 26, 2013, Anat Admati summarized the response: past failures to make sure that banks could not hide risks using various tricks in opaque markets is hardly reason to give up on essential new regulations. We must face the challenge of drawing up appropriate rules and enforcing them or pay dearly for failing to do so.” For more details see Chapter 13 and Admati et al. (2013, Section 10).

<sup>134</sup> See Jiang et al. (2020).

<sup>135</sup> This argument is made plays a key role in discussions about rules set by the Basel Committee on Banking Supervision. Since the first Basel Accord, “Basel I,” concluded in 1988, there has been an understanding that the rules on which the Basel Committee agrees will provide a minimum standard for legislation and regulation of participating states such that banks from jurisdictions that satisfy these standards can be active in other countries subject only to supervision from home country authorities. Because the traditions and practices of banks in different countries differ, there always is a question to what extent the jointly agreed rules allow for the differences. Bankers from any one jurisdiction are quick at complaining that given rules are biased against them. For example, in debates about “finalizing Basel III” or about the “Basel Endgame,” European bankers and governments have complained that stricter equity requirements for real estate mortgages would tilt the playing field in favor of US financial institutions because, in Europe, mortgages are largely held by the issuing banks and, in the US, they are largely securitized and sold, so the share of mortgages in bank balance sheets is larger in Europe than in the US. US banks also complain routinely about capital rules in the US being harsher than those imposed in Europe, putting US banks at a competitive disadvantage in the global marketplace. See, for example, Sean Campbell, “Large Bank Capital and International Competitiveness: US vs. Europe”, September 30<sup>th</sup>, 2019, a document prepared for the Financial Services Forum, a “policy and advocacy organization whose members are the chief executive officers of the eight largest and most diversified financial institutions headquartered in the United States;” <https://fsforum.com/news/large-bank-capital-and-international-competitiveness>.

Haselmann et al. (2022) provide evidence showing that negotiators in the Basel Committee are mainly motivated by the desire to get a set of rules favoring “their” banks. The European Union is deliberately deviating from the 2017 agreement “finalizing Basel III” in order “to take account of European specificities.” The US very much reduced the impact of the home country principle by requiring foreign institutions to organize all their US activities under the umbrella of bank holding companies under US law.

fields” in global competition is highly damaging if it leads to a race to the bottom, where each country ends up fighting stricter regulation on behalf of its members of the industry.<sup>136</sup>

**Flawed Claim 43:** Stricter national regulation would harm “our” banks; instead, we should be supporting them in global competition.<sup>137</sup>

**What’s wrong with this claim?** Like the preceding claim, this claim is false, as we discuss in detail in Chapter 12.<sup>138</sup> The success of a nation’s banks in global competition is not an appropriate objective for policy. Before the crisis of 2007-2009, Icelandic and Irish banks were very successful in global competition indeed, and for both countries, the ultimate outcome was a disaster.

The global economy is not a sports event where a country might win medals in all disciplines. Rather, it is a system in which people and firms from different countries trade with each other, and a country necessarily “loses” in the markets for those goods which it imports. For the country, and for the people living in it, it is efficient to specialize on goods they are good at and to import the others. Government subsidies to banks, or indeed any firms, in international competition is undesirable; such subsidies create distortions in favor of these firms at the expense of others in the economy, and it may direct too many resources, including talent, inefficiently to one industry over others. Weak regulation that allows banks or other firms to take risks at the expense of others is also very distorting. It is also legitimate for national regulators to protect their citizens by regulating foreign banks’ subsidiaries if they deem regulations in the banks’ home country to be insufficient or ineffective. Instead, there is evidence that discussions of regulation at the Basel Committee on Bank Supervision, regulators tend to align their claims domestic “national champion,” namely the largest banks in their jurisdiction.<sup>139</sup>

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<sup>136</sup> The race to the bottom is a natural consequence of the interactions described in the preceding footnote. See also Anat Admati and Martin Hellwig, “Global Level Playing Field Arguments are Invalid,” *Financial Times*, June 3, 2011, at [https://gsb-faculty.stanford.edu/anat-r-admati/files/2022/04/battle\\_to\\_regulate\\_banks\\_has\\_just\\_begun.pdf](https://gsb-faculty.stanford.edu/anat-r-admati/files/2022/04/battle_to_regulate_banks_has_just_begun.pdf) and, in a slightly longer version, at [https://gsb-faculty.stanford.edu/anat-r-admati/files/2022/04/print\\_-\\_global\\_level\\_playing\\_field\\_arguments\\_are\\_invalid\\_economists\\_forum.pdf](https://gsb-faculty.stanford.edu/anat-r-admati/files/2022/04/print_-_global_level_playing_field_arguments_are_invalid_economists_forum.pdf)

<sup>137</sup> Under the guidance of Chancellor Hunt, the UK government’s Financial Services and Markets Bill proposed to make the competitiveness of banks in the UK a focus of regulation, along with (instead of?) financial stability. A group of academics objected on the grounds that the costs of having favored competitiveness over financial stability had been shown to be astronomical in the financial crisis (see a letter posted here <https://financeinnovationlab.org/wp-content/uploads/2022/05/Economists-Competitiveness-Letter-16-May-22-Final.pdf>). In the Senate Committee hearing on December 6, referred to in the context of Flawed Claim 1 and elsewhere, (available here <https://www.c-span.org/video/?532146-1/oversight-wall-street-firms>) bank CEOs repeatedly claimed that they are “strategic assets” of the U.S. Jane Fraser, Citigroup CEO said that the Basel Endgame proposal will harm US competitiveness in international markets multiple times. See also the discussion of Flawed Claim 42.

<sup>138</sup> On the expansion of US banks globally, see Steele (2023). See also Wilmarth (2013) on the politics of banking regulation in the US.

<sup>139</sup> See Haselmann et al. (2022).



**Flawed Claim 44:** The politics of banking makes effective regulation impossible, and therefore debating the merits of specific regulations such as equity requirement is “beside the point.”<sup>140</sup>

**What’s wrong with this claim?** This claim suggests that there is no choice but to allow flawed claims and dangerous policies to persist. The claim is analogous to saying that “politics makes corruption unavoidable, thus debating the merits of specific anti-corruption strategies is beside the point,” or: “the politics of organized crime makes effective criminal enforcement impossible, thus debating specific strategies for fighting organized crime is beside the point.” Whereas the politics of financial reform (including the outsized influence that banks have on the political process and the symbiotic relations of banks and governments, described in many places in the book, particularly the new Chapters 14 and 17) certainly makes quick progress unlikely, the eventual success of many reform movements has shown that change is possible. Reform, however, requires public awareness and debate, and sensible debate requires understanding of the issues. Clarifying the issues and empowering more people to participate can contribute to public pressure on those who refuse to engage or to take action.

In reviewing the first edition of our book, Martin Wolf concluded that our views are not more widely accepted because “bankers are so influential and the economics are so widely misunderstood.”<sup>141</sup> This situation persists. In the final chapter of the new edition of our book, we discuss the motivation and tactics of the numerous enablers of the system that make change so challenging.<sup>142</sup> Because risk from banking is more abstract than risk from plane crashes or shoddy bridge construction, flawed claims about banking may have more staying power. However, the harm from a distorted and dangerous financial system is large and affects many people. The current rules and regulations can be greatly improved, bringing large benefits to society. And understanding the issues does not require advanced training. If more people understand the issues, improving policy becomes more likely.

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<sup>140</sup> This claim is made in Levitin (2014, p. 2067), who reviews our book together with others. A few of these books describe the writers’ experiences in politics and regulation. The books by Sheila Bair, Neil Barofsky and Jeff Connaughton highlight the political challenge and aim to increase political pressure for reform, but they do not explain the underlying economics in as much detail as we do in our book.

<sup>141</sup> See Martin Wolf, “Why Bankers are Intellectually Naked,” *Financial Times*, March 17, 2013.

<sup>142</sup> See also Admati (2017).

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