Bloomberg Editors Commet on Capital Requirements for Banks

Would a safer financial system be bad for the economy? Big banks say it would, because tougher banking rules will squeeze their lending and hold back investment. Markets don't seem to agree.

The relationship between banking and economic dynamism will be a crucial topic in coming weeks, as U.S. regulators collect comments on new capital rules aimed at making the country's largest banks more resilient. A proposal published earlier this week would require bank holding companies to fund each $100 in assets with at least $5 in capital -- equity from shareholders and other forms of financing that, as opposed to borrowed money, can absorb losses and prevent insolvency in times of crisis. Some officials have suggested going farther and setting the requirement at $10, and we've said we agree. The global minimum is $3, a level at which a net loss equal to only 3 percent of assets would be enough to render a bank insolvent.

Banks warn that a higher capital requirement could be disastrous. They say they will have a hard time raising the necessary equity from investors on desirable terms. Instead, they will reduce the capital ratio's denominator -- assets -- to meet the requirements, or charge more for loans. The result will be less credit for companies looking to expand and for people looking to buy houses; the slow recovery might stall altogether.

If financial markets thought this prediction was likely, they would react negatively to announcements of higher capital requirements. Stock prices should fall on concerns that companies would face a credit crunch. Bond prices should rise on expectations that the Federal Reserve would be forced to keep interest rates low to support the recovery.

Largely Unmoved

That's not what has happened. On July 9, the day regulators published their proposal, the S&P 500 Index (SPX) rose 11 points and the price of the 10-year U.S. Treasury note held steady. The two were also largely unmoved on July 2, when Federal Reserve Governor Daniel Tarullo announced regulators' intention to boost capital requirements. On June 21, when Bloomberg reported that regulators were considering the new capital rules, the S&P rose four points and the 10-year Treasury fell.

Why so little concern? Perhaps because the proposed increase in capital is less onerous than the banks have been claiming; perhaps because the proposals are still just proposals, and could get milder before they are put into force. But it's also possible investors recognize that requiring banks to raise more capital presents no threat the economy.

As it stands, banks have an incentive to be big and dangerous: The more damage their failure would do, the more certain they and their creditors can be that the government will rescue them in an emergency. In effect, this is a subsidy that distorts markets and encourages the creation of credit bubbles.

Higher capital requirements would reduce the subsidy by making banks less likely to fail and by making sure shareholders, not taxpayers, pay the price for bank executives' mistakes. Big banks' funding costs might rise, but this would level the playing field for smaller banks and other financial institutions, which could pick up the slack in lending. What's more, the added capital would improve the banks' capacity to keep credit flowing during economic downturns -- a benefit demonstrated in recent research published by the International Monetary Fund.

It isn't even a foregone conclusion that tougher capital rules would be bad for the banks' own shareholders. True, the rules would reduce the implicit subsidy; on the other hand, most of the biggest banks currently have so little capital that investors can't be sure they're solvent. For some, raising more capital would boost confidence and share prices. When Deutsche Bank AG sold 2.96 billion euros of new stock in April, its share price surged.

Markets don't seem to be buying the idea that there's a trade-off between safer banking and a stronger economy. Regulators should press on and bring capital requirements in line with what prudence would dictate.