Brown-Vitter cannot fix US banks by itself

Regulators are urging one thing and legislating for another, writes Mark Roe

Financial Times
Mark Roe
May 15, 2013

Senators Sherrod Brown and David Vitter have caused a stir in Washington and on Wall Street with their bill to make banks safer. The idea is simple: banks should hold much more capital to absorb losses and have less risky debt. It is bipartisan: one sponsor from the Democratic left and another from the Republican right. Although the bill's passage is unlikely, banks are worried, because it is shifting the scope of possible regulation. But, even if it were to pass, the bill would not be enough on its own to solve finance's problems.

In part this is because banks will resist – first with attack memos from their law firms, then with lobbying muscle, and later by finding loopholes should the bill become law. Even if regulators tell banks to hold more equity, the bankers – encouraged by corporate tax rules and existing financial regulation – have strong incentives to find stealthy ways to avoid doing so. They much prefer using debt.

Consider the issue from their perspective. Wall Street does not like Brown-Vitter because it is, at the moment, reasonable to assume that if a big bank fails, the government will bail it out and pay off the bank's lenders. This makes bank debt cheap – if you lend to a big bank, you probably can't lose. Shareholders and senior managers on Wall Street do not want banks to use more equity financing because debt financing with government back-up is cheaper.

Remember, too, that the US corporate tax system is perversely biased towards debt and against equity. It allows for tax deductions of debt interest payments while taxing shareholder profits. If US banks start to register strong profits and today's low interest rates end, this tax disparity will become even more important. So the too-big-to-fail subsidy and tax rules make bank debt relatively cheap and provide an incentive for bankers to use more of it – and then lawmakers tell them to go against the price signals.

The landmark Dodd-Frank act and its related rules also encourage the holding of debt, rather than equity. While they do tell banks not to use too much short-term funding – it can evaporate in a crisis, after all – the rules also make it much more likely that short-term, overnight debt will be paid, even if the government has to step up to support it. Therefore, the rules facilitate banks' holding risky debt, while telling them not to hold too much of it.

A more coherent policy initiative is hard to pull off but there are ways for the senators to improve their bill. If they thought more about banker incentives rather than bank risks, they would be more effective. They should first try to align executives' compensation structure with their proposal. Make it in the bankers' interest to hold less debt and to ensure it is paid off. For example, if bank capital falls below some super-safe level, the bank must pay senior managers primarily in IOUs, which would make executives depend on the bank being around down the

road for them to be paid. If the bank is gone by then, because it had too little capital and too much debt to handle losses, then the executives will not be paid.

Incentives for shareholders and boards also need to change. Instead of the tax code taking a whack out of big finance's equity, there should be a tax on bank debt. The German economist Michael Tröge suggested such an idea for Germany's banks. One way would be to tax banks on their gross income before the deduction for interest payments, at lower rates than they currently pay. With debt taxed more and equity taxed less by such a reform, the incentives inside big banks would better align with Brown-Vitter.

Getting these private incentives and public regulations in place simultaneously will not be easy. But at the moment regulators are urging banks to do one thing and legislating for another – we tax equity, so we get less of it; we reward bankers for passing the risks of unpaid debt on to the public, so we get more debt. Messrs Brown and Vitter are right to say that mandating US banks to get some higher level of equity is a plausible policy, but Wall Street will resist as long as its incentives go the other way. And US banks are good at defeating and working around much unwanted regulation anyway. So lawmakers should not make it harder than it already is. They should begin by making sure that market signals point in the same way as the Brown-Vitter bill.