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Group of Experts in Banking Issues (GEBI)

The social cost of capital and the impact of Basel III

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Key point:

- Key to debate is difference between private and <u>social</u> cost of capital (for banks).
- Private sector perceives high cost, partially because of micro perspective, but mostly because of tax considerations.
- (Excess) <u>Social</u> cost of capital = 0
- => Cost of Basle III = zero!

Social cost of capital for banks:

- Does not involve use of real resources!
- Only difference between debt and equity financing is the payoff matrix (promised to investors).
- Given the asset side of a bank's balance sheet the total payoff to <u>all</u> investors combined (and government) is the same whatever the debt/equity ratio (MM).

Social versus private cost of capital:

- Bankers argue: if capital requirements go up <u>perceived</u> cost of capital goes up (because cost of equity unchanged) => interest margin up (economy down).
- Wrong: cost of equity (maybe even that of debt) must go down because banks become less risky.
- => even perceived cost of capital unchanged, except for tax considerations.

Why private cost of capital might change:

- With higher capital less likely that banks has to be rescued.
- If banks is rescued as going concern authorities overpay for equity (whose ‘market’ price incorporates likelihood of public guarantees.
- => with higher capital requirements banks lose valuable franchise
- => perceived private cost of capital might go up.

Tax considerations

Bank with 100 in assets which yield 6 % return, debt costs 5 %.	4 % capital	8 % capital
Corporate tax take:	**0.3**	**0.35**
After tax return on equity:	**0.9/4 = 22.5 %**	**1.05/8 = 12.6 %**

Key insight :

- Increasing capital requirements leads, ceteris paribus, to higher corporate income tax (assume at level of investor no difference between dividends and interest – of course every country different).
- No need for bank tax if capital up (or rebate taxes?).

Model based impact studies

- Increasing capital requirements = higher taxation of bank intermediation.
- Partial equilibrium view then implies taxation of intermediation with negative impact on GDP.
- General equilibrium results (considering tax rebates or lowering taxes elsewhere) would be different.

Special topics :

- Sub-prime equity (hybrids).
- SME financing.

Hybrids

- Hybrids constitute (sub prime) equity for regulators.
- And at the same hybrids constitute debt for tax authorities, interest payments are tax deductible.
- Simple solution: regulators and tax authorities decide on a common line: either debt or equity: problem solved!

Hybrids II (hybrids are toxic)

- Distribution of payoff of hybrids has a ‘spotty fat tail’: losses only under extreme scenarios – often macro crisis.
- => Attractive for large institutions: individual responsible for investment choice has moved on when tail risk materializes.
- Macro tail risk: Investment officer is judged on relative performance.
- De facto authorities have protected investors in hybrids (politically well connected).

Hybrids III fiscal gains

- EU banks hold about 600 billion of subordinated debt.
- => Interest payments about 30 billion (5 %)?
- => loss in corporate tax revenues of about 8 – 10 billion with corporate tax rate of 27-30%.

SME financing

- SME financing is area where asymmetric information and adverse selection looms largest.
- Not correct to compare capital requirements for SME financing to rated borrower because information base not the same.
- => Concern for SME financing no reason to lower capital requirements (increase for sovereigns instead).

Concluding Remarks I

- Key to understanding impact of Basel III on economy is to distinguish between (perceived) private and real <u>social</u> cost of capital.
- Social cost of capital = 0
- => economic cost of Basle III = 0,
- => implement immediately in EU (= 1.1.2012?).

Concluding remarks II: Implementation

- Long transition periods justified when real investment needs to be made.
- Not the case of Basle III.
- Complicated implementation time tables stretching over a decade increase uncertainty and create time inconsistency (time is never ripe).
- If bankers argument were right, logical conclusion would be: increase capital requirements even more and then lower them.

Concluding remarks IIa: transition

- Long transition periods justified by short term supply of curve of capital, which might be steep?
- Even if this were true: Not a reason to delay: Whatever the cost of capital to be raised quickly: bygones are bygones.
- (Of course present owners are diluted and resent this.)

Concluding remarks III: Outlook

- Level playing field argument should be discarded.
- Banks that have increased capital have not felt competitive disadvantage.
- But level playing field argument should be disregarded (at level of EU) even if higher capital ratios were to lead to migration of bank activity elsewhere (where? US?):
- Crisis has shown that large scale bank activity brings with it large scale potential fiscal costs.

Conclusion:

- The EU should act quickly and implement Basle III in the toughest possible form as quickly a possible.

Thank you