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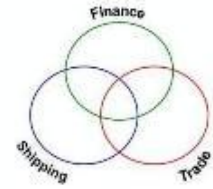
# Seventh City of London Biennial Meeting 2013

Looking Ahead with Optimism and Realism





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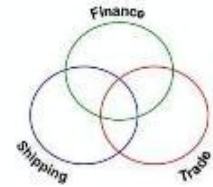
# The Trouble with Banks

Professor John Thornton, Bangor Business School



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# The Trouble with Banks

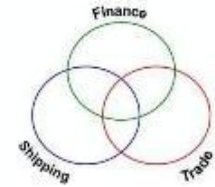
- They face unique risks
  - Exposure to deposit 'runs' because of maturity mismatch and opacity surrounding the quality of your loans
  - Interconnectedness
- The risks frequently materialize
  - 1970-2007, 124 systemic banking crises in 101 countries; Fiscal costs range from 3-55% GDP
- They collude with regulators and politicians





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*1-16-09 The Financial Markets Universal Press Syndicate*





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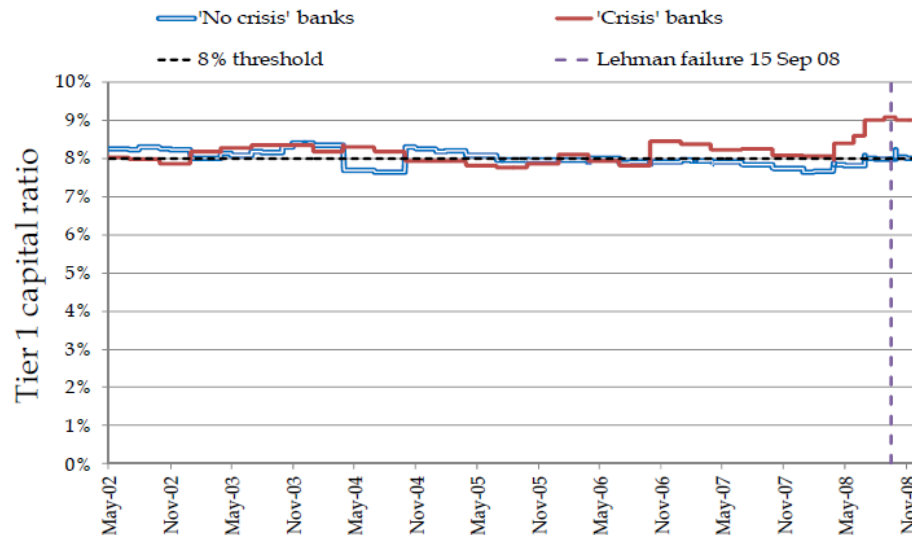
# The Nonsense of Regulatory Capital

- Capital ratios are meaningless indicators of capital strength—don't provide timely recognition of emerging bank weakness
- Basel approach made it possible for banks to operate on a very small aggregate capital cushion and a very high leverage
  - Tiered approach to the measurement of capital reduces the quality of capital
  - System of RWA ratios reduces the quantity of capital





# Capital ratios and 'failed' and solvent banks



*Note:* 'Crisis' banks are defined as major financial institutions which in autumn 2008 either failed, required government capital or were taken over in distressed circumstances. They include: Alliance & Leicester, Bradford & Bingley, Citigroup, Commerzbank, Dexia, Fannie Mae, Freddie Mac, Goldman Sachs, HBOS, ING Group, Lloyds TSB, Merrill Lynch, RBS, Wachovia and Washington Mutual. 'No crisis' banks include: ANZ Banking Group, Banca Popolare di Milano, Banco Popular, Banco Sabadell, Barclays, BBVA, BNP Paribas, Commonwealth Bank of Australia, Crédit Agricole, Deutsche Bank, HSBC, JP Morgan Chase, National Australia Bank, Royal Bank of Canada, Santander, Société Générale, Unicredit and Wells Fargo.

*Source:* Haldane (2011).





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# The Particular Nonsense of RWA

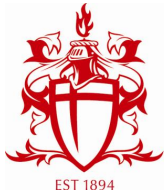
	<b>Regulatory capital ratio</b>	<b>RWA/total assets</b>	<b>Leverage</b>
Deutsche bank	14	18	39
Credit Suisse	22	13	35
UBS	20	15	32
Morgan Stanley	17	20	30
Societe Generale	12	30	28
BNP Paribas	15	30	23
Barclays	17	27	22
JP Morgan Chase	16	33	20
Goldman Sachs	19	27	19
Citigroup	17	39	16
Bank of America	16	39	16
Unicredit	13	49	16
Santander	13	50	15
HSBC	15	45	15
BBVA	14	57	13
Mean	16.0	32.8	22.6
Standard deviation	2.8	13.5	8.3

Source: Annual reports

Notes: Regulatory capital ratio is the ratio of risk-weighted assets to regulatory capital; leverage is total assets divided by regulatory capital







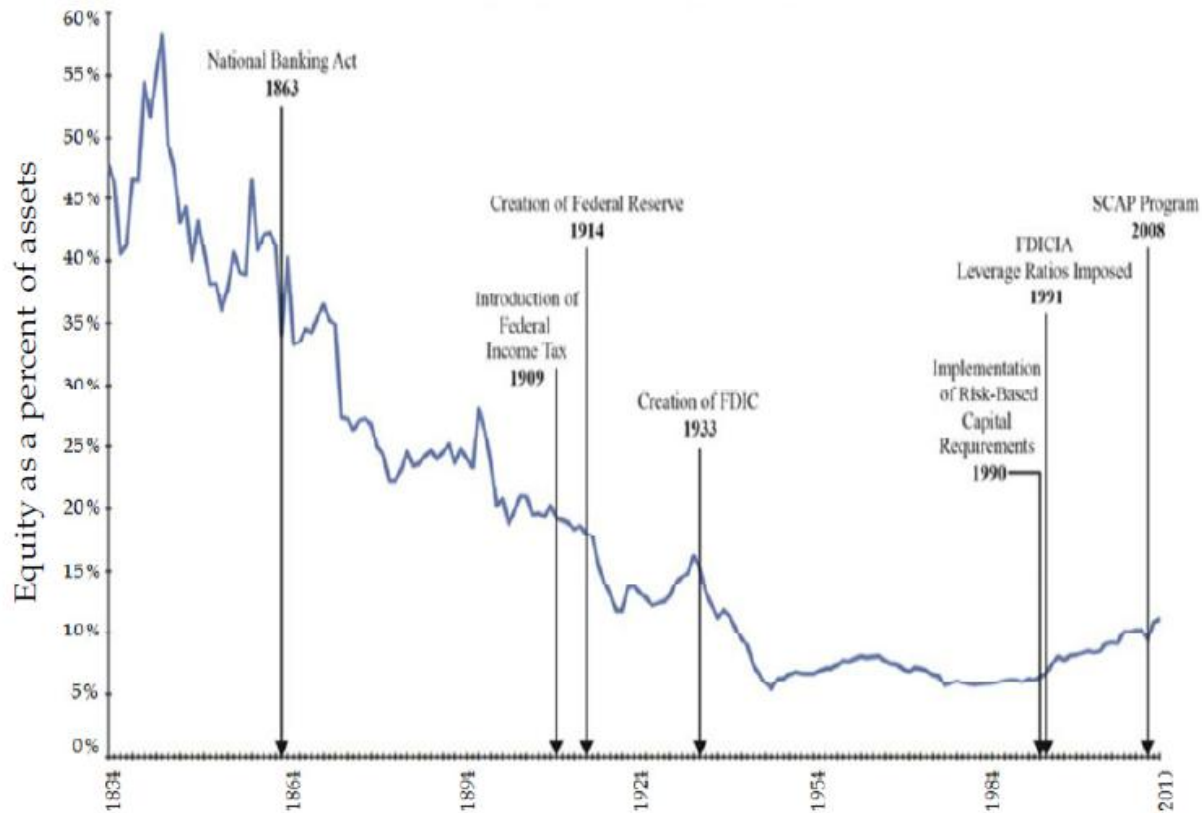
# What should be done?

- **Make banks more capital**
  - Scrap RWAs and impose a high common equity ratio e.g. 25%
  - Runs less likely; A large cushion to absorb losses; Fewer assets to be sold when deleveraging takes place
- **Reduce supervisory forbearance**
  - Adopt indicators of capital strength based on the market value of equity and oblige supervisors to act when the capital indicators show that a bank is weakening
- **Strengthen market discipline**
  - Oblige banks to issue junior debt convertible into equity, with conversion based on the market value of capital





# High Bank Capital Ratios are Not New



Source: Herring (2011a).

