

## Why bank capital raising is not a panacea

**WE SUGGEST: Gilt-Bund spread to remain wide**

**SUMMARY: UK banks' capital buffers have increased dramatically over the last two years. This is part of a necessary adjustment in the banking sector, alongside reduced dependence on short-term wholesale finance. Lloyds and RBS have both announced further plans to increase their equity capital. Politicians argue that banks need more capital to support their lending; but in recession these plans could backfire.**

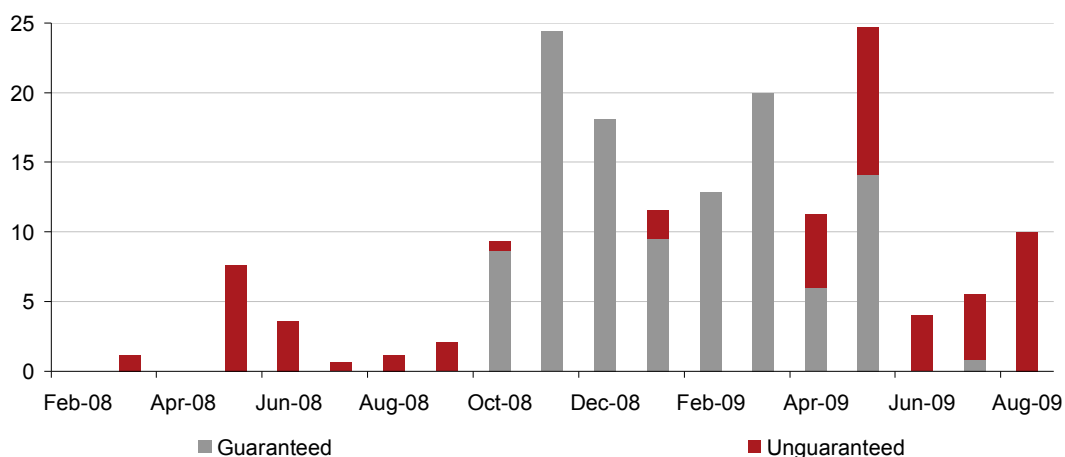
There is little debate that the UK banking system was undercapitalised as crisis broke in 2007. But there is an inherent tension between banks' need for more capital and the short-term objective of bringing the economy out of recession. Although the major banks had a median tier 1 capital ratio of 7.6%, far above the regulatory minimum, this dramatically understated the amount of risk and leverage embedded in banks' balance sheets. Policymakers across the world are in widespread agreement that banks need to hold a lot more capital, both as a buffer against credit losses in this cycle, and to prevent future asset bubbles from developing. The FSA, for instance, has recently indicated that it now expects UK banks to maintain a core tier 1 capital ratio of 4% at all times and a tier 1 ratio of 8% in 'normal circumstances'. There is a valid financial stability argument for an increase in banks' regulatory capital. Excessive leverage in the banking system is at the heart of all financial booms. This cycle has been no exception. Substantial state support has prevented catastrophic damage to the banking system and real economy, in particular through massive provision of term funding to the banks. Higher levels of capital will be needed to convince private investors to fill this funding gap, as and when state support is withdrawn.

Bank capital acts as a buffer against losses, so it should be drawn down during recessions and increased during booms, to minimise the accelerator effect from the real economy to credit supply. The issuance of new bank equity, whether purchased by the private sector or the government, can, in the short term, cause monetary conditions to tighten, thus dampening economic activity and asset prices. When the economy and banks are fragile, this can cause banks to write-down their assets and capital, thus restricting credit supply even further.

UK politicians also argue that banks need more capital so that they can satisfy unmet private sector demand for credit. Yet coming out of a recession caused by excessive private sector debt, firms and individuals will not want to borrow more. The UK private sector wants to pay off debt; but because of increased uncertainty and higher risk premia also wants to hold more money. When a bank loan is paid off, it 'destroys' money. Similarly, when a bank raises new equity the money stock is reduced since investors in the bank's shares use a bank deposit to make the purchase. In the case, where the government injects new equity into a bank, the monetary consequences depend on how the share purchases are financed. If government bonds are sold

to the non-bank private sector to raise the funds, the net effect is still a fall in the private sector's bank deposits.

### UK banks' senior debt issuance, \$bn



At the end of 2007, the major UK banks had a core tier 1 capital ratio of 6.0%. Write-downs and impairment charges were broadly matched by core revenues over the course of 2008. Risk-weighted assets rose markedly, as borrowers were downgraded and liquidity support was provided to off-balance sheet vehicles. However, banks also raised a considerable amount of new equity, such that by year-end the core tier 1 ratio had risen to 6.6%. By June this year, core capital ratios had risen to 7.7%, according to the Bank of England. But this estimate does not account for the protection afforded to RBS by the Asset Protection Scheme nor the £21bn of new equity soon to be issued by Lloyds Banking Group. A back-of-the-envelope calculation suggests that once these things are taken into account, UK banks' core equity capital ratios will have risen two percentage points during the recession.

The chart below shows the six month rolling sum in the banking system's (net) non-deposit sterling liabilities, which are broadly equivalent to newly-raised domestic currency debt and equity. As explained above, such issues reduce the money stock in the first instance. Post Lehman Brothers, the UK government effectively forced the major UK banks to raise considerable amounts of new equity. The consensus view is that financial market panic was causing a 'flight to safety'; the demand for money was rising rapidly, causing asset prices to plunge. As credit losses mounted, bank capital came under severe pressure, inducing a sharp contraction in credit supply. A government-led equity injection was necessary to break this vicious spiral. It was positive for the real economy because it arrested the panic and increased investor demand for risk assets (i.e. reduced their demand to hold money). *LSR* takes the view that UK government policy made the problems worse. The panic surrounding US banks' future loan losses was transposed to the UK banks, whose loan books were generally in better shape<sup>1</sup>. The issue was not a lack of capital *per se*; but the effect that insolvency fears had on the short-term money markets. Counterparties were reportedly refusing to lend to some of the UK banks except overnight. By early October, there were even fears that RBS and HBOS funding would dry up entirely<sup>2</sup>. At this stage, the Bank of England should have begun full-scale 'quantitative easing' to boost the stock of money, while temporarily guaranteeing short-term interbank lending

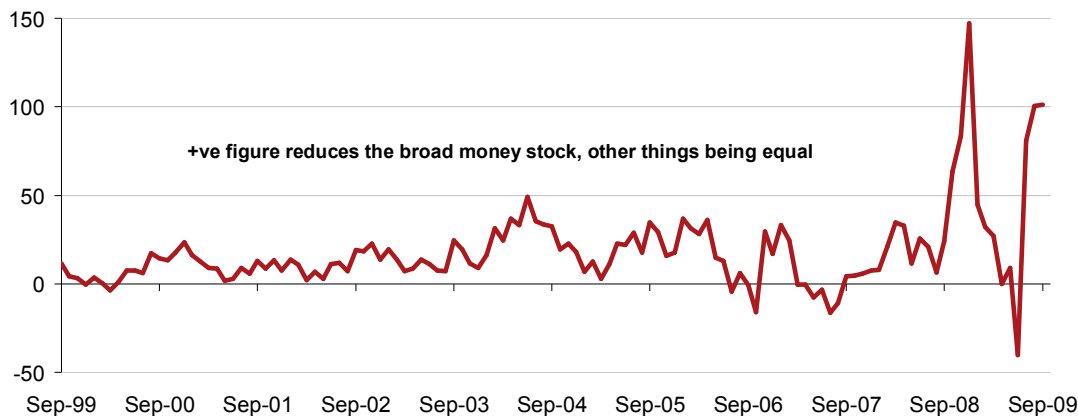
<sup>1</sup> By this stage of the crisis, the major UK banks had already booked severe losses on their portfolios of 'available-for-sale' and 'held-for-trading' assets.

<sup>2</sup> See Mervyn King's interview for the BBC's *Love of Money* programme, 24<sup>th</sup> September.

to limit the panic in wholesale money markets. However, by imposing on the banks much more onerous capital requirements, the government brought about the tightening of credit supply it hoped to prevent. Moreover, by sucking money out of the economy, the capital raising exercise exacerbated the drop in asset prices and confidence.

### Change in banking system's net non-deposit £ liabilities

Last six months, £bn



The cost and availability of bank funding have improved substantially since the turn of the year. Banks continue to raise large amounts of new debt and equity (see both charts above). But with the recovery still fragile and broad money growth anaemic, there have to be concerns that the large equity infusion which Lloyds and RBS are about to receive could backfire. The two banks are issuing £46bn of new equity between them. That is more than the increase in broad money over the last year. A less leveraged banking system is both a necessary and sufficient condition for medium-term recovery. But forcing the banks to raise their capital ratios, when the economy is still extremely weak, can make matters worse.

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