

BOOK REVIEW

**“THE BANKERS’ NEW CLOTHES: WHAT’S WRONG WITH  
BANKING AND WHAT TO DO ABOUT IT”  
BY ANAT ADMATI AND MARTIN HELLWIG**

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*ABSTRACT* Anat Admati and Martin Hellwig identify the key problems in banking as excessive borrowing and risk-taking, increased interconnectedness between banks, ineffective regulation and supervision, distortions and inefficiencies from explicit or implicit government guarantees and subsidies, and banks’ governance problems. The authors propose a simple solution: raising the bank equity requirement to 20-30 percent of total assets. They argue that this solution would significantly reduce the fragility of banks. Finally, the authors also highlight the importance of political will as an essential element for meaningful financial reform.

*JEL* G21, G28

*Keywords* Bankers’ New Clothes, Capital requirements, Banking regulation, Book Review

Öz Anat Admati and Martin Hellwig bankacılıkla ilgili başlıca sorunları şu şekilde belirlemektedir: aşırı borçlanma ve risk alma, bankalar arasında karşılıklı bağımlılıkların artması, etkin olmayan düzenleme ve gözetim, hükümetler tarafından verilen açık veya zımnî garantiler ve sübvansiyonlar, bankaların yönetim sorunları. Yazarlar bankaların sermaye yeterliliklerini toplam varlıkların yüzde 20-30’u düzeylerine yükseltecek basit bir çözüm önermektedir. Yazarlar bu çözümün bankaların kırılabilirliğini belirgin şekilde azaltacağını savunmaktadır. Son olarak, yazarlar anlamlı bir finansal reform için politik kararlılığın önemine dikkat çekmektedir.

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*Anahtar Kelimeler* Bankers’ New Clothes, Sermaye yeterliliği, Bankacılık düzenlemesi, Kitap Eleştirisi

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## 1. Introduction

The destabilising impact of the global financial crisis has been so enormous that almost everyone has an interest in what went wrong in the banking system. Even Queen Elizabeth II did famously ask academics during a visit to the London School of Economics in November 2008 about why no one saw the financial crisis coming. Four years later, she was offered a three-fold explanation at her visit to the Bank of England from one official “People thought markets were efficient, people thought regulation wasn’t necessary. Because the economy was stable there was this growing complacency,” he told the Queen, adding that “people didn’t realize just how interconnected the system had become.”<sup>1</sup> After reading this book, one may replace the word “people” in this statement with “bankers, regulators, and politicians” in order to better qualify who these people are.

The book, *The Bankers’ New Clothes*, by Anat Admati and Martin Hellwig, two prominent economics and finance scholars, is devoted to make a very strong case for higher bank capital requirements. The authors’ main motivation is to show how the financial crisis could have been avoided had the troubled banks had higher capital and less borrowing with respect to their balance sheets. The title of the book and the cartoon presented on the cover is a reference to Hans Christian Andersen’s tale, *The Emperor’s New Clothes*. The authors use this tale as a metaphor to explain how arguments by those who oppose higher capital requirements and stricter regulation in general (i.e. bankers, regulators, politicians, and even some academics) can often be unfounded, misleading or even manipulative, and hence, can be viewed as creating a certain mystique attached to banking and bankers. To this end, the authors reveal a number of (23, to be precise)<sup>2</sup> what they call “the bankers’ new clothes”, that is, “flawed claims” against the case for higher bank capital requirements.

The sub-title of the book, “What’s Wrong with Banking and What to Do about It”, provides the reader at the outset with sufficient hint that the authors have very strong opinions about the banking system. Indeed,

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<sup>1</sup> CNBC, “Britain’s Queen Quizzes Central Bank on Financial Crisis”, December 14, 2012. Accessed at <http://www.cnbc.com/id/100313755> on December 9, 2013.

<sup>2</sup> The authors maintain a web site at <http://bankersnewclothes.com> that contains additional material about the book. There is also a list of the “23 flawed claims debunked” which summarises the authors’ main arguments against common defensive claims by bankers. See Admati and Hellwig (2013b).

regarding the first question, the book describes the current state of the financial/banking system as being too fragile particularly to the changes of the price of banks' assets or the price of collateral to which their assets are attached. The fragility arises from banks' excessive borrowing relative to their capital, which significantly amplifies their potential losses as well as profits. However, the authors claim that, given the implicit or explicit bailout guarantees from the government, banks (and their managers in particular) take on excessive risks in the comfort of these guarantees so that the downside risks are in effect transferred to taxpayers while the banks accrue the benefits themselves.

This book is intended for a broader audience than solely professionals or academics. One major objective of the book is to create a political opinion among the society towards stronger and quicker action for a safe and prudently regulated banking system. The authors attempt to do so by explaining how the current state of banking exposes the public to significant risks. They advocate that the risks emanating from the fragility of the banking system can largely be avoided by significantly raising the amount of capital (equity) to 20-30 percent of total assets. They claim that this solution has virtually no cost to society, while the cost to banks may be much smaller than claimed by bankers when the expected fall in banks' riskiness (due to much higher capital relative to total assets) is properly taken into account. They also criticise ongoing reform efforts (Basel III) as being slow, inadequate and unnecessarily complicated, and call for robust reforming of the financial sector.

In their quest for convincing the average voter, Admati and Hellwig pursue a strategy consisting of two aspects. The first part of their strategy is to dissolve the mystique surrounding the business of banking. They educate the reader on the issues of risk and return, and their relationship with equity, as well as on the jargon that bankers use. The second aspect of their strategy is to challenge and discredit many claims that are used by bankers or by those who are sceptical about tighter banking regulation. The most important one is the claim by bankers that if capital requirements were to be raised, then the banking sector would not be able to extend so much credit as before because the cost of capital is high. The authors suggest that the reason why bankers argue that bank capital is costly is because their required return on equity (ROE) is very high to compensate for risks elevated from excessive borrowing. They also point to the existence of very successful non-financial firms which never borrow but raise funds through retained earnings or issue of new equity, and ask why bank capital would be more expensive than the cost of equity for non-financial firms once the risks from excessive leverage are appropriately taken into consideration.

## 2. Contents of the Book

The book is organised in 13 chapters and 3 parts. The first chapter, “The Emperors of Banking Have No Clothes”, can be seen as a summary of the book with a concise explanation of the motivation for writing on such a topic. The chapter also provides a sampling of the “bankers’ new clothes”, that is, bankers’ claims, which the authors dub as “flawed”, against the case for tighter banking regulation. The authors also provide a discussion of why bank safety matters, or why bank failures –especially failure of a systemically important bank– would have more disastrous consequences than the failure of a non-financial firm.

The first part, “Borrowing, Banking, and Risk”, builds the foundation for the discussions in the subsequent parts. The authors lay out the conceptual framework through an exposition of the relation between borrowing and risk. Chapters 2 and 3 discuss this relation in more general terms and not specific to banking. The next two chapters reflect this analysis to banking, and review the implications of excessive risk-taking for the banking system.

Chapter 2, “How Borrowing Magnifies Risk”, starts with a mortgage example and shows how fluctuations in the value of the house expose the borrower to greater risks when the down payment is relatively small. There is also a comparison of personal borrowing with business borrowing and corporate borrowing. This chapter goes on to show that corporations can raise funds without borrowing, mainly through issuing new shares or retaining profits; and also that banks rely on borrowing much more than do other firms.

Chapter 3 exposes the reader to “The Dark Side of Borrowing”. When the borrower faces financial difficulties and defaults on her debt, not only the borrower, but also lenders and possibly others may run into financial distress. The authors introduce the concepts of default and bankruptcy, and also differentiate liquidity problems from solvency problems. Finally, the authors argue that once debt is in place the borrower has an incentive to borrow more and resist reducing her indebtedness because of the fact that downside risks are shared by the lender.

Chapter 4, “Is It Really ‘A Wonderful Life’?” shifts the focus to banks and what they do. The chapter explains how the traditional deposit-taking savings banks offer the society an important service through deposits and the payment system, but at the same time, how they are prone to bank runs. The authors do this by providing a brief historical account of the banking sector in the US. In particular, they explain how rising interest rates during 1970s set the demise of commercial and savings banks as depositors directed their savings to money market mutual funds, and how commercial and savings

banks subsequently started to invest in very risky assets in order to cover their previous losses. The authors conclude this chapter by analysing risks from lending (credit risk) and the way financial innovation is used to manage these risks, for example, through mortgage securitisation.

Chapter 5, “Banking Dominos”, tries to answer the question of why the financial system was so vulnerable at the 2007-2008 financial crisis, and why the damage was so great. The main discussion in this chapter flows through the role of contagion and increased interconnectedness between financial institutions. The effect of sophisticated financial risk-management instruments such as securitisation, credit default swaps, and derivatives is also elaborated. In the last section of the chapter, the authors ask, should we let banks fail? They cannot reach a solid conclusion, but they stress their concerns regarding the difficulties involved in the resolution of large and complex financial institutions that span across international borders. However they also mention potentially large costs to the rest of the economy if financially distressed or insolvent banks are not resolved.

The second part of the book, “The Case for More Bank Equity”, consists of five chapters. This part is based on authors’ premise that unlike natural disasters such as earthquakes, financial crises are preventable or their likelihood can be significantly reduced. The main message of this part is that the financial system need not be so fragile, and that reforming the financial system does not necessarily impose costs to society, in the form of reduced credit availability, or impaired payment system.

Chapter 6 is devoted to the issue of what can be done to reduce the fragility of banks. The authors consider various banking regulation measures in order to induce banks to take account of negative externalities they impose on the rest of the economy. Prudent regulation starts from better bookkeeping. To this end, the authors propose eliminating the use of off-balance sheet items as much as possible. The authors briefly review various approaches to managing risk from banks’ investments, including limiting banks’ exposures to individual counterparties, geographical restrictions, “breaking up the banks into smaller, more manageable, and less complex entities”, and separation of deposit banking from investment banking. They also discuss controlling liquidity risks by means of reserve requirements, liquidity coverage ratio regulation, and government or central bank guarantees to provide liquidity as the lender of last resort. Lastly, they discuss the merits of a third approach, capital regulation, which “focuses on the banks’ ability to absorb losses without becoming insolvent”.

Chapter 7, “Is Equity Expensive?”, is one of the most critical chapters of the book. It challenges bankers’ arguments against higher capital requirements and their claim that tighter regulations would harm the

economy because higher cost of capital relative to debt would increase banks' overall funding costs. The authors approach the question of whether equity is expensive for banks from two angles. First, they explain why and how the required rate of return on equity is closely related to the risk of the investment being undertaken. Second, they argue that the *composition* of funding for a particular bank is also decisive on properly identifying the cost of equity relative to debt. The greater the weight of debt in the debt-equity mix, the higher is the risk of default, and hence the cost of borrowing also increases. As for the required rate of return on equity, the greater the leverage of the bank, the risk to shareholders is also greater. The authors also hint of further analysis in following chapters by also arguing government guarantees or deposit insurance can make borrowing cheaper and more attractive for banks.

Chapter 8, “Paid to Gamble”, criticises the role of corporate culture and governance problems in banking which promote excessive risk-taking by bankers. The authors show that bankers almost always concentrate on the upside while they typically underestimate and ignore the downside risks. They take on the claim of “higher capital would decrease return on equity” and demonstrate how this statement overlooks the downside risk scenario in which the actual return on equity is greater (less negative) when capital is higher. The authors also state that the *required* return on equity is also much lower when equity is higher. Bankers often set higher ROE targets supposedly for the benefit of shareholders. However, the authors state that “shareholders might actually be harmed by action that managers take to try to achieve a target ROE”. Bank managers' such behaviour, the argument goes, is very much related to the way they are paid on the basis of the profits their banks make. Therefore bank managers may engage in activities to hide risks, which may eventual lead to ineffective auditing of managers by the board.

Chapter 9, “Sweet Subsidies”, tackles the question of why banks can, “despite being so highly indebted, find willing lenders and continue to borrow at terms that are sufficiently attractive for them”. The key role in answering these questions falls onto guarantees and subsidies. The authors argue that explicit or implicit bailout guarantees, which are intended to ease financial distress and reduce the likelihood of bank failures, paradoxically encourage banks to increase the riskiness of their balance sheets, knowing that the downside risk would be borne by guarantors and creditors. Also, tax codes in many countries favour debt over equity by subsidising the cost of borrowing through allowing interest expenses to be deducted from taxable income. Furthermore, the authors also argue that these guarantees and

subsidies give banks a strong incentive to expand by borrowing in order to earn the status of “too big to fail”.

Chapter 10, “Must Banks Borrow So Much?”, investigates the rationale for the current state of banking with too little equity and too much borrowing. The authors conclude that there is no legitimate justification for banks’ over-borrowing and that the society is better off when banks rely less on subsidised borrowing and use more equity. They also add that services by banks, such as deposits and payment systems, would not be compromised when banks borrow less; on the contrary, confidence in banks’ ability to withstand possible losses makes bank runs less likely, enhancing the efficiency of the payments system and the banks’ role as liquidity transformers.

Having made a strong case for higher bank capital and tighter banking regulation, the final part of the book, “Moving Forward”, provides the reader with an appraisal of the current and proposed regulations (Basel III), as well as with some policy recommendations.

Chapter 11, “If Not Now, When?”, tries to answer how banks must be reformed to become safer and less prone to exposing the economy to unwarranted risks and possible crises. They oppose procrastination of reform efforts based on objections that the economic recovery must not be jeopardised with tight regulations. The authors’ main recommendation for strengthening banks immediately is to ban dividend payments to shareholders and to require banks to retain earnings until they have significantly more equity. The authors also criticise Basel regulations for the minimum capital requirements and leverage ratios. The proposed Basel III capital requirements fall significantly short of the 20-30 percent range that the authors advocate. Besides, the authors find it complex and counter-productive that capital is assessed relative to a risk-weighted measure of total assets, for which the banks themselves determine which asset falls under which weight category. Therefore they propose using *total assets* without using risk-weights, including the so-called off-balance sheet items, and avoid netting of certain exposures.

Chapter 12, “The Politics of Banking”, reveals how the interactions between banks, politicians, and regulators delay and impair reforms on bank capital regulations. The authors point to banks’ lobbying efforts against stricter capital regulation on the grounds that the “national” banking system’s global competitiveness would be hurt, which they claim to be at odds with national interests. However, the author’s response to these claims are based on the extent to which government support for banks could create economic distortions, as well as on the distributive consequences arising from risk-sharing between banks and society.

Another aspect of banking politics is about the way politicians view banks as a source of funds that is exempt from budgetary considerations as well as auditing. Banks, on the other hand, see these kinds of requests from politicians as an expense in exchange for favourable treatment from the government. The authors also touch on the issue of what they call the “regulatory capture”. It refers to regulators’ failure to set and enforce rules to prevent the accumulation of risk by banks. Regulatory capture can arise because regulators might see banks as their prospective employers, or because they become biased if the “crowd of banking onlookers” also favours banks, or because the interest groups have some kind of gentlemen’s agreement with the government such that in exchange for contributions to election campaigns the government would be willing to appoint dovish regulators.<sup>3</sup>

Chapter 13, “Other People’s Money”, is the epilogue of the book, which brings together the key issues addressed in earlier chapters. The authors call for stricter capital regulation for banks in order to safeguard financial stability and to reduce the fragility of banking which exposes the society to inordinate economic and social costs. They see political will as an essential element of the transition to a safer banking system that is able to support the economy without subjecting the society to excessive risks. They conclude by stating once again that the society can achieve a better financial system at practically no social cost.

### 3. Some Remarks

While the issue of whether or not monetary policy was to blame for the financial crisis is still open to debate, it seems fair to argue that low policy rates of major advanced economies’ central banks might have induced banks to operate on greater leverage ratios and take on excessive credit and liquidity risk. Systemic risks emanating from the rapid rise in banks’ non-core liabilities in the past few years prior to the crisis have been difficult to assess properly, given the lack of consistent and transparent regulatory procedures and adequate macro-prudential supervision.

Admati and Hellwig undertake a daring responsibility in writing this book. The book is essentially a political manifestation of ideas and policies required to transform the banking business in a radical way. The authors aim to raise political awareness towards the case for much higher equity in

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<sup>3</sup> On this issue, it is interesting to note that the Queen’s response to the explanation given to her (see Introduction) was to ask whether there had been a “lax” attitude to financial regulation. The Queen also questioned whether the Financial Services Authority may not have been aggressive enough in its policing, by saying: “The Financial Services – what do they call themselves, the regulators – Authority, which was really quite new ... it didn’t have any teeth.”

banking. As they put it nicely, “financial stability has no constituency but is everyone’s business”.

Consequently, one of the major objectives of the book is to educate the voters on the importance of having strong and prudent banks and on policy options that would focus on public interest. Given that the audience is comprised of mainly non-professionals, the authors rightly chose a non-technical style in writing the book. Therefore, they shy away from the use of economic and financial terminology. For instance, the main issues discussed in the book cover many microeconomic concepts such as, moral hazard, principal-agent problems, competitive coordination failures, incentive compatible contracts, time inconsistency of economic policies, adverse selection, and etc. The authors refrain from using these terms, but they explain very successfully the basic intuition underlying these concepts in an eloquent way. The book also contains a comprehensive collection of endnotes that makes it possible for the more-interested reader to explore the academic or technical aspects of the discussion.

The case for higher bank capital and the “flawed” claims that have been challenged by the authors have already been the centre of debate on financial reform. The book has received the attention of bankers, policymakers, and academics. Admati and Hellwig (2013b) provide a selection of responses to the analysis and policy recommendations of the authors. On the academic front, Calomiris (2013) addresses the policy recommendation of the book. Although Calomiris also agrees on the need for raising bank equity ratios, he proposes to raise required equity to roughly 10 percent of total assets, compared to 20-30 percent advocated by Admati and Hellwig (2013a). Calomiris recommends also ensuring that banks maintain that ratio in *actual* equity relative to risk. Edward (2013), Mariathasan and Merrouche (2013), Miles (2013), and Ratnovski (2013) also analyse separately the issue of bank capital from various aspects.

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