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How to recapitalise banks

The current approach to solving the banking crisis is to put more government money into banks. The problem with this approach is that it creates fear of government meddling in the operational and financial decisions of the banking sector. Banks can only survive if they are run by managers and boards who sincerely believe their goal is to maximise shareholder value. This requires managers who are willing to maximise shareholder value and are capable of doing so.

The problem with government control is that these conditions are not likely to be met. Take the recent cap on compensation imposed by US President Obama on assisted banks. Neither a maximum nor a minimum wage is likely to promote the long-term competitiveness of these banks. Politicians and bureaucrats fundamentally care about stakeholders, not shareholders, so that government control represents bad corporate governance.

The result is that, although government injections of new capital increase the book value of equity, the market value of equity may actually decrease as a result of collapsing stock prices after the announcement of government 'help'. The result is that bank stocks end up in a death spiral, fuelled by the ultimate threat to shareholder value: nationalisation.

The alternative, putting more private capital into banks may also be badly received by capital markets as it may be interpreted as a bad 'signal' that the bank is in trouble. Unless existing shareholders buy all the newly-issued equity, such a negative signal means that banks that are (wrongly) perceived to be bad are forced to sell undervalued equity to new investors, which dilutes the interest of current stockholders. Moreover, equity holders are reluctant to put new money into a company when they perceive that the main beneficiaries of this capital increase are the debt holders. This debt-overhang problem prevents the obvious deleveraging that is necessary to put the banks back on sound financial footing.

So, how to get out of this dilemma? Perhaps the world should get some inspiration from the Belgian tax reform of 1982, which represents the most successful experiment in government-engineered deleveraging in history.

In 1982, the Belgian government introduced a law allowing companies to deduct the cost of equity (estimated at 13 per cent) of newly-issued equity from its corporate taxable income for the next 10 years. The rate of 13 per cent was based on the prevailing rate of interest on corporate debt in 1982. So a company that issued one million euros in equity could deduct 130,000 euros a year from their taxable income, the same amount as if it had issued one million euros worth of debt.

At the same time, Belgian investors were allowed to deduct up to 1,000 euros of investments in Belgian stocks from their taxable income. As a result more companies issued equity in 1982 than during the previous 13 years and the Belgian stock markets rose by 50 per cent as seen in the graph below which shows the movement of the Belgian stock market index relative to the Morgan Stanley World Market market index from January 1981 to January 1984. Note that in 1981, the Belgian market behaved like others around the world, but then experienced a 50 per cent jump in the spring of 1982 when the law was announced.

Let's think about a similar global tax reform today.

First, end the tax subsidy to debt financing by making the cost of equity tax deductible in the same way as the cost of debt. Specifically, every company should be allowed to take a charge against the book value of equity, at a rate tied to the corporate borrowing rate. A similar law has existed in Belgium since 2006. This will take away the tax advantage of borrowing money. This means that more banks and their clients will be interested in equity issues, which will encourage deleveraging without negative tax consequences. This tax law change should be permanent.

Second, give a tax deduction or a tax credit to anyone who buys newly-issued bank shares in 2009. This will increase the demand for bank shares: in some ways, banks have now obtained a licence to sell tax credits to investors. Note this part of the tax law would be applied only to equity issued in 2009 to encourage immediate action.

Such a tax measure will have three major advantages over the current approach of putting more taxpayer money into banks. First, the government will not become a shareholder in the bank, preserving the benefits of private ownership. Second, by tying equity issues to tax credits, the negative signal will be avoided. Banks that issue equity will be considered as banks that sell tax credits, not banks that are in trouble. When firms issued equity in Belgium in 1982, stock prices increased significantly, in contrast to the typical decline observed after announcements of capital increases. Third, the critique that taxpayers are bailing out banks would be avoided. Of course, the government will help finance the bailout by giving tax reductions, but the cost of these reductions is going to be smaller than the costs of the guarantees and subsidies that governments are handing out right now.

Will such a change in tax laws reduce banks' incentives to borrow and have more reasonable leverage ratios? We would hope so, although we are still concerned about one major issue: in spite of the Nobel prize-winning contributions of Merton Miller and Franco Modigliani, who have shown that without tax benefits, there is no reason to prefer debt over equity, there seems to be a widespread belief in banks that debt is cheaper than equity, regardless of the tax treatment. This is, I believe, a result of the obsession with earnings per share and return on equity as corporate objectives. It is true that borrowing increases earnings per share and expected return on equity, but it makes earnings more risky so that the present value of earnings is independent of capital structure. So, the boards of financial firms have to make sure that executive bonuses are not tied to earnings per share or return on equity targets, but to performance measures that take risk into account.

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