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RETHINKING EQUITY-BASED REGULATION: HOW BANKS CREATE FICTIONAL EQUITY AND WHY THIS MATTERS

Abstract:

Significantly higher equity ratios make banks more crisis-resistant. That is a widespread assumption among many financial market regulators and political economists. But reality is different, more complex and full of tricky strategies how to circumvent or undermine specific capital requirements. What if banks use their power to create money to generate the required additional equity capital in the end themselves? How effective can an equity-based regulation be in such cases? Well-documented case studies from Iceland, Switzerland and Great Britain combined with balance sheet analyses help to show how these transactions work and what effects they have. Whether cross-shareholdings, cross-funding or insider loans to their own investors – banks and their owners are often creative in pretending higher solvency and thus higher risk buffers while actually promoting instability through such funding strategies. These types of transactions may seem unbelievable and ethically highly objectionable, but are sometimes legal. Typically, they are only discovered after a bank failure, when it is too late.

Keywords:

money creation, bank equity, bank regulation, insider lending, bank failure

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