

Clarification concerning our referencing of Admati et al. in our JMCB paper

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In their 2010/2011 discussion paper, Admati et al argue in favor of substantially higher capital adequacy requirements than those contemplated by Basel III. The introduction of our 2012 JMCB paper apparently led some readers to view our research as a critique of higher capital requirements and thus of their policy proposal. This is not the case, and this clarification aims at dispelling any ambiguity created by imprecise writing on our part.

In a nutshell, our paper is “orthogonal” to theirs; first, as stated in the introduction, by not lending itself easily to a calibration of the optimal capital adequacy ratio (CAR), it neither supports nor provides ammunition against their policy recommendation. Second, its contribution resides entirely in the analysis of how the CAR should adjust with the cycle, and not on the determination of its absolute level: Put differently, it focuses not on *levels* but on *changes* in capital requirements across the business cycle.

Our sole purpose in the paper is to build on a theoretical model in which outside equity is relevant, in order to start thinking, from an optimal contracting perspective, about various forms of *macro-prudential policies* (countercyclical buffers, capital insurance, CoCos...). As for Admati et al., its Section 5 reviews in detail and criticizes a large number of prominent corporate finance and banking models, arguing that these models rely on highly unrealistic assumptions, so that their conclusions do not provide a basis for assessing the costs of changes in the debt-equity mix in the real world.

In our paper, we stress a point that actually is at the centre of Admati et al.’s analysis: while it is widely acknowledged that inside equity is limited, it is much less clear why outside equity is or should be. This point is what prompts Admati et al. to argue in favor of higher capital ratios, and prompts us to develop a theory in which outside equity matters.

References

Admati, A., DeMarzo, P., Hellwig, M. and P. Pfleiderer (2010) “Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive” Preprint 10-42, Max Planck Institute for Research on Collective Goods, Bonn 2010 (revised version March 23, 2011).

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