BANK OF ENGLAND

Bank executives: now we have your attention…

Article by

Robert Jenkins, Member of the Financial Policy Committee, Bank of England

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It sometimes seems that when banks do well, they are owned by their employees; when they struggle, they are owned by their government. One would have thought they are owned by their shareholders. We may soon find out. Stung by sub-par returns, shareholders and their money management agents are protesting bank pay. Message to those few bankers who may have forgotten: "it's not your money."

Shareholders have two ways of making their views known. One is to sell the shares; the other is to engage bank boards whilst retaining their investment. Both are now at work. The current price-to-book at which many banks are trading indicates that investors believe that some entities represent too much risk for too little reward. Meanwhile, mounting protest votes suggest that too much of that "too little reward" is going to employees rather than owners.

I congratulate the investment industry on finding its voice. But now that certain boards are more eager to listen, it might be useful to think carefully as to what exactly you are going to tell them. Yes, you want a better link between pay and performance. But exactly what performance target do you want them to hit?

For more than a decade the primary target has been that of a double digit Return on Equity (RoE). This was the target promised by many bank boards. It was the target embraced (and often encouraged) by many investors in banks. It was the wrong target. Has the quest for high RoE produced it over time? No. Have such targets produced attractive bank shareholder returns? No. Why? Because a focus on short term RoE does not capture the risks run in pursuit of that return.

For bank executives, short term Return on Equity has been a most convenient metric. One can achieve it in two ways. You can increase the return "R" or you can reduce the Equity "E." Many bankers increased the R *sometimes* and kept the E low *at all* times. These "sometimes" were frequent enough to collect short term executive compensation but insufficiently sustainable as to build long term shareholder value. In other words, the risks that are run over time may produce periods of apparently high "returns" for which the losses come later. "Later" came recently. Thus the primary measure for many risk-taking institutions is not adjusted for risk.

Money managers have now understood this – some before the crisis; others since 2008. Some bankers have not. The crash was a painful reminder that the successful investor does not seek high RoE-targeting enterprises; he seeks high relative *risk-adjusted* returns. If a bank achieves gains in RoE through greater leverage (read risk), then investors should adjust the share price downwards appropriately. Conversely, the bank with less leverage, less earnings volatility and more dependable dividends, will be rewarded with a higher earnings multiple. Moreover a higher multiple even with lower earnings can yield the same or higher market cap. And it is the combination of changing market cap plus dividends that determines shareholder value and return.

It is therefore disappointing that many bankers rail against rising capital requirements. Regulation, they claim, is driving up their cost of capital. Is it? Is that the way it works? I don't suppose higher capital costs for some might be a consequence of the market's new-found understanding of the risks that banks run? And could it be that the prospective removal of government subsidies and safety nets is being factored into the calculus?

Irrespective of the cost in absolute terms, one's cost of capital *relative* to that of one's competitor is largely within the control of bank boards. Higher equity in the balance sheet mix may well reduce short term RoE but it does not necessarily increase the cost of capital. Not only buyers of bank *shares* but investors in bank *debt* will accept less return from a less risky institution. They will value more highly a higher quality earnings stream. This not just theory. Those financial institutions with relatively less leverage are trading at better valuations than those of their more aggressively managed counterparts. Prudence pays.

This is all pretty basic stuff. Alas, for a time it was forgotten. The "great moderation" together with a misplaced faith in bankers' risk-management prowess contributed to a false sense of security. The short term targeting of non-risk adjusted RoE was felt synonymous with shareholder value. It was not then. It is not now. Many bank boards understand this. All bank boards need to. For those who don't, shareholders should teach them or replace them. For example, the notion of delaying bonuses a little longer while the CEO redoubles his efforts at maximizing short term RoE goes in precisely the wrong direction.

And this brings us back to where we started. Shareholders, now that you have your banker's attention what will you tell him? May I suggest that at a minimum you tell the board three things: 1) you work for us, we do not work for you; 2) we are not interested in short term RoE – we are interested in growth in shareholder value; and 3) if you wish to target RoE, we will set the target and rewards which go with it over an appropriate time period (10 – 15 years). In short, banks are in the risk taking business. Bank performance metrics must reflect the risks they take to achieve a given return. As shareholders you want to understand both - and insist they do as well.

Robert Jenkins is an external member of the Financial Policy Committee of the Bank of England.

He writes in a private capacity.