BANK OF ENGLAND

Banking myths and shibboleths

Article by

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

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"The remorseless rise in regulation has become the greatest risk facing the banking sector." Have you heard that one lately? Who hasn't?

The growth in regulation is the predictable consequence of the near death experience from which we all suffered and suffer still. "Never again!" is the legitimate demand from our citizenry. True, not all banks were guilty of greed, reckless risk-taking and monumental stupidity. But would the debacle have happened in its absence?

And yes, when it comes to culpability, the regulatory establishment is not exempt. I have not heard many bankers accept blame for the crisis but quite a few within the regulatory ranks have acknowledged their failings. However, for avoidance of doubt, let me say it here and now: the regulatory establishment blew it! We messed up in two ways. First, we misjudged the breadth and depth of the risks that many banks were running. Second, we misjudged bankers' ability to judge those risks. Of the two, the latter is the most damning. How could we have been so dumb as to assume that bankers were so smart? Both groups belong to the human race and the human race is hubris hungry and error prone.

None-the-less, the cascade of consultations with which banks must now cope is challenging. So let me suggest a deal – one which I stress is not in my gift and which I offer as a proposal in my private capacity only. How about a moratorium on all new regulation followed by a review and roll back of the rule book? In exchange, all banks everywhere would agree to raise their tangible equity capital to 20% of assets. The logic? Well: 1) we all agree that too many bankers got it wrong in the past and will likely get it wrong in the future; 2) similarly, too many regulators got it wrong in the past and will likely get it wrong in the future; and 3) we agree that the taxpayer should never again be stuck with the tab for our collective failures. Right? So, the only dependable solution is to set the minimum loss-absorbing capital at a level which both discourages recklessness and permits the shareholder purse to pay for it. Many leading academics and economists place the optimal level of such equity at 20%.

"Ah," will respond the bankers: "we agree with the rollback but not with the capital commitment." Sorry fellows - the future is not what it used to be. No one will trust you again to manage your risks free from oversight unless the taxpayer is exempt from the consequences (at least not for a generation).

"But such capital requirements will bring the economy to a halt" they will argue. "Raise our capital and we will have to lower our lending." I can hear it now. I have heard it before. Nice try. This is the first of two myths making the rounds. Take a minute to do the math. Bank "A" has a trillion dollar balance sheet supported by $50 billion of equity. Now, let's double the equity required to 100 billion and retire 50 billion of debt. Has the balance sheet shrunk? No. Has the bank had to cut credit? No. So does more capital *necessarily* lead to less lending? No. Does society have to choose between safety and growth? No. So much for myth number one. "How dumb can you be?" will be the bankers' retort. "Equity is expensive. Make us double our equity and you will lower our Return on Equity (RoE), damage shareholder value and discourage the supply of bank capital."

This is myth number two. Let's take it in two parts. First, as a long term (10 years plus) measure of banking profitability RoE may make sense. But as a short term target it is flawed and dangerous. Ask yourself: has this fixation on double digit RoE achieved it over time? No. Has the annual emphasis on RoE produced attractive and sustainable shareholder returns? No. So, does the short term focus on RoE equate to shareholder value? No. Why? Because it does not adjust for risk. The returns may come short term but the risks come later. (Later came recently.) Second, the prospective investor is not interested in promises of short term RoE; he is interested in achieving attractive risk-adjusted returns. The higher the perceived risk, the higher the return required. The lower the perceived risk, the lower the return expected. Capital will flow in either combination but its price will be different. Banks with little equity and lots of leverage are more risky than those with less leverage and more equity. Investors in both bank equity and bank debt will charge accordingly. That "charge" is the bank's cost of capital. Given that markets reward more predictable earnings with higher multiples, even lower earnings need not lower the market cap, dividends or shareholder returns. Not convinced? Look at bank shares. The market is attaching relatively higher valuations to the relatively less leveraged.

In summary, higher capital requirements *are* compatible with both economic growth and shareholder value. So do consider a deal. What's the downside? The upside is less regulation.
Oh, I forgot to mention: that opening quote about remorseless rise in regulation being a threat – it was taken from a reputable report published in 2005.

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

He writes in a private capacity.