BANK OF ENGLAND

Stumbling towards stability

Article by

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

Published by Financial News on 14 January 2013

It took four years plus a string of scandals but in 2012 bankers began to acknowledge publicly their past failures and failings. Perhaps (some admitted), reputation was critical after all. Perhaps customers should not come last. Maybe, irreplaceable executives were more easily replaced than thought. Maybe some businesses really were too complex to manage. Maybe bonuses tied to risk-taking should not be paid until the risks taken had matured. And yes, in retrospect the industry could not be trusted to regulate itself. That these lessons had to be relearned by many highly paid professionals is disgraceful. That they are being learned at last is progress.

May the momentum continue – for there are three banking basics yet to be grasped or if grasped, then embraced by many senior bankers. The first is that the financial institutions for which they are responsible require a more stable financial system. The second is that a more stable financial system depends on a less leveraged banking regime. The third is that neither of these is inimical to shareholder value.

Stable banks need a stable financial system

Since the advent of the crisis, the financial world has received a refresher course in the basics of banking. In 2007 we rediscovered credit risk; 2008 – liquidity risk; 2009 – market price risk; 2010/11 – sovereign risk. (And coming soon to a theatre near you: geopolitical risk.) These risks are not new but what has dawned is the degree to which the interconnectedness of the financial system now amplifies such threats. Thus balance sheet values for an otherwise sound institution may plunge because of the forced sale of assets by less sound members of the fraternity. Wholesale funding flees those suspected of weakness. Exposures to "risk-free" sovereign debt can tie vulnerable banks to vulnerable countries. And it does not stop there. Even those financial firms free from direct sovereign exposure remain at risk if their financial counterparties are so exposed. Interconnectedness and the domino effects it can trigger are now a fact of financial life.

As we have witnessed, the loss of confidence in large financial institutions can cause a loss of confidence in the system as a whole. Had AIG been allowed to fail, the impact would have been felt on both sides of the Atlantic. But here's the rub: should (when) such threats return, the public may be in no mood to bail out the behemoths – and the public purse may be insufficient to do so.

A stable system needs stable banks

If banks need a sound and stable system in which to pursue success, it is equally true that a stable system depends on the perception that the most interconnected banks are sound and stable. This becomes all the more urgent with the prospective removal of government guarantees. Markets must believe that when faced with financial loss, banks will either: 1) be able to stand on their own two feet; or 2) be able to be closed down without sparking systemic contagion. Such confidence can come only from a system in which banks' risk-taking is kept within their loss-absorbing ability. This in turn requires sharply less leverage than in the past and more loss-absorbing capital in the future. How much? Well, the new "tougher" Basel rules about which the banking lobby so bitterly complain will limit a bank's assets to 33 times its equity. Thirty three times leveraged! (Hedge funds by the way average 2.5 times). At 33 times gearing, banking executives would have to suffer a mere 3% write down of assets to wipe out their equity, render their banks insolvent and trigger a loss of confidence – again.

Stability is good for shareholder value

Few financiers have stepped forward to embrace these banking basics. When was the last time you heard the financial titans of our time argue for the need for a more stable financial system? When was the last time you heard them support a sharply less leveraged banking regime? Why? Because they believe, or want others to believe, that lower leverage equates to lower profitability - for themselves and for their shareholders. For themselves: probably. For their shareholders: not necessarily.

Now, it is certainly true that *if* you define shareholder value in terms of *short-term* profitability and short-term profitability in terms of *short-term* "<u>R</u>eturn on <u>E</u>quity" – then raising the level of equity, "E", appears to threaten shareholder value. But pause for a moment and ask: has this banking focus on short-term RoE achieved success over time? No. Has this fixation delivered shareholder value to the loyal investor? No. Why? Because short-term RoE does not adjust for the risks taken to achieve it. The returns may come short term but the risks come later. Many bankers collected the windfalls short term and the shareholders collected the fallout medium term. It's a game played with dice loaded in favour of the executives – not their owners. Fortunately, investors have caught onto this and are increasingly focusing on risk-adjusted returns. Indeed, the marketplace is rewarding, with higher multiples and price-to-book valuations, the less leveraged / less risky financial firms. And higher multiples plus a more secure dividend can produce better shareholder value.

In summary, banks have a stake in a stable system. A stable system depends on a less leveraged banking regime. Such a regime *is* compatible with attractive risk-adjusted shareholder returns – though it may well be incompatible with past levels of banker pay.

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

He writes in a private capacity.