BANK OF ENGLAND

# Speech

Remarks given by

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Fellow members of the CFA fraternity: in a moment I will have the honour of introducing a very special guest speaker. Before doing so allow me to introduce myself - and make an appeal for your help.

My name is Robert Jenkins. As you will have seen from my bio I have spent 16 years on the "sell side" followed by 18 years on the "buy side." More recently I have embraced a regulatory role. I am a member of the interim Financial Policy Committee (FPC) of the Bank of England. The "FPC" is Britain's newly created locus for macro-prudential policy. Its objective is to identify and to the extent possible mitigate, threats to financial stability. Today I would like to highlight one such threat. I select it because it is also one which you, the investment community are uniquely placed to rectify. Please note that my remarks today are my own.

Ladies and gentlemen if you give an artillery commander the wrong target the result is likely to be collateral damage. Give regiments of global bankers the wrong target and we should not be surprised by a similar outcome. This is what board directors have done. Many bankers lapped it up. The result: considerable western wreckage. During the conference I will record a pod-cast which will address this point properly. You can also refer to a speech I made recently entitled the *Capital Conundrum*. It is available through the Bank of England website.

But here is the essence of what I say there and will continue to say elsewhere:

Bankers don't own the banks. Shareholders own the banks. You represent the shareholders.

Many large banks focus on RoE as their primary measure of profitability. RoE - related targets are hard wired into senior compensation incentives.

RoE is a convenient target. One can hit it by increasing the return - "R." Or you hit it by reducing the amount of equity "E." Many banking behemoths tried both. They increased the R *sometimes* and kept the E low *at all times*. These "sometimes" were frequent enough to collect short term rewards but insufficiently sustainable as to build long term shareholder value.

In other words, the risks that are run over time may produce short periods of apparently high "returns" for which the loss making risks come later. (Later has come.)

Thus the primary target guiding many risk-taking enterprises is not adjusted for risks.

The successful investor is not interested in high RoE producing enterprises. He is interested in high risk adjusted returns.

If high RoE comes with higher risk investors should adjust accordingly. Banks with little equity that strive for high returns are clearly riskier than banks with more equity in the mix. The cost of capital should therefore be higher for the highly leveraged and lower for the better capitalized. Banks would have you believe otherwise.

Lower expected return does not mean lower risk adjusted return. And it need not mean less shareholder value.

If bankers insist on using RoE, then the period for determining success should be lengthened to a period of 10 years plus. If they and their boards don’t wish to wait for 10 years or more to find out if they built value, then they should embrace risk adjusted return targets. If they embrace risk adjusted returns they will better appreciate the relative attractiveness of loss absorbing capital. To the extent they act upon that realization, their cost of capital will fall.

In short, RoE, is the wrong target. Over the last 10 to 15 years it has helped to make many bankers rich and loyal shareholders poor. Moreover it prompts banks to fight to keep loss absorbing capital low. This makes their enterprises vulnerable and our financial system fragile. As the key driver of bank behavior it has to go. If it does not, you can expect more collateral damage in the future.

This is pretty basic stuff but it has escaped a number of the more highly paid financiers of our time. So please explain this to the banks and their sell side analysts. The financial system to which you contribute daily and on whose stability your efforts depend needs your help. You can have an impact well beyond your daily duty to your clients.

And now ladies and gentlemen, let us move to our guest speaker….