BANK OF ENGLAND

Speech

The capital conundrum

Speech given by
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At the Annual Conference of the International Centre for Financial Regulation, Berlin
19 October 2011

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Ladies and Gentlemen, my name is Robert Jenkins. I have worked on both the sell side and the buy side of finance. I now join many of you in a regulatory role. Specifically, I am a member of the interim Financial Policy Committee of the Bank of England. The Committee was created as the locus for macro-prudential policy in the UK. Its objective is to identify and, to the extent possible mitigate threats to financial stability. At the moment, one could say that its priority is to help protect the banks from the financial system and the financial system from the banks. I am speaking to you today in a private capacity.

It is late in the conference and late in the day, so here is the executive summary:

1. Banks have and continue to target Return on Equity (RoE) as their primary measure of profitability.
2. They do this because they have confused RoE with shareholder value.
3. Focus on the first has not produced the second.
4. RoE targets are built into banker remuneration. It is the wrong target.
5. While it remains the target, banks fight any measures which raise the "E" in the denominator of RoE.
6. Investors meanwhile have realized that to target RoE without adjustment for the risks taken to achieve it, is a bad bet. They are now adjusting.
7. Higher equity in the balance sheet mix, would likely be positive for shareholder value in the long run and possibly even the short run.
8. In short, it is not only in the interests of regulators and taxpayers to increase capital requirements, it may very well be in banks shareholders interests as well.

How did I arrive at these conclusions? Well, it all started with a question(s).

How do banks calculate their cost of capital? And, how *should* they? The question is simple. The answer is not. That is a pity. For upon this question may well turn the speed and magnitude of the next financial crisis. It may even have a bearing on the resolution of our current troubles.

Some of you in the audience will not know the answer but will assume the answer to be well known. Others will feel they know the answer but will soon find that your interpretation differs from that of fellow financiers. Should one apply the tried and tested Capital Asset Pricing Model? Does cost of capital relate to the alternative cost of bank funding? Is it a function of dividend payout ratios? Is it the presumed RoE target expected by the shareholder – or promised to him by management?

Why is this boring subject so potentially exciting? We are living through the greatest credit crisis of our generation. And, needless to say it is not over. Now credit bubbles are not new. They are always the same, and always a little bit different. All such episodes feature heavy doses of reckless lending, greed and stupidity. What made our bubble different was the extent and degree of *leverage.* Ladies and gentlemen, we

will not abolish greed. We cannot outlaw stupidity. But we can and must place prudent limits on leverage. It is therefore the debate over the degree of bank leverage which becomes central to regulatory reform and systemic stability. Regulating bank leverage in turn begets the search for the appropriate degree of equity on the balance sheet. And here, opinions diverge.

Banks want as little equity in the mix as their formidable lobby can achieve. Regulators supply the other side of this tug of war. Sadly, the investment community has been largely mute on the matter.

To the regulator, banks insist that higher equity ratios will reduce bank profitability, credit availability and therefore damage the economy. To their investors, banks warn that higher equity in the mix will raise their cost of capital depress their return on equity, and thereby damaging shareholder value. Will it? Is that the way it works?

Bankers may well target high RoE. But *investors* (read bank shareholders) *should* target *high risk-adjusted* returns. If a bank achieves gains in RoE through greater leverage [i.e. risk], then investors should apply a discount to the share price. Not only buyers of bank *shares* but investors in bank *debt* should demand a higher return for lower equity in the capital structure. Conversely, a bank with more equity in the mix should benefit from a lower cost of debt and, all else being equal, a lower cost of equity capital.

Another way of looking at it is that a less leveraged bank will have a higher predictability of earnings, even if those earnings might be lower at times. In return for lower volatility, the market rewards the firm with a higher earnings multiple. Lower earnings combined with a higher multiple can produce the same or higher market capitalization than the opposite combination of high earnings and high volatility. And it is market capitalization that determines shareholder value and together with dividends, shareholder returns.

This is pretty basic stuff. Yet banks would rather focus the debate on RoE. And indeed in such a world you have two ways of hitting your target – raise the return (R) and / or reduce the amount of equity (E). In a world which defines RoE as the main measure of profitability more equity does mean lower profitability. But it does not mean less risk adjusted returns and certainly does not mean less shareholder value. So, why the fixation?

There are three possible explanations. The first is that bankers do not understand the notion of risk-adjusted returns. The second is that ROE targets have become so ingrained in bank compensation that it has taken on a life of its own. Indeed, investors may very well have encouraged the phenomenon by egging on bank management to achieve higher returns on the naïve assumption that it could be done while maintaining more traditional levels of prudence. RoE-linked measures such as Earnings per Share were not only allowed but encouraged *without regard to the riskiness of the assets or activity.* That period of investor complacency appears to have passed - witness the underperformance of the banking sector amidst a more general rebound in shares. It now seems that the investment community is applying the concept of risk-adjusted

returns to bank shares even if bank management is not. How ironic that the capital value of banking enterprises may be suffering because the banks are successfully fighting the very measures which might boost their capital value.

A third and more legitimate possibility is the fact that interest on bank debt is tax deductible; dividend payments are not. This still begs the question as to whether cheaper equity and lower required bond yields don't more than compensate the tax benefit. Even so, if interest deductibility is the issue then bankers should be taking their case to the legislators and not to the regulator.

There are other oddities. Bankers talk in terms of higher equity ratios as having to "set aside capital." Yet nothing is being set aside. Equity is another form of funding and a secure one at that. And as we see from the above, it is not a given that equity funding is necessarily more costly than other sources. Perhaps bankers are confusing equity with reserve requirements. In short, one can grow the loan book with equity as well as with debt though admittedly, not as quickly. But who here wants to return quickly to the credit levels and therefore credit standards of 2006? Is that the goal banks would have politicians fearful of missing?

Determining a bank's cost of capital is further complicated by current market conditions and prospective changes. How much of the rise in today's cost of senior debt is attributable to the removal of government guarantees - either because governments will refuse to bail out debt holders or because they will not be able to? And equity is temporarily expensive partly because the current market price anticipates the dilution from new issuance – the need for which the market recognizes and accepts even if bank managements do not.

So how *do* bankers calculate their cost of capital? And how should they? As to the former, I confess I am still trying to find out. Not one of 30 bankers I have approached could tell me – though they all assured me that the cost was going up because of regulators. Do an experiment and pose the question yourself.

As to how *should* they calculate it? They should start with the basics. Here are the basics:

1. The bankers don't own the banks. Shareholders own the banks.
2. RoE does not equate to shareholder value.
3. Investors seek and will reward attractive risk adjusted returns
4. Executive remuneration should jettison RoE and EPS-focused targets
5. Targets which incorporate risk should be incorporated in remuneration packages

Ladies and gentlemen, a lot of fuzzy thinking has fueled our current difficulties. A bit of clear headed dialogue on the true cost of capital is long over due. Indeed, more equity in the mix may very well be beneficial to bank shareholders as well as to the financial system at large. Instead of fighting it, bankers should be pushing for it.