



BANK OF ENGLAND

Speech

A debate framed by fallacies

Speech given by

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International Centre for Financial Regulation's 3rd Annual Regulatory Summit, London

25 September 2012

Ladies and gentlemen: good afternoon.

Our theme for discussion is: “*Striking the balance between domestic priorities and international convergence: the challenge of regulatory coordination.*” The topic as tabled presumes tensions and trade-offs. Alas, this is the perception and has become the reality. Need it be so? Perhaps. But the regulatory reform debate has suffered needlessly for having been framed by a series of false choices advanced by lobbyists and accepted as given. This is true at both the domestic and international level. One result is suboptimum regulation; another is to make global coordination more difficult than it need be. Remove these myths and one might more quickly agree than one fears. Perhaps that was precisely the worry of those who advanced the myths to begin with.

Here are three such myths which lead to false choices which in turn create tensions both domestic and international.

The first myth is that we must choose between safety and growth. The banking lobby would have us believe that higher capital requirements and lower leverage will damage economic growth and retard the recovery. “Increase our capital requirements and we will reduce our lending!” You have heard it before. I can hear now. But take a minute to do the math. Bank “A” has a trillion euro balance sheet supported by 50 billion of equity. Now, let’s double the equity required to 100 billion and retire 50 billion of bank debt. Has the balance sheet shrunk? No. Has the bank had to cut credit? No. Does more capital *necessarily* lead to less lending? No. So does society have to choose between safety and growth? No. So much for myth number one.* But if you fall for this fallacy you will agonize between doing what is right for the economy short term and what is right for stability and your country long term. Bankers have exploited this fear. Depending on their political weight, the degree of banking recapitalization required, and the prospects for domestic growth, different nations will automatically have different views as to the appropriate levels of capital and the timing with which to reach them.

To the exposure of myth number one, bankers retort: “How dumb can you be?” “Equity is expensive. Make us double our equity and you will lower our **Return on Equity**, damage shareholder value and discourage the supply of bank capital.” Here we have myth number two. Let me take it in two parts.

First, short term RoE is a poor proxy for medium term profitability much less shareholder value. Just ask yourself: has this fixation on double digit RoE achieved it over time? No. Did the annual emphasis on RoE produce attractive and sustainable shareholder returns? No. So, does a short-term focus on RoE equate to medium term profitability and long term 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 no longer 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. And 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 share prices. The market is attaching relatively higher valuations to the relatively less leveraged.

The third myth follows from the second – to wit: governments must choose between domestic financial stability and the competitiveness of their domestic financial centers. Clearly, if you believe that higher capital requirements damage bank profitability and shareholder returns then you must also fear for the competitiveness of your domestic banking champions, the attractiveness of your country as a global *finanz platz* and the tax take for your treasury. But as we have seen, one need not choose between safer banks and profitable banking. PwC underscores this point in its recent report entitled “*Banking Industry Reform: a New Equilibrium.*” Less leverage will not only be rewarded with a lower cost of capital but also in lower costs for most sources of funding – from bank debt to wholesale deposits. And in terms of market share, the strongest banks are growing their clientele (eg revenue) at the expense of weaker competitors. In a world of increased risk awareness, letting your banks off the capital hook will likely *damage not enhance* their ability to compete. Extend the analogy to your country as financial centre: where would clients and counterparties like best to do business? In a stable, well regulated regime? Or in one burying problems and ducking issues because regulators fear their banking system too fragile to fix? Needless to say, the tried and booed alternative - light touch/highly leveraged regimes proved devastating to gross domestic product, the taxman’s take and to public confidence in banking and its regulation.

Now at this juncture you will be asking: if these are in fact myths, why do bankers propagate them? Are they not working for their shareholders? Do they not have a paramount interest in financial stability? Do they not want their respective financial centres to be strong and confidence inspiring? Surely they would never dream of putting their personal interests ahead of those of society and their owners? I let you be the judge. But I can think of a few possible explanations. First, it is conceivable that many bankers simply do not understand the basics. Have you met a single senior banker who understands his cost of capital? I have not - though I should probably get out more. Second, many do not understand fully the notion of risk-adjusted returns – witness their recent quest gone wrong of chasing returns without adequate understanding of risk. Third, many managements remain transfixed by the notion of RoE as the primary measure of profitability. They have promised it to their boards and to their shareholders. The targets were written into their remuneration plans. Results fed their bonuses. And there is no doubt about it, all else being equal, higher equity reduces the measure of short term RoE. Never mind that it is the wrong measure and therefore the wrong target. Finally, it is possible that some bankers and boards actually wish they had more capital - but dare not admit it without putting their jobs at risk. This is partly because many have insisted throughout that they were “well capitalized” and partly because they demonstrably failed to tap the market for equity each time it could have been had more cheaply.

Now on these points I have both good news and bad. The good news is that there is progress to report. First, RoE targets are being revised downwards or de-emphasized. Two banking behemoths have done so in the recent weeks. More will follow – partly because their managements cannot achieve the old (non-risk adjusted) RoE targets and partly because the market would not reward their share and bond prices if they tried to do so. Second, the structure of bank compensation is changing. The tilt towards shares, longer vesting periods plus the introduction of claw backs means that executive pay will be better tied to the risks that they take as well as the rewards that they claim. Third, balance sheet strength is increasingly understood to be a source of competitive advantage – by clients if not yet completely by bank management. And fourth, the change of leadership at the top of many financial institutions offers the new management a one time window to do what the market is demanding.

The bad news is that the old guard did such a good job of scaring the bejezzus out of politicians that the regulatory landscape still reflects the shibboleths of the last five years. Secondly, a few of the high profile survivors of the trauma still believe in these fantasies – or at least want you to believe. Naturally these titans must be the smartest of us all right – subsequent scandals notwithstanding? Last but not least is the fact that many western financial institutions have yet to come clean because to do so would reveal their fragility and trigger the very equity issuance which they maintain to be unnecessary. And here you would be right to ask: in such cases would the capital be available? Answer: for the viable firm yes - perhaps not at the price that current shareholders would like to see but most certainly at a price which new shareholders would embrace. At the right price, the money would come - although the management might have to go. If the equity is not available at any price then the institution should go as well. And there's the rub.

In summary, governments and their regulators have been operating on the basis of a series of myths and false choices. This has produced suboptimum reform and complicated international coordination. In reality, one need not choose between better capitalized banks and economic growth. One need not choose between safer banks and profitable banking. And one need not choose between a stronger banking system and one that can compete - on the contrary. But as long as such fallacies frame the regulatory debate, decision makers will think in terms of trade-offs both domestic and international. Trade-offs in turn imply winners and losers. And given the primacy of national interest and continued (albeit reduced) influence of the banking lobby, international cooperation will suffer – producing agreements at the level of the lowest common denominator and woefully insufficient to resolve the greatest regulatory challenge of our time. Remove the myths and better regulation and coordination will follow. It's not too late.

One final observation: the degree to which the banking system is sufficiently capitalized is the degree to which we can absorb bank failures safely. The degree to which we can let banks fail safely is the degree to which we can reduce the ever expanding rule book aimed partly at preventing the failure of banks. In an earlier speech entitled "*Let's Make a Deal*" I offered, not entirely tongue in cheek, to roll back the regulatory rule book in return for sharply higher capital levels. And in his recent address Andy Haldane suggested that

increasing the number and complexity of rules could well prove less effective than simply lowering levels of leverage. Needless to say, global regulators would have less to argue about if there were fewer rules to coordinate and fewer regulations to enforce.

Thank you.