FINANCIAL TIMES

# What do the banks’ target returns on equity tell us?

September 25, 2011 5:00 pm

According to a FT article last week, Lloyds’ bank has a target return on equity of 14.5 per cent. Banks like to argue that this is the level of return on equity they need to earn, in order to gain funding from the markets. Naturally, remuneration is linked to achieving such objectives. The question, however, is whether such objectives make any sense. The brief answer is: no.

Forget banks, for the moment. What would you say if someone offered you an investment with a promised real return of close to 15 per cent? You might say: “How much can I buy?” Alternatively, you might say: “What is the catch?” Sensible people must take the latter view. If you thought that you were being offered a reliable real return at such an exalted level, you would buy as much as you could. This must be particularly true now when real returns on the bonds of relatively safe governments are close to zero.

So what is the catch? The obvious answer has to be that the real return in question is extremely risky, because it is volatile and offers a significant chance of total wipe-out.

Indeed, it is perfectly obvious that these cannot be sustainable safe returns in economies growing at 2 per cent a year, for such a large and well-established industry. At a 15 per cent real return, the value of cumulative retained earnings would double in five years and increase 16-fold in 20 years. Pretty soon, bank equity would be the only real asset in the world!

If you were confident banks could earn 15 per cent real returns, you would not ask for distributions, since the returns would be so much higher than you could plausibly earn anywhere else. Thus, the example of compound growth of bank equity, under reinvestment of profits, is not unreasonable if the returns were themselves plausible. But they are not. Incidentally, if these really were plausible returns, there would also be no problem in obtaining much higher capital in banks, very quickly: just prevent distributions for a few years.

The important point, then, is that these desired returns must represent the result of extreme risk-taking. In an important paper (“What is the contribution of the financial sector” in Adair Turner and others, The Future of Finance: the LSE

Report",) Andrew Haldane, Simon Brennan and Vasileios Madouros of the Bank of England made exactly this point of UK banking: "Trends in ROE are clearly divided into two periods. In the period up until around 1970 ROE in banking was around 7 per cent with a low variance. In other words, returns to finance broadly mimicked those in the economy as a whole . . . But the 1970s mark a regime shift, with the ROE in banking roughly trebling to over 20 per cent . . . These returns were by no means unique to UK banks. . . . During much of this period, banks internationally were engaged in a highly competitive ROE race."

That race was run by increasing leverage of the balance sheet. But the cost was high risk, as the Bank of England paper demonstrates. Just how big that risk was emerged during the crisis, when real returns became significantly negative and several institutions failed, including some extremely large banks, triggering a global systemic financial crisis.

In truth, there are two other reasons why banks might earn 15 per cent returns on equity, apart from the fact that these highly leveraged balance sheets are risky. One is that they can earn monopoly profits. The other is that they are subsidised, principally because taxpayers provide insurance against catastrophic risk, particularly for bank creditors. The two – monopoly and subsidy – are, of course, related. Without barriers to entry, subsidies would be arbitraged away.

In short, when banks tell us that 15 per cent (or something in that neighbourhood) is their target returns on equity, they are saying that their businesses are very risky and/or protected against competition and/or well subsidised and probably a bit of all three.

A big part of the answer then is to make banks less risky, since we cannot live with the huge economic costs of financial crises, as the Independent Commission on Banking, on which I served, argued in its final report. (See, in particular, Annex 3.)

We concluded that the best way to do so would be a combination of higher equity and loss-bearing debt, along with structural ringfencing of retail banking, to make the resolution of banks, at the cost of shareholders and creditors, far more credible.

Banks tend to respond that if banks were made less risky, particularly with higher equity requirements, they could not be funded at all. This is shown, they argue, by discounts in equity markets on the book value of the equity. I would respond that what this shows, instead, is profound scepticism among investors about the quality of bank assets.

Indeed, the scepticism may be so great that banks cannot now fund their existing balance sheets. But the answer to this cannot be to subsidise the entire banking balance sheet, through cheap government-supplied insurance. If the government wanted to subsidise specific activities – small business lending, for example – it should explicitly take the tail risk on such lending.

The standard argument is, instead, that if banks funded themselves with more equity and less debt, the return on equity required could fall significantly, because its riskiness would indeed decline. This is, in fact, necessarily true, as David Miles of the Monetary Policy Committee of the Bank of England and co-authors prove in an important recent paper, Optimal Bank Capital.

Some object that the cost of bank intermediation would rise sharply, if capital requirements were raised, to the detriment of the economy. This is doubly wrong. First, the cost of funding ought to fall, except to the extent that higher capital shifts the risk from taxpayers to shareholders (which is a private loss, not one to the economy at large).

Second, even if the cost of funding were not to fall, the effect is still extremely small. Let us suppose we raised risk-weighted capital requirements by three percentage points, from 7 per cent to 10 per cent and that the risk weights were 50 per cent, so that the true increase in capital would be 1.5 percentage points. Let us assume the cost of equity is 15 per cent and the after-tax cost of the debt it replaces is only 5 per cent. How much would the overall cost of funds rise for this bank? The answer is 15 basis points. Anybody who says this would be the end of the economy's recovery thinks that the economy is finished, anyway. It just cannot matter that much.

The conclusion is quite simple. If a bank says it needs a real return on equity of 15 per cent, to obtain funds from investors, it is telling you that it is running an enormously risky business. The question you need to ask yourself is this: can we afford to have financial institutions that are both so large and so essential and yet run such huge risks? I suggest the answer is: no. Make them safer. It really is not going to hurt.

*This post is closed to further comments*.

Tags: banks, equity, regulation, returns, risk, Vickers
Posted in Economics, Financial crisis | Permalink

Back to top