

# Rethinking how banks create value

**Return on equity (ROE) is often used by banks as a measure of profitability and performance, and to determine managerial compensation on the basis of comparing realised ROE to a target figure or the level of return on equity of competing banks. This approach is unfortunate, because it encourages bankers to choose a strategy of high leverage and risky investments to drive performance, which is not always the best way to generate shareholder value.**

The focus on ROE also fuels strong resistance by banks to new regulations requiring them to have more equity on their balance sheets. Increased equity requirements may not be good for ROE, but they do not prevent value creation by banks and, by protecting against future banking crises, they are good for the economy.

Bob Diamond, CEO of Barclays, has recently set a target of 13% ROE by 2013, and the bank is reportedly rethinking about how much risk it should take on in order to achieve this goal. Barclays is also said to be considering the issuance of contingent capital bonds (known as CoCos), which convert to equity under certain conditions. Their appeal, unlike additional equity, is that they would not adversely affect ROE. This links to bankers' complaints in recent months that higher capital, and particularly equity requirements, would reduce their ROE, and therefore their profits – as assessed by the market – by too much.

## **BALANCING RISKS AND RETURNS**

In well-functioning and competitive financial markets there is a trade-off between risk, properly measured, and average or required return, because investors expect higher compensation for bearing more risk. However, the fact that an institution is able to increase its realised, or even average ROE, taken in isolation, cannot tell us whether it is

generating shareholder (or societal) value through the actions of its bankers. It may simply be that ROE is rising because it is taking on more risk and/or using more leverage, which was the historical trend among US and UK banks over the 20 years leading up to the crisis.

Leverage increases realised ROE when realised returns on assets are above the borrowing rate, by magnifying the impact that rises in asset values have on earnings. However, high leverage also magnifies losses when returns on assets are low – a small negative return on an asset relative to the borrowing rate can wipe out much, or even all, of the equity. This damaging effect of leverage is what sub-prime borrowers, as well as highly leveraged banks, experienced in the recent financial crisis.

**'... greater use of equity need not increase the overall cost of banks' funding.'**

Unless leverage and risk are held constant, ROE comparisons across managers or banks are meaningless. A manager who produces value for investors might have a lower average ROE than a manager who uses a combination of increased leverage and/or increased risk but generates no value for investors.

When Diamond suggests that Barclays would consider taking more risky investments to reach its

target ROE, it implies that he is not focused on generating greater value for his shareholders. Investors would be foolish to reward this approach because a high ROE generated through risk-taking alone is the result of luck or market moves but not the talent of Barclays' bankers. If equity represents a small fraction of the total balance sheet of the firm, higher ROE might not even translate into higher profitability.

## **THE REAL COST OF DEBT**

While many see equity as a more expensive form of funding than debt, this does not take account of the fact that a bank that is funded with relatively more equity will present less risk to its equity holders (and possibly to its debt holders too). Lower risk on bank equity will reduce the required return on equity. So, as discussed in more detail in the paper referenced at the end of this article, and as taught in any basic corporate finance course, greater use of equity need not increase the overall cost of banks' funding.

The one reason why increased leverage, and possibly risk, can generate value for banks is that it magnifies the savings to their cost of capital obtained by using debt funding, which are due to the tax code and to subsidised government guarantees. For example, the cost of bank debt is kept artificially low because interest on debt is tax deductible, and because deposit insurance and other guarantees are underpriced relative to the riskiness of the assets they protect. In addition, debt holders do not engage in as much monitoring or put as many constraints on banks as they would if the guarantees were not in place. This exacerbates the distorted incentives for banks



to undertake excessive risks, which allow their management and their equity holders to benefit from the upside while leaving large losses to be covered by creditors or taxpayers.

Any loss of subsidies associated with debt does not represent a cost to society because subsidies ultimately come from public funds. The excessive leverage and risk banks choose exposes the economy to increased fragility and systemic risk. Requiring banks to operate with significantly less leverage, and making sure they do not take on excessive risk, would produce great benefits to society at essentially no social costs.

#### CREATING GENUINE VALUE

Jamie Dimon of JP Morgan said recently that requiring much more equity than Basel III specifies would be a 'nail in banks' coffin'. This and similar statements implying that any reduction in ROE due to increased equity requirements would 'kill' the banking industry seem to suggest that banks cannot generate profits without government subsidies. If

true, this would be disturbing. Banks can perform all of their valuable activities, including lending, taking deposits and providing liquidity, and they can be profitable with significantly less leverage.

### 'ROE is a flawed and misleading measure.'

Meanwhile, as the US economy has begun to recover, banks have been able to generate significant profits, which is likely to translate into relatively high levels of ROE. This is not surprising since regulation has changed little, and banks are benefitting from low interest rates, subsidised funding costs, and high leverage that magnifies any positive profits. Banks should be focusing on value creation that goes beyond finding creative ways to undertake leverage and risk. Unless banks are required to use significantly more equity funding, the seeds of the next crisis might already be in place.

ROE is a flawed and misleading measure that should not be used to measure value creation and profitability, or to determine managerial compensation. And it is particularly inappropriate for measuring social value. The fixation on ROE in the banking sector reflects and breeds a love of leverage and risk that is dangerous for society as a whole. ROE considerations should therefore have no place in the debate on banking regulation.

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*Fallacies, Irrelevant Facts and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive* and related writings are available at [gsb.stanford.edu/news/research/admati.etal.html](http://gsb.stanford.edu/news/research/admati.etal.html)