Shareholder value and stability in banking: Is there a conflict?

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Understandably, the global regulatory response to the global financial crisis has stirred controversy. That response, with Basel III at its core, seeks to strengthen the resilience of the banking system. In doing so, it asks shareholders to give up high leverage as a source of high returns on equity. And it asks bondholders, especially those of systemically important institutions, to take more of a hit in the event of failure. In this light, it is easy enough to imagine that investors would have little reason to hail the new framework.

This view, however, tells only part of the story. It assumes that, on balance, bank investors were well served by the pre-crisis system. It also posits a conflict between value for shareholders on the one hand and the public interest in safer banking on the other.

In my remarks today I would like to suggest that this supposed conflict of interests is overstated. Yes, tensions may arise over a short investment horizon. But over long horizons, they tend to disappear – because, in the long term, the focus necessarily shifts to *sustainable* profits and returns. This is not just theorising: we'll take a look at the statistical evidence in a moment. And unless one believes that markets can be consistently timed – a rare gift at best – it is long horizons that should matter for investors.

Let me first outline what we in Basel mean by safer banking and take stock of where we stand in the development and implementation of new standards. This is an issue in which, I am sure, you will have a keen interest. I shall then argue that the concerns of investors and bank supervisors are remarkably well aligned in the long term.

Basel's vision of safe banking

In the past few years, the Basel Committee on Banking Supervision has conducted a sweeping review of regulatory standards and it has put in place a strengthened framework

that incorporates new macroprudential elements. This framework is in several ways a great improvement over the pre-crisis regulatory approach.

First of all, it sets a much more conservative minimum ratio for capital that is of far better quality. When the whole Basel III package is implemented, banks' common equity will need to be at least 7% of risk-weighted assets. This compares to a Basel II level of 2% – and that is before taking account of the changes to definitions and risk weights that make the effective increase in capital all the greater. Among the improvements in capturing risk on the assets side, I would especially point to the improved treatment of risks arising from securitisation and contingent credit lines. Moreover, these risk-based capital requirement measures will be supplemented by a non-risk-based leverage ratio, which will serve as a backstop and limit model risk. This new framework responds to the main lessons from the crisis: banks had leveraged excessively, had understated the riskiness of certain assets (particularly those considered practically risk-free), and had made innovations that reduced the loss-absorbing capacity of headline capital ratios.

Second, Basel III takes the notion of a "buffer" much more seriously. The 7% figure includes a 2.5% capital conservation buffer, which banks can draw upon in difficult times. Dividends and remuneration will be restricted at times when banks are attempting to conserve capital. Supervisors will have the discretion to apply an additional, countercyclical buffer when risks show signs of building up in good times, most notably in the form of unusually strong credit growth. The goal is to build up buffers in good times that banks can draw down in bad times.

Third, the package contains elements to address systemic risk head-on, both by mitigating procyclicality and by cushioning the impact of failures on the entire system. I have already mentioned the countercyclical buffer, which aims to address the procyclical build-up of risk, and the leverage ratio, which will help contain the build-up of excessive leverage in good times. The framework now also recognises explicitly that stresses at the largest, most complex financial institutions can threaten the rest of the system. The Financial Stability Board (FSB) and the Basel Committee envisage that these systemically important financial institutions, or SIFIs, will have greater loss absorbency, more intense supervision, stronger resolution and more robust infrastructure. These aims complement each other, and share a common rationale. Greater loss absorbency – including capital surcharges that range from 1 to 2.5% for those institutions designated as SIFIs – and better supervision should reduce the probability that problems at these big market players disrupt activity throughout the wider financial system. Stronger resolution and better infrastructure should reduce the systemic impact of a SIFI's closure or restructuring and thereby strengthen market discipline. In addition, methods to identify globally systemically important insurers are being developed

and should be ready for public consultation by the G20 Leaders' Summit in June 2012. And, work is under way to address the issue of banks that are systemic on a national rather than a global level, as well as to identify other globally systemic non-bank financial institutions.

Fourth, liquidity standards have been introduced. These comprise a liquidity coverage ratio, or LCR, and a net stable funding ratio, or NSFR. The standards will ensure that banks have a stable funding structure and a stock of high-quality liquid assets to meet liquidity needs in times of stress. Importantly, the group of governors and heads of supervision that oversees the Basel Committee has confirmed that this liquidity buffer is there to be used. Specifically, banks will be required to meet the 100% LCR threshold in normal times. But, during a period of stress, supervisors would allow banks to draw down their pools of liquid assets and temporarily to fall below the minimum, subject to specific guidance. The Committee will clarify its rules to state this explicitly, and will define the circumstances that would justify use of the pool.

Since this is the first time that detailed global liquidity rules have been formulated, we do not have the same experience and high-quality data as we do for capital. A number of areas will require careful potential impact assessment as we implement these rules. The Basel Committee has therefore taken a gradual approach in adopting the standards between 2015 and 2018, and will meanwhile assess the impact during an observation period. At the same time, in order to reduce uncertainty and to allow banks to plan, key aspects of liquidity regulation, such as the pool of high-quality liquid assets, are being reviewed on an accelerated basis. But any changes will not materially affect the framework's underlying approach, which is to induce banks to lengthen the term of their funding and to improve their risk profiles, instead of simply holding more liquid assets.

Finally, it is time for these new rules and frameworks to be implemented. The Basel Committee is already engaged in the full, consistent and timely implementation of the framework by national jurisdictions. To this end, the Committee has started to conduct both peer and thematic reviews through its Standards Implementation Group. Last October, the Committee published the first regular progress reports on members' implementation of what they have agreed. Each member will also undergo a more detailed peer review, starting with the EU, Japan and the United States. And the Committee is currently reviewing the measurement of risk-weighted assets in banking and trading books, with an eye to consistency across jurisdictions.

The goal of these measures is clear: to have a stronger and safer financial system. This should benefit everyone – the banking industry, users of financial services and taxpayers. But some may question whether shareholders will benefit as well. Has the leveraged

business model of the past really served them well? The record, to which I turn next, suggests that it has not.

Shareholder returns and the leveraged business model

Over the long term, banks have turned in a sub-par performance, whether assessed on accounting measures or by return on equity.

Historically, the average return on equity in banking has matched that of other sectors (see Table). But unlike in other sectors, these returns have involved the generous use of leverage, either on the balance sheet or, frequently, off it. We know that banking involves leverage and maturity transformation, but the question is how much is appropriate? There may be no clear answer, but let's look at the data. Bank equity was on average leveraged more than 18 times in 1995–2010. Equity in non-financial firms was leveraged only three times (see Table). This implies that, compared with other firms, banks have succeeded in delivering only average return on equity over the long term but at the cost of higher volatility and losses in bad times (Graph 1).

Turn now to stock returns and the message does not change much. Anyone who at the start of 1990 had invested in a portfolio that was long global banking equities and equally short the broad market indices would today be sitting on a loss (Graph 2, right-hand panel). And, over the long term, risk-adjusted returns have been sub-par. The main exception is Canada, where banks have barely suffered in the recent crisis (Graph 2, left-hand panel).

It is high leverage that has contributed to the volatility of bank profits. And it is high leverage that makes banks perform so badly on a rainy day. During periods that comprise the worst 20% of stock market performance, banks do worse than most other sectors (Graph 3, left-hand panel). Clearly, the flip side is that they do very nicely on sunny days (Graph 3, right-hand panel).

For investors, this is not a compelling value proposition. To be sure, some may be agile enough to profit from the downside in bank stocks. But most investors inevitably entered the global financial crisis fully invested or overweight in bank stocks. And, historically, market timing has proved an elusive strategy.

Not only is the performance of banks over time inconsistent with the notion that shareholders can benefit from high leverage and state support; the evidence across banks actually suggests that the banks that were more strongly capitalised at the outset weathered the crisis better. The left-hand panel of Graph 4 suggests that no particular relationship existed between Tier 1 capital and the pre-crisis return on equity. Indeed, banks with stronger Tier 1

equity could and did match the returns of less well capitalised peers. When the crisis hit, however, the less well capitalised banks scrambled to raise funds in difficult market conditions, while their stronger competitors could avoid fire sales and distressed fund-raising (centre panel). And it was the banks that had reported high-flying returns before the crisis that were the most likely to resort to fire sales and distressed fund-raising (right-hand panel). The conclusion is that stronger capital makes a difference. A further consideration is that it is easier and probably cheaper to raise capital in good times. Together, these observations suggest that leverage is not the only way to generate returns – and that, when returns don't depend on leverage, they are more sustainable.

What investors can expect from banks

All this indicates that investors could reach a better understanding with bank managements. The key is sustained profitability through both good and bad times.

Recent work at the BIS suggests that, when economic activity moves from peak to trough, the betas on bank stocks, relating percentage changes in their value to that of broad market indices, increase by well over 150 basis points.[1] In effect, banks are generating good returns in good times by writing out-of-the-money puts that come back to haunt them when the market falls. How did we get here?

The story of a major UK bank is symptomatic. Twenty years ago, the head of the bank promised investors that the institution would beat its cost of equity, which he took to be 19%. For a while, the bank was able to achieve this return by closing branches. But ultimately such promises led bank managers to invest their liquidity reserve in asset-backed securities, boosting earnings in effect by writing puts on both credit and liquidity.[2] When it came to the crunch, the bank could not keep its return on equity above 20% during the global financial crisis and had to seek help from the state.

Given the trend decline in inflation and government bond yields, 20% in the early 1990s translates to something more like 15% today. Still, bank managements that continue to promise such returns may find themselves again writing puts, effectively making themselves hostage to bad times in order to pump up returns in good times. Accounting norms that treat risk premia in good times as distributable profits do not help. In any case, managements who

[1] K Tsatsaronis and J Yang, "Bank stock returns, leverage and the business cycle", *BIS Quarterly Review*, March 2012, pp 45–59.

[2] Nor was this the only bank to do so. See *UBS report to shareholders on write-downs*, 18 April 2008.

promise sustained 15% returns in a low-inflation, deleveraging economy may be leading investors astray.

Over time, sustained profitability at more reasonable levels should bring bank share prices back to a premium over book values. Past behaviour supports this conclusion. In particular, my colleagues estimate that if leverage decreases from 40 to 20, the required return – the return investors demand – drops by 80 basis points.[3] The intuition is that, when banks increase their equity base (or reduce leverage), they work each unit of equity less – that is, the risk borne by each unit of equity falls—and so does the return investors require.

This prospect would characterise a new long-run understanding between shareholders and bank managements that produce sustained profits. But how should banks get there? Here I do not refer to the immediate problem banks face in bringing their assets into line with their capital, leading to considerable deleveraging. Instead, I refer to the longer-term problem. How should banks generate returns in order to be sustainable?

I would argue that such returns can arise from a reconsideration of banks' business models. In line with the lessons drawn from the crisis by banks, investors and prudential authorities, these models would recognise that our knowledge of systemic risk is incomplete. As a result, bank managers would seek sustainable profit less in risk-taking and maturity transformation and more in operational and cost efficiency.

Cost efficiency can powerfully contribute to bank earnings. As a rule of thumb, on average across countries, a 4% reduction in operating expenses translates into roughly a 2 percentage point increase in return on equity**.**[4] Moreover, experience strongly suggests that determined attempts to clean up balance sheets and cut costs can go hand in hand with a sustained recovery in profits on the back of a stronger capital base. This is precisely the experience of Nordic countries, which suffered serious banking crises in the early 1990s (Graph 5). With costs under control, banks can achieve higher profitability with stronger capital.[5]

[3] K Tsatsaronis and J Yang, op.cit.

[4] *An assessment of the long-term economic impact of stronger capital and liquidity requirements*, Basel Committee on Banking Supervision, August 2010.

[5] C Borio, B Vale and G von Peter, "Resolving the financial crisis: are we heeding the lessons from the Nordics?", *BIS Working Papers*, no 311, June 2010.

Conclusions

Let me pull together the threads of the argument. The banks that fared better in the crisis were those that were more prudently capitalised. Investors as well as regulators want to ensure that this wisdom is written into the rules of the game.

The financial reforms that have been agreed will increase the quality and amount of bank capital in the system; they will also promote increases of capital buffers in good times that can be drawn down in bad times. Big, interconnected and hard-to-replace banks will carry extra capital. The authorities are working to ensure that no bank is too complex to be wound down. They are refining new liquidity standards. And they are taking unprecedented steps to make sure that the new regulations are implemented effectively across countries. The outcome should be a stronger financial system. But regulation is only part of the answer and stronger market discipline will also be necessary to ensure resilience.

I have presented the case that, over the long term, there is no conflict between shareholder value and the public interest in safer banking. This proposition is supported by the record of return on equity and bank share price performance – a record that refutes the argument that banks have used leverage to produce *sustained* shareholder value – and the key word here is "sustained". Bank returns may have been comparatively high in good times. But those returns have melted away in bad times. And they have come at the cost of greater risk. In the long run, bank business models have produced middling returns with substantial downside risk. This means that in good times banks have overpromised and overestimated their underlying profitability. They have written put options on their liquidity and credit and reported the premia as current income. In effect, they have made distributions out of what should have been treated as expected losses.

How can investors help banks move in the right direction? They could encourage sustainable business models based less on risk-taking and more on a careful analysis of competitive advantage and operational efficiencies. And they should be wary of entertaining unrealistic expectations about sustainable rates of return. Only when solid business models and realistic commitments to sustainable returns are rewarded can shareholder value be reconciled with safe banking. Indeed, there is no other way.

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As a postscript, and for the sake of completeness, let me outline three other regulatory initiatives.

First, the FSB, with the involvement of the IMF, the World Bank and standard-setting bodies, will draft an assessment methodology that provides greater technical detail on the Key

Attributes of Effective Resolution Regimes for Financial Institutions. The FSB will use the draft methodology to begin, in the second half of 2012, a peer review evaluating member jurisdictions' legal and institutional frameworks for resolution regimes (and of any planned changes). And supervisors plan to put in place resolution plans and institution-specific cooperation agreements for all 29 G-SIFIs by end-2012.

Second, work continues towards strengthening OTC derivatives markets. This includes meeting the commitments by G20 Leaders to move trading in standardised contracts to exchanges and central counterparties by end-2012. Market supervisors and settlement system experts are close to finalising standards for strengthening CCPs and other financial market infrastructures. Meanwhile, banking supervisors are reviewing the incentives for banks to trade and clear derivatives centrally. Another important initiative here is the establishment of a global, uniform legal entity identifier, for which the FSB, with the support of an industry advisory panel, is developing recommendations to be presented to the next G20 Summit in Mexico in June.

Third, potential risks related to the shadow banking system are being addressed. Banking supervisors are examining banks' interactions with shadow banking, including issues related to consolidation, large exposure limits, risk weights and implicit support, and will propose any needed changes by July 2012. Market supervisors are looking at the regulation of money market funds and at issues relating to securitisation on the same schedule. Multidisciplinary FSB task forces are examining other shadow banking entities and, separately, securities lending and repo markets, with a view to making policy recommendations later this year.

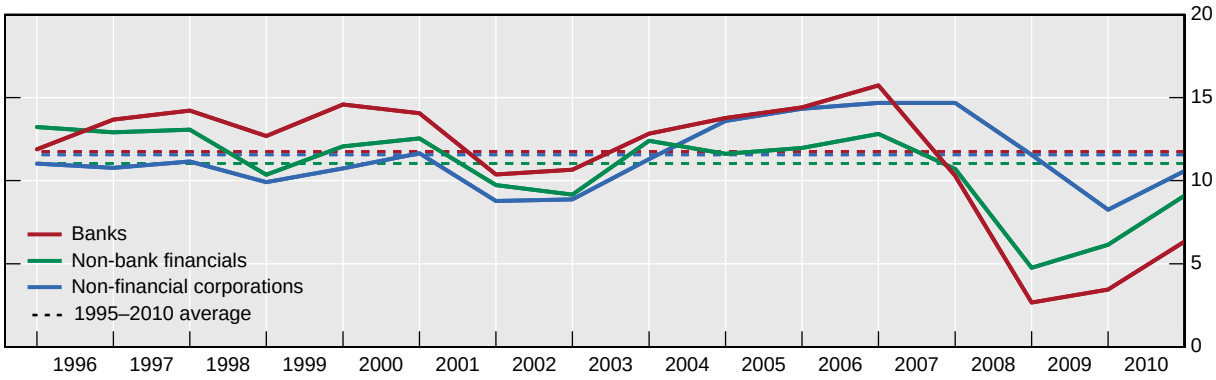
Table: Profitability and leverage (1995–2009)[1]

	Return on assets[2]				Return on equity[3]				Leverage[4]			
	All years	95–00	01–07	08–09	All years	95–00	01–07	08–09	All years	95–00	01–07	08–09
Banks	0.6	0.7	0.7	0.2	12.2	13.3	12.8	3.2	18.3	17.8	19.1	17.4
Non-bank financials	0.9	1.0	1.0	0.5	11.2	12.3	11.4	5.4	12.1	12.5	12.1	10.8
Non-financials	3.2	3.0	3.4	2.8	11.7	10.9	12.8	9.8	3.0	3.0	3.0	2.9

[1] Medians across firms and years. Sample includes 102 banks, 25 non-bank financials and 250 non-financial companies. [2] Net income over total assets, in per cent. [3] Net income over total shareholder funds, in per cent. [4] Total assets over total shareholder funds.

Source: Bloomberg.

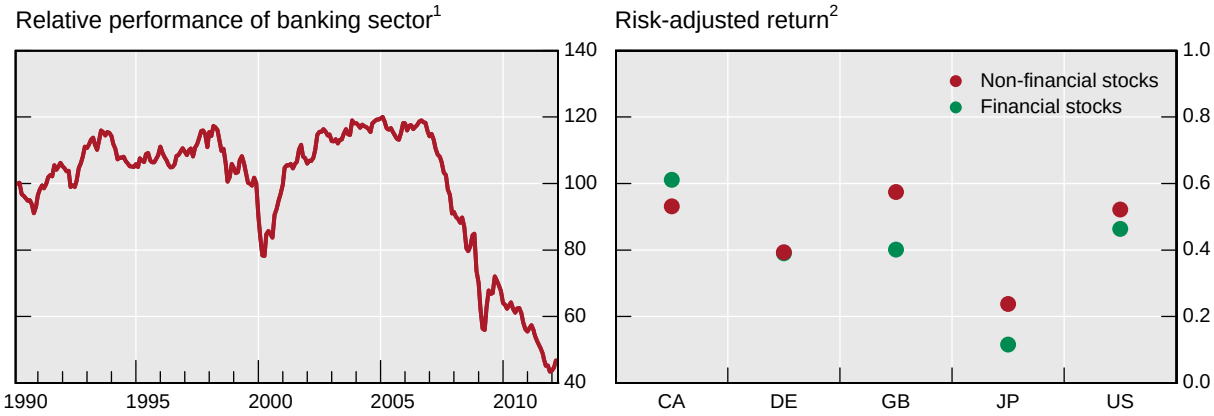
Graph 1: Median return on equity[1]



[1] Net income over total shareholder funds; in per cent.

Sources: Bloomberg; BIS calculations.

Graph 2: Underperformance of bank stocks

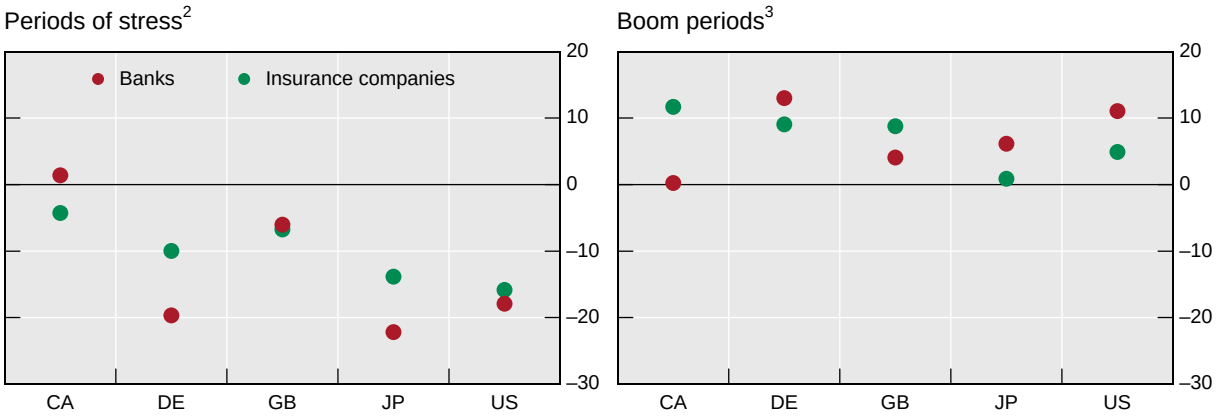


CA = Canada; DE = Germany; GB = United Kingdom; JP = Japan; US = United States.

[1] Ratio of banking stock price index to total market index; average for United States, euro area, Japan and United Kingdom; sample period = 100. [2] Average return between 1973 and 2010, divided by the corresponding standard deviation of returns.

Sources: Datastream; BIS calculations.

Graph 3: Financial stocks in extreme market events (1973–2010)[1]

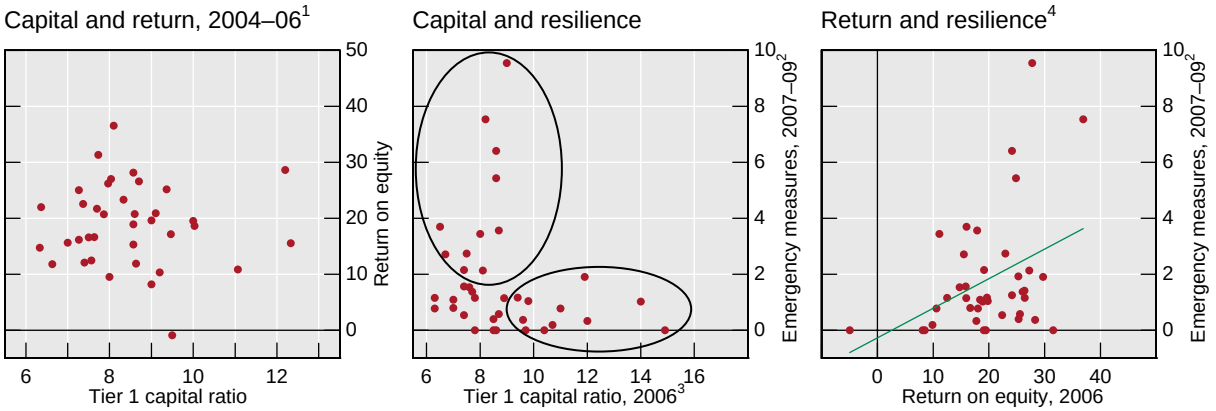


CA = Canada; DE = Germany; GB = United Kingdom; JP = Japan; US = United States.

[1] Average quarterly return in each financial subsector minus that in non-financial sectors; annualised; in per cent. [2] When the quarterly return in the whole market is equal to or smaller than the 20th percentile of its empirical distribution. [3] When the quarterly return in the whole market is equal to or greater than the 80th percentile of its empirical distribution.

Sources: Datastream; BIS calculations.

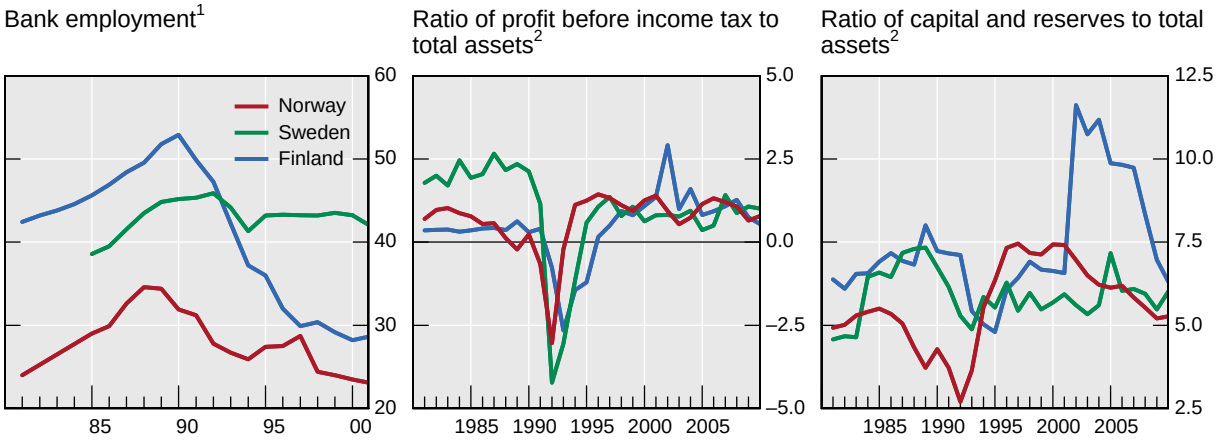
Graph 4: Bank characteristics and performance in crisis (40 banks)



[1] Averages for each bank over the period; in per cent. [2] Sum of guaranteed debt, capital and hybrid instruments issued and assets sold from mid-2007 to end-2009, divided by total liabilities in 2006; in per cent. [3] At end-year; in per cent. [4] The regression line is statistically significant at the 95% confidence level.

Sources: Bankscope; Bloomberg; company reports.

Graph 5: Restructuring after the crisis: Nordic banks



[1] Employees in deposit-taking institutions; in thousands. [2] In per cent.

Sources: OECD; BIS calculations.