

# FINANCIAL TIMES

THURSDAY JUNE 19 2008

## COMMENT

# Banks should be rewarded for transparency

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The banking industry has gone through a remarkable transformation, much of it driven by the way the industry is regulated. Banking regulations may unwittingly have contributed to the current financial crisis and an understanding of how and why this occurred is essential to finding appropriate remedies.

Banks profit by charging a higher rate of interest on the loans they make than they pay on customer accounts. They also earn fee income by providing services and earn trading or investment income by risking their own capital. Collectively, customers need immediate access to only a fraction of what is in their accounts at any time so banks need only keep a small proportion of their assets in immediately available funds. In case of emergency, banks turn to the central bank for funding and in exchange they agree to be regulated.

Based on this model, most of a bank's earnings should be interest on loans and fee income. We find, instead, that many banks carry vast amounts of liquid assets on their balance sheets and earn more from investing this

liquidity than they do from their core business. While it is prudent in times of crisis to have surplus liquidity, some banks now carry \$1,000bn (€645bn, £510bn) or more in liquid assets and finance this with extraordinarily high levels of debt and third-party financing. Some of the largest banks appear, therefore, to be running gigantic in-house "hedge funds" alongside their core banking business.

Until now, banking regulators around the world have sought to protect depositors by limiting the assets that may be carried for any given level of equity capital. This approach is not entirely straightforward since "risky" assets (customer loans) are treated differently from "less risky" assets (government securities and other triple A rated paper) – the former requiring substantial equity capital and the latter very little or none. As a result, instead of keeping bank leverage to a sensible level, these rules created an incentive for banks to build up huge portfolios of supposedly risk-free securities, with very little equity capital.

Given the current situation, it might be easy to conclude that banks should reduce leverage across the board – bringing the debt-to-equity ratio of their in-house "hedge funds" into line with that of their core banking busi-

nesses. This could be sensible as a long-term objective, but its immediate implementation would put the investment banks out of business, cause enormous harm to the real economy and inflict even more pain on an already bruised stock market.

A better way would be (i) to let the market do what it does best, namely to award a higher share price to banks

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that perform well and do not borrow excessively, while (ii) improving disclosure requirements relating to banks' underlying performance and leverage, and (iii) insisting on a much more direct link between stock market performance and management's long-term pay. The three need to be considered together for this to be effective.

Performance in the banking industry is generally measured in terms of return on equity (ROE), which is a direct consequence of the way banks

are regulated. It should be obvious, however, that an increase in ROE may be achieved through an increase in leverage, through an increase in return on assets (ROA), or through a combination of the two. Increases in ROE that come from increased leverage come with increased risk and do not necessarily represent improved performance.

Unfortunately, most banks fail to publish financial information in a way that allows one easily to calculate ROA by division – or eliminate the profits attributable to liquid assets (which need to be assessed separately). Divisional balance sheet data are usually incomplete and do not include debt or liquid assets, while income statements are usually not sufficiently detailed to allow one to calculate earnings before interest expense and excluding income from surplus liquid assets. Where banks do publish ROAs, they frequently use net income (ie, after deduction of interest expense) as the quotient despite using gross assets (ie, before deduction of debt) as the denominator, a completely meaningless figure.

Our own analysis based on divisional ROAs suggests that, stripping out investment and trading income, many banks fail to earn enough on their core banking businesses to cover the cost of

their deposits, let alone their overall cost of capital – except in markets where they have very significant scale. The gross returns (ie, before interest expense) on their vast investment and trading portfolios often barely exceed those on risk-free one-year US Treasury bills after operating expenses are taken into account. Of course, the ROE on these investments looks more presentable because of the very significant leverage, but this comes with significant risk attached.

Greater transparency with respect to the above should ensure that banks with true performance and acceptable leverage (which need not be the same for each bank) will be rewarded by superior stock market performance. The most effective way of achieving this is by ensuring the interests of the executives who are responsible for overall performance are directly aligned with those of the shareholders. Needless to say, long-term incentives must be structured in such a way that payouts do not automatically rise with increased leverage, as is the case with earnings-per-share and economic profit (or return on equity) based schemes.

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