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## COMMENT

# Lenders should have to pay a price for taking risks

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**T**he cost of capital of business enterprises is determined by providers of debt and equity. It generally rises with increasing leverage and business risk, and this contributes to an efficient allocation of capital. Strangely, unlike other companies, banks appear to have a cost of capital that does not rise with increasing risk. Most banks enjoy a lower cost of debt than, say, the National Grid, a monopoly with no business risk and significantly less leverage. There is a paradox here that goes to the heart of how banks take investment decisions and has implications for investors, taxpayers and the economy.

For banks, the cost of deposits is reduced by an explicit guarantee provided by the state. For “systemically important” financial institutions, the state also provides an implicit guarantee to other creditors. Little if anything is charged for these. This has allowed the largest banks to have almost unlimited borrowing capacity at a cost that reflects the state’s creditworthiness, not their leverage or business risk. The state attempts to

control leverage by requiring banks to hold minimum amounts of equity capital for different types of assets – but critically requires almost no capital at all for a wide variety of supposedly risk-free assets. The combination of unlimited cheap debt with minimal capital constraints permitted the largest banks to create huge proprietary trading books almost entirely financed by debt. This is the wholesale banking model that has developed during the past decade.

Does this benefit shareholders? Not really. Although the lower cost of debt is an “advantage”, it is shared by all systemically important banks and it seems that banks compete it away. Secondly, the absence of market discipline leads banks to invest in riskier

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assets – such as subprime mortgage loans – at prices that fail to reflect this risk. Thirdly, the extremely high leverage of

many banks means that their equity can be destroyed by tiny variations in asset values, even if the assets are fundamentally sound. Fourthly, these arrangements have led to responsibility for external risk-monitoring being transferred largely to regulators instead of being borne by the market. This undermined the accountability of boards to shareholders. Finally, this has incentivised banks to make themselves systemically important, i.e., too big to fail. The winners in this game of financial brinkmanship have been mostly bondholders and senior employees, not shareholders or taxpayers.

While the cost of debt is unaffected by risk, this is absolutely not true of the cost of equity. It is difficult to observe this in the market since banks rarely issue new equity – but when they do, this results in massive dilution to existing shareholders. It is also hard to detect this from management’s behaviour since, with so little equity in the capital structure, it matters little what the cost of equity is. As of June 2008, Europe’s wholesale banks had only 2.3 per cent tangible equity to total assets: there comes a point at which everything is just “funding”.

The solution to this is neither increased regulation, nor asking taxpayers to pay for the banks’ past folly. The banking

sector will need to find far more equity than has been raised over the past year and the bulk of this can only come from existing institutional shareholders – or from restructuring outstanding debt. In the longer term, shareholders (and taxpayers) are better served by correcting the incentives for banks and their managers and letting the market do the heavy lifting. Banks should pay for the state’s guarantee, according to their leverage, to ensure that their costs of debt rise with the risks they assume. Managers should be incentivised to maximise a return on assets rather than metrics such as return on equity or earnings per share, which are boosted by leverage. Boards should publish simpler annual reports designed for shareholders not regulators, highlighting ROA and leverage, and strive for absolute not relative total shareholder returns. The market will reward conservative, well managed banks through a rising share price over time. Finally, shareholders would benefit by restructuring the boards of these banks to include experts who are independent and prepared to act as owners.

Radical changes are required in corporate governance, remuneration, disclosure and the way banks treat shareholders. Very few banks have

reached out to existing investors on these critical issues. It is time they did so.

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