# Impact of the financial crisis and bank failure

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# Introduction

Some questions and issues which will affect the future of the financial services industry.

1. Was the banking crisis a liquidity or a profitability crisis?
2. Some UK banks assumed a cost of equity of 10%. Was this about right?
3. Is the cost of equity the right metric to target bank profitability?
4. Why Government guarantees obscure true cost of capital;
5. Better measures of performance and remuneration are needed;
6. Simple versus complex banks?

# 1. The role of guarantees

**Guarantees reduce cost of debt to risk free levels**

**Banks believe this reflects low risk of their assets**

**Cost of equity looks relatively low**

**Incentives for excessive leverage**

**Explicit deposit guarantees – and implicit guarantees on other loans – may lead to incorrect measure of the cost of capital and excessive gearing**

# The role of guarantees

Impact of government guarantees

- Guarantees are unconditional up to some level of a bank's leverage

- Until this point is reached, the bank's cost of debt is flat; beyond this point there is concern that the guarantees are unsafe and the cost of debt rises sharply

- Flat cost of debt → high leverage → low cost of capital but …

# How we should deal with guarantees

Combating the effects of guarantees

- Measuring the cost of debt without assuming the Central Bank guarantee can serve as a prudential tool in bank governance to curb excessive debt and risk-taking

- Better for Government to charge for bank deposit guarantees on marked-to-market basis.

- Why this is complex.

# 2. Implications for the cost of capital

With bank guarantees equity is an <u>*unattractive*</u> source of finance

Even if banks correctly calculate the cost of debt capital, they tend to incorrectly calculate the cost of equity

- ❑ Commonly assume cost of equity is flat along a range of leverage. **But:** ↑ leverage → ↑ cost of equity
- ❑ Unduly low cost of equity may be based on risks measured using data solely from good times (and implying implausibly low levels of business risk).
- ❑ Why don't traditional models (CAPM) capture this pricing of risk?

# 3.The role of Return On Equity (ROE)
# Is ROE maximisation a valid business objective?

- ROE presents a snapshot of a period's performance
- short-run ROE can be inflated by highly risky strategy which is profitable in short-run and value-destroying in long-run

**There is no golden fixed number like 10% = cost of equity for the banking sector!**

## The role of ROE
## Resolving Governance and compensation problems

**Given the lack of a golden ROE number, a pure ROE maximisation objective is not in the long-run objectives of bank shareholders.**

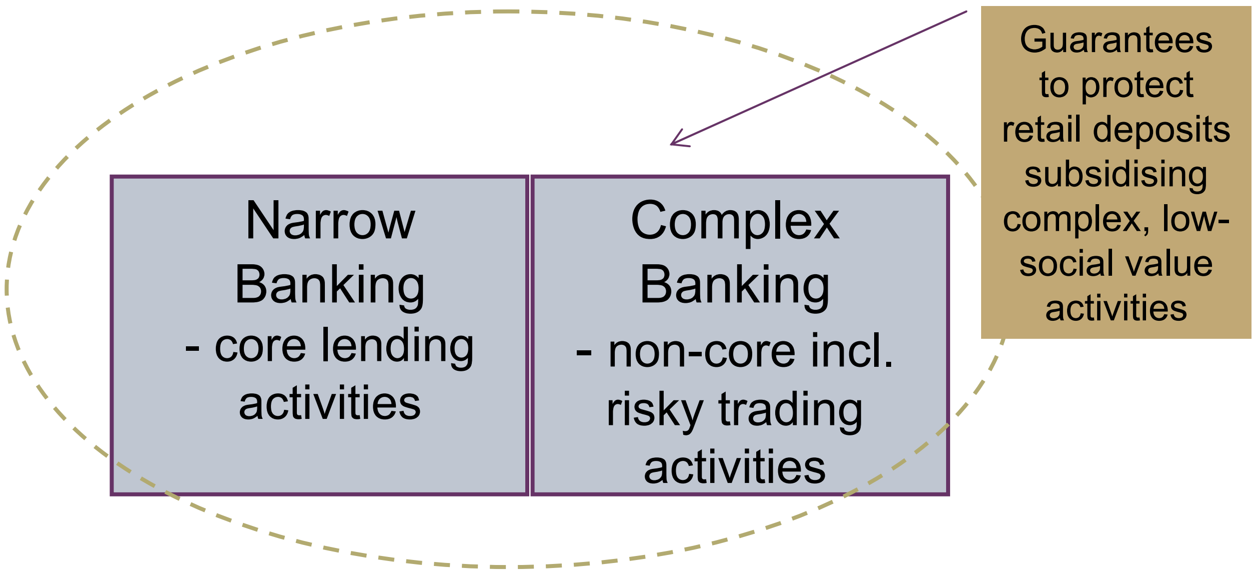
→ Compensation of management should not be based on short-run ROE or earnings per share. Compensation should be based on a relatively long run measure of return on assets (ROA)

→ Banks should compare the ROA to a target that is based on a cost of capital that accounts for bank leverage **and** costs of debt and equity capital 'over-the-cycle'

→ Banks should actually employ a cost of capital they would face in a world where they did not have access to government guarantees.

# 4. Implications for banking structures
# Separation of narrow and complex banking (I)

**Status Quo**



## Implications for banking structures
## Separation of narrow and complex banking (I)

**A need for separation?**

Narrow Banking

Complex Banking

Ring fence activities of the guaranteed bank to produce a simple utilities-like bank?

## Implications for banking structures
## Separation of narrow and complex banking

- Regulators are trying to address banking sector concerns by increased regulation and higher capital requirements.

- But deposit or debt guarantees can be used to finance risky, low social-value, trading activities- regulatory arbitrage.

## Implications for banking structures
## Separation of narrow and complex banking (II)

To prevent the negative effect of guarantees:

- Price the fees charged for loan guarantees depending on their purpose and risk? This would be very difficult.
- So, impose Glass-Steagall style separation between narrow and complex banking to prevent value of guarantees seeping into non-core activities
- Separation would do away with "too-big-to fail" status
- International coordination required to prevent jurisdictional regulatory arbitrage by large banks

# 5. The outlook for universal banking
# Defining ‘universal’

A universal bank is one which carries out both retail and complex banking activities.

- Such banks tend to be 'universal' in a broader sense than **product offerings**; tend to be universal in their **geographic scope** as well

As discussed, in light of the ongoing crisis there is a case for separating simple and complex banking

**What is the outlook for universal banking?**

# The outlook for universal banking
# Cross-border exposure

- Regulatory philosophy has hitherto allowed major global banks to benefit from global scale operation and flexibility.

- However, as Mervyn King asserts, global banks are "global in life but national in death"

  e.g. failure of Landsbanki, given its passporting rights across EU, showed that European single market in retail banking is "unsafe and untenable" (Lord Turner, Turner Review Conference, March 18th)

- Will universal banks be allowed to retain cross-border exposure?

# Conclusions

1. Government guarantees can induce excessive gearing and lead to the incorrect measurement of cost of capital.

2. Banks typically underestimate their cost of capital by a misguided approach towards equity financing.

3. There needs to be a reduced reliance on ROE and increased focus on long-run ROA.

4. There is a case to be made for separating simple and complex banking.

5. The crisis has affected the outlook for universal banking.