Regulatory Impact on ROE/Dividends

**Knowledge@Wharton:** How will all of these new regulations likely affect profit margins, ROE [Return on Equity] and dividends over the next year or two, or three? Bill, let's start with you.

**Bill Schlich:** Well, I think it's clear that ROEs are going down. Cost of capital is going up. Margins are shrinking. We had together in September [2010] the lead directors from 18 of the largest institutions in the world – financial institutions – and the consensus was ROEs are going to be cut in half from what they were a couple years ago. So if you were at 20 you are going to be at 10. And they put the range of a return equity for a global institution between 8% and 12%

I think it's clear with capital requirements going up, margins are shrinking, ROEs coming down. The interesting point to all of that: Where is the investor on this? We haven’t really heard from the investor yet. What's their reaction to an ROE of 8% versus 12%? How will they respond? Will banking investments still be attractive or not attractive? What pressure will shareholders put on management? We need to increase profits. We need to take on more risk. So the constituency that hasn’t been heard from yet is the shareholders and what their thinking is around ROE.

**Donald Vangel:** When you talk to bankers there is a lot of interest about migrating to businesses that are less demanding for capital and liquidity, and [that are] more fee based. What that means for banking in terms of credit creation and sort of intermediation is a real question in my mind. If you look to maximize a return on equity in this market and to optimize in effect your use of capital, I think you are going to move to businesses that are less balance-sheet intensive and demanding of liquidity and capital.

**Richard Herring:** I think all of that is true. Theory would teach us that by raising equity you should be able to get a better return on the debt you raise. But since these trillion dollar institutions are already going to be benefiting from the implied guarantees from the safety net, they are not going to realize that. It's just sheer cost. And so it is, in a way, taking away the safety net – maybe not very convincingly but that's part of what's happening in this and it is not going to make for a happier firm.

On the other hand we should note that there have been profitable financial institutions that have in fact done very well with 20% equity. You just do different sorts of things.

**Donald Vangel:** Right.

**Knowledge@Wharton:** At least initially, since we are still a rather slow economy, banks will be measured against other industries right? And other choices that investors have. So if these other industries aren’t giving the returns that they did pre-crisis, then the banks may not look so out of line if their ROE is dropping by 50%. Is that correct?

**Bill Schlich:** Could be. The investor thinks about not just the totality of the return but the risk of the return. So it will depend on how the investor looks at the banking industry in totality.

**Richard Herring:** We shouldn’t leave out the point that the Fed, by keeping interest rates at virtually zero, is trying to provide an enormous subsidy to the banking industry that we should not let go unnoticed. Because they are able to gather funds at virtually no cost, and they can lend them out at very handsome margins, which is half the reason that they have delayed the phase-in of the capital rules for a very long time, they realize it is expensive to go out and raise new equity in the markets.

Transaction costs are very high and people are not enthusiastic I think it’s safe to say about banks today. But if they can retain it as earnings from these very fat spreads, it’s really – if you like – a transfer from those of us who are trying to save to the banks who need to rebuild their capital positions.

**Knowledge@Wharton:** How much longer do you think that will be necessary?

**Richard Herring:** Well, they are talking about five, six or seven years, I think.