ARE BANKS USING LEVERAGE TO TARGET RETURN ON EQUITY? INTERNATIONAL EVIDENCE, 2001-2013

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Motivated by Haldane (2009) we test the joint hypothesis that banks (a) adopt return on equity (*RoE*) targets and (b) use leverage to achieve them. Based on an international panel of commercial banks and bank holding companies for the period 2001-2013, we find evidence that the use of leverage to steer *RoE* towards a target intensifies in the pre-2007 period, especially for banks with relatively low leverage and possibly more scope to increase leverage in the presence of regulatory and market constraints. Myopic behavior of that kind could amplify cyclical fluctuations as banks take on high leverage to achieve high returns when risk premia are low, while "rush for the exit" when the cycle turns and reduce leverage to contain losses.

The results survive alternative model specifications, they hold for both the US and EU, and seem to be driven primarily by big banks. In particular, big banks tend to use leverage consistently for targeting *RoE*, both pre- and post-crisis and regardless

of their initial leverage level. Small banks with relatively low leverage appear to use leverage to speed *RoE* towards a target in the period before the crisis, but not after the crisis. Also EU banks with relatively low leverage demonstrate the strongest effect of leverage on the speed of *RoE* adjustment, both before and after the crisis. For US banks this is true only for the pre-2007 period.

Overall, the results point to a possible market failure where bank executives chase the short-term return on equity without internalizing the longer-term consequences of leverage on the riskiness of the bank. That behavior could impose a negative externality on the economy as a whole by affecting leverage dynamics and amplifying cyclical variations. Therefore, recent proposals that aim to align executive pay with long-term performance by restricting the use of short-sighted profitability measures, such as the *RoE*, from remuneration schemes are in the right direction.