THE ULTIMATE CAPITALIST RATIO, AND WHY IT MATTERS TO YOUR BANK'S FUTURE

Building equity up can sound like taking vitamins. But is there a dark side?

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The Return on Equity ratio is probably the basic calculation underlying all of private sector financial analysis. ROE methodology takes the firm's after-tax income and divides it by the shareholders' equity. This produces a ratio that represents what the equity is earning. After all, shareholders provide the equity either in the form of a direct investment or by allowing the firm to retain part of its earnings.

ROE represents the productivity of the equity investment, so to speak. More is better.

If income goes up and equity stays the same, the ROE is greater. If earnings stay the same, but equity goes up, ROE declines.

So, to the extent that the government dictates higher capital ratios and all else remains the same, ROE levels for the industry will decline. This is the big problem with the recent political argument for more equity for the largest banks. Their owners say that it's not fair. I think they have a point. The community bankers say that the biggest banks were reckless and were the major contributors to the problem rather than the community banks. There's some logic there, too.

A look in O'Leary's portfolio presents a lesson

As a small stockholder of a New Mexico community bank, I've seen some recent numbers, as of March 31, 2010.

Earnings are about flat one year to the next. Equity is up by examiner fiat and so ROE is down. Maybe this is necessary and maybe it isn't.

I don't know of a more conservatively and prudently run loan book than this bank's. Yet the examiners found concentrations of real estate credit. So they ordered a cessation of dividends to increase the capital base.

The bank is a Subchapter S corporation. To provide the funding source for those taxes-due from the stockholders, not the company-the bank has maintained a prudent but consistent payout ratio over the years. Suddenly, the stockholders don't have the dividend to offset taxes on their share of the bank's income.

This is another example of unintended consequences and the byproduct of a relatively mindless application of examiner discretion. I don't argue with the discretion. But the results are uneven nationally and many of you reading this right now know first hand what I'm saying.

Why ROE matters to the whole banking industry

Many banks are being hammered these days by the examiners on both asset quality and equity levels.

Asset quality is being looked at in a very harsh light. It's not that it's necessarily unjustified, but there seems to be a "one size fits all" approach to how loans are evaluated. The equity standards of banks, while enshrined in the law (adequately capitalized, well capitalized, etc.) are being further manipulated by examiners who are requiring more equity in virtually all contexts. Loans are more heavily criticized and not only are loan loss reserve levels being increased, the capital requirements of the banks are being raised too, regardless of the statutory definitions of capital adequacy. I wouldn't rule out that statutory requirements for equity may be increased too.

Some will say "What's wrong with that? Banks are in the business of risk and the public needs banks to be appropriately capitalized."

The real point here is that over the long term, equity capital is a scarce resource and that's true over the entire range of businesses. If too much capital is required, returns will diminish and capital will seek a higher return elsewhere in other industries.

The dark side of hiking equity requirements

Or the opposite may occur. Banks will try to improve returns on equity by taking more risk.

The risk levels might not be evident in the lower degree of financial leverage but could be buried in new product lines or geographic markets. The need for a competitive ROE could also take the form of higher borrowing rates. This would have the perverse effect of increasing borrowing costs to all borrowers while not necessarily reducing the level of systemic risk in the banking system.

It's possible that we won't have fixed a thing other than to have mandated that banks reduce financial leverage, thereby creating a capital scarcity or increasing costs on borrowers or both.

Dangers of "prevailing wisdom"

Industry experts and bank regulatory authorities have correctly noted over the years that larger banks tend to use capital more efficiently than smaller banks. In other words, big banks generally have both higher degrees of financial leverage and produce higher returns on equity than smaller banks.

The prevailing wisdom as recently as two years ago was that large banks could employ capital more efficiently due to their size and relative sophistication. Sophisticated analytical techniques applied to the loan loss reserve calculation and a well-oiled loan review process were seen as exemplifying the ways that large banks could effectively and efficiently reduce capital to optimum levels. Portfolio diversification by product and geography also contributed to the impression of less overall risk in very large bank portfolios. Operations conducted on a large scale yield commensurate economies of scale. That's certainly true of large banks and they are more easily able to afford the increasingly onerous burdens of compliance and regulation.

Smaller institutions, lacking diversification opportunities, economies of scale, and the financial sophistication characteristic of larger institutions, usually settle for more equity capital to give boards of directors and owners a higher level of comfort.

ROE results over the last several years typically reached into the low to mid-twenties for the big banks and a corroborating metric, the Efficiency Ratio, improved in apparent confirmation of this phenomenon.

Short-term relief, long-term risk

The likelihood of higher equity capital ratios for the entire industry is a welcome development in the short run, however painful they may be to attain.

The longer-term implications though, of a possible equity capital scarcity and higher loan costs for all borrowers, especially at the very large institutions, may be unintended consequences.

And they may come at a high and largely hidden cost to our economy.

It's for reasons like these that we all hope to see our national legislative bodies deliberate these issues thoroughly and not rush to politically inspired solutions suitable to the moment, rather than the age.

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear free audio interviews with Ed about workouts here. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

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