ALPHA, BETA AND BANK VALUE

by Steve Brown

A banker recently remarked that he feels more like a portfolio manager than a banker these days. Marking to market the balance sheet, more loan trading, looking at risk-adjusted returns, liability structuring and hedging makes this analogy apt, as bankers no longer can get away with putting assets and liabilities on their books and then forgetting about them. These days, should a banker face decreasing profitability, tactics such as selling loans, buying credit protection or calling CDs are all possibilities to help control earnings fluctuations. If truth be told, the modern day bank CEO is closer to a hedge fund manager than ever before. In the early days of hedge funds (back in the late '80s), managers were only concerned about total return in excess of their benchmark or something called "alpha." For banks, let's call the current benchmark an 11.3% return (as of March). If a bank produced a 15.3% return on equity, then they beat the market by 4% - not bad. A problem arises however, because alpha contains no comparative measure of risk. Items like leverage, concentration in speculative land lending and a strict geographical focus all tend to complicate the return picture for banks. To handle risk, fund analysts introduced "beta." Beta is a measure of risk compared to the market. For banking, returns have a variance of about 57bp. Banks that produce returns that have a similar variance are said to have a beta of 1. Like hedge funds, to outperform, managers either must produce positive alpha while maintaining beta, or produce similar returns to the market while having a beta of less than 1. To equate apples to apples, fund managers compare themselves by an "alpha ratio" which is simply the alpha adjusted for beta. For the bank that produced a 4% alpha, excess return is divided by 1 for a ratio of 4. If the bank could lower its risk so that its beta was 0.85, then its alpha ratio would go to 4.7. Conversely, if a bank produced a 10.3% return for an alpha of -1.0% and a beta of 1.1, then its alpha ratio would be negative to the tune of -1.1%. Without risk adjusting the individual asset, liability and fee income cash flows, this calculation is an easy way to see if a bank is adding value or not versus the industry benchmark. Positive alpha banks are deserving of more capital, while negative alpha banks should be allocated less capital in the marketplace. The ironic thing is that most bank investors are an unsophisticated lot and often place capital into a bank that has a negative alpha ratio. If they thought about it, they would be able to garner better long run returns by investing in a bank index, or at least a representative sample of publicly traded banks. Over the next 5Ys, since this bank portfolio concept is really in its infancy, we will see some exciting changes. Better adjustments for correlations, grouping asset classes not just by type or sector, but by alpha ratios and managing loan portfolios with regard to beta will all take place. The beauty of this is that smart community banks (with their knowledge of the local area and small size relative to the market), are in an excellent position to outperform competitors by tracking alpha ratios and allocating resources accordingly.

BANK NEWS

M&A

Amegy Bank (TX, $10B), a sub. of Zions Bancorporation ($48.4B, UT), will acquire InterContinental National Bank (TX, $111mm) for an undisclosed amount. The move adds 3 branches and gives Zions a foothold in San Antonio.

M&A

Mercantile Bancorp ($1.5B, IL) has agreed to invest $1.05mm to buy a 4.4% interest in de-novo bank Solera National Bancorp (CO). Solera is expected to open for business late in the 2Q or early 3Q of 2007. To date, Mercantile has made 8 such investments into various de-novo banks for a total of $14mm. The bank said it is utilizing the strategy to generate growth and deliver value to shareholders at rates greater than Mercantile could achieve solely from its core banking operations.

Remote Capture

Wells Fargo indicates 17% of the bank's depository commercial banking customers are now using its remote deposit capture (RDC) product. From our data, community banks that have implemented RDC have less than 5% of their customers on it.

Significant Competition

Wells Fargo has announced a new program designed to capture more merchant business. The program, dubbed "Merchant Checking," combines a business checking account with credit and debit card processing - all at a flat rate. The program targets cash-based businesses (such as nail salons, dry cleaners and doctors) by giving them access to funds the next business day. Transaction pricing is 1.99% plus 30 cents for all signature-based Visa and MasterCard transactions. Wells is pushing the program as a way for those clients to better manage accounts, obtain more cash flow predictability and expand cost controls. The bank is leveraging industry research that shows small business owners that accept card payments can increase revenues by as much as 23%.

Stock Buybacks

During the 1Q, banks bought back $18.5B in stock, the highest of any quarter in the past 7Y.