LENDING IN SLOVENIA

by Steve Brown

To be a successful commercial lender you don't have to know the capital of Slovenia, nor do you have to know much about venture capital. You do, however, need to understand economic capital and how it relates to your bank's ROE and credit risk. The 1st question many ask is what is economic capital? The 2nd question is why does the calculation matter to a community bank? The answer to the first question is that economic capital is the amount of equity required at a bank in order to secure that bank's safety and soundness. It is also a function of that bank's risk. To understand, consider that the vast majority of risk at a bank resides in the form of credit risk in loan assets. While the exact method and mathematical rigor needed to compute economic capital is laborious, a good pricing model will get you the number very quickly for individual loans and a portfolio. The best way to describe economic capital is by providing an analogy. if you had a choice to make 100 successive loans (assume a time loop), at $1mm each and for 1Y terms to either Microsoft (it's our analogy and in our analogy Microsoft wants to borrow from our bank) or to Ford Motor Company (again it's our analogy and our bank is comfortable with Ford Motor credit), then the computed regulatory capital for each scenario would be identical (under BASEL I) but economic capital will be very different. After 100 years of lending to Ford Motor Company, that borrower may have defaulted on 10% of those loans, leading to severe losses for the bank. Microsoft may not have defaulted on any of the 100 successive loans. Now assume that Microsoft and Ford were paying the same coupon on their loans. Obviously the bank that was lending to Microsoft would have been better compensated for the risk and received a higher return on its economic capital. But if we loosen the previous stipulation that both credits had the same coupon, then we can get to the crux of the issue - how much more coupon must Ford pay to compensate for the capital required for higher anticipated losses? The answer is not simple and once again we must turn to some number to compute an answer. The 2nd question, which is more pertinent in our opinion, asks why community banks should calculate risk adjusted capital. After all, banks report performance based on regulatory capital, and set loan loss reserves based on regulatory capital. The answer is simple, since every bank measure of performance is based on economic capital. For instance, consider that accounting and regulatory ROE overstate performance in low credit default cycles (like the one we have experienced in the last 6Ys, or the first few times a bank lends to Ford Motor Company) and understate performance in high credit default cycles (like some argue we have already entered). Over time, economic capital and regulatory capital converge. Therefore, banks that do not measure performance or risk based on economic capital end up making more loans to riskier counterparties (overstating immediate performance). Furthermore, more than 90% of loan assets in the country are controlled by institutions that use economic capital as their measure of risk and return. As a bank competing for loans against large banks, conduits and insurance companies, by definition, community banks are therefore pricing credits to economic capital. To manage risk, every loan booked or lost, must be substantiated on economic capital and return on economic capital. We urge every one of our readers to educate themselves on economic capital risk measurement. By the way, the capital of Slovenia is Ljubljana. While we are not authorities on the pronunciation, we are also told it's nice this time of year.

BANK NEWS

M&A

St. Martin Bank and Trust ($314mm, LA) will purchase American Bank ($62mm, LA) for about $15 million in cash, or 1.5x book value.

Job Cuts

A new study found that financial firms, led by mortgage lenders, cut more than twice the number of jobs in the first 8 months of the year as they did in the same period of 2006. This marks the first year since 2003 that the financial services industry has reduced its workforce.

Cashless Society

A new VISA survey found that an overwhelming majority of echo boomers (people born 1979-1989) and baby boomers (people born 1946-1964) believe that electronic payment transactions will one day replace cash and checks. According to the study, echo boomers and baby boomers will account for 50% of consumer spending ($4.6T and $2.45T, respectively) by 2015.

Housing Sector

The number of homes on the market reached a 16Y high in July, as home prices nationwide fell for the 12th straight month. There is now a 9.6 month supply of homes for sale.

More CP Problems

Cheyne Capital Management Ltd. announced that its $20B commercial paper program may have to liquidate due to losses in the value of securities backed by subprime loans.