LICKING YOUR LEVERAGE

by Steve Brown

One of the best things about a dog is their firmly held belief that licking is the appropriate action for all problems. If dogs ran a bank today, they would lick their financial statements.

We have long held the belief that the amount of leverage a bank employs is a mathematical equation. Since we never really could quantify loan underwriting accuracy, our methodology revolved around a banks ability to fund itself with below-market core deposits. The cheaper the bank could raise deposits below Libor (the assumed funding baseline index) and the lower the correlation the funding had to Libor, the more the bank should leverage (according to our formula in order to optimize ROE).

Unfortunately, many banks leveraged their loans when credit quality was at an all-time high. Now, as credit quality reverts to the mean, banks are finding their earnings are falling at a faster rate. The trend doesn't stop at banks, either, as deleveraging has become the hottest thing since dog toys. Investment banks, CDOs, REITs, hedge funds and even corporations are reducing leverage at an unprecedented rate.

One of the structural legacies the subprime crisis will leave with us (at least for the next 3Ys) is the need to carry less leverage. More stringent write downs of credit, greater loan loss allowances and a higher recommended capital cushion will automatically reduce the ROE of banks for the foreseeable future. The question bankers should ask themselves is how sensitive their earnings are to leverage?

To answer the question, we will take an average top performing bank that produced an ROE of greater than 12% for 1Q 2008. Since the relationship of leverage to earnings is not linear (a topic for another time), we will assume an average amount of leverage for the example bank is 11% risk-based capital ratio. To simplify things, let's just define "leverage" as straight equity-to-total assets - which for our sample bank is a little above 12%. Let us further assume that leverage travels a similar path as it did in the 4Q of 2007 and 1Q of 2008. Now let's assume this bank reduces leverage to 13%. That 1% change in leverage would result in a corresponding 1.6% change in ROE (from 12% down to 10.4%). Should leverage continue to decrease, the effect to ROE would be less (because of the non-linear nature of leverage). The opposite is also true that if a bank already employs less leverage (then the effect will be greater). Moving equity-to-total assets from 11% to 12% would result in almost a 2% decrease in ROE.

Understanding your bank's sensitivity to equity leverage will be increasingly important in the coming months. Bank management must make decisions regarding the fine-line of taking an "abundance of caution" when it comes to holding more capital and ROE targets. For those banks "forced" to hold more capital (by their regulators) plan on ROE changing 2% for every 1% change in leverage.

BANK NEWS

Softness Continues

Housing starts came in 2x as bad as expected, falling to a 17Y low. Construction has slowed sharply, as foreclosures push down property values and add to unsold home inventories.

Earnings - JP Morgan

The 3rd largest bank reported profit fell 50%, as it took $5.1B in writedowns and provisions on home equity loans, subprime mortgages and leveraged financing obligations. JP has posted about $10B of writedowns and losses since the beginning of the year.

Earnings - Wells Fargo

The bank reported net income fell 11%, including a $334mm gain from Visa's IPO, which was offset by a $2B loan loss provision and $1.53B in net charge-offs. Specifically, credit card and automobile consumer lending charge-offs jumped 26%.

Bank Earnings

An analyst at Oppeheimer has released a report projecting large banks will report their biggest losses in 20Ys this year, as consumer loan defaults rise. Loss ratios are projected to exceed 1.25% in the 1Q and 1.75% for the year.

Not Great

A research team from Goldman Sachs projects 1Q corporate earnings will be "awful" and a "harbinger of things to come." Slowing economic growth, rising energy prices and a general credit malaise have led analysts to cut their 1Q projections for corporate earnings. Analysts now expect 1Q earnings to drop 12%, compared to nearly a 5% projected increase at the start of the year.

Spirit Account

Huntington Bank ($54B, OH) has been successful at marketing their Spirit Check program. In it, the Bank has teamed up 91 local area high schools to market a customized checking account with checks that bear each school's mascot and logo. The Bank charges an additional $3 per box of checks, which it donates to the school. While numbers were not disclosed, the program is generating some good buzz.