EQUITY RISK PREMIUMS

by Steve Brown

One area that should be monitored by the Board and management is the equity risk premium for their bank (if public) or the industry, to get a sense for what the market perceives as risk. The equity risk premium is the return bank investors receive above a risk-free investment, such as Treasuries. The equity risk premium is neither a mathematical number nor statistical in nature, but is an implied opinion of what investors feel about your bank and its future prospects. This number is important as it determines the costs of equity for the bank and helps answer the question when to take on more debt, when to issue more equity (in addition to regulator considerations), when to accumulate more cash and how to value the bank.

The investment banking world used to believe that equity risk premiums in liquid markets were fairly stable and once too high or too low, a bank's premium would return to its mean. However, during the 4Q of 2008, the world of equity risk premiums radically changed, almost doubling for most corporations and more than double for banks.

There are 3 ways to estimate your equity risk premium. One way is to calculate it using historic performance which while good, is still backwards looking. Here, the average risk premium for all equity is about 4.3% over Treasury bonds, based on data from the last 80Ys. Community banks, which are a little less liquid, usually are at a premium over that number, in the 5.5% range. It should also be noted that the standard error is about 2.4%, thus the risk premium for banks could be as high as 10% (assuming the standard 2 standard deviation test).

A second way for bankers to estimate premium is by looking at what people are paying for stocks today, which takes into account their forward estimation of cash flow. Here, general equity indexes are trading based on about a 9% return. Netting out a 4.6% Treasury Bond rate yields an implied equity risk premium of about 4.4% for the market in general. This is a forward-looking measure and implies some optimism of cash flows when compared to historic measures.

Finally, perhaps the best way to find out the risk premium is to survey your investment banks and investors to find out where they would raise or invest more capital into your bank. For banks, these actual values range from a low of 3% (usually bank insiders) to a high of 12% (bank speculators), with a mean of about 6%. This step is important, as it folds in the non-quantifiable positive value that local investors get when investing in a community bank and is a good indication of what a more practical number might be if your bank had to raise capital today.

The end result of this analysis is that as a general statement about banks, investors will demand about a 9% return on their money. As mentioned, this number changes constantly, but it is good to calculate from time to time. It will not only help you make decisions on internal investments, dividends and capital such (as SBLF, which is cheap by comparison); but also to better understand how investors perceive risk. Monitoring this number will keep you more attuned to risk, which in turn should result in a lower required risk premium for your bank.

BANK NEWS

Mortgage Servicing Crackdown

Banking regulators announced enforcement actions against the 14 largest mortgage-loan servicers (represent 68% of the mortgage industry) that require them to improve their foreclosure practices. The action requires servicers to provide delinquent borrowers with a single point of contact; ensure that foreclosures are not pursued once a mortgage has been approved for modification; establish controls over third-party vendors; and reimburse borrowers who suffered financial losses because of wrongful foreclosures or other deficiencies.

More Mobile

To address customer complaints, Wells Fargo has launched a program that will allow travelers to use microchip-embedded EMV credit cards overseas. EMV chip technology is standard in Europe, but Wells Fargo is the first major US bank to deploy Visa credit cards with the technology.

Hedging Rules

Banking regulators have issued a proposed rule that would require swap entities to collect minimum amounts of initial and variation margin from counterparties based on the risk of the counterparty and also of the swap.

Employee Healthcare

A study by Aon Hewitt finds employer insurance premiums are up 9% since last year and out of pocket healthcare costs have risen 12%.

RBC

The Bank joins a list of others that has or will put its consumer banking division up for sale due to profitability. Rumors swirl that US Bank, BB&T, Toronto-Dominion and BBVA might be interested in the 410-branch network with its share of real estate related loan problems.