

BANK EQUITY RISK PREMIUM

by [Steve Brown](#)

As you complete your strategic planning and budgeting cycle for 2011, one little-understood, but crucial metric for a bank is your "equity risk premium." This premium is the "charge" investors seek above the risk-free rate to attract them to your bank. If investors are worried about the future this premium will rise. However, should the risk free rate or other investment alternatives (like the S&P) fall; the risk premium on your equity will be less. Understanding this is an important tool to determine the value of your bank, the optimal split between debt / equity and your cost of capital. The metric also determines the important question of whether you should accumulate cash for capital investment or return it in the form of a dividend.

Determining your equity risk premium takes a little bit of effort and can be done in 3 ways. The simplest and most accurate is to survey investors to determine what they will require in order to part with their money and invest in your bank. Here, premiums range from 5% for local investors to 10% for many private equity firms. Add this premium on top of the risk free rate, and you get an implied return expectation of approximately 7% to 12% for the average community bank.

However, conducting a survey isn't always feasible and has the disadvantage of potentially worrying existing investors and going out of date quickly. That brings us to method 2, which is using historic data. Here, you can look at the actual return in equity less the historical risk-free rate. Looking back over the past 80Ys, this number is about 4.35% (implying a 7.45% required return on average for large publically traded banks). This method is somewhat data intensive and has a fairly large standard error (of about 2.4%). Further, one never really knows what period of history to use, adding confusion and calculation problems.

The 3rd and easiest way to calculate your equity risk premium is by looking at what people are paying for stocks now, figuring out what the potential growth is in the future and then discounting those cash flows back. By subtracting a risk-free Treasury rate, you can then deduce an implied equity premium and make an adjustment for a specific-sized bank (smaller banks tend to require a greater premium than larger ones). Astute readers will pick up on the fact that we are introducing the potential for unknown error here when we estimate the future growth rate of both dividends and earnings, but this isn't an exact science and the error factor is on par with utilizing historical data. This method also has the advantage of being forward-looking, so what it lacks in accuracy it makes up for in predictive power. For fun, we calculated the equity risk premium for an \$800mm sized bank and came out with an equity risk premium of 7.39%.

That number implies that an \$800mm bank would need to produce a return of 10.49% (after adding back the risk-free rate) in order to make investors "indifferent" between owning equity in the bank, investing in the S&P or buying a long-term Treasury. This figure also suggests the hurdle rate for new investments, such as acquisitions, new products or other resource decisioning. Those that can't produce a return over 10.48% over the long-run it could be argued should be sold or shuttered.

As a thank you for being our reader and to further endear ourselves to you, we are giving away our simple bank implied equity risk premium model to save you the trouble of building one. This is a free

model and while we have tried to make it as accurate and useful as possible; check with your own experts before making any decisions based on it. This model will allow you to determine an implied risk premium given future market changes. If you are comfortable with running a simple "What If" analysis in Excel you should find this model useful. We will send it out next week, so if you are a banker or regulator and would like to see it, feel free to click the link and subscribe. <http://www.zoomerang.com/Survey/WEB22DEAHT5WAR>

BANK NEWS

JPMorgan

JP (the first major bank) reported 3Q income fell to \$4.3B from \$5.4B in 2Q and \$4.4B in the same period last year. JP's results were buoyed by a \$1.9B accounting gain on a change in the value of its liabilities; it saw investment banking fees plunge 31% from the prior year; deposits climbed 21% from the prior year and 4% from 2Q; consumer and small-business client profits jumped 62% from a year earlier; and loan loss reserves were \$2.4B (down from \$3.2B a year earlier, but up from \$1.8B level of 2Q).

SBA Expansion

The SBA has proposed expanding the maximum revenue allowed for a small business to qualify in 37 industries that fall within the sectors of administrative, support, waste management and remediation services (under NAICS), as well as 15 industries in the sector of information. In many cases the increase to the size standard is modest.

Muni Risk

In a rare move, the City Council of Harrisburg, PA passed a resolution calling for a Chapter 9 bankruptcy filing.

Foreclosures & Defaults

Realty Trac is reporting foreclosure filings declined 34% in 3Q from a year earlier, following 12 months of YOY declines. Before breaking out the bubbly however, analysts caution the slowdown is only a pause in the action, as banks slow processes in response to the probe by state attorneys general. Meanwhile, default notices soared 14% from the 2Q, marking the first increase in 5 quarters.

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