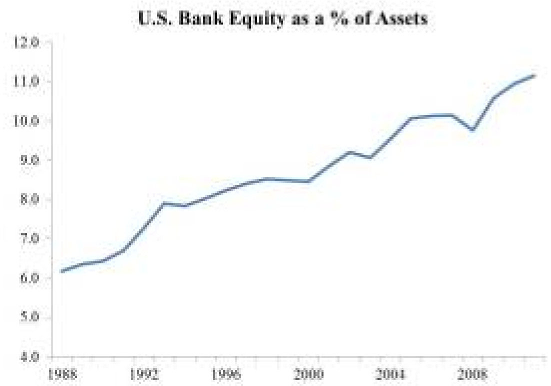
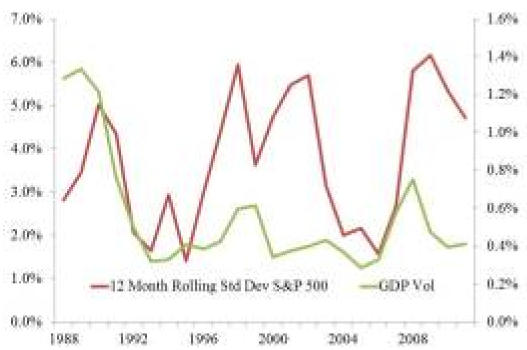
Banks and Leverage

Another near death experience in equity markets avoided – at least for now. Kevin KAL Kallaugher's cartoon in last month's newsletter could scarcely have been better timed (if you missed it October's letter is available on our website). Stepping back to examine levels of risk seems a reasonable place to start.

There is perhaps no more fundamental a question for bank regulators than knowing how much systemic risk exists, and its trajectory. Although it's hard to believe looking back over the past few years, there is a well-established trend in the U.S. to increase the amount of equity capital supporting banks. The chart below from the St. Louis Federal Reserve shows that banks have reached 11% equity to assets with only a modest drop during the financial crisis. The numbers exclude companies such as Lehman Brothers (which was not a commercial bank) whose equity: assets was reported to be as low as 3% (i.e. balance sheet leverage of around 30:1) when they filed for bankruptcy in 2008. When Goldman Sachs and Morgan Stanley quickly converted to banks in the aftermath an immediate consequence was that they reduce leverage. But looking at the system as a whole and measuring common equity divided by total assets there is a clearly improving trend upwards. This analysis does not include any risk-weighting of assets, nor does it include any off-balance sheet instruments such as derivatives that might be altering, perhaps substantially, the apparent reduction in risk displayed here.



Systemic banking risk may be lower by one measure, but it's obviously an imperfect yardstick based on recent history. The chart below shows the standard deviation of GDP (from the U.S. Bureau of Economic Analysis) and the S&P 500. Economic swings have been fairly consistent for most of the past couple of decades while equity market volatility has been at times breathtaking. So is systemic risk really coming down or not?



The now soggy and cold Occupy Wall Street crowd may not yet articulate a coherent set of views, but one might speculate that the financially literate amongst them would favor still less risk rather than more. Measuring equity as a percentage of bank assets is a crude and obviously out-dated tool, in addition to which some of the biggest losses occurred outside the banking system (such as AIG and the Federal housing agencies FNMA and FHMC). The broader socialization of credit risk and a recognition that some banks are too big to fail have been necessary precisely because the banking system is (or at least was found to be in 2008) undercapitalized. And even with 11% equity: assets, there can be little doubt that banks are in a class of their own when it comes to making their equity capital work hard. No other industry operates with anything like the leverage that banks employ. Companies with far more stable earnings incur far less balance sheet risk. To select a few by way of illustration: Bristol-Myers Squibb (BMY) has 34% equity: assets and Johnson & Johnson (JNJ) 36%. These calculations exclude goodwill from assets and therefore use tangible common equity to be more conservative. As a result no adjustment is made to these and many other companies that own operating assets whose value has increased substantially since they were acquired but which have not been written up in value on their balance sheets. Financial services companies rarely own assets worth more than their stated value. Loans and bonds are hopefully worth their face amount, but doing much better than getting your money back is hard unless such assets were acquired in distress and while banks often hold distressed assets they rarely acquire them as such. Even within the financial services sector Travellers (TRV) gets by with almost 21% equity. Not coincidentally, these are all holdings in our **Hedged Dividend Capture Strategy**, which seeks to offer better returns than corporate bonds through a hedged portfolio of equities of steadily growing and prudently managed companies. As regular readers know, outperforming high-grade bonds is not simply a reasonable objective it’s most likely imperative in order to avoid a loss in after-tax real wealth.

Banking leverage is definitely good for banks and is necessary at some safe level in order to allow credit creation and economic growth. While leverage has come down, financial risk has not and there may be a link between increasing compensation and higher levels of risk since the two have grown together. Reducing bankers’ bonuses shouldn’t be an objective of public policy, but further increases in capital would result in a greater share of profits to the providers of capital rather than labor and a safer system too. I've long felt banks were much better places to provide labor than capital, which is why I worked for a bank for a long time but have never invested in one beyond the requisite restricted stock employees receive. But since society bears much of the downside of banking catastrophes, it's reasonable to ask whether society is receiving commensurate benefit. The financial system is measurably riskier over the past twenty years. Who else has this helped beyond the financiers?

It's a complex question. The global economy has become more linked, and of course there's only ever one version of history to evaluate. We can't know how things would have turned out with even lower bank leverage but an otherwise unchanged script. There is no "control experiment" with which to compare, so it's probably a question that will never have a satisfactory answer. There may be many problems with the Basle III capital guidelines, but directionally the shift towards even greater capitalization seems uncontroversial. If Greek sovereign debt hadn't been assigned a risk weighting of zero under previous rules, French and German banks who suspended critical thought wouldn't now hold so much of it. We wouldn't have a semi-annual Euro crisis. As banks strenuously debate every increase in regulation, their attitude to systemic risk should be part of their response.