BANKING

Bank earnings – the V, U or L-shaped recovery

As recent events have amply demonstrated, there are many reasons to be cautious about the outlook for financial institutions globally, although the major Australian banks are well capitalised. The availability of risk capital will be a key determinant of future earnings.

IN 2007, EQUITY MARKETS had a tempestuous relationship with financial institutions, especially those with large investment banking operations. For a period early in 2008, investors saw buying opportunities – the bigger the write-off, the bigger the dividend cut, the bigger the capital raising and, perversely, the greater the investor buying interest. However, as recent events have demonstrated, there are now lots of reasons to be very cautious about the outlook for financial institutions.

The asset quality of the major international banks remains uncertain. Svein Andresen, Secretary General of the Financial Stability Forum, which is made up of global regulators and central bankers, recently told a conference of bankers in Cannes: 'We are now 10 months through this crisis and some of the major banks have yet to make disclosure in [crucial] areas'.

Despite significant write-downs, sub-prime assets remain vulnerable and there are substantial differences in valuations (see Figure 1).

Figure 1. Values (%) of CDO Super Senior Tranches

Underlying Collateral	High Grade	Mezzanine	CDO Squared
Minimum	63.96	25.04	23.04
Range	20.05	55.10	34.74
Maximum	84.00	80.14	57.77

Source: Bank of England (April 2008) Financial Stability Report No. 23, p. 9.

Since September 2008, deteriorating market conditions have meant that these valuation problems have worsened and bank balance sheets have changed significantly.

Reduced asset quality

Traditionally, commercial bank assets consisted primarily of loans and high-quality securities whereas investment bank assets generally consisted of government securities and an inventory of trading securities.

In recent years, however, asset credit quality has deteriorated across the board. And, high-quality borrowers have disintermediated the banks, financing directly from investors. Banks have also held lower quality assets in order to boost their returns.

Bank balance sheets also now include investments – private equity stakes, principal investments, hedge fund equity, different slices of risk in structured finance transactions and derivatives (of varying degrees of complexity). Sometimes, the assets don't appear on balance sheet, being held in complex off balance sheet structures with various components of risk being retained by the bank. Further write-downs in asset values cannot be discounted.

Under US accounting rules, assets must be classified into:

- Level 1 (*mark-to-market*) – liquid assets or instruments that are actively traded;
- Level 2 (*mark-to-model*) – instruments that cannot be priced based on trade prices but are valued using observable inputs; and
- Level 3 (*mark-to-make believe or mark-to-myself*) – the asset or liability cannot be priced using observable inputs and requires the use of modelling techniques and substantially subjective assumptions.

Asset quality uncertainty can be gauged by looking at a bank's Level 3 assets (see Figure 2).

In the second half of 2008, the asset positions of many US and UK financial institutions deteriorated rapidly and several large banks and investment banks have either filed for bankruptcy, merged to avoid default or had to be 'bailed out' by governments.

Globally, banks require recapitalisation to restore their balance sheets. The capital required is in excess of US$ 800–1000 billion (40–50% of total global bank capital) to cover losses and assets returning onto their balance sheet (as the vehicles of the 'shadow banking system' are unwound). Additional capital will also be needed to support future growth.

Availability of capital

Banks have raised a significant amount of capital to date but the prospects of raising additional capital are increasingly bleak. The availability of capital, the cost of new capital and the dilution of earnings will all affect future performance.

Earnings growth in recent years has been driven by a rapid expansion of lending – both traditional and disguised forms such as securitisation and derivatives activity. Bank balance sheets have expanded at rates well above GDP expansion. Lower volumes in the future will mean lower earnings.

Lack of lending capacity may also affect other activities. Corporate finance and advisory fees are driven by the capacity to finance transactions and co-invest in risk positions. Lower origination of lending driven deals may reduce this income significantly. Earnings from leveraged finance deals are currently down 90% from one year ago.

While structured finance and securitisation, including CDO activity, have contributed strongly to earnings in recent years, volumes have collapsed

SATYAJIT DAS is a risk consultant and author of *Traders, Guns & Money: Knowns and Unknowns in the Dazzling World of Derivatives* (2006, FT-Prentice Hall).

in 2008. The virtual closure of structured finance markets has complex effects. Banks had been generating large earnings from off balance sheet vehicles in the shadow banking system as these vehicles provided banks with the ability to 'park' assets and reduce capital. They also provided significant revenue – management fees, debt issuance fees and trading revenues. Recovery in these earnings is unlikely any time soon.

Trading revenue has been a bright spot. Increased volatility and much wider bid-offer spreads have generated increases in both client driven and proprietary trading earnings. However, several factors may limit trading income. Revenues may diminish as investors and borrowers curtail their use of such instruments preferring simpler products that are less profitable to the bank. Trading revenues have relied heavily on hedge funds and financial sponsors and hedge fund activity is slowing through consolidation and reduced leverage. Reduction in financial sponsor activity will limit revenue from this source.

Prior to the global credit crisis, banks had increasingly relied on proprietary trading to supplement earnings. This increases risk and depends on the availability of capital. It also relies on the availability of counterparties and liquidity. Concern about counterparty risk and reduction in market liquidity in some products increases the risk of this activity and reduces its earnings potential.

Future earnings will be affected by the availability of risk capital. The banks may not be able to access capital to the extent needed. The demise of the shadow banking system will mean that purchased capital will not be available. Regulators may also increase capital levels for some transactions exacerbating the capital problem.

Risk models in banks are a function of market volatility. The low volatility regime of recent years reduced the amount of capital needed. Increased market volatility will increase the amount of capital needed. This may restrict the level of risk taking and therefore earnings potential.

Figure 2. Analysis of Level 3 Assets

	CitiGroup	JP Morgan	Goldman SAchs	Merrill Lynch	Morgan Stanley
Total Assets (US$ bn)	2,167.63	1,562.15	1,119.98	1,020.05	1,045.41
Level 2 Assets (US$ bn)	933.64	1,093.06	573.63	768.07	225.92
Level 3 Assets (US$ bn)	133.44	71.29	54.72	41.45	73.65
Total Capital (US$ bn)	134.12	132.24	42.80	31.93	31.93
Level 3/ Total Assets	**6%**	**5%**	**5%**	**4%**	**7%**
Level 3/ Total Capital	**99%**	**54%**	**128%**	**130%**	**231%**
% Change in Level 3 Assets Needed to Eliminate Capital	**101%**	**185%**	**78%**	**77%**	**43%**
% Change in Level 2 & 3 Assets Needed to Eliminate Capital	**13%**	**11%**	**7%**	**4%**	**11%**

Note: All data is as at end 2007 and based on published financial statements.

The prospects for earnings performance

Higher costs will also increase, limiting the earnings recovery. Bank funding costs have increased significantly for much of 2008. Most firms have been forced to issue substantial amounts of term debt to fund assets returning to balance sheet and protect against liquidity risk. To the extent that these costs cannot be passed through to borrowers, the higher funding costs will affect future funding.

Banks have issued high-cost equity to recapitalise their balance sheets. Hybrid capital issues paying between 7.00% and 11.00% p.a. will be a drag on future earnings. Highly dilutionary equity issues (often at a discount to a share price that had fallen significantly) will impede earnings per share growth and return on capital.

Banks also face additional short-term costs. Litigation against banks has increased. There may also be prosecutions of banks. The costs of these are unknown. In the longer term, banks face higher regulatory and compliance costs.

Accounting factors may also affect any earnings recovery. FAS157 (fair value accounting) allows the entity's own credit risk to be used in establishing the value of its liabilities. Changes in the entity's credit standing are therefore reflected as changes in fair value. This results in gains for credit downgrades and losses for credit upgrades.

As credit spreads have increased, banks have taken substantial profits to earnings from revaluing their own liabilities. If markets stabilise and the credit spreads for banks improve, banks will have to reverse these gains. There may be significant mark-to-market losses especially on new debt issues by banks at high credit spreads since mid-2007.

Investors are looking for a rapid recovery in bank earnings. Earnings may recover but the 'gilded age' of bank profits may be difficult to recapture.

Glamorous banks reliant on 'voodoo banking' (where banks have geared their balance sheet to use the capital several times) may find it difficult to achieve the high performance of the 'go-go' years.

Banks with sound traditional franchises that have avoided the worst excesses of the past 10–15 years will do well in the changed market environment. Such old-fashioned banking may ironically do well in the 'new' environment. Until the latest round of interest rate reductions by central banks around the world, the interest rates that banks have charged customers have increased. Bank deposits have become far more attractive than other investments. Stronger banks have also benefited from a 'flight to quality'.

Will the recovery in bank stocks take the form of V or U? It may even be an L-shaped recovery. Central banks and governments have signalled that major banks are 'too big to fail'. This is a necessary but not sufficient condition for the recovery of bank earnings and stock prices. The recovery might take the form of an 'L' – with a small upturn at the far right of the flat bottom. ●

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