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Why banks must think carefully before they shrink their assets

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Raise your capital ratios," say the regulators. "Force us and we will shrink," say the banks.
What's this all about? Why should we care? Capital as a percentage of risk-weighted assets is one measure of financial strength. It is a ratio that European regulators have told EU banks to increase by June next year. To move the ratio up, banks either can increase the numerator or decrease the denominator.

To increase the numerator, you have to increase capital (equity plus qualifying debt). This is the loss-absorbing and confidence-inspiring stuff. One way to increase capital is to make profits and retain them. You can retain more profits to the extent that you reduce dividends. Present shareholders don't like that idea. You can make more profits to the extent that you pay less bonus. Present shareholders like this approach; the bankers they employ do not. Finally, you can raise more capital by issuing more shares. Neither shareholders nor bank chief executives like that idea. Why?

Current shareholders fear that the issue of additional equity may depress prices further. In normal times, they would be right. Yet these are not normal times. Bank share prices are depressed because prospective shareholders either have lost confidence in the banks or because they expect banks to issue new shares. More shares would make for a stronger bank, and a stronger bank would build confidence among shareholders, present and prospective.

And why might some bank chief executives reject the need for more equity? Well, partly because they said that they did not need it when it would have been a lot cheaper to raise. And partly because many bank chief executives remain excessively focused on return on equity (RoE) as a measure of their success.
Sadly, RoE takes no account of the risks taken to generate a given return. It is a discredited measure of short-term profitability and has been a poor predictor of medium-term shareholder value.

Yet for many, these targets are still in place. And as long as they are, a CEO measured by RoE is encouraged to hit the target. He can do so by boosting the R (return) or he can do so by minimising the E (equity). Many minimise the E.

This is a pity. Minimising equity makes the balance sheet weak and investor confidence weaker. This raises the cost of bank debt and, most probably, the cost of bank equity. This is not a theory. Bank stocks with higher levels of equity are outperforming those with less, both in terms of share price and price-to-book value.

Alternatively, you can decrease the denominator — by shrinking the asset base. This is the profit-and-loss-producing stuff. One way to shrink is to reduce the amount of loans to households and small businesses. This client segment is of varied importance to financial conglomerates but vital to the health of the economy — the economy that banks are meant to serve and from which they make their living. The technical phrase here is "adverse feedback loop". The less technical phrase is "shooting yourself in the foot".

A second way is to reduce the vast financial product activity conducted with fellow financiers. This includes the sexy, high-risk (and sometimes) high-reward arena often marked by opacity, high-volume and model-dependent valuations. Unfortunately, if you are wedded to short-term RoE measures, you are prompted to pursue the high-risk R business without which you have little chance of hitting your RoE target. Never mind that it is the wrong target.

A third way is to dispose of assets on the balance sheet. Which assets will you sell? If you sell the good stuff, then you are giving up quality earnings in favour of lower-quality revenues. Will the market reward your share price for that? Alternatively, you can sell the bad stuff. If you have marked this to market properly, you will suffer no loss, improve your ratios and free up funding. If you have not, you will incur a loss — and need still more equity.

In summary, European regulators demand better bank ratios. Markets want better banks. Better ratios may be an indication of stronger balance sheets, but the ratio can be hit in different ways. Some banks want to reduce the denominator (assets). The market expects — and regulators would prefer — that banks increase the numerator (equity). Reducing the denominator may well damage the financial system without improving shareholder value. Increasing the numerator may well improve both. Banks should think carefully before they shrink.

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