COMMENTARY 20170910

Why are some banks more valuable than others?

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Recent evidence suggests that banks' ability to generate deposits from the least interest-rate sensitive depositors is the main determinant of differences in value across banks. Banks' ability to identify high- and low-risk borrowers, and price loans accordingly, plays less of a role in creating shareholder value.

Is it because some banks are better at identifying high- and low-risk borrowers, and pricing their loans accordingly? Or is it because some banks are better at convincing depositors to lend to the bank at low interest rates on savings accounts? Recent evidence by researchers at Harvard and the London Business School suggests that the latter explanation is more important (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2938065).[1]

The researchers compared the market-to-book ratio of U.S. banks to two measures of productivity – the ability of a bank to generate interest and fee revenue for a given asset base, termed asset productivity, and the ability of a bank to generate more deposits for given asset base, termed deposit productivity. They found that deposit productivity explained twice the variation in the market-to-book ratio across banks as asset productivity. In other words, a bank can create more value for shareholders by being the best bank at generating deposits, compared to the bank which is best at generating interest and fees from loans. In addition, within different categories of deposits, it is the ability of banks to generate more savings deposits that leads to the greatest increase in value, as opposed to transaction deposits or time deposits (like certificates of deposit).

The reason savings deposits are so valuable for banks is that consumers rarely switch banks. Or in economic terms, demand for savings deposits is highly inelastic. This reluctance to switch means that interest rate competition for savings deposits is low. Banks can rely on savings deposits as a very stable, and low cost, source on funds to underpin their lending activities. In contrast, consumers pay more attention to interest rates when deciding on a CD, and businesses pay attention to interest rates when shopping for loans. Interestingly, on the loan side, market-to-book ratio loaded up primarily on asset productivity from real estate loans, rather than other types of loans. Again, non-price competition can explain why real estate loans

[1] Egan, M., S. Lewellen, and A. Sunderam, 2017. "The cross-section of bank value," March 20.

create so much shareholder value. Sure, consumers care about rates when comparing mortgages. But non-interest factors are more important for consumers on a relative basis compared to businesses seeking loans.

From a policy perspective the evidence matters for the regulation of banks. The reason we have capital requirements for banks is that bank shareholders do not bear all the risk associated with lending. Taxpayers bear the risk of having to bail out depositors, and mitigate this risk with minimum capital requirements. The better banks are at screening risky borrowers and setting interest rates accordingly, the less taxpayers need to be concerned with a bank collapse. But the evidence suggests that banks' asset productivity doesn't vary much across banks, and what variation does exist is not the primary source of shareholder value creation. Banks' have more ability to create shareholder value by marketing their services to get deposits, rather than increasing loan productivity.

For investors, the message is to pay attention to banks' ability to generate deposits, especially savings deposits. This sticky source of low cost funding increases margins and lowers risk, compared to an otherwise equivalent bank.