

DO FEE BUSINESSES ABSORB OR PROVIDE RISK CAPITAL?

Banks that implement sophisticated economic capital methodologies must allocate capital to all their businesses, including fee businesses such as asset management, brokerage and mortgage production.

This often leads to internal political problems because asset managers and mortgage bankers maintain that their businesses do not require risk capital. Unlike commercial lending businesses and bank trading desks, they argue, fee businesses are not much subject to credit and market risks, and are therefore unlikely to make large losses. As they do not make large losses, they do not need to be supported by risk capital.

This logic is apparently strengthened by the way fee business risks fly under the radar screen of traditional regulatory regimes.

As we'll explain, banks must rebut this argument and insist on accurately measuring the risks of fee businesses. However, the news is not all bad – sometimes fee businesses turn out to be net providers of equity for the institution.

VOLATILITY OF RETURNS = SHAREHOLDER RISK

While managers may be right to claim that accounting losses are unlikely in feebased businesses, the intrinsic value of these businesses is often significantly volatile. For example:

- the value of mortgage businesses (eg, origination) is strongly dependent on interest rate changes; and
- an asset manager's profits are at the mercy of market movements that drive returns as well as investor enthusiasm, determining the amount of assets under management (AUM).

From an enterprise and shareholder perspective, this volatility requires substantial returns. The shareholder, after all, expects a return on investment commensurate with the systematic risk of the bank (according to the Capital Asset Pricing Model). Other things equal, a shareholder is indifferent between, for example, an earnings shortfall from a fee business and unusually high losses in commercial lending.

Banks must insist on accurately measuring the risks of fee businesses

It follows that shareholder equity should be allocated to business units in proportion to risk defined as deviations from expectations – and that fee businesses should pay for their fair share of allocated capital.

THE BONDHOLDER ECONOMIC VIEW

Like shareholders, bondholders should put aside artificial regulatory definitions of risk. Banks that experience a dramatic loss in value could find it more difficult to access funding and may face a liquidity crisis, so bondholders should worry about shocks to bank value as well as accounting losses.

Bondholders should also adopt a notion of equity that differs from the notion of regulatory capital. For example, regulatory capital does not include goodwill or intangibles. The bondholder, by contrast, should be willing to count any 'excess value' (ie, goodwill and other intrinsic franchise values) of the asset management business to the extent that this excess value is available as a financial resource in the event of distress.

The calculation of excess value must be conservative and reflect any loss in value

that might be necessary in a quick sale. Excess value can erode quickly in a severe crisis scenario, eg, existing customer relationships may be damaged and the value associated with them may fall.

Importantly, the excess value should be counted as fully available equity against the portion of economic capital allocated to the excess value loss (since the value of the business and the allocated capital will be eroded at the same pace).

The same principles for setting capital against risk apply, whether a fee business was acquired by raising equity or grown organically, even though bankers tend to feel more comfortable applying these principles in the former case because of accounting rules about goodwill.

THE BENEFITS OF ADDING VALUE

Despite the fact that fee businesses require economic capital to cover their risks, they are often net providers of equity for the institution.

What benefit do the fee businesses get from this, one may ask? Fee businesses that offer high returns and low risks will be rewarded with impressive risk-adjusted return on capital (RAROC) numbers while these businesses are building up equity value.

In turn, these RAROC numbers will drive the bank's risk-based performance measurement and incentive compensation system, which rewards all the business units creating value for shareholders.

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