A DISCUSSION OF BANK CAPITAL, CAPITAL RATIOS AND CONCENTRATIONS

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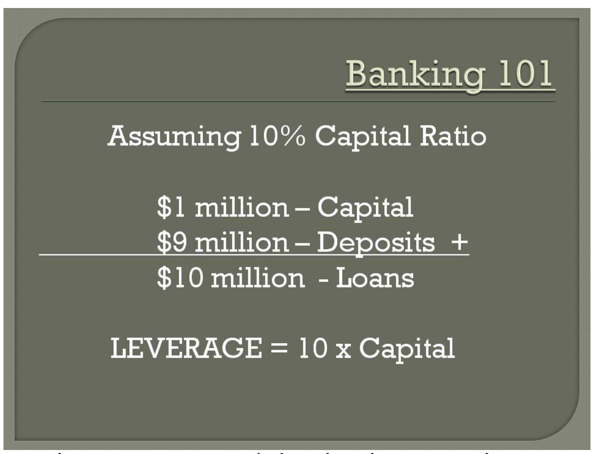
by Howard M. Headlee, Utah Bankers Association January 6, 2010

Unfortunately, most of what you hear in the media about banks is fairly inaccurate. In fact, usually when someone in the media refers to a bank, they are not even talking about a real, FDIC insured bank. In order to help consumers understand what they are hearing in the news and experiencing in the real world when it comes to borrowing money, it is important to understand how a bank works.

A bank's balance sheet looks like any other business' balance sheet. A bank's Assets must equal its Liabilities plus its Owners Equity. In general a bank's Assets are the loans it makes (money borrowers owe the bank), its Liabilities are the deposits it takes (money the bank owes its depositors) and the Owners Equity is the bank's Capital. Therefore, in a bank its loans equal its deposits plus its capital.

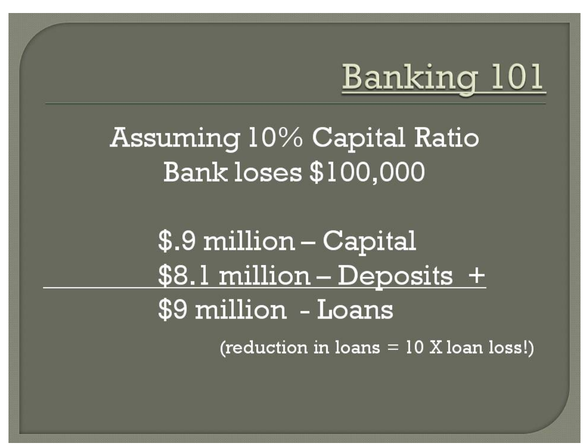
Banks have to maintain a certain level of capital for every loan they make. Therefore, the ratio of capital to loans limits the overall size of every bank. On average, banks have capital ratios of around 10%. This means that the total loans they can make are about equal to 10 times the amount of capital they have.



For example, if a bank has $1 million in capital, it would need to collect $9 million in deposits and make $10 million in loans to properly leverage its balance sheet. If the bank makes good loans and those are repaid with interest, the bank earns a profit.

As a bank earns a profit, its capital grows. For every dollar in profit a bank makes, it can make an additional $10 in loans. So when it is reported that banks are making record profits, this is good news for everyone in the community that needs to borrow money.

However, when banks lose money on loans, those losses come directly out of the bank's capital. For every dollar a bank loses it can make $10 less in loans. So in our previous example, if the bank loses $100,000, it would lower its deposits by $900,000 and reduce its outstanding loans by $1,000,000, thus maintaining a 10% capital to asset ratio. The reduction in loans is 10 times the original loan loss. This process is referred to as "de-leveraging" the balance sheet.



Banking 101

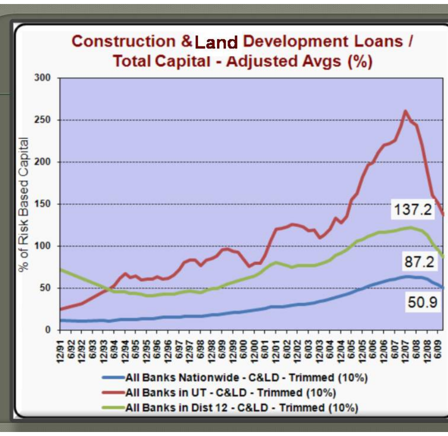
Assuming 12% Capital Ratio
Bank loses $100,000

$.9 million – Capital
$6.6 million – Deposits +
$7.5 million - Loans

(reduction in loans = 25 X loan loss!)

During a serious economic downturn, if loan losses become significant, bank regulators will often require banks to carry higher capital ratios. This results in further "de-leveraging" of a bank's balance sheet. In the example above, if the bank which had lost $100,000 were also required to increase its capital ratio to 12%, it would have to reduce its outstanding loans another $1.5 million to $7.5 million resulting in a total reduction in loans equal to 25 times the original loan loss.

Another factor bank regulators will take into consideration is the concentration level of certain types of loans as a percentage of a bank's capital. For example, Commercial Real Estate (CRE) loans can be more volatile than other types of loans, especially during a significant real estate correction. Regulators watch the ratio or "concentration" of CRE loans as a percentage of capital. Specifically, in Utah regulators have been very concerned about the concentrations of a particular type of CRE loan – Construction & Land Development Loans (C&LD).



Historically, Utah banks have used their capital to make a much higher percentage of C&LD loans that banks throughout the country. Over the past 15 years, Utah's banks have had much higher concentrations of C&LD loans than the other banks in the west and the rest of the country. Bank regulators have been putting extreme pressure on Utah banks to bring these concentrations down. This has been very painful for banks as well as their real estate borrowers. And despite significant decreases in C&LD concentrations on average among Utah banks, Utah banks' C&LD concentrations are still second highest in the nation and three time higher than the national average.

Rank	State	C&LD / Capital 9/09 - Trimmed Mean (10%)
1	NC	137.24
2	**UT**	**137.18**
3	GA	134.03
4	WA	129.73
5	NV	126.98
6	SC	121.41
7	ID	110.25
8	OR	104.21
9	MD	100.64
10	FL	100.32

It should be noted that these are averages, and some Utah banks' concentrations are above these levels and other are below these levels. Potential borrowers should investigate which banks still have C&LD capacity and which do not.

Nevertheless, these three factors (1. Decreases in Capital, 2. Pressure to increase Capital ratios, 3. Pressure to decrease C&LD concentrations) have dramatically reduced the amount of credit available to build and develop residential and commercial property. Some would say this is a natural result of the recent real estate bubble and the over-development of our real estate market. Nonetheless, it is also resulting in significant stress in Utah's real estate market.

Banking 101

↓ Capital

↑ Capital Ratio

↓ Real Estate Concentrations

With this understanding, it is easy to understand one of the biggest myths in the mainstream media – the so-called "Bank Bailout." Anyone who uses the word "Bank" and the word "Bailout" in the same sentence is either misinformed or attempting to deceive, either way they probably are not a reliable source of information.

Legally, the only institution that is allowed use the word "Bank" in its name are those institutions insured by the Federal Deposit Insurance Corporation (FDIC). AIG, Bear Stearns, Merrill Lynch, Lehman Brothers (and of course Chrysler and GM) are not banks. Assuming the word "Bailout" refers to the injection of capital into an institution in order to prevent its failure; not a single FDIC insured bank received TARP money in order to prevent a failure. In fact, only healthy banks were allowed to apply for TARP funds and only healthy banks received TARP funds.

This banking initiative was called the Capital Purchase Program (CPP) and was entirely separate from other TARP disbursements (bailouts). The program was designed to offset the negative effects of the massive de-leveraging that was naturally occurring in the banking industry due to loan losses. In some cases the CPP injections allowed banks to hold lending levels constant, in some cases overall lending by individual banks even rose slightly. Criticism that banks took TARP money but did not increase lending was made by individuals who didn't understand the corresponding de-leveraging that was taking place.

The distribution of TARP funds to some non-bank institutions clearly represented a bailout. However, when the public stigma of these bailouts was projected onto the banking industry and the CPP program, most banks refused to accept CPP capital injections preferring to let the market run its course by de-leverage their balance sheets. This has and will continue to result in an overall reduction of credit in the marketplace. Combined with the destruction of the secondary credit markets, this de-leveraging will no doubt result in a much more gradual economic recovery.