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An Alco Perspective on What Drives Bank Value

Our second President, John Adams, opined, *"Facts are stubborn things; and whatever may be our wishes, our inclinations, or the dictates of our passions, they cannot alter the state of facts and evidence."*

While our current thoughts may not be strictly in line with President Adams, I believe a fact-driven approach to Asset/Liability Management is far preferable to the alternative. Consequently, in this article I will explore the question of what drives bank value from the perspective of factors that are typically managed through the Alco process. We explore the question both over a long period of time and when there is a significant short-term change that offers contrasting conclusions.

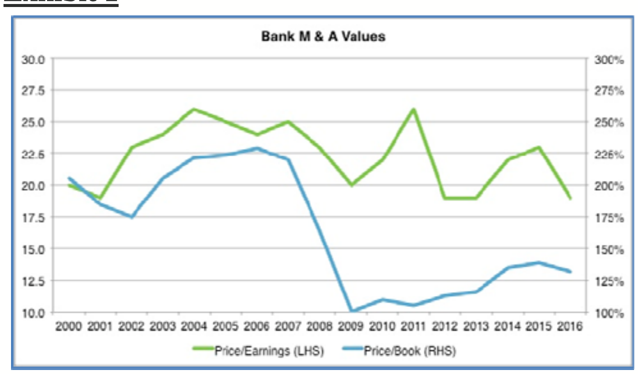
Consider the following chart *(see Exhibit 1)* showing bank acquisition prices compared to book value and to earnings during the 21st century. At the turn of the century, prices to book were elevated as banks generated above-average profits. These prices collapsed as the recession took hold in 2008 and are slowly recovering, albeit to levels consistent with the industry's now lower returns on equity.

The price-to-book value figures have ranged from a high near 230% just prior to the financial meltdown to a low of 100% as credit problems clocked bank earnings in 2009. Note, however, that price-to-earnings ratios were far more stable, ranging from 19x to 26x.

The most knowledgeable buyer of a bank is another bank because they not only know a great deal about the business but also have the opportunity to perform due diligence before putting their final offer on the table. The conclusion is clearly that earnings matter, and that book value pricing is a result rather than an input.

Mr. Jamesson goes on to consider the type of reports that a bank's ALCO typically reviews regarding interest rate risk including: a) <u>EVE Analyses</u>; b) <u>One-Year Simulation Models; and, Yield Curve.</u> Mr. Jamesson concludes from these observations that higher rates should result in lower economic value, but higher net interest income in the long run. If the two standard Alco models for interest rate risk are in conflict, it is important to determine which one is more in line with reality….

<u>Exhibit 1</u>



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To read this article in its entirety, see the March 2017 issue of our
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