

The House of Finance • 4th Quarter 2009

Newsletter Q4

- RESEARCH: Investment, Income, Incompleteness_4
- RESEARCH: Customer Equity Reporting as a Smart Way to More Transparency_6
- RESEARCH: Venture Capital Exit Rights_8
- INTERVIEW: The G20 Summit Pittsburgh – a Strong Signal for a Stable and Sustainable Global Financial System_10

CUSTOMER EQUITY REPORTING AS A SMART WAY TO MORE TRANSPARENCY



By Prof. Bernd Skierra, Manuel Bermes and Lutz Horn, Goethe University and E-Finance Lab

The financial crisis currently disrupting the economic system and banking worldwide often gets blamed on securitization. Banks, however, fundamentally need securitization due to liquidity, funding, capital and risk considerations. But they commonly use securitization also to manage their earnings streams by transferring loans and the credit risk of their loan portfolios to other investors. In return, the banks do not hold the loans until their maturity on their own books, but instead receive earnings from them directly at their net present value. As such, they do not follow the traditional “buy and hold” banking business model, rather they switch over to an “originate and distribute” model.

The move towards short-term profit realization at the expense of long-term value creation yields additional, largely ignored threats. The transformation of periodic loan payments into one down payment enables a bank to realize earnings immediately instead of over the lifetime of the loans. Basically, this corresponds with the behavior of soccer clubs, such as Schalke 04, which started selling revenues from future ticket sales to banks, and

whose coach only realized recently that the respective income would be lacking in upcoming periods. Ambiguous requirements for financial statements provide limited means for detecting such value shifts, and make the consequences of securitization for long-term value creation nontransparent – banks (as well as other firms) are not required to report future earnings. Instead, they generate incentives to use securitization excessively in order to boost short-term profits. Such a lack of transparency can lead to severe problems. For instance, supported by accounting rules, managers have incentives to adjust a bank's earnings streams through securitization to better reach personal goals. Unfortunately, the problems that arise from such shifts in profit realization continue to be largely ignored in current discussions of the financial crisis.

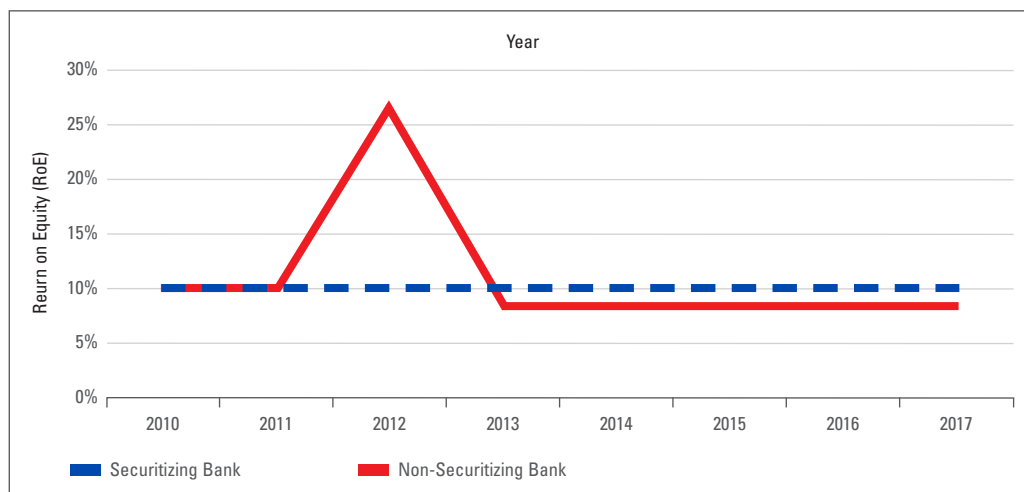
In our research, we analyzed 32 banks in the most important banking markets in the United States and Europe to determine how much information they provide about securitization in their financial statements. Our empirical results illustrate that many banks fail to provide sufficient transparency about their securi-

tization activities. Actually, only about 10% of the analyzed banks rudimentarily report the information required to detect a shift from long-term value creation towards short-term profit realization. This lack of transparency makes it difficult, if not impossible, for stakeholders to evaluate which earnings come from ongoing banking business and which result from the one-time effects of securitization. Hence, an evaluation of the consequences for long-term value creation has to be omitted.

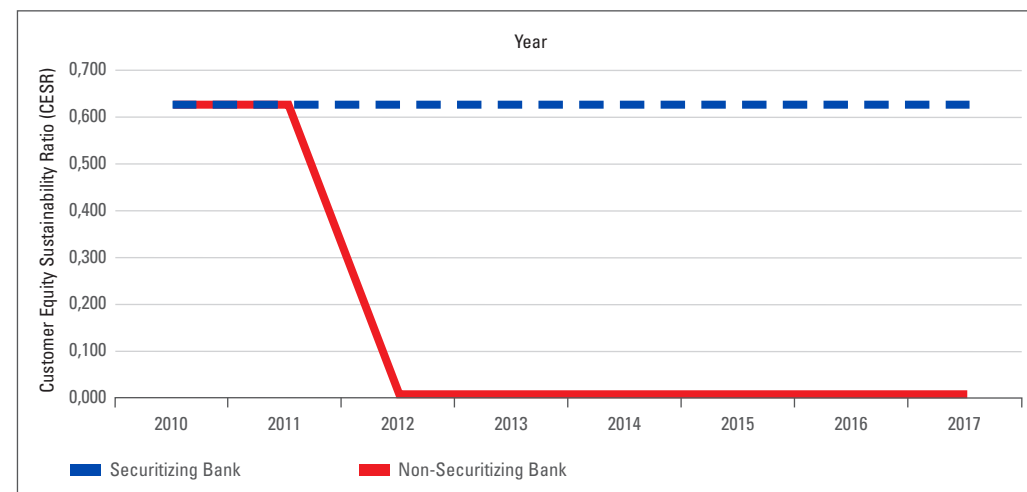
Customer equity reports, however, may offer a smart way of creating the transparency necessary in financial statements. Over the past decade, enough knowledge has been accumulated by research to calculate customer equity, i.e. the value of a customer base, so that the ignorance of future earnings now prevalent is no longer justified. Based on this approach, we propose two means of reaching more transparency.

■ **Customer Equity Reporting (CER)** provides stakeholders with valuable information about the long-term value of a bank's current customer base and its development

Securitization risks have turned down the economy. Yet, the current discussion has largely ignored the shift towards short-term profit realization at the expense of long-term value creation that is also inherent to securitization. This shift creates additional threats because it might cause a misperception of a bank's economic situation and its future profitability.



Graph 1: Return on Equity



Graph 2: Customer Equity Sustainability Ratio (CESR)

over time. Detailed customer structures with related earnings and costs in absolute numbers are published that allow for issuing forward-looking statements.

■ **The newly developed Customer Equity Sustainability Ratio (CESR)** compares the likely future profit of existing customers to corresponding current profits. It identifies shifts in value realizations over time and reports the sustainability of a bank's earnings as a relative number in a simple and substantial way.

Both means provide banks with an opportunity to offer stakeholders sufficient information regarding the time horizon of their business models without disclosing confidential information.

The results of our recent counterfactual analysis of Countrywide (US) show that this bank shifted from a situation in which approximately 75% of the value created is realized in the future towards one in which 80% of value creation is realized immediately.

In the numerical example shown in Graphs 1 and 2, we compare a non-securitizing bank with a securitizing one. In the non-securitization case, the bank generates a stable earnings stream and return on equity (RoE) from its long-term oriented loan portfolio. The securitizing bank, however, aims at increasing its RoE and starts securitizing all its loans in 2012. In this case, the bank already receives the earnings in the short-term, and realizes a significantly higher RoE in the relevant year. An investor who solely considers the RoE for

that year when assessing the bank's growth potential will overestimate its value if he fails to adjust for the inflationary effects of securitization.

However, as securitization per se neither creates nor destroys value, this short-term profit realization comes at the expense of long-term value creation. Additional value accrues only if securitizers and buyers differ in their valuation of underlying earnings. Thus, in the long-run, the RoE for the securitizing bank falls below that for the non-securitizing bank (Graph 1).

The Customer Equity Sustainability Ratio (CESR) enables the transparency required for long-term value creation. Graph 2 illustrates that the non-securitizing bank exhibits a con-

stant CESR while the securitizing bank's CESR drops to a minimal zero at the moment when all its earnings are securitized, indicating the shift towards short-term profit realization.

REFERENCES

Dechow, P. M., Shakespeare, C. (2009) "Do Managers Time Securitization Transactions to Obtain Accounting Benefits?", *The Accounting Review*, 84 (1), pp. 99–132

Franke, G., Krahnert, J. P. (2008) "The Future of Securitization", *Brookings Institution*, Washington.

Wiesel, T., Skiera, B., Villanueva, J. (2008) "Customer Equity: An Integral Part of Financial Reporting", *Journal of Marketing*, 72 (2), pp. 1–14