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THE FUNDAMENTAL
DETERMINANTS OF
RISK IN BANKING

by
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and
Philip R. Perry

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THE FUNDAMENTAL DETERMINANTS OF RISK IN BANKING

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1. Introduction and Overview

The operating risk in a bank can be precisely defined as the unpredictable variability of the present value of the bank. Risk is most commonly studied by observing changes in the earnings or worth of the firm. Such measures of risk, based as they are upon the bank's accounting practices, capture some aspects of risk accurately but overlook others. For example, changes in the market value of the bank's assets are imperfectly captured. Accounting measures of earnings also tend to smooth the time path of earnings and, in so doing, tend to obscure the fluctuations which can be used to establish the level of risk.

The market value of the bank's liabilities, at any point in time, is an estimate of the present value of the bank. The common stock is a large portion of the long-term capital of most banks, and it is that part with the greatest exposure to changes in the bank's present value. Since accurate measures of the market value of other bank liabilities are lacking, a study of the month-to-month variability in the outstanding value of the bank's common stock becomes a natural approach to measuring bank risk.

Two aspects of the risk of common stock are studied below. The first is the systematic risk, as measured by beta. The second is the residual variability, measured by the variance of the stock's residual or unsystematic return. A number of "descriptors" of the bank's operating characteristics are used as predictors for these two risk measures.

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Data on more than 100 banks for about 100 months are available; there are 11,219 data points in all. Predictive models for systematic and residual risk are fitted to this pooled cross-section time series.

The empirical results are quite satisfying. The estimated coefficients are generally consistent with our a priori expectations concerning the effects of a bank's operations upon its risk. The coefficients are estimated with fair precision, and a large number of the effects are statistically significant.

One important measure of the success of the prediction rule is the degree to which fundamental descriptors (descriptors of the operating characteristics of the bank) can substitute for historical risk measures as predictions of future risk. If all operating determinants of risk were perfectly captured, the historical risk measure would become redundant and would make an insignificant contribution to future prediction. Conversely, if the fundamental descriptors were inadequate, the historical risk measure would remain as an important predictor of future risk. In this study, the historical risk measures are only marginally significant and add very little to the explanatory power of the fundamental prediction rules.

Two other satisfying aspects of the estimated prediction rules are insensitivity to the time period selected and to the inclusion or deletion of various descriptors. We have estimated the models over several different time periods and found little change in estimated coefficients. Indeed, "Chow" tests of changed coefficients only weakly reject changes in the structure of the model. Also, the deletion of insignificant variables or of groups of variables of different types generally does not change the signs of the remaining coefficients. This makes it seem less likely that the coefficients of included variables are importantly influenced by surrogate effects for other variables which may have been excluded.

The results of the study may be useful in a number of ways. First, they provide prediction rules for investment risk that have potential usefulness in regulatory practice. Second, the information content of various descriptors is tested: some commonly used descriptors of operating characteristics are found to be important predictors of investment risk and others are not. Third, the risk coefficients for various asset and liability categories are a natural measure of the capital costs that should be associated with them.

The plan of the paper is as follows. Section II defines the components of risk. Section III explains the procedure used to fit prediction rules for systematic and re-
The exact formulas are given in the appendix to the paper. Section IV discusses the descriptors which have been employed. Section V explains the sample. Section VI reports the empirical results, and Section VII provides a conclusion.

II. The Components of Risk

The single-factor, market-index model of security returns has received widespread attention. It has the advantage of simplicity, and it exploits the fact that a large part of the covariance among security returns can be explained by a single factor analogous to a market index. Yet, in a pioneering study, King [5] concluded that there are important covariances among security returns beyond those attributable to an overall market factor. His conclusions are consistent with the beliefs of professional portfolio managers and security analysts, who generally agree that there are important components of security returns associated with the economic and financial characteristics of the firm. These components of return influence all (or almost all) firms having the associated characteristics and thereby induce correlations among the returns of different firms possessing such characteristics.

In a recent paper, Rosenberg [6] developed a multiple-factor model of security returns. This model implies a single-factor, market-index model of the usual form, which, however, possesses two additional interesting properties: (1) there exists a set of residual factors that contribute additional, or "extra-market," components of covariance among security returns; (2) the familiar beta coefficient (a measure of systematic risk) is a function of the parameters of the underlying multiple-factor model. With the additional assumption that both the specific risk and the factor loadings of the firm are linear functions of know characteristics of the firm, which can be represented by "descriptors" derived from accounting data and stock market price behavior, Rosenberg showed that it is possible to construct a set of transformed factors with loadings identical to the descriptors. These transformed factors may be directly estimated by ordinary regression. This approach—which is the one utilized in this paper—has the advantage of statistical simplicity, and it exploits such information as is available concerning the economic character of the factor loadings.

The single-index model of security returns provides a relationship between returns and two aspects of risk, systematic and specific; the multiple-factor model includes a
third type of risk, extra-market covariance. To make this terminology a bit clearer, consider the following explanations of the three types of risk that contribute to security returns—systematic risk, specific risk, and extra-market covariance.

1. **Systematic risk** arises from the tendency of the asset price to move along with the market index. The amount of systematic risk of any asset is sometimes called its "volatility." The measure of systematic risk is widely known as "beta." If beta is 1, then the asset price tends to fall in the same proportion that the market falls, other things being equal, and to rise by the same proportion that the market rises. If beta is 1.5, the asset price tends to fall (or rise) proportionally by one and one-half times as much as the market falls (or rises).

2. **Specific risk** is the uncertainty in the return of an asset that arises from events that are specific to that firm. It is that part of risk that is due to events in the firm that are unrelated—or, at most, distantly related—to events that impact other firms. A leading example of this kind of risk was provided by the sudden announcement of Franklin National Bank's troubles. The news had a disastrous effect on the prices of its common stock and other liabilities. Of course, the announcement also conveyed, by implication, some fresh news about the state of the economy and banking in general. The interrelationship was negligibly small in comparison to the changed values of Franklin's own liabilities. This aspect of risk has been called the "unique" risk or "independent" risk of the company.

3. **Extra-market covariance** is the remaining component of risk. It is manifested as a tendency for the prices of related assets to move together in a way that is independent of the market as a whole. An illustration is the tendency for money center banks to rise and fall together as the prospects of the group change, at times when the market may be moving in the other direction. The term "covariance" refers to the tendency of the stock prices to move together, or "covary." The adjective "extra-market" rules out that part of the tendency of assets to move together that is related to the market as a whole. Covariance within an industry group is intermediate between systematic and specific risk: systematic risk impacts all firms in some way, specific risk impacts only one firm, and industry-group covariance impacts a group of firms. Other forms of extra-market covariance may impact a very large number of firms; for example, a contractionary monetary policy may reduce the values of firms that have assumed much financial risk, at the same time that the market as a whole is rising because of favorable economic news. In this example, a large group
of firms, which cuts across industries, will be exposed to the change in monetary policy and will covary.

Residual return is the sum of specific return and return due to extra-market factors. It is called the "residual" return because, in a regression model to explain the security return as a function of the market return, it is the residual from the market return (the difference between the actual security return and the predicted value).

The remainder of this paper deals with the prediction of systematic and residual risk for banks. The decomposition of residual risk will be reported in a later paper.

III. Evaluating and Fitting Prediction Rules for Systematic and Residual Risk

With respect to systematic risk, we will consider the prediction of beta, which is the response coefficient that determines relative exposure to market risk. To predict beta successfully, it is necessary to discriminate between stocks that will tend to move substantially when the market moves and stocks that will move little. Figure 1 shows an instance of relatively successful beta prediction. On the horizontal axis are plotted the betas published by Merrill Lynch for roughly 700 companies with largest capitalization on December 31, 1972. Hereafter, the beta computed by this formula on any date will be called the "historical beta" as of that date and will be denoted by the two-letter symbol Hβ. On the vertical axis are plotted the returns to these common stocks in the next six months. This was a period when the market declined substantially, so that if the historical betas were correctly predictive, stocks with high Hβ should have declined more than stocks with low Hβ.

The figure clearly shows that this occurred. (The strength of this tendency is apparent when it is noticed that tightly clustered points are represented by integers (e.g., 7 indicates 7 cases).) The regression line through the data shows a pronounced downward slope, and the average returns for ten deciles of Hβ (shown as ten horizontal steps extending across the decile ranges) decline in an orderly fashion as Hβ increases. When the market falls, the results appear as in Figure 1. When the market rises, the results appear as if reflected about the axis of zero return: high Hβ stocks show greater positive returns; low Hβ stocks show smaller positive returns.

The criterion for a successful prediction rule for beta is that it accurately arranges stocks in proportion to the response to the market. The closer the fit of the predicted market response for the security to the actual security return, the better is the prediction. Each interval of market
Common Stock Returns 1/1/73 - 6/30/73 for 700 Large U.S. Companies Plotted Against 12/30/72 Historical Beta

Regression line $r = b_0 + b_1 (H^2 \beta_{i1})$, and average returns by beta deciles are shown as solid lines. The dashed line shows the expected relationship, under the basic capital asset pricing model, if $H^2 \beta$ were a perfect predictor of $\hat{\beta}$. 
movement provides an opportunity to test the accuracy of predictions available at the start of the interval. A succession of monthly intervals provides a long history of evaluations and hence an extensive examination of a prediction rule.

The solid line in Figure 1 is the line of best fit to the data. However, if we were actually predicting returns using HS, our predictions would lie along the dashed line. In the case of a stock with predicted beta of zero, predicted return is the riskless rate, which was roughly 4 percent over that six-month period. For other stocks, the predicted return equals the riskless rate plus beta times the market excess return. The measure of success is the degree to which the return predictions for individual stocks lying along the dashed line fit the actual returns. The measure of goodness of fit is the coefficient of determination or R-squared.

Although the regression line achieves a good fit, there remain large errors about the line. These errors are the manifestation of residual risk, or the residual returns of the stocks. Of course, the residuals are influenced by the predicted betas. If a better rule were used to predict betas, residuals would be typically smaller. Nevertheless, all of the improvements that appear to be possible in beta prediction achieve only a small reduction in the magnitude of the typical residual return. Further, we know, from a multitude of studies, that little of the variance of residual returns can be accounted for by means of security analysis predictions of mean returns. Hence, these residual returns are largely unpredictable elements of return. The problem of predicting residual risk is equivalent to the problem of predicting the expected magnitude (absolute value) of the residual return on a stock. If this expected magnitude is small, the residual risk is small—and conversely.

Figure 2 illustrates the prediction of residual risk. On the horizontal axis, the residual risk prediction, defined as the predicted standard deviation of residual return, or $\sigma$, is plotted. Stocks with higher levels of risk appear to the right. The vertical axis represents the absolute residual return for the stock. At several points, the expected frequency distribution of residual returns for stocks at that level of residual risk is drawn. Since the absolute value of residual return is under analysis, it will always be positive. The shape of the curve is that of half of a bell-shaped curve. Even for stocks with very high levels of risk, as in the probability distribution at the right, the least likely residual return lies at the bottom of the bell-shaped half curve, a residual return of zero.
Prediction of Cross-Sectional Differences in Variance

Typical probability distribution of $|r_{nt}|$, for three values of $\hat{\sigma}_{nt}$.

Probability distribution of all returns (a long-tailed mixture of the constituent distributions).
However, for high-residual-risk stocks, there is a possibility of very large residual returns, and so the distribution extends upward to the top of the page. For low-residual-risk stocks, with small \( \delta \), we expect a tightly bunched distribution of returns, as in the drawings nearer the vertical axis. The dashed line drawn in the figure plots the predicted mean absolute residual return. This is a constant proportion of the standard deviation (76 percent in the model that will be developed below). The small kink in the straight line near zero is explained in appendix A.

There is a natural statistical procedure to evaluate a prediction rule for residual risk. The dependent variable is the observed absolute residual return for the stock. The independent variables are predictions for the amount of residual risk. If the prediction is successful, then those stocks with high levels of predicted residual risk will show frequent large absolute residual returns, as in the distribution at the extreme right. Conversely, stocks having low levels of predicted risk will exhibit a tight distribution of residual returns, as in the distributions farther to the left. A suitably defined measure of goodness of fit for the regression, analogous to an R-square, summarizes the success of the prediction rule. This approach is explained in Section VI.

IV. The Descriptors: Information Sources Used in Risk Prediction

In an attempt to predict risk, one can draw on many different kinds of information. There are indications of future risk in the current balance sheet and income statement, such as proportions in various asset and liability categories, and operating margins. There are indications of the normal risk of the firm's operations in the historical variability of items in the income statement. When fluctuations obscure a policy of the firm, as in fluctuations over time in the payout ratio due to transitory earnings fluctuations, a historical average of the policy, such as a five-year cumulative payout ratio, is useful. Trends in variables measure the changing position of the firm and provide some indication of growth orientation. Variables capturing market judgment, expressed as ratios of market values to income-statement or balance-sheet variables, such as "leverage at market value," are often powerful indicators of the market's forecasts of the firm's prospects.

Another important item of information is the regional location and type (e.g., money center, New York, etc.) of the banks; we use indicator (dummy) variables for six such groupings. The final category of information is the behavior
of the market-price of the common stock. Table 1 lists the descriptors that we have used, along with a brief definition of each; detailed definitions are provided in Appendix B. Summary statistics for these descriptors are in Table 2.

The reader may complain that we are going too far afield in scrounging information from so many distinct sources. Why not restrict oneself to a historical measure of the aspect of risk in question? One justification is that it is important to ascertain the fundamental determinants of risk. And the second justification will be found in predictive performance.

A number of principles were observed in constructing the descriptors.

1. No descriptor was employed unless there were compelling a priori grounds to believe that it might be predictive of subsequent risk. Such descriptors were found in three categories:

(a) Historical statistics on past risk for the bank's stockholders: these may be viewed as estimates (subject to measurement error) of past underlying aspects of risk. As such, they are useful in predicting an aspect of subsequent risk to the degree that both the following conditions are satisfied:

(i) the historical estimate is an accurate estimator of the underlying aspect of past risk, not obscured by measurement error; and

(ii) that historical aspect of risk is correlated with the future aspect of risk that is to be predicted.

(b) Fundamental descriptors of the bank's operations and balance sheet, which economic theory leads us to believe are determinants of risk or correlated with risk. These may be subdivided into those that relate exclusively to business risk, those that relate exclusively to financial leverage, and those that measure the interaction of both.

(c) Indicators of the judgment of investors concerning the firm, which provide indirect measures of the bank's risk. Foremost among these are valuation ratios such as book/price and earnings/price (indicative of investors' expectations concerning the bank's future growth and success).

2. The second principle concerns the problem of multicollinearity. When a number of descriptors are included in the analysis, correlation among them will inevitably arise, and it will therefore be more difficult to discriminate among their effects. There is a remarkable widespread misunderstanding of the effects of multicollinearity in a multiple regression: many people believe that the presence of
### TABLE 1
THE DESCRIPTORS

#### A. Descriptors of Asset Mix

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>NCMKDA - the ratio of net commercial lending to assets</td>
</tr>
<tr>
<td>2</td>
<td>COMLNA - the ratio of commercial loans to assets</td>
</tr>
<tr>
<td>3</td>
<td>NCNLDA - the ratio of net consumer lending to assets</td>
</tr>
<tr>
<td>4</td>
<td>CONLNA - the ratio of consumer loans to assets</td>
</tr>
<tr>
<td>5</td>
<td>MUNIBA - the ratio of tax-exempt bonds to assets</td>
</tr>
<tr>
<td>6</td>
<td>RELNSA - the ratio of real estate loans to assets</td>
</tr>
<tr>
<td>7</td>
<td>ISECTA - the ratio of all investment securities to assets</td>
</tr>
<tr>
<td>8</td>
<td>TRDASA - the ratio of trading account securities to assets</td>
</tr>
</tbody>
</table>

#### B. Descriptors of Liability Mix

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>9</td>
<td>CONTDA - the ratio of consumer time deposits to assets</td>
</tr>
<tr>
<td>10</td>
<td>DEMNDA - the ratio of demand deposits to assets</td>
</tr>
<tr>
<td>11</td>
<td>NFFBA - the ratio of (net) federal funds borrowed to assets</td>
</tr>
<tr>
<td>12</td>
<td>FORDPA - the ratio of foreign deposits to assets</td>
</tr>
<tr>
<td>13</td>
<td>SAVEDA - the ratio of savings deposits to assets</td>
</tr>
<tr>
<td>14</td>
<td>TBORA - the ratio of total borrowings to assets</td>
</tr>
<tr>
<td>15</td>
<td>TICAPAS - the ratio of total capital to assets</td>
</tr>
<tr>
<td>16</td>
<td>TIMEDA - the ratio of time deposits (other than savings) to assets</td>
</tr>
</tbody>
</table>

#### C. Descriptors of Asset/Liability Characteristics

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>17</td>
<td>ATOLB - the ratio of assets to long-term liabilities (book value of equity, plus long-term debt)</td>
</tr>
<tr>
<td>18</td>
<td>BLEV - leverage, at book value: the ratio of the book value of (equity plus debt) to the book value of equity</td>
</tr>
<tr>
<td>19</td>
<td>DILU - potential dilution: the ratio of net income per share fully diluted to net income per share</td>
</tr>
<tr>
<td>20</td>
<td>DTOA - the ratio of total debt to assets</td>
</tr>
<tr>
<td>21</td>
<td>KMTMN - average maturity of tax-exempt bond portfolio, in months</td>
</tr>
<tr>
<td>22</td>
<td>KMTUS - average maturity of taxable bond portfolio, in months</td>
</tr>
<tr>
<td>23</td>
<td>KPDEP - the percentage depreciation in the bond portfolio: the ratio of the difference between bond portfolio market and book values to bond portfolio book value</td>
</tr>
<tr>
<td>24</td>
<td>RLTTL - the ratio of &quot;risky&quot; liabilities to long-term liabilities</td>
</tr>
</tbody>
</table>

#### D. Descriptors of Operating Characteristics

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>25</td>
<td>ATAX - the ratio of income taxes to pretax income, last 5 years</td>
</tr>
<tr>
<td>26</td>
<td>FFMTK - federal funds market-making activity: the ratio of the minimum of (federal funds purchased, federal funds sold) to assets</td>
</tr>
<tr>
<td>27</td>
<td>FLOI - the ratio of average cash flow to current liabilities</td>
</tr>
<tr>
<td>28</td>
<td>FRGNO - the ratio of foreign offices to total offices</td>
</tr>
<tr>
<td>29</td>
<td>PAYI - payout: the ratio of common dividends to earnings available for common the prior year, last 5 years</td>
</tr>
</tbody>
</table>
### E. Descriptors of Earnings Success

<table>
<thead>
<tr>
<th>Code</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>37</td>
<td>CUTC</td>
</tr>
<tr>
<td>38</td>
<td>DELE</td>
</tr>
<tr>
<td>39</td>
<td>DMNE</td>
</tr>
<tr>
<td>40</td>
<td>NRGIN</td>
</tr>
<tr>
<td>41</td>
<td>REVENA</td>
</tr>
<tr>
<td>42</td>
<td>ROEQ</td>
</tr>
</tbody>
</table>

### F. Descriptors of Growth

<table>
<thead>
<tr>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
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<tr>
<td>43</td>
<td>AGRO</td>
</tr>
<tr>
<td>44</td>
<td>DMSS</td>
</tr>
<tr>
<td>45</td>
<td>EGRO</td>
</tr>
<tr>
<td>46</td>
<td>OFFEX</td>
</tr>
<tr>
<td>47</td>
<td>RSKLGO</td>
</tr>
</tbody>
</table>

### G. Descriptors of Size

<table>
<thead>
<tr>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>48</td>
<td>ASSI</td>
</tr>
<tr>
<td>49</td>
<td>MKTS</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>50</td>
<td>HBET</td>
</tr>
<tr>
<td>51</td>
<td>BT5Q</td>
</tr>
<tr>
<td>52</td>
<td>HSIC</td>
</tr>
<tr>
<td>53</td>
<td>SGSQ</td>
</tr>
<tr>
<td>54</td>
<td>BS</td>
</tr>
<tr>
<td>55</td>
<td>BADJ</td>
</tr>
<tr>
<td>56</td>
<td>LPRH</td>
</tr>
<tr>
<td>57</td>
<td>RSTR</td>
</tr>
<tr>
<td>58</td>
<td>TREC</td>
</tr>
</tbody>
</table>

**I. Descriptors Dependent upon the Market Valuation of Common Stock**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>59</td>
<td>ATOLM</td>
<td>the ratio of assets to long-term liabilities (market value of equity, plus long-term debt)</td>
</tr>
<tr>
<td>60</td>
<td>BBET</td>
<td>&quot;Beaver&quot; beta: the regression coefficient taken from the regression of the normalized earnings-to-price ratio of the firm on the normalized earnings-to-price ratio of the economy</td>
</tr>
<tr>
<td>61</td>
<td>BTOP</td>
<td>the ratio of book value to market value of equity</td>
</tr>
<tr>
<td>62</td>
<td>CAPT</td>
<td>the (natural) logarithm of the market value of equity (in millions)</td>
</tr>
<tr>
<td>63</td>
<td>DMUL</td>
<td>a dummy variable indicating extremely low dividend yield</td>
</tr>
<tr>
<td>64</td>
<td>ENTP</td>
<td>the normalized earnings-to-price ratio</td>
</tr>
<tr>
<td>65</td>
<td>ETOP</td>
<td>the ratio of earnings to price</td>
</tr>
<tr>
<td>66</td>
<td>ETP5</td>
<td>the &quot;typical&quot; earnings-to-price ratio, last 5 years</td>
</tr>
<tr>
<td>67</td>
<td>LIQU</td>
<td>a measure of liquidity, equal to the ratio of (cash plus receivables less current liabilities) to the market value of equity</td>
</tr>
<tr>
<td>68</td>
<td>MLEV</td>
<td>leverage, at market value: the ratio of (market value of equity plus book value of debt) to the market value of equity</td>
</tr>
<tr>
<td>69</td>
<td>ECAP</td>
<td>the market value of equity (in millions)</td>
</tr>
<tr>
<td>70</td>
<td>PTEQ</td>
<td>the ratio of plant (fixed assets) to the market value of equity</td>
</tr>
<tr>
<td>71</td>
<td>YILD</td>
<td>the ratio of dividends paid to the market value of equity</td>
</tr>
<tr>
<td>72</td>
<td>YLD5</td>
<td>the &quot;normal&quot; value of dividend yield (over 5 years)</td>
</tr>
<tr>
<td>Code</td>
<td>Description</td>
<td></td>
</tr>
<tr>
<td>------</td>
<td>-------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td>73</td>
<td>DRYNY: a dummy variable indicating a New York money center bank</td>
<td></td>
</tr>
<tr>
<td>74</td>
<td>DRMNY: a dummy variable indicating a money center bank outside of New York</td>
<td></td>
</tr>
<tr>
<td>75</td>
<td>DRSE: a dummy variable indicating a southeastern bank</td>
<td></td>
</tr>
<tr>
<td>76</td>
<td>DRMW: a dummy variable indicating a midwestern bank</td>
<td></td>
</tr>
<tr>
<td>77</td>
<td>DRSW: a dummy variable indicating a southwestern bank</td>
<td></td>
</tr>
<tr>
<td>78</td>
<td>DRWC: a dummy variable indicating a west coast bank</td>
<td></td>
</tr>
</tbody>
</table>

*See Appendix B for detailed descriptor definitions.*
### TABLE 2

**SUMMARY STATISTICS OF THE DESCRIPTORS FOR THE JUNE 1977 CROSS SECTION**

<table>
<thead>
<tr>
<th>Descriptor</th>
<th>Minimum Value</th>
<th>Equal-Weighted Mean</th>
<th>Maximum Value</th>
<th>Capitalization-Weighted Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 NCMALDA</td>
<td>-1.1475</td>
<td>0.1460</td>
<td>.4120</td>
<td>.1239</td>
<td>0.844</td>
</tr>
<tr>
<td>2 COMLNA</td>
<td>.1057</td>
<td>0.2333</td>
<td>.3837</td>
<td>.2298</td>
<td>0.557</td>
</tr>
<tr>
<td>3 NCMALD</td>
<td>-.6350</td>
<td>-0.2385</td>
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There are the number of banks in each group.
multicollinearity results in bias in estimated coefficients, 
or estimated standard errors, or both. This is not true. 
The regression provides an unbiased indication of the coe-
ficients for (partial derivatives with respect to) the de-
scriptors, and of the degree to which these are accurately 
estimated in spite of the correlation with other descrip-
tors. The t-statistics for the estimated coefficients pro-
vide a reliable test of the wisdom with which descriptors 
were constructed. With this in mind, we were not excessive-
ly afraid of multicollinearity.

On the other hand, when two descriptors are highly cor-
related, it becomes difficult to distinguish their effects; 
consequently, every effort was made to anticipate correla-
tions in advance, and to construct well-differentiated de-
scriptors that would exhibit significant variation relative 
to one another. For instance, instead of employing a mul-
titude of financial ratios, we designed one or two which 
were believed to be the best measures of that aspect of fi-
nancial condition. When two measures of the same conceptual 
variables were employed, it was always for one of two rea-
sons: sometimes both measures were subject to independent 
measurement errors, so that a weighted average of the two 
would be a more accurate estimator of the underlying con-
cept than either separately; sometimes we were uncertain a 
priori which would be the better descriptor, recognizing 
that the two definitions were clearly substitutes for one 
another, and relied on the regression to discriminate be-
tween the two. The latter was the case for four descriptors 
(NCHLDA, NCMLDA, FLOL, PAVI). Two definitions of each were 
employed in the early stages, and the best was chosen for 
the subsequent analysis.

3. The third principle was the requirement that each 
descriptor be valid across the entire cross section of 
banks. We were careful to operationalize our concepts 
through formulas that would be applicable to all cases. 
This aspect of our approach is best explained by an illus-
tration of its violation: In many studies, the chosen meas-
ure of earnings growth blew up when earnings were negative, 
with the result that all banks that had had negative earn-
ings had to be excluded from the sample; in contrast, we 
ever deleted an observation because a computational formu-
la failed. As another instance of this principle, we only 
employed descriptors for which there were available data 
for the majority of our sample.

4. A fourth principle was the search for robust formu-
las—in other words, for formulas that yielded reasonable 
descriptors for the conceptual variable regardless of the 
peculiar historical circumstances of the bank. This prin-
ciple led in many cases to the use of five-year averages,
to smoothed values, or to the need for a truncation rule that wiped out otherwise extreme values. In general, the goal was a formula that would always produce a value that seemed reasonable when the raw data were examined.

5. A fifth principle was a variant of Occam's razor: When alternative formulas for a conceptual variable were available, and the difference in their validity was expected to be small, we chose the formula which was more familiar to professionals in the field of finance.

6. A sixth principle was that the descriptors were transformed to obtain a model that was linear. We attempted to transform descriptors and to draw in extreme outliers, so that the relationship between risk and the descriptors would be linear. In all cases, histograms of the descriptors were constructed to verify that the descriptor's range was appropriate and that a linear relationship would make sense. Only in the cases of historical beta, historical sigma, and capitalization (descriptors that have important predictive content for risk, and for which the relationship is clearly nonlinear) did we include several functions of the variables as descriptors in order to obtain a nonlinear relationship.

7. A seventh and final principle was that we relied on a priori judgment wherever possible. In other words, we attempted to select the descriptors on the basis of economic theory and in conformity with the above-mentioned principles. Then, we computed the values of each descriptor and examined them across a sample population to check for robustness and reasonability. We examined the correlation matrix among descriptors and redefined them in a few cases where extreme correlations showed up. Only after this was done were the descriptors introduced into a regression where any aspect of risk was the dependent variable.

Another important issue concerns the treatment of extreme or outlying values of the descriptors. No matter how robust a formula is, a few extraordinarily low or high values for banks in peculiar circumstances may be generated. Sometimes the formula is so constructed that these values represent equally extreme states of the underlying characteristic: In this case, the descriptor should be left as it is. But in other cases, the extreme values exaggerate the differences between the bank and the population of banks with ordinary values. In this case, it is appropriate to "pull in" the extreme value toward a more ordinary one. The reasoning behind this is that the bank really does not differ much from the group of banks at the boundary of the commonly observed region for the descriptor, so that the descriptor for this bank should be set equal to the value at the boundary.
This can be done by defining a lower and upper bound for the descriptor and redefining all values that fall outside the bounds to equal the bounds. Any value that falls below the lower bound is transformed to equal the lower bound; any value that is above the upper bound is transformed to equal the upper bound. This process may be called "Windsorizing," or, to use a more familiar but less specific term, truncation. For the majority of descriptors, the truncation criteria have been expressed in terms of multiples of the cross-sectional standard deviation among all banks. This means that values falling more than some number (5, for example) of cross-sectional standard deviations above the capitalization-weighted mean will be set equal to that upper bound.

The outcome of all this is that the descriptors seem to be fairly satisfactory. First, they appear to be meaningful in comparison across the full range of normal banks; this applies both within a cross section and in comparisons of the same bank over time. Second, the outlying cases have tended to coincide with a difficult period for the bank in question. Thus, the descriptors have proved to be accurate indicators of extreme risk.

Some descriptors which may indicate banks with potential or clear-cut problems are listed in Table 3, along with the banks so indicated (as of June 1977). In general, these outliers are quite far from the mean—the values for ROE, ETP, ETOP, and MLEV, for example, ten standard deviations. Two variables, DMNE and DMYL, are dummy variables; the outliers here are values of one. It is interesting to note that of all twelve descriptors, five are calculated from only accounting data (BLEV, PNCV, VERN, DMNE, ROE), one is a descriptor of market price variability (HSIG), and the remaining six utilize both accounting data and the market valuations of common stock. We feel that these findings are potentially important and deserve further study.

V. Procedure

Our primary data source is the COMPUSTAT bank tapes [1] which contain data on 124 large U.S. banks. Both the annual and quarterly tapes were used, although the only information taken from the latter was the monthly closing price of the common stock. A few additional items were drawn from the Keefe Bank Manuals [4]. Because of the pattern of data availability, the present study begins in March 1969 and continues through June 1977; this gives us a total of 11,219 data points, each being a monthly observation of a bank.
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<tr>
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\(^a\)See table 3B for bank identification.

\(^b\)A value of one.
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<td>99</td>
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The first step is to compute, for each of the thirty-four quarters, the value of each descriptor for each bank in the sample, as it could have been computed at the beginning of that quarter. It is important to note that data are used for any quarter only if they would have been available at the start of that quarter. Data related to the stock market are presumed to be published immediately. Annual accounting data are not presumed to become available until four months after the end of the fiscal year; this allows for the ninety-day reporting delay and thirty more days for the data to be assembled into machine-readable form. This procedure insures that an observer could actually have computed these descriptors at the start of each quarter.

The sample of banks for any quarter is made up of all banks; any descriptor which is unavailable for a particular bank is assumed to be equal to the average value of that descriptor for that cross section. For each of the three months in the quarter, the monthly subsample is made up of all banks for which stock price returns in that month are available. These stock price returns are analyzed in relation to the descriptors computed as of the beginning of the quarter. Thus, three monthly samples are predicted with each set of descriptors, in conformity with a prediction rule that is revised quarterly and is based upon previously published information.

The model and the estimation procedure used are described in detail in Appendix A. Several interesting points which should be noted are:

1. The estimation approach is iterative, in that the prediction rule for beta is estimated first; this is then used to define the dependent variable for the sigma prediction rule regression.

2. Generalized Least Squares is used to account for heteroscedasticity. The resulting prediction rules are more statistically efficient.

3. The prediction rules are estimated simultaneously for all individual banks in all time periods, through a pooled time-series, cross-sectional regression.

4. The beta prediction rule is conditional upon the market return (the CRSP RETV index [3]), and the sigma prediction rule is conditional upon the typical cross-sectional standard deviation of residual return in any given month.

The study adhered strictly to the principles of experimental design. All procedures were specified in advance of examining the returns to be predicted. This was done to insure that the study would be self-validating. Otherwise, there would be no assurance that the results were likely to persist into the future.
VI. Empirical Results

As a preliminary to the multiple-regression results, Table 4 reports the simple regressions of investment risk on each of the descriptors. The predictive content of each descriptor, taken separately, is given for beta and for sigma. Since the multiple regression is not used, the predictive content of each descriptor includes its role as a surrogate for all other descriptors, as well as its own intrinsic relevance.

The t-statistics for the relationships and the relative order of importance of the descriptors are interesting. For beta, the single most powerful predictor is HRET, the historical estimate of beta. The second and fourth best predictors are, respectively, BS, the geometric average of the historical estimates of beta and sigma, and ETSQ, the square of HRET. The third most effective is ASSI, which measures the total assets of the bank: the larger the bank, the greater its beta. The fifth most important is the "relative strength" (RSTR) of the bank in the preceding year: the better the past market performance of the common stock, the lower the expected beta. Sixth is YLD5, the "normal" dividend yield. Seventh is total equity (market) capitalization (CAPT). Eighth is AGRO, the asset growth rate: the higher this growth rate, the higher the bank’s beta. Next is a measure of leverage, the ratio of total assets to long-term liabilities or capital, valued at book (ATOLB). Tenth is ETP5, the bank’s "typical" earnings-to-price ratio: the higher this ratio (or the lower the price-earnings ratio), the lower the bank’s beta.

For residual standard deviation, or sigma, the two most important descriptors are measures related to historical sigma (USIG, SGSQ). The third is the historical variability of earnings (VERN), while the fourth is related to historical sigma and beta (BS). Fifth is the logarithm of the price of the common stock (LPRI): the higher the price, the lower is sigma. Two different measures of leverage in the capital structure (MLEV and BLEV) are sixth and eighth in importance: the greater the leverage—whether calculated using book or market value of equity—the greater the residual variance. Seventh is a measure of "accounting beta" (ABET), and ninth is ETP5: the higher this ratio, the lower is sigma. Finally, historical beta (HRET) is tenth.

It is significant that those descriptors with the highest predictive content for beta are not the same as those for sigma; only three (HRET, ETP5, BS) are among the top ten for both beta and sigma. Thus, not only are systematic risk and residual risk fundamentally different aspects of
### TABLE 4

INDIVIDUAL DESCRIPTORS AS PREDICTORS OF SYSTEMATIC AND RESIDUAL RISK

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<thead>
<tr>
<th>Descriptor</th>
<th>Prediction of Beta</th>
<th></th>
<th></th>
<th>Prediction of Sigma</th>
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<td>t-statistic</td>
<td>Order of Importance</td>
<td>Coefficient</td>
<td>t-statistic</td>
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a For beta, the coefficient gives the adjustment to predicted beta for a unit change in the descriptor. For sigma, the coefficient gives the adjustment to the relative value of sigma (i.e., sigma ÷ cross-sectional average sigma) for a unit change in the descriptor.

b For purposes of interpretation, it is also useful to know the change in the dependent variable implied by a one-standard-deviation shift in the descriptor, i.e., the coefficient with respect to a normalized descriptor. This adjusted coefficient is obtained by multiplying the reported coefficient by the descriptor's standard deviation, which is given in Column 5 of Table 2.

c This is the R² statistic for the simple GLS regression in which the descriptor is the only information used to predict risk, with 11217 degrees of freedom. The critical point for the 99% confidence level is 2.58. The larger the absolute value of the t-statistic, the larger is the predictive content of this descriptor when used alone. The R² (coefficient of determination) achieved by each descriptor alone is proportional to the squared t-statistic.

c This is the rank of the descriptor, among all descriptors, in terms of explanatory power, with 1 being the highest. The asterisks denote the top ten.
the overall risk of a bank, but they are, in addition, determined by different aspects of the bank's operational characteristics.

Table 5 reports the results of regressions for beta, using descriptors of assets and liabilities. Using the simplest model of the investment risk of a portfolio of assets and liabilities, the systematic risk of the net portfolio (excluding capital accounts) is a linear function of the proportions in asset and liability categories, with coefficients that reflect the systematic risks of the various categories. The systematic risk of the shareholders' equity is then obtained by multiplying portfolio systematic risk by the leverage ratio, and is consequently a nonlinear (inverse) function of the proportion of long-term capital. However, for simplicity, we first estimated a model for beta as a linear function of asset and liability proportions. (The coefficient of the equity proportion in this equation can be interpreted as the first-order term in a Taylor expansion, and is therefore expected to be negative.)

Relationships including asset and liability proportions as descriptors were first estimated alone, and then with one added descriptor of the size of the institutions: ASSI, the logarithm of total assets. The total asset variable is highly significant: the coefficient is positive for beta and negative for sigma. The coefficients of asset and liability proportions generally change very little as ASSI is brought into the regressions. The major exception is in the coefficient of foreign deposits (FORPDA), which is positive for beta and negative for sigma when ASSI is excluded, and reverses sign in both cases when ASSI is brought into the regression. Clearly, the proportion of foreign deposits is a surrogate for bank size. The general insensitivity of other coefficients to inclusion of ASSI is a sign that multicollinearity is absent. To save space, the results are reported for only one set of regressions, those including ASSI.

The regressions for beta in Table 5 are of the form

\[
\text{predicted } \beta = \text{constant } + \sum_{j=1}^{J} b_j \left( \frac{\text{dollars in asset/liability category } j}{\text{total assets}} \right).
\]

The regressions for sigma in Table 6 are of the form

\[
\frac{\text{predicted } \sigma}{\text{average } \sigma} = \text{constant } + s_{\text{ASSI}} \left( \ln(\text{total assets}) \right).
\]
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<th>Liabilities Only</th>
<th>All Asset/Liability Descriptors</th>
<th>With Net Asset/Liability Descriptors</th>
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<td>-.355 (.251)</td>
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<td>.302 (.135)</td>
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<tr>
<td>3 NCMILDA</td>
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<td>.302 (.135)</td>
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The standard error of each coefficient is given in parentheses.
The asset categories and liability categories are mutually exclusive, but not exhaustive. The coefficients $b_i$ (or $s_i$) are not the beta (or sigma) levels for the categories, but rather are adjustments to the otherwise normal beta (or sigma) for a bank due to the category. The essential content of the results lies in the differences between any pair of coefficients $b_i$ and $b_j$ (or $s_i$ and $s_j$). If funds are moved from category $i$ to category $j$, the difference in coefficients gives the expected effect on risk. For example, if 1/10 of a bank's liabilities are shifted from net federal funds borrowed (NFFBA) to demand deposits (DEMNDA), the effect on risk can be found by comparing the coefficients for these two categories. For beta, $b_{\text{NFFBA}} = .849$ and $b_{\text{DEMNDA}} = -.645$. The difference in beta is $(.849) - (.645) = 1.494$. A shift of 1/10 of liabilities from NFFBA to DEMNDA would cause 1/10 of this change, or a reduction in beta by .1494. For sigma, the difference is 1/10 $[(-.562) - (-.239)] = -.080$. This is interpreted as a reduction in residual standard deviation (sigma) equal to .080 (8.0%) of average sigma. Of course, these computed values are only estimates, but the relatively small standard errors for the coefficients allow us to place some confidence in the results, as being representative of the sample period in which the model was estimated.

The first regression in Table 5 predicts beta based upon asset proportions. Tax-exempt bonds (MUNIBA) and to a lesser degree consumer loans (CONLNA) are found to be high beta categories, while investment securities other than tax-exempts (ISECTA) and the trading account (TRDASA) are found to be very low beta, and real estate loans (RELNSA) and commercial loans (COMLNA) are moderately low beta. The standard errors of the estimated coefficients are typically small relative to the estimated magnitudes.

The second regression includes liabilities only. Consumer time deposits other than passbook savings (CONTDA) is a high beta category, and net federal funds borrowed (NFFBA, the excess of borrowing over lending on the federal funds market) is moderately high beta. Demand deposits (DEMNDA) are relatively low beta. Shareholders' equity (TCAPA) greatly reduces beta, as is to be expected.

The third regression brings in both assets and liabilities. When compared to the two previous regressions, there are no changes in sign among the assets, and several changes in sign involving insignificant magnitudes in the liabilities. The stability of coefficients suggests that each
group of variables is not an important surrogate for the opposite category.

The final regression uses alternative measures of the portfolio, which rely on net differences between asset and liability groups rather than the separate amounts in the categories. Net consumer lending (NCNLDA), for example, equals consumer lending (CONLNA) plus real estate loans (RELNSA) less passbook savings (SAVEDA) and consumer time (CONTD). The original reasoning behind the definition of these net activities was that interest rate and liquidity risks of the paired asset and liability categories were similar, so that the net would be a parsimonious measure of exposure. As expected, the loss in explanatory power due to replacement of asset/liability categories by the nets is relatively small (Table 9 below). For consumer lending the net category is bound to be overly simplistic, for it lumps together real estate loans, a very low beta category, with consumer lending, a relatively high beta category. It probably would have been better to net consumer lending (CONLNA) against consumer time deposits other than passbook (CONTD) and to net real estate lending against passbook deposits.

Table 6 reports the regressions for sigma. It is interesting to compare these regressions with the beta regressions. The sigma regressions are estimated with substantially greater accuracy: the typical standard error is about one-half as great as for beta. This generally occurs when the same data base is used to estimate systematic risk and residual risk, because the data are more informative concerning residual risk (a variance), than concerning systematic risk (a covariance).

Comparison of the asset/liability regressions for the two aspects of risk is also instructive. Equity capital and demand deposits are in both cases the two most risk-reducing liabilities. Conversely, net federal funds borrowing is a major risk-enhancing liability in both. However, two liability categories differently effect beta and sigma: consumer time deposits (CONTD) and foreign deposits (FORDPA) negligibly affect sigma, but each variable has a substantial estimated effect on beta. Foreign deposits are estimated as reducing beta, as is natural, since the covariance of their profitability with the economy might be expected to be low. Consumer time deposits are the highest-beta liability.

On the asset side, consumer lending (CONLNA) is a high-risk category in both cases; the trading account and investment securities (TRDASA, ISECTA) are the lowest and second or third lowest in risk in the two cases. The risk contributions of municipal bonds (MUNIBA) are opposite in the two cases: municipal bonds are a far higher risk as regards beta, and a far lower risk as regards sigma.
TABLE 6*  
ASSET/LIABILITY DESCRIPTOR REGRESSIONS FOR SIGMA

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<th>All Asset/Liability Descriptors</th>
<th>With Net Asset/Liability Descriptors</th>
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<td>(.168)</td>
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<td>-.069</td>
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<td>(.013)</td>
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*The standard error of each coefficient is given in parentheses.
The coefficient of asset size (ASSET) remains to be discussed. It is negative and virtually constant in all regressions for sigma and positive and virtually constant in all regressions for beta. The coefficient for beta is quite similar to the simple regression coefficient, but the coefficient for sigma is larger in magnitude than the simple.

Table 7 reports regressions including all fundamentals. In addition to those relating to asset and liability proportions and total assets, descriptors of asset ratios, and of the operating characteristics and income statement of the bank are added. The coefficients of the first sixteen descriptors are directly comparable with the estimates in Tables 5 and 6. The sign of an estimated effect that is significant in one or the other table never changes as a result of including the other fundamentals. The insensitivity of signs and magnitudes of estimated effects to the added fundamentals is another encouraging indication of low multicollinearity.

A number of descriptors of operating characteristics are significant in the prediction of residual risk but only one is in the prediction of beta. Among the significant descriptors in prediction of residual risk, most signs are plausible: the higher the effective tax rate (ATAX), the lower the residual risk; the greater the ratio of average cash flow to liabilities (FLOW), the lower the residual risk; the greater the payout ratio (PAY), the lower the residual risk; the greater the earnings variability (VERN), the higher the residual risk; and the greater the covariance of earnings with economywide earnings (ABET), the higher the residual risk. However, one effect is puzzling: the greater the apparent probability that fixed charges will not be covered (PNCD), the lower is the predicted residual risk. Obviously, the reverse sign is the one to be expected. The simple regression coefficient was positive and highly significant. Apparently this variable is interacting with other measures of leverage. Also, the degree of variability in capital structure (VCAP) was expected to be predictive of higher residual risk but, in fact, has a significant negative coefficient. Finally, one significant effect was not clearly predictable from our a priori expectations: the extent of federal-funds-market-making activity (FFMKT) is found to be predictive of lower residual risk. This suggests that an active market maker can better control its destiny. The reverse sign would have suggested that market making leads to increased uncertainty, due to speculative risk from unpredictable short-term movements in the federal funds market.

In prediction for beta, only one of these descriptors of operating characteristics achieves significance. The
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<td>3.120**</td>
<td>5.432**</td>
</tr>
<tr>
<td>59 ATOLM</td>
<td>-.061</td>
<td>-.061</td>
</tr>
<tr>
<td>60 BRET</td>
<td>.0055</td>
<td>.0055</td>
</tr>
<tr>
<td>61 BTOP</td>
<td>.047</td>
<td>.047</td>
</tr>
<tr>
<td>62 CAPT</td>
<td>.208***</td>
<td>.352***</td>
</tr>
<tr>
<td>63 DNMY</td>
<td>.250</td>
<td>.250</td>
</tr>
<tr>
<td>64 ENTP</td>
<td>.061</td>
<td>.061</td>
</tr>
<tr>
<td>65 ETP5</td>
<td>1.464**</td>
<td>.673</td>
</tr>
<tr>
<td>66 LIQU</td>
<td>-.061</td>
<td>-.061</td>
</tr>
<tr>
<td>67 MQY</td>
<td>.000400***</td>
<td>.00048***</td>
</tr>
<tr>
<td>68 MLEV</td>
<td>-.061</td>
<td>-.061</td>
</tr>
<tr>
<td>69 YLD5</td>
<td>3.120**</td>
<td>5.432**</td>
</tr>
<tr>
<td>70 YLD5</td>
<td>-.061</td>
<td>-.061</td>
</tr>
</tbody>
</table>

*aSignificance levels, as derived from the appropriate F-statistic, are denoted as follows: *, 95%; **, 99%; ***, 99.9%.*
signs of the effects are typically the same, with the exception of PNCV and VCAP, where the expected positive signs occur, and VERN, where the expected positive sign is contradicted by a small negative coefficient.

Turning next to measures of earning success, the indicator for previous dividend cuts (CUTD) is a highly significant predictor of both higher systematic risk and higher residual risk. Operating margin (MARGIN) is predictive of lower systematic and residual risk. The ratio of operating revenue to total assets (REVENA) is likewise predictive of lower residual and systematic risk. Return on equity (ROE) is predictive of higher risk.

No measures of earnings growth are consistently important, although the indicator for an available earnings history is marginally predictive of higher systematic risk with a negligible effect on sigma. Of the two measures of size, only ASSI (asset size) achieves significance. The coefficients are somewhat greater in magnitude than they were in the previous regressions with asset/liability characteristics only, probably because of an interaction with the size of market capitalization descriptor (CAPT), to be discussed below. The coefficient for asset size (ASSI) in prediction of beta has changed sign and lost significance. Again, this is probably the result of interaction with the coefficient for market capitalization.

Finally, we come to measures of financial ratios and other characteristics which are dependent on the market valuation of common stock, taken in conjunction with income-statement and balance-sheet data. Here the nature of the effects must be interpreted with some care. First, the dummy variable for negligible yield (DNVL) is predictive of greater risk, as is to be expected. However, current yield is significantly predictive of higher risk. When this is contrasted with the negative coefficient for the five-year normal yield and for the payout ratio, it may be interpreted as a surrogate for a recent decline in the bank's circumstances. Current yield is defined as the ratio of the previous year's dividends to current price. This ratio is often high, relative to the payout ratio, because of a recent pessimistic adjustment in the future prospects of the bank, which causes a reduction in the denominator (price), but is not yet reflected in the numerator (last year's dividends). Thus, a high value of current yield, relative to past yield, often indicates that the circumstances of the bank have recently declined and is thus predictive of greater risk.

The same pattern of signs is seen in the earnings/price ratio. The normal earnings/price ratio (ETP) is predictive of lower risk or, equivalently, a high price/earnings ratio is predictive of higher risk. This is consistent with a
general property of growth-oriented firms, which is that the longer the apparent duration of the promised stream of future dividends, the greater is investment risk. The sign of the current earnings/price ratio (ETOP) is also negative for sigma, but it is positive for beta. This last effect can possibly be understood again as indicating that the decline in the present price is reflective of a downward adjustment in future prospects, relative to recent earnings.

Greater liquidity (LIQU) is predictive of lower residual risk and has a smaller effect upon systematic risk. Finally, greater market capitalization (CAPT) is predictive of higher risk. It is important to note here that (1) there is a substantial positive correlation (approximately .72 in our sample) between CAPT, the logarithm of market capitalization, and ASSI, the logarithm of total assets; and (2) their difference (ASSI - CAPT) is the logarithm of "the market valuation of each dollar of assets." This difference is thus a measure of the manner in which the bank is operated. Consequently, a positive coefficient for CAPT, in conjunction with a negative coefficient for ASSI, suggests that greater expected profitability with a given asset base results in higher risk.

Finally, Table 8 reports the regression coefficients for the six dummy variables which bring in the regional characteristics of the banks. The regressions show that the typical New York money-center bank is much higher in systematic risk than the norm, but a little bit below normal in residual risk. West Coast banks are next highest in systematic risk and also a little above the norm in residual risk. The Southeastern banks are significantly above normal in both the risk measures. All of the earlier regressions, reported in Tables 5-8, were also run in an alternative mode with regional dummy variables included. Happily, when the fundamental characteristics of banks are included, the regional dummies lose significance: the group as a whole generally lacked statistical significance (by the F-test), and when the regional variables were considered singly, only the dummy variable for the Southeast region was usually significant, with a small positive coefficient. Thus, most of the regional differences in systematic and residual risk can be attributed to various fundamental characteristics of the banks.

Table 9 reports the overall adjusted R² statistics for the regressions in the earlier tables. In addition, adjusted R² are reported for certain regressions of special interest which incorporate historical risk measures, as well as fundamental descriptors. The first row of the table relates to the assumption that all banks have identical risk
TABLE 8

REGRESSIONS WITH ONLY THE REGIONAL-TYPE DUMMY VARIABLES

<table>
<thead>
<tr>
<th>Descriptor</th>
<th>Beta Prediction Rule</th>
<th>Sigma Prediction Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>73 DRYN</td>
<td>.239***</td>
<td>-.035</td>
</tr>
<tr>
<td>74 DRMON</td>
<td>.083</td>
<td>.0048</td>
</tr>
<tr>
<td>75 DRS</td>
<td>.135***</td>
<td>.116***</td>
</tr>
<tr>
<td>76 DRW</td>
<td>-.055</td>
<td>-.070**</td>
</tr>
<tr>
<td>77 DRSW</td>
<td>.031</td>
<td>.041</td>
</tr>
<tr>
<td>78 DRWC</td>
<td>.217***</td>
<td>.095**</td>
</tr>
</tbody>
</table>

*Significance levels, as derived from the appropriate F-statistic, are denoted as follows: *, 95%; **: 99%; ***: 99.9%.

TABLE 9

SUMMARY OF ADJUSTED R² STATISTICS

<table>
<thead>
<tr>
<th>Independent Variables</th>
<th>Regression for:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Beta</td>
<td>Sigma</td>
</tr>
<tr>
<td>Constant</td>
<td>.2594</td>
<td>.0887</td>
</tr>
<tr>
<td>Historical estimate</td>
<td>.2659</td>
<td>.1052</td>
</tr>
<tr>
<td>Historical estimate for beta and Bayesian adjustment thereto</td>
<td>2.675</td>
<td>---</td>
</tr>
<tr>
<td>All market price variability descriptors</td>
<td>2.755</td>
<td>.1096</td>
</tr>
<tr>
<td>Asset proportions and asset size</td>
<td>.2671</td>
<td>.0929</td>
</tr>
<tr>
<td>Liability proportions and asset size</td>
<td>.2673</td>
<td>.0933</td>
</tr>
<tr>
<td>All asset/liability proportions and asset size</td>
<td>.2690</td>
<td>.0959</td>
</tr>
<tr>
<td>Net asset/liability proportions and asset size</td>
<td>.2685</td>
<td>.0954</td>
</tr>
<tr>
<td>Selected fundamentals (including market valuation descriptors)</td>
<td>.2830</td>
<td>.1222</td>
</tr>
<tr>
<td>All fundamentals (including market valuation descriptors)</td>
<td>.2829</td>
<td>.1235</td>
</tr>
<tr>
<td>All descriptors</td>
<td>.2852</td>
<td>.1321</td>
</tr>
</tbody>
</table>
levels in each period. $R^2$ in the predictive regression for 
beta is .2594, indicating that this proportion of the vari-
ance of monthly bank common stock returns can be attributed 
to a common and identical dependence on the overall market 
return. $R^2$ for the corresponding assumption for the predic-
tion of sigma is .0887, indicating that this proportion of 
the variance in the average absolute residuals in the pooled 
cross-section time series can be attributed to month-to-
month differences in cross-sectional average residual vari-
ability.

The second row refers to the attained $R^2$ when the only 
descriptor is the historical estimate of the risk measure 
(beta and sigma, respectively). Next is the $R^2$ achieved in 
prediction of beta, where a Bayesian adjustment term for 
measurement error in historical beta is included along with 
the historical beta. The fourth row of the table gives re-
sults when all market-price-variability descriptors are in-
corporated.

The second section of the table gives $R^2$ for the var-
ious regressions including asset/liability descriptors and 
asset size. The third section reports the regressions in-
cluding all fundamental variables. The final row reports 
the regressions including all descriptors.

It is encouraging that the regressions including all 
fundamentals but no others (i.e., market-price-variability 
descriptors are omitted) achieve nearly the same $R^2$ as the 
regressions that include the market-price-variability de-
scriptors as well. The increase in $R^2$ from use of all de-
scriptors is .0258 (.2852 -.2594) for beta, and .0434 
(.1321 -.0887) for sigma. The prediction rule for beta based 
on all fundamentals attains 90 percent of this increase, 
while the prediction rule for sigma attains 80 percent.

Thus, the measures of the behavior of the stock price in 
the market add little to our ability to predict its subse-
quent variability in the market. Moreover, the fundamentals 
taken alone do substantially better than the market-price-
variability descriptors taken alone. Since the market-
price-variability descriptors include the natural Bayesian 
predictions from historical data, this result suggests that 
the explanatory power of the fundamental descriptors is 
fairly complete. Otherwise, the historical descriptors 
would serve as surrogates for the omitted fundamental vari-
able and would achieve substantial importance in the pre-
diction of systematic and residual risk. Because of the 
small significance of the market-price-variability descrip-
tors, we chose to save space by omitting the tables refer-
ing to these regressions. It is sufficient to note that, 
in general, inclusion of the market-price-variability
descriptors did not importantly affect the signs or significance of the fundamental variables.

The regressions reported thus far are related to the period from March 1969 through June 1977: thirty-three quarters and one partial quarter, or 100 months. We also had available to us less complete data on a smaller sample of banks for a longer history (forty-five quarters). We divided this longer history into two intervals and fitted separate regressions to each interval to investigate the stability of the coefficients. Tests for significant changes in the structure of coefficients were either insignificant or barely exceeded the 99 percent critical level. This was encouraging in indicating that the structure of the risk relationships has not substantially changed in the recent past.

VII. Conclusions and Implications

The central conclusion of the study is that systematic and residual risk in banks can be predicted from predetermined fundamental data. Prediction rules estimated in this way can serve a useful function in monitoring bank risk. The predictive significance of fundamental descriptors serves as a measure of the appropriateness of the descriptor as an indicator of risk, and hence as a target for regulation. For example, alternative formulas for capital adequacy can be validated and compared in terms of their predictive content.

The descriptors used in this study were restricted to the limited coverage of the COMPSTAT data base and Keefe manual. It was not possible to test the various capital-adequacy formulas that are now used, since some data were missing. However, a number of natural descriptors of balance sheet, income statement, and operating variance could be computed. Some of these were found to be indicative of serious bank difficulties, in the sense that they produce substantial outliers when bank circumstances were aberrant. Perhaps more important, after the effect of the outliers was diminished by truncation of extreme values, the transformed descriptors were predictive of differences in risk across the full continuum of banks in the sample.

The fundamental descriptors were quite successful in predicting differences in risk. A large number of descriptors were statistically significant. The historical measures of market-price variability added little to the explanatory power of the fundamentals. The fundamental information, taken as a group, explains more than the market-price-variability data.
Interestingly, the predictors of systematic and residual risk differ importantly. Only three of the ten best simple predictors of beta are also included among the ten best simple predictors of residual risk, and two of these are historical measures of market variability. Among the important simple fundamental predictors of beta are descriptors of size, dividend yield, equity capitalization, and the asset-to-long-term-liability ratio. The most important simple predictors of residual risk are earnings variability, leverage in the capital structure (with common stock valued at book and market), and a measure of accounting beta. In the multiple-regression models, the signs of descriptors are generally the same for prediction of beta and residual risk, but the relative magnitudes are often significantly different.

Several aspects of the results are suggestive. For example, size (best measured by total assets or, alternatively, measured by market share or total value of common stock) is a good single predictor of beta: the larger the size of the bank, the higher the expected systematic risk. However, in the multiple-regression models, size is only one among a number of important descriptors and loses its dominant role. Thus, the larger banks are clearly more exposed to systematic risk in the economy, but most causes for this exposure are captured by other descriptors in the model.

It is interesting that net federal funds borrowed (NFFBA) is a predictor of increased risk in regressions for both beta and sigma (statistically significant for beta), but that federal funds market-making activity (FFMKT) -- defined as the volume of offsetting borrowing and lending -- is predictive of lower risk (significant for sigma). This suggests that measures of risk based on the gross amount of federal funds borrowed are incorrect. Instead, net borrowing, being predictive of higher risk, should be used as an indication of increased leverage.

It is also interesting that the ratio of long-term debt to total assets is predictive of lower risk, confirming that long-term debt is a stabilizing influence that can be regarded as an element of capital. However, from the point of view of variability of the common stock price, senior liabilities constitute a leveraging device that increases investment risk, and it is not surprising that leverage due to senior long-term liabilities, whether measured in terms of the book value of capital (BLEV) or the market value of capital (MLEV), is a good simple predictor of increased risk. In the multiple regressions, BLEV is the more important descriptor. The two measures of leverage which are the best simple predictors of beta are the ratio
of total assets to long-term liabilities (ATOLB) and the ratio of risk liabilities to long-term liabilities (RILTTL). These are also effective simple predictors of residual risk. However, in the multiple regressions, with a number of other highly correlated leverage descriptors present, ATOLB is less significant and the coefficient of RILTTL changes sign.

No single descriptor in the model fully captures the profitability of the bank. One can think of profitability as the product of two ingredients: revenue per dollar of assets (REVENAL) and operating profit per dollar of revenue (MARGIN). The former is a simple predictor of increased risk, but the sign changes in the multiple regressions for beta and sigma. Operating margin (MARGIN) is consistently a predictor of reduced risk, presumably due to the fact that the bank's assets are being managed more effectively. The extent of prior dividend cuts (DIVCUT) is another strong and consistent predictor of increased risk, which amplifies the effect of operating margin.

It is natural, from the point of view of capital asset theory, to assign capital costs for assets and liabilities in relation to the contribution of the item to systematic risk. For this purpose, the adjustments for systematic risk obtained from Table 5 are the appropriate estimates. For example, the beta coefficients for municipal bonds and for real estate loans differ by $1.724 - (-0.737)] = 2.461.

In a typical bank, after correction for the leverage in the capital structure, the beta of municipal bonds is estimated to be 2.461 greater than for real estate loans. Since the contribution to beta per dollar of assets in municipals significantly exceeds the contribution to beta from real estate loans, the capital cost assessed per dollar of municipal investment should be correspondingly greater. Investment securities other than municipals and trading account securities show up as other low-beta assets. On the liability side, capital accounts, demand deposits and foreign deposits show as low-beta liabilities, and consumer time deposits and net federal funds borrowed show as high-beta liabilities.

A number of measures of aggressiveness in the bank’s growth policy show up as predictive of higher risk, particularly in regard to residual risk. These include the normal payout ratio and normal yield (both indicators of lower retention rates and hence of lower growth), which are predictive of lower risk, and the growth rate of total assets, predictive of higher residual risk.

Having discussed the prediction of differences in risk, mention should be made of the absolute risk levels in our sample of banks. Natural measures of risk are averages of beta, computed relative to the CRSP RETV index over a sixty-
month history, and the average residual standard deviation (sigma) in these regressions. The sample average beta, with each bank weighted by the market value of outstanding common stock (market capitalization), was .71 for the sixty-month period ending in January 1977. The equal-weighted average increased similarly, from .63 to .96. For residual risk, defined as the standard deviation of monthly residual returns, the capitalization-weighted average increased from .051 in the early period to .072 in the latter, while the equal-weighted average increased from .054 to .068. These increases signal increased difficulty in bank regulation. Increased systematic risk in the banking system raises the probability of widespread disaster, however small the probability may be, since the aggregate net worth of all banks is more unstable. Increased residual risk is associated with more frequent difficulties for individual banks, independent of the economy as a whole. The prevention of failure has become more difficult, and the insurance liability has grown because of the higher probability that extreme returns will occur as a result of the intrinsic uncertainty in the bank's operations.
APPENDIX A: THE MODEL USED

The Model and Definitions

The following definitions will be used:

- \( t = 1, \ldots, T \) the month, varying from 1 to \( T \)
- \( n = 1, \ldots, N \) the index of the individual bank, varying from 1 to \( N \)
- \( j = 1, \ldots, J \) the index of an individual descriptor, with \( J \) descriptors
- \( (1 + i_{Mt}) \) the riskless return in month \( t \), defined as the 4-6 month prime commercial paper rate at the start of that month
- \( (1 + i_{nt}) \) the market return in month \( t \). We use the CRSP Retv (value-weighted returns), including dividends
- \( r_{nt} = \ln(1 + i_{nt}) - \ln(1 + i_{Mt}) \) the logarithmic excess return for the market index, closely similar to the arithmetic excess return \( i_{Mt} - i_{Mt} \)
- \( r_{nt} = \ln(1 + i_{nt}) - \ln(1 + i_{Mt}) \) the excess logarithmic return relative on security \( n \)
- \( x_{jnt} \) the value of the \( j \)th descriptor for bank \( n \) in month \( t \).

In each month \( t \), let the probability distribution of logarithmic return relatives be determined by the model:

\[
    r_{nt} = \alpha + \beta_{nt} r_{Mt} + e_{nt}, \quad n = 1, \ldots, N_t
\]

with \( \alpha \) = overall average excess return, approximately zero

- \( \beta_{nt} \) = systematic risk coefficient of bank \( n \) in month \( t \)
- \( e_{nt} \) = residual return of bank \( n \) in month \( t \)
- \( N_t \) = number of banks in month \( t \).

Let the model for \( \beta_{nt} \) be:

\[
    \beta_{nt} = b_0 + b_1 x_{1nt} + \ldots + b_J x_{Jnt},
\]

for all time periods \( t \) and banks \( n \), where \( b_0, \ldots, b_J \) are the coefficients of the prediction rule for systematic risk. Let
\[ E(e_{nt}) = 0, \quad \text{Cov}(e_{nt}, r_{Mt}) = 0 \quad \text{for all} \quad t, \]

and let \( \sigma^2_{nt} \) be the residual variance of \( e_{nt} \). The model for the standard deviation is:

\[ \sigma_{nt} = s_t \left( s_0 x_{nt} + s_1 x_{1nt} + \ldots + s_J x_{Jnt} \right), \]

where \( s_t \) is the typical cross-sectional standard deviation in month \( t \) and \( s_0, \ldots, s_J \) are the coefficients of the prediction rule for residual risk.

Define:

\[ \delta_{nt} = E(|e_{nt}|), \quad \text{the mean absolute residual return for security} \quad n \quad \text{in month} \quad t \]

\[ \gamma = \frac{\sigma_{nt}}{\delta_{nt}}. \quad \text{It may be shown that} \quad \gamma = \sqrt{1+c^2(|x|)} \]

when \( E(x) = 0 \), where \( c(|x|) \) is the coefficient of variation of \( |x| \).

Then the model for residual risk can be rewritten as:

\[ \delta_{nt} = \bar{s}_t \left( s_0 x_{nt} + s_1 x_{1nt} + \ldots + s_J x_{Jnt} \right), \]

where \( \bar{s}_t = \frac{1}{T} (s_t) \) is the typical mean absolute residual in month \( t \).

The Estimation Approach

Each regression is run over the pooled sample of all data points \( n \) in all months \( t \). The estimation proceeds in two passes: Each pass consists of two forms of regression. The first is a "market-conditional" regression for beta. In pass 1, it takes the form:

\[
(1) \quad r_{nt} = \alpha + b_1 (x_{int} r_{Mt}) + b_2 (x_{2nt} r_{Mt}) + \ldots + b_J (x_{Jnt} r_{Mt}) + e_{nt} \quad n=1, \ldots, N_t \quad t=1, \ldots, T
\]

This regression provides preliminary estimates of the prediction rule for beta, with coefficients \( b_1, b_2, \ldots, b_J \).
Then, for each bank in each month, a preliminary predici-
tion of beta is computed as:

\[
\hat{\beta}_{nt} = \hat{\beta}_1 x_{1nt} + \ldots + \hat{\beta}_J x_{Jnt}.
\]

These preliminary predictions for beta are substituted to
obtain predictions of residual returns defined as:

\[
\hat{e}_{nt} = r_{nt} - \hat{\beta}_{nt} r_{nt}.
\]

The next regression is fitted to estimate residual risk. It
takes the form:

\[
\frac{\hat{\epsilon}_{nt}}{\bar{\sigma}_t} = s_1(x_{1nt}) + s_2(x_{2nt}) + \ldots + s_J(x_{Jnt}) + \epsilon_{nt},
\]

\[
\bar{\sigma}_t = \frac{\sum_{n=1}^{N_t} w_{nt} |\hat{e}_{nt}|}{\sum_{n=1}^{N_t} w_{nt}},
\]

where \( w_{nt} \) is the capitalization weight for bank \( n \) at
time \( t \), equal to the proportion of the market value of all
stocks in that bank. Thus, \( \bar{\sigma}_t \) is the capitalization-
weighted, cross-sectional average of absolute residual returns. This regression obtains the preliminary prediction rule for relative specific risk, with estimated coeffi-
cients \( \hat{s}_1, \ldots, \hat{s}_J \).

Pass 2 involves repetition of each of these equations
using generalized least squares. To accomplish generalized
least squares, each observation is weighted inversely to its
disturbance variance. In this model, the disturbance var-
iance is proportional to the variance of the bank's resid-
ual return in both regressions! Therefore, we compute for
each bank \( n \) in each month \( t \) a prediction of residual
risk provided by:

\[
\hat{\sigma}_{nt} = \gamma \hat{\sigma}_t (\hat{s}_0 + \hat{s}_1 x_{1nt} + \ldots + \hat{s}_J x_{Jnt}).
\]

To avoid extremely small predicted variances, \( \hat{\sigma}_{nt} \) is set
equal to \((1/3)\gamma \hat{\sigma}_t\) if the prediction for relative standard
deviation is less than (1/3); hence the kink in Figure 2. Then the market-conditional regression for beta is repeated, with observations divided by their predicted residual risk:

\[ r_{nt}/\sigma^2_{nt} = \alpha \left( 1/\sigma_{nt} \right) + b_0 \left( r_{Mt}/\sigma_{nt} \right) + \ldots + b_I \left( \frac{x_{Int} r_{nt}}{\sigma_{nt}} \right) + e_{nt} \]

These weights obtain estimates that are efficient in the statistical sense of maximal accuracy. The intuitive meaning of the weights is best understood by noting that banks with low residual risk are given greater weights than banks with high residual risk, with the weights in proportion to \( 1/\sigma_{nt}^2 \). Also, the weights vary over time periods due to fluctuations in \( \bar{\sigma}^2_t \): A cross section with the highest level of residual variance is given about one-sixth the weight of a cross section with a very low level of residual variance. Predictions for systematic risk in Tables 4, 5, 7, and 8 were obtained from Type B regressions.

The fitted betas from the Type B regression are used to recompute the estimates of residual returns \( e_{nt} \). With these modified residual returns, the next step is to carry out the second-pass regression for residual risk:

\[ \frac{|e_{nt}|}{\sigma^2_{nt} \sigma_t} = \alpha \left( \frac{x_{Int}}{\sigma_{nt}} \right) + \ldots + \beta_I \left( \frac{x_{Int} \sigma_{nt}}{\sigma_t} \right) + e_{nt} \]

Notice that the same weights are used here as in the prediction rule for beta. Predictions for residual risk in Tables 4, 6, 7, and 8 were obtained from Type R regressions.

The rationale behind this estimation approach is derived in detail in Rosenberg and Marathe [8]. The only changes in the present approach, relative to the approach set forth in that paper, are (i) the ignoring of extra-market covariance in the second-pass generalized least squares regression for beta, and (ii) the use of a regression for absolute residual returns rather than for squared residual returns in the Type R regressions for residual risk. The first change simplified the computational procedure and will be reconsidered if time permits. The second change was taken in part because, in the presence of the slightly long-tailed distributions of security returns that we find, the use of absolute residual returns should slightly improve statistical efficiency.
APPENDIX B

DESCRIPTOR DEFINITIONS

Please note the following:

(1) We have utilized the CRSP RETV (value-weighted returns, including dividends), obtained from the Center for Research on Security Prices at the University of Chicago, as the market return for all descriptors dependent upon the market (e.g., HMET).

(2) We have decided that for some COMPSTAT variables, "unavailable" is essentially equivalent to unimportant; if these variables are unavailable, they are therefore set at zero, and the calculations described herein are then carried out. These variables are:
Cash and due from banks
Trading account securities
       Federal funds sold and securities purchased under
       agreements to resell
Total demand deposits
Consumer-type time deposits
Total savings deposits
Money market certificates of deposit
Total time deposits (other than savings)
Federal funds purchased and securities sold under
       agreements to repurchase
Mortgage indebtedness
       Acceptances executed by or for the account of this
       bank and outstanding
       Total liabilities (excluding valuation reserves)
Capital notes and debentures
Preferred stock—par value
Number of foreign offices
In addition, the COMPSTAT variable "number of domestic offices" is set equal to one if it is unavailable.

(3) For many of the descriptors, we have included a brief discussion of the rationale for the definition. To conserve space, we have omitted discussions whenever we felt the rationale was relatively clear.

(4) The terminology of the Compustat data base documentation is used to identify data items in most cases.
1. **NCMLDA**  
   **Net Commercial Lending to Assets**  
   (commercial or industrial loans)  
   - (money market certificates of deposit)  
   - (net federal funds purchased and securities sold under agreements to repurchase)  
   \[ NCMLDA = \frac{(\text{commercial or industrial loans})}{\text{total assets}} \]  
   **Availability criterion:** current data.

2. **CONLNA**  
   **Commercial Loans to Assets**  
   (loans to financial institutions)  
   + (loans for purchasing or carrying securities)  
   + (commercial or industrial loans)  
   \[ \text{CONLNA} = \frac{(\text{commercial or industrial loans})}{\text{total assets}} \]  
   **Availability criterion:** current data.

3. **NCNLDA**  
   **Net Consumer Lending to Assets**  
   (real estate loans, total)  
   + (loans to individuals for household, family, and other consumer expenditures)  
   - (total savings deposits)  
   - (consumer-type time deposits or total time deposits, other than savings, or 0)  
   \[ \text{NCNLDA} = \frac{(\text{real estate loans, total}) + (\text{loans to individuals for household, family, and other consumer expenditures}) - (\text{total savings deposits}) - (\text{consumer-type time deposits or total time deposits, other than savings, or 0})}{\text{total assets}} \]  
   **Availability criterion:** current data.

4. **CONLNA**  
   **Consumer Loans to Assets**  
   loans to individuals for household, family, and other consumer expenditures  
   \[ \text{CONLNA} = \frac{(\text{loans to individuals for household, family, and other consumer expenditures})}{\text{total assets}} \]  
   **Availability criterion:** current data.

5. **MUNIBA**  
   **Ratio of Tax-Exempt Bonds to Assets**  
   obligations of states and political subdivisions  
   \[ \text{MUNIBA} = \frac{\text{obligations of states and political subdivisions}}{\text{total assets}} \]  
   **Availability criterion:** current data.
6. RELNSA  
   Ratio of Real Estate Loans to Assets  
   \[ \text{RELNSA} = \frac{\text{real estate loans}}{\text{total assets}} \]
   
   Availability criterion: current data.

7. ISECTA  
   Ratio of Investment Securities to Total Assets  
   \[ \text{ISECTA} = \frac{\text{total investment securities}}{\text{total assets}} \]
   
   Availability criterion: current data.

8. TRDASA  
   Ratio of Trading Account Securities to Assets  
   \[ \text{TRDASA} = \frac{\text{trading account securities}}{\text{total assets}} \]
   
   Availability criterion: current data.

9. CONTDA  
   Consumer Time Deposits to Assets  
   \[ \text{CONTDA} = \frac{\text{consumer-type time deposits}}{\text{total assets}} \]
   
   Availability criterion: current data.

10. DEMDFA  
    Demand Deposits to Assets  
    \[ \text{DEMDFA} = \frac{\text{total demand deposits}}{\text{total assets}} \]
    
    Availability criterion: current data.

11. NFFBA  
    Net Federal Funds Borrowed to Total Assets  
    \[ \text{NFFBA} = \frac{\text{(federal funds purchased and securities sold under agreements to repurchase) \ - (federal funds sold and securities purchased under agreements to resell)}}{\text{total assets}} \]
    
    Availability criterion: current data.

12. FORDPA  
    Foreign Deposits to Assets  
    \[ \text{FORDPA} = \frac{\text{total foreign deposits}}{\text{total assets}} \]
    
    Availability criterion: current data.
13. SAVEDA Ratio of Savings Deposits to Assets
   \[
   \text{SAVEDA} = \frac{\text{total savings deposits}}{\text{total assets}}
   \]
   Availability criterion: current data.

14. TBORA Ratio of Total Borrowings to Assets
   \[
   \text{TBORA} = \frac{\text{total borrowings}}{\text{total assets}}
   \]
   Availability criterion: current data.

15. TCAPA Ratio of Total Capital to Assets
   \[
   \text{TCAPA} = \frac{\text{total capital accounts}}{\text{total assets}}
   \]
   \[
   \text{and minority interest}
   \]

16. TIMEDA Ratio of Time Deposits to Assets
   \[
   \text{TIMEDA} = \frac{\text{total time deposits}}{\text{total assets}}
   \]
   \[
   \text{other than savings}
   \]
   Availability criterion: current data.

17. ATOLB Assets to Liabilities, Book Value
   \[
   \text{ATOLB} = \frac{\text{total book value (of equity)}}{\text{total assets}}
   \]
   \[
   + (\text{capital notes and debentures})
   \]
   Availability criterion: current data.

18. BLEV Book Leverage
   \[
   \text{BLEV} = \begin{cases} 
   \text{total book value (of equity)} & \text{if } 0 \leq \text{BLEV} < 10 \\
   \text{+ long-term debt} & \text{otherwise}
   \end{cases}
   \]
   \[
   \text{where long-term debt is defined under VCAP.}
   \]
   Availability criterion: current data on all items.

Discussion: In theory, the business risk of the company is transferred to common stockholders to a degree that is magnified by financial leverage. On the other hand, recognizing this, management tends to reduce financial leverage when business risk is high. Thus, in a comparison across firms, high
financial leverage may or may not be indicative of higher investment risk. However, to the degree that other descriptors in the analysis capture differences in business risk, the role of financial leverage as a surrogate for business risk will disappear, and it will remain as a predictor of investment risk directly attributable to financial leverage.

19. DILU Potential Dilution

\[
\text{DILU} = \begin{cases} 
\text{net income per share, including extraordinary items, fully diluted} \\
\text{net income per share, including extraordinary items} \\
0 \text{ if the above ratio is less than 0} \\
1.2 \text{ if the above ratio is greater than 1.2}
\end{cases}
\]

\textbf{Availability criterion:} current data.

\textbf{Discussion:} This descriptor is the dilution factor arising from outstanding convertible senior securities, options, and warrants. A high value is indicative of past aggressive financial policy and hence greater risk. On the other hand, the presence of overhanging convertible assets may reduce fluctuations in common stock price, since the price may be held near the conversion ceiling.

20. DTOA Total Debt to Assets

\[
\text{DTOA} = \frac{\text{(long-term debt) + (debt in current liabilities)}}{\text{total assets}}
\]

where: (1) long-term debt is defined under VCAP, (2) debt in current liabilities = (other liabilities for borrowed money) + maximum of \{[0], [[federal funds purchased and securities sold under agreements to repurchase] - (federal funds sold and securities purchased under agreements to resell)]\}.

\textbf{Availability criterion:} current data.

\textbf{Discussion:} This descriptor measures the proportion of the book value of debt to the book value of assets.
As such, a higher value indicates that there may not be adequate liquidation value in the firm's assets to pay off debt and hence suggests a danger of bankruptcy with its attendant costs. The validity of the descriptor is limited by the accuracy of the book value of total assets as an estimate of their market value, but intra-industry comparisons—such as those we are dealing with here—may be fairly reliable.

21. KMTMN Average Maturity of Tax-Exempt Bond Portfolio (Keefe Data)

\[ KMTMN = \text{average maturity, in months, of the tax-exempt bond portfolio} \]

Availability criterion: current data or most recent data.

22. KMTUS Average Maturity of Taxable Bond Portfolio (Keefe Data)

\[ KMTUS = \text{average maturity, in months, of the taxable bond portfolio} \]

Availability criterion: current data or most recent data.

23. KPDEP Percentage Depreciation in the Bond Portfolio (Keefe Data)

\[ KPDEP = \left( \frac{\text{market value} - \text{book value}}{\text{book value}} \right) \]

Availability criterion: current data or most recent data.

24. RLTLTL Ratio of Risky Liabilities to Long-Term Liabilities

\[ RLTLTL = \frac{\text{(acceptances executed by or for the account of this bank and outstanding)} + \text{(total time deposits, other than savings)} + \text{(other liabilities for borrowed money)} + \text{maximum of \{0, [(federal funds purchased and securities sold under agreements to repurchase) - (federal funds sold and securities purchased under agreements to resell)\]}}} {\text{(mortgage indebtedness) + (capital notes and debentures) + (preferred stock-par value) + (total book value)}} \]
25. **ATAX**  
Applicable Federal Tax Rate  
\[ \text{ATAX} = \frac{\sum_{i=-4}^{0} (\text{income taxes})}{\sum_{i=-4}^{0} (\text{pretax income})} \]

where the sums are over the last five years. The descriptor is truncated at an upper bound of 0.55 and a lower bound of 0.

**Availability criterion:** one year's data.

**Discussion:** This descriptor gives the percentage of cumulative pretax earnings that has been paid out as tax. A high value for any one bank is indicative of past success, for a lower value would result if major write-offs were available to obtain tax reductions. Another interpretation of the variable is as an indicator of the conservatism of management, with a lower value suggesting the use of tax-reducing schemes or subsidiaries. The availability of tax-exempt bonds makes this descriptor less clear-cut for banks than for industrials. Nevertheless, a higher value is suggestive of a lower level of risk.

26. **FFMKT**  
Federal Funds Market-Making Activity  
\[ \text{FFMKT} = \frac{\text{minimum of \{[(federal funds purchased and securities sold under agreements to repurchase), [federal funds sold and securities purchased under agreements to resell]\} \}}{\text{total assets}} \]

**Availability criterion:** current data.

27. **FLO1**  
Average Cash Flow to Current Liabilities

\[ \text{FLO1} = \begin{cases} 
\text{average cash flow} & \text{current liabilities} \\
5 & \text{if FLO1 would otherwise be } > 5 \\
-5 & \text{if FLO1 would otherwise be } < 5 
\end{cases} \]

where: (1) the average is taken over the last five years,  
(2) cash flow = (net income or net income available for common) + (provision for loan losses) + (furniture and equipment depreciation, rental cost, servicing, etc.),
(3) current liabilities = (other liabilities for borrowed money) +
maximum of \{0, \{(federal funds purchased and securities sold un-
der agreements to repurchase) -
(federal funds sold and securities purchased under agreements to re-
sell)\}\} + (acceptances executed by or for the account of this bank
and outstanding) + (money market certificates of deposit).

**Availability criterion:** In the numerator, data for at
least 2 years must be available; "available" here
implies that all three components must be available
in any given year for that year's data to be con-
sidered available. The denominator must be avail-
able.

**Discussion:** This descriptor is a measure of the li-
quidity of the firm's current financial position.
A low value indicates that cash flow may not be ade-
quate in relation to current liabilities.

28. FRGNO  Proportion of Foreign Offices

\[
FRGNO = \frac{\text{number of foreign offices}}{\text{(number of domestic offices) + (number of foreign offices)}}
\]

**Availability criterion:** current data.

29. PAY1  A Measure of Normal Payout in the Last 5 Years

\[
PAY1 = \begin{cases} 
0 & \text{common dividends} \\
-1 & \text{earnings available for common} \\
1 & \text{if PAY1 would otherwise be nega-
tive}
\end{cases}
\]

where both pieces of data must be available
before current dividends and previous year's
earnings enter the summation.

**Availability criterion:** one year of data and a non-
zero denominator.

**Discussion:** The payout ratio was proposed by Beaver
et al. as an accounting-based risk measure. Low
payout ratios are identified with high risk through-
out the security-valuation literature. Firms with
high payout ratios are expected to be more stable, and stocks of such firms should bear more resemblance to fixed-income investments than do stocks of low payout firms. This is not surprising, since a low payout company must provide returns to its shareholders through the earnings on new projects financed by new investment, rather than from the ongoing income of existing projects. The returns from new projects are presumably less easy to forecast and more sensitive to changing economic circumstances than those from existing projects.

30. Estimated Probability of Noncoverage of Fixed Charges, Using a Trended Value for Current Operating Income

\[
PNCV = \begin{cases} 
1 & \text{if } [(\text{fixed charges}) - (\text{forecasted operating income})] > 3\sigma \\
0 & \text{if } [(\text{fixed charges}) - (\text{forecasted operating income})] < -3\sigma \\
\frac{z}{\sigma} & \text{otherwise,} \\
\end{cases}
\]

where: (1) \( z(x) = \text{PROB}[N(0,1) < x] \) is the cumulative standard normal distribution.
(2) \( \sigma \) = the standard error of operating income over the last 5 years;
\[
\sigma = \sqrt{\frac{\sum_{t=1}^{5} (X_t - \bar{X})^2}{N - 1}}^{1/2}
\]
(3) "Forecasted operating income" = \( \frac{\sum_{t=1}^{N} X_t}{N} \) + 2(TREND) and
\[
\text{TREND} = \frac{\frac{1}{N} \sum_{t=1}^{N} (X_t)(\bar{X})}{\frac{1}{N} \sum_{t=1}^{N} (X_t)^2}
\]
with:
(a) \( X \) = operating income
(b) \( t \) = yearly index; \( t=1,2,3,4,5 \)
(c) the sums are over the last 5 years
(d) \( N \) is the number of years for which data exist.
(4) Operating income = current operating earnings before income tax.
(5) Fixed charges = (interest on capital notes and debentures) + (preferred dividend deductions).

Availability criteria: (1) "fixed charges" must be available in the current year;
(2) "Operating income" must be available at least 4 of the last 5 years.

Discussion: This descriptor is an estimate of the probability that operating income will be smaller than fixed charges in the coming year. This estimation is accomplished by fitting a normal distribution for operating income, with mean equal to the current value on a 5-year trend of operating income, and with standard deviation equal to the standard deviation about trend of operating income in the past 5 years. Then the probability in the lower tail of this distribution lying below current fixed charges is computed. As such, a high value for this descriptor is an indication of poor coverage of fixed charges, and thus of default risk from the conjunction of business risk and financial leverage.

31. SALTOR  
Ratio of Salaries and Related Expenses to Total Revenues

\[ \text{SALTOR} = \frac{\text{salaries and wages of officers and employees} + \text{pension and employee benefits}}{\text{total current operating revenue}} \]

Availability criterion: current data.

32. TRDVRA  
Ratio of the Variability of Trading Account Income to Assets

\[ \text{TRDVRA} = \frac{1}{100} \left[ \frac{\sum_{t=-4}^{0} (x_t - \bar{x})^2}{N - 1} \right] \]

where: (1) \( x \) = trading account income
(2) \( N \) = number of available data points.

Availability criterion: four years of data.

33. VCAP  
Variability in Capital Structure
\[
V_{\text{CAP}} = \begin{cases} 
0 & \frac{\left(\text{total book value}\ (t-1) - \text{total book value}\ (t)\right) + \left|\text{long-term debt}\ (t-1) - \text{long-term debt}\ (t)\right|}{\sum_{t=-4}^{4} \left(\text{total book value}\ (t) + \text{long-term debt}\ (t)\right)} \\
0 & \text{if denominator is available and no data are available for the numerator,}
\end{cases}
\]

where long-term debt = (mortgage indebtedness) + (capital notes and debentures) + (preferred stock, par value).

Availability criterion: current values for the items in the denominator must be available.

Discussion: This item measures the proportional variation in capital structure effected by management in the last 4 fiscal years.

34. \text{VERN} \quad \text{Variability of Annual Earnings in Last 5 Years}

\[
\text{VERN} = \sqrt{\frac{\sum_{t=-4}^{T-1} (\text{earnings} - \text{average earnings})^2}{\text{average earnings}}} 
\]

where:
(1) earnings = net income available for common,
(2) average earnings = the average, over the preceding 5 years, of earnings,
(3) \(T\) is the number of years that data exist,
(4) if \(\text{VERN} > 5\), \(\text{VERN}\) is set to 5.

Availability criterion: two years of data.

Discussion: This is a pure number that measures the intrinsic proportional variability of earnings and is an accounting-based measure of risk.

35. \text{VFLO} \quad \text{Variability of Cash Flow}

\[
\text{VFLO} = \begin{cases} 
0 & \frac{\left(\text{cash flow} - \text{average cash flow}\right)^2}{\sum_{t=-4}^{T-1} \text{average cash flow}} \\
5 & \text{if VFLO would otherwise be} > 5
\end{cases}
\]
where: (1) cash flow = (net income or net income available for common) + (provision for loan losses) + (furniture and equipment depreciation, rental cost, servicing, etc.)
(2) average cash flow = the average of cash flow over the last 5 years
(3) T = the number of years of data averaged

**Availability criteria:**
(1) Cash flow is available only if all of its components are available; 2 years of cash-flow data must be available.
(2) Average cash flow is available if cash flow is available for at least 2 years.

**Discussion:** This is an alternative to VERN as a measure of the variability of the bank's operations, computed through the identical formula applied to cash flow rather than earnings.

36. **ABET**

\[
ABET = \begin{cases} 
\left( \frac{\sum (\Delta X \cdot \Delta Y)}{\sum (\Delta X)^2} \right)^2 \cdot \frac{\sum (\Delta X)^2}{N} \quad \left( \frac{\sum (\Delta Y)^2}{N} \right)^{1/2} \\
0.0 \text{ if } ABET^2 \text{ would otherwise be negative} \\
5.0 \text{ if } ABET \text{ would otherwise be } > 5
\end{cases}
\]

where: (1) \(Y\) = earnings per share
(2) \(\Delta Y\) = earnings per share in year \((t)\) - earnings per share in year \((t-1)\)
(3) \(\Delta X\) = U.S. corporate earnings in year \((t)\) - U.S. corporate earnings in year \((t-1)\)
(4) the sums are taken over all previous years for which data exist
(5) \(N\) is the number of years summed over.

**Availability criterion:** at least 2 years of consecutive data.
Discussion: This measure captures the covariance of the bank's earnings with aggregate earnings to all corporations. It is a pure number, expressing the proportion of normal earnings that is exposed to fluctuations in the aggregate economy. In statistical terms, it is the "coefficient of explained variation" of the bank's earnings with respect to the movements in economywide earnings. It is natural to view a measure of this kind as analogous to a beta for earnings, and we term it an "accounting beta" in the tradition of Beaver et al. [2]. The definition of accounting beta proposed by those authors, somewhat modified, is retained below as another descriptor (BBET).

37. CUTD Average Proportional Cut in Dividends, Last 5 Fiscal Years

CUTD = average over the last 4 years of DIF, where:

\[
DIF = \begin{cases} 
\frac{\text{yearly common div}(t-1) - \text{yearly common div}(t)}{\left|\text{com div}(t-1)\right| + \left|\text{com div}(t)\right|} & \text{when: com div}(t) < \text{com div}(t-1); \\
0 & \text{otherwise.}
\end{cases}
\]

Availability criterion: 2 consecutive years of available dividends in the past 5 years.

Discussion: This descriptor captures the apparent risk to the bank, as reflected in the frequency and magnitude of circumstances that caused it to reduce common dividends. In view of the great reluctance shown by firms in the matter of reducing dividends, any dividend reduction is likely to be a sign of straightened circumstances for the bank and is so viewed by the market. We do not pronounce on the rationality of this policy, but only upon the realities of the message conventionally associated with dividend reductions.

38. DELE Delta Earnings: A Measure of Proportional Changes in Earnings Per Share in the Last 2 Fiscal Years

DELE = \[
\begin{cases} 
2\left(\frac{\text{earnings/share, year T}}{\left|\text{earnings/share, year T-1}\right|}\right) & \text{if earnings are zero in both years.}
\end{cases}
\]

\[
-\left(\frac{\text{earnings/share, year T-1}}{\left|\text{earnings/share, year T-1}\right|}\right)
\]

\[
+\left(\frac{\text{earnings/share, year T-1}}{\left|\text{earnings/share, year T-1}\right|}\right)
\]

(earnings/share, year T)
Availability criterion: two years of data.

Discussion: This is a measure of earnings growth rate in the past year. The measure equals the trend rate divided by the average when earnings are positive in both years; the absolute values in the denominator insure reasonable values for the descriptor when earnings in one or both years are negative or zero.

39. DMNE  

Indicator of Negligible Earnings

\[ DMNE = \begin{cases} 
0 & \text{if } ETOP \geq 0.005 \\
1 & \text{if } ETOP < 0.005 
\end{cases} \]

where ETOP is defined below.

Availability criterion: ETOP must be available.

Discussion: This variable is zero unless annual earnings are less than 1/2 percent of the value of the common, in which case it is equal to one. Thus, it is an indicator of dangerously low current earnings—that is, of a situation that must be reversed if the bank is to survive—and hence can be expected to be positively related to risk. This descriptor may also be viewed as introducing a nonlinearity into the relationship between risk and E/P otherwise introduced by the ETOP descriptor.

40. NRGIN  

Earnings Margin

\[ NRGIN = \frac{\sum_{t=-2}^{0} (\text{net income})}{\sum_{t=-2}^{0} (\text{total current operating revenue})} \]

Availability criterion: one year of data.

41. REVENA  

Ratio of Revenue to Assets

\[ REVENA = \frac{\text{total current operating revenue}}{\text{total assets}} \]

Availability criterion: current data.

42. ROEQ  

Return on Equity
\[ \text{ROEQ} = \frac{0}{t=-4} \sum_{t=-5}^{-1} (\text{net income available for common}) / (\text{total book value}) \]

Availability criteria: (1) net income for one year and book value at the end of the prior year must be available for any pair of data to be included in the sums;

(2) there must be at least 3 years of data available.

Discussion: This is a measure of the average return to the bank on its equity investment, valued at book, over the past 5 years. The ratio of the sums is used, rather than the average of the ratios, because of the greater stability of the former when book value oscillates or approaches zero.

43. AGROAsset Growth Rate, Equal to the Annual Trend in Total Assets Divided by Average Value, Last 5 Years

\[ \frac{\sum t X - \frac{1}{N} (\sum t) (\sum X)}{\sum t^2 - \frac{1}{N} (\sum t)^2} \]

\[ \frac{1}{N} (\sum X) \]

where: (1) \( X \) = total assets
(2) \( t \) = yearly index; \( t=1,2,3,4,5 \)
(3) the sums are over the last 5 years, or over years for which all data exist
(4) \( N \) is the number of years for which data exist.

Availability criterion: at least 4 years of data.

Discussion: This was proposed by Beaver et al. [2] as an accounting-risk measure, relying mainly on the argument that above-normal growth derives from opportunities to gain "excessive" earnings and that these are vulnerable to competitive pressures and more uncertain than "normal" earnings. Thus, rapid growth identifies with high risk and thus with high return.
44. **DMS5**

Indicator of Availability of a 5-Year History of Earnings Information, from a Substantial Base

\[
DMS5 = \begin{cases} 
1 & \text{if total capitalization 4 years previously \( \geq \$20,000,000 \) and there are at least 4 data points available for the calculation of EGRO, or if earnings-per-share data are available for 1959.} \\
0 & \text{otherwise}
\end{cases}
\]

**Availability criterion:** always available.

**Discussion:** This indicator variable is one for those banks having a 5-year history of earnings from a $20,000,000 initial capitalization, equal to zero otherwise.

45. **EGRO**

Earnings Growth Rate

\[
\text{EGRO} = \begin{cases} 
\frac{\sum_{t} x_t - \frac{1}{N} (\sum_{t} x_t) (\sum_{t} x_t)}{\sum_{t} x_t^2 - \frac{1}{N} (\sum_{t} x_t)^2} & \text{if } |\text{EGRO}| \leq 0.5 \\
\frac{\sum_{t} x_t - \frac{1}{N} (\sum_{t} x_t) (\sum_{t} x_t)}{\sum_{t} x_t^2 - \frac{1}{N} (\sum_{t} x_t)^2} \times \frac{1}{N} \sum_{t} |x_t| & \text{if } |\text{EGRO}| > 0.5 \text{ and } |\text{EGRO}| \leq 1.0 \\
1.0 & \text{if } |\text{EGRO}| > 1.0
\end{cases}
\]

where: (1) \( x \) = earnings per share, adjusted for capital for capital transactions
(2) \( t \) = yearly index; \( t=1,2,3,4,5 \)
(3) the sums are over the last 5 years
(4) \( N \) is the number of years for which data exist.

**Availability criteria:** (1) Number of shares outstanding must be available for the first year.
(2) Price per share at end of first year must be available.

(3) Total capitalization (shares outstanding times price per share), calculated at end of the first year, must be greater than $20 million.

(4) There must be at least 4 years of available data.

Discussion: This measure of the growth rate of earnings per share seems to correspond reasonably well to the rate which an intelligent judge would deduce from the data, and it has the advantage of great validity in the frequent cases of large earnings fluctuations which destroy exponential or proportional growth models. The growth rate in earnings per share, adjusted for capital transactions, is used as a measure of the increased profitability of the bank and, hence, as a measure of recent success. The use of per-share figures, rather than total earnings, removes the contribution to growth from amalgamation, except to the degree that amalgamation occurs on terms that are favorable to the stockholders. The growth rate of total assets, defined above, captures the pure growth component of the bank. The requirement that the earnings growth begin at a substantial capitalization base is designed to remove those banks which may have achieved extraordinary and probably unrepeatable growth in their early years.

46. OFFSET Domestic Office Expansion Rate

\[
\text{OFFSET} = \frac{\sum_{t=1}^{5} (\text{Ex}_t - \frac{1}{N} \sum_{t} (\text{Ex}_t)(\text{Ex}))}{\sum_{t=1}^{5} (\text{Ex}_t)^2 - \frac{1}{N} \sum_{t} (\text{Ex}_t)^2}
\]

Regression co-efficient of X on T

where: (1) X = number of domestic offices
(2) t = yearly index; t=1,2,3,4,5
(3) the sums are over the last 5 years
(4) N is the number of years for which data exist.

Availability criterion: at least 3 years of data.

47. RSKLGO Growth Rate of Risky Liabilities
48. ASSI  

Logarithm of Total Assets

ASSI = the natural log of the average, over the last 5 years, of total assets.

**Availability criterion:** at least one data point.

**Discussion:** Total assets was suggested by Beaver et al. [2]. They support the common belief that large firms are less risky than small, at least in terms of default risk. Moreover, if the investing public considers large firms safer, then the result of this belief will be to reduce the price reaction to any threatening news. For banks, however, the asset size is clearly a surrogate for systematic business risk.

49. MKTS  

Current Operating Revenue

MKTS = total current operating revenue.

**Availability criterion:** current data.

**Discussion:** This is another measure of the size of the bank.

50. HBET  

Historical Beta, the Regression Coefficient in a Regression of Monthly Common Stock Returns on Monthly Returns for the Market
\[
HBET = \frac{\sum_{t=-59}^{0} \left( \frac{\text{monthly return of stock} - \text{average return of stock}}{\text{return of the market} - \text{average return of the market}} \right) \cdot (\text{return of the market} - \text{average return of the market})^2}{\sum_{t=-59}^{0} \left( \text{return of the market} - \text{average return of the market} \right)^2}
\]

where the averages are over the last 60 months. If some returns are unavailable, the sums and averages are taken only over the period where data are available; the minimum number of data points is 36. The "returns" for the stock and for the market are actually in the form of logarithmic excess returns. For instance, the return on the stock in month \( t \) is defined as:

\[
r_t = \ln\left(\frac{P_t}{P_{t-1}}\right) - \ln(1 + i_{FT}),
\]

where \( \ln \) denotes the natural logarithm, \( P_t \) denotes the month and price, and \( i_{FT} \) is the risk-free rate of return.

**Availability criterion:** There must be at least 36 available monthly returns.

**Discussion:** Our experience has shown that the logarithmic return results in a more stable and more accurately predictive estimate of beta than the alternative specification in terms of monthly arithmetic rates of return, although the difference is very small. There are also plausible grounds for specifying the dependence of the security return on the market return as linear in logarithms rather than linear in arithmetic returns: In the former case, when the market level varies and then returns to its original position, the logarithmic model implies that securities are expected to return to their original levels, while the arithmetic model implies an implausible pattern of expectations.

**51. BTSQ Beta Squared**

\[
\text{BTSQ} = (\text{HBET})^2
\]

where HBET is defined above.

**Availability criterion:** available whenever HBET is available.

**Discussion:** BTSQ is the square of the truncated value of HBET, to introduce a nonlinearity in the prediction rule. To constrain this to take the appropriate
shape, BTSQ is itself truncated; otherwise, the fitted relationship would turn downward too sharply at very high values of HBET.

52. \( \text{HSIG} \)  
**Historical Sigma, the Standard Deviation of Residual Returns from the Regression for HBET**

\[
\text{HSIG} = \left\{ \frac{1}{T-2} \sum_{t=59}^{T} \hat{e}_t^2 \right\}^{1/2}
\]

where:
1. \( \hat{e}_t \) is the residual in the regression for HBET in month \( t \)
2. \( T \) is the number of data points available.

**Availability criterion:** at least 36 months of data.

**Discussion:** HSIG is the conventional estimate of the residual standard deviation of returns, but applied to the logarithmic return model. A substantial improvement in estimation accuracy is obtained through the logarithmic specification, since the skewness and kurtosis of residuals are greatly reduced.

53. \( \text{SGSQ} \)  
**Sigma Squared**

\[
\text{SGSQ} = \text{HSIG}^2
\]

where HSIG is defined above.

**Availability criterion:** availability of HSIG.

**Discussion:** SGSQ is the square of the truncated value of HSIG and is itself truncated, because previous experience has shown that the coefficient of SGSQ in beta is typically negative, offsetting the contribution of sigma at large values. If SGSQ were not limited at the upper bound, an excessive negative adjustment at the few banks with large sigma values would be implied. Thus, the truncation is an attempt to obtain the correct nonlinear form for the prediction rule.

54. \( \text{BS} \)  
**Square Root of the Product of HBET and HSIG**

\[
\text{BS} = \left( \text{HBET} \cdot \text{HSIG} \right)^{1/2}
\]

where HBET and HSIG are defined above.

**Availability criteria:** Available whenever HBET and HSIG are available, and HBET is nonnegative.
Discussion: This variable is also employed to allow for non-linearity in the prediction rules. As in the case of BTSQ, BS is set to equal the product of HBET * HSIC (after truncation of these variables where appropriate), and is itself truncated.

55. Bayesian Adjustment to Historical Beta

\[ \text{BADJ} = \frac{(HBET - HBET) \cdot \text{VAR}(HBET)}{V_\beta + \text{VAR}(HBET)} \]

where: HBET is the estimated cross-sectional average of HBET, capitalization weighted, taken to be 1.03; V_\beta is the estimated cross-sectional variance of beta, capitalization weighted, taken to be .1; and VAR(HBET) is the estimated error variance for HBET, equal to:

\[ \frac{\text{HSIC}^2}{\sum_{t=-59}^{0} \frac{\text{return of the market - average return of the market}}{\text{average return of the market}}} \]

where: HSIC is defined above and the sum is taken over months where data are available for the HBET regression.

Availability criterion: HBET and HSIC must be available.

Discussion: If sigma were independent of beta, the Bayesian prediction rule, as a function of HBET, that would yield minimum mean square error in estimating underlying historical beta would be essentially HBET - BADJ. Thus, BADJ is the Bayesian adjustment to historical beta, under the (erroneous) assumption that the underlying values of beta and sigma are independent.

56. LPRI Natural Logarithm of the Common Stock Price

\[ \text{LPRI} = \ln[\text{price}] \]

where price is the closing price for the most recent month.

Availability criterion: the month-end price must be available.

Discussion: This captures the current price level, perhaps useful as an indication of risk, because
firms with high risk tend to maintain the stock price at a lower value to facilitate trading. Market folklore treats lower-priced stocks as more speculative than higher-priced stocks. This belief may reflect deliberate corporate control of the stock price, through capital transactions, or the effect of uncontrolled declines in value.

57. RSTR  
Logarithmic Rate of Return over Last Year  
(Relative Strength)

\[
RSTR = \sum_{t=11}^{0} (\ln[\text{monthly stock closing price}] - \ln[\text{last month's stock closing price}])
\]

Availability criterion: all data points must be available for all months.

Discussion: An indicator of recent success, this is the logarithm of the return to investors in the common equity of the bank over the past year, excluding dividends. The logarithm is taken to retain a more symmetric measure than would be provided by the arithmetic return.

58. TREC  
A Measure of Common Stock Trading Recency, Equal to the Reciprocal of the Number of Prior Years of Available Monthly Prices

TREC = \left\{ \begin{array}{ll} 12 & \text{maximum of } [12; \text{ the number of months ago a closing price/share was first recorded}] \\ \end{array} \right.

Availability criterion: always available.

Discussion: This variable is equal to one for the first 12 months that monthly closing prices for a bank are contained in the data base and declines asymptotically to zero thereafter. After T years of data, the value of the variable is 1/T. The purpose of the descriptor is to capture the recency of the status of the bank as of interest to institutions, presuming that addition to the COMPUSTAT data base is correlated with this.

Remark on Historical Values: Since all banks added to that data base prior to 1964 were major banks at the date of inclusion, the value is set to zero immediately for these banks. Thus, if any data are available prior to 1964, TREC is set equal to zero throughout the history of that bank.
59. **ATOLM**  
*Assets to Liabilities, Market Value*

\[
ATOLM = \frac{\text{total assets}}{(\text{price times shares outstanding}) + (\text{capital notes and debentures at book})}
\]

**Availability criterion:** current data.

60. **BBET**  
"**Beaver** Beta, Regression Coefficient for Normalized Earnings/Price Ratio of the Bank on Normalized Earnings/Price Ratio of the Economy"

\[
BBET = \frac{\sum_{s \geq t-10} \{\text{ENTP}_s \cdot \text{ENTPM}_s \}}{\sum_{s \geq t-10} \{\text{ENTPM}_s \}^2}
\]

where: (1) \( \text{ENTP}_s \) is the normalized earnings/price ratio, defined elsewhere, for the bank in year \( s \)

(2) \( \text{ENTPM}_s \) is the same formula applied to: (a) aggregate quarterly corporate earnings, interpolated when necessary to correspond to the fiscal year of the firm, and (b) the S&P 500 index at that year end

(3) the sums are taken over years of available data.

**Availability criterion:** \( \text{ENTP} \) must be available for at least two of the last five years.  
**NB:** \( \text{ENTPM} \) is always available.

**Discussion:** This descriptor measures the typical relationship of the bank's E/P ratio to the economy-wide E/P ratio. A higher value implies that the E/P for the bank is typically higher than that for the economy, or conversely, that the P/E is typically lower. This descriptor differs from that introduced by Beaver et al. [2] (their version of accounting beta) only in that there is no constant term in the regression, so that the regression line is forced to pass through zero. Beaver et al. referred to it as an accounting beta, because it is the regression of the E/P ratio on the economy's E/P ratio. However, an inspection of the descriptor confirms that although it has something of the nature of a covariance of earnings, it is really closer to a measure of the normal value of E/P.
61. BTOP Book Value to Price

\[
\text{BTOP} = \frac{\text{total book value}}{(\text{price}) \times (\text{shares outstanding})}
\]

where price is the latest monthly closing price, if available; if not, the price at the end of the previous calendar year.

Availability criterion: current data.

Discussion: This is a measure of the pessimism with which the bank is valued. A high value, relative to other banks, corresponding to a low P/B ratio, implies that investors do not expect the bank to earn well on its past capital investment. This ratio is used in preference to the more familiar P/B ratio, because the latter behaves wildly as book value approaches zero and discontinuously as book value becomes negative.

62. CAPT An Indicator of Capitalization, Equal to the Natural Logarithm of the Market Value of Common Equity

\[
\text{CAPT} = \ln\left(\frac{\text{number of shares outstanding}}{\text{price per share}}\right)
\]

where price is the latest monthly closing price, if available; if not, the price at the end of the previous calendar year.

Availability criterion: shares outstanding and price must be available.

Discussion: This variable is an alternative measure of the size of the bank, equal to the logarithm of the aggregate value of its outstanding common stock. It is closely related to the descriptor ASSI, but measures the total value placed by the investing public on the potential flow through from the bank's activities to equity investors. Differences between the two variables arise from monopoly rents to capital, from differences in leverage, and from the past success of the bank as reflected in the ratio of book value of equity to market value of equity.

63. DMYL Indicator of Extremely Low Yield

\[
\text{DMYL} = \begin{cases} 
0 & \text{if YILD > .005} \\
1 & \text{if YILD < .005}
\end{cases}
\]

where YILD is defined below.
Availability criterion: If YILD is available.

Discussion: This descriptor indicates those banks with yield less than 0.5%. Such banks are either in such trouble as to have omitted current dividends, or they are extremely strongly growth oriented. As such, they may be distinguished from other banks to such a degree that this indicator becomes useful. It may also be viewed as allowing for a nonlinearity in the relationship between risk and yield otherwise determined by the descriptor YILD.

64. ENTP  \[ \text{Normalized Earnings/Price Ratio} \]
\[ \text{ENTP} = \frac{\frac{1}{N} \sum_{t=1}^{N} \left( \frac{\text{Ex}}{N} \right) \left( \frac{(Et)(t)}{N} \right) \left( \frac{\text{Ex}}{N} \right) \left( \frac{(Et)^2}{N} \right) - \frac{1}{N} \sum_{t=1}^{N} \left( \frac{(Et)(t)}{N} \right) \left( \frac{\text{Ex}}{N} \right) \left( \frac{(Et)^2}{N} \right)}{\text{price}} \]

where:
1. \( X \) = earnings per share, adjusted for capital transactions
2. \( t \) = yearly index; \( t=1,2,3,4,5 \)
3. the sums are over those of the last 5 years for which data are available
4. \( N \) is the number of years for which data exist
5. price is monthly closing price/share, if available; if not, the price at the end of the previous calendar year is used.

Availability criteria:
1. "earnings per share" must be available for at least 2 of the last 5 years
2. "price" must be available.

Discussion: This descriptor is an alternative to ETOP. It differs only in that the latest year's earnings is replaced by the fitted value from a linear least-squares trend passed through the last 5 annual earnings-per-share figure. Transitory fluctuations in earnings are likely to play a smaller part in ENTP, so that it may be a better indication of the expected long-term growth rate.

65. ETOP  \[ \text{Earnings to Price} \]
\[ \text{ETOP} = \frac{\text{latest annual earnings per share}}{\text{price per share}} \]
where price is: (1) latest monthly closing price, if available; if not, (2) price at end of previous calendar year.

Availability criterion: current data.

Discussion: This is the reciprocal of the ratio commonly used in the financial press. The more usual price/earnings ratio has conceptual disadvantages, since it approaches extreme positive values when earnings are near zero, and then discontinuously becomes negative when earnings are negative. In contrast, the E/P ratio behaves smoothly when earnings fall. Low E/P stocks (those that are "expensive" when scaled against earnings) are presumably priced in this way because investors expect future earnings to be higher; implying that earnings recovery or future growth is expected. Thus, a low E/P ratio is indicative of expected growth in earnings.

66. ETPS

$\frac{\text{ETPS}}{\text{ETPS}} = \frac{\text{average over last 5 years of}}{\text{closing stock price}} \frac{[\text{earnings available for common}}{\text{shares outstanding}]}}{\text{average over last 5 years of}}$

Availability criterion: at least one data point must be available for each of the "average" calculations.

Discussion: This is a measure of the typical earnings/price ratio over the last 5 years. The ratio of the means is taken, instead of the mean of the ratios, because of its smaller sensitivity to extreme fluctuations in stock price.

67. LIQU

LIQU = \frac{[(\text{cash}) + (\text{receivables})] - (\text{current liabilities})}{(\text{shares outstanding}) \cdot (\text{price})}$

where: (1) price is for latest month, if available; if not, price is for the end of the previous calendar year
(2) cash + receivables = maximum of 
[[0], 
[(federal funds sold and securities purchased under agreements to resell)] - (federal funds purchased and securities sold under agreements]
to repurchase]) + (cash and due from banks) -
(required reserve ratio for demand deposits ×
total demand deposits) - (required reserve ra-
tio for savings deposits × total savings depos-
ts) - (required reserve ratio for time deposits ×
total time deposits, other than savings)
(3) current liabilities = (other liabilities
for borrowed money) + maximum of ([0], [(fed-
eral funds purchased and securities sold under
agreements to repurchase) - (federal funds sold
and securities purchased under agreements to
resell))].

Availability criterion: current data.

Discussion: This descriptor is a measure of the liquid-
ity of the bank's current financial position. It
attempts to improve upon other measures of liquid-
ity by expressing current liquidity as a proportion
of the market valuation of common equity. The think-
ing behind this is that only when the bank is il-
liquid and that illiquidity is a large proportion
of the market value of common equity will there be
an indication of default risk and, hence, of the
credit stringency that follows from apparent de-
fault risk.

68. MLEV

\[
MLEV = \begin{cases} 
\frac{\text{(shares outstanding times price)}}{\text{(shares outstanding times price)}} + \text{(long-term debt)} & \text{if this ratio is < than 10 and nonnegative;} \\
10 & \text{otherwise} 
\end{cases}
\]

where: (1) long-term debt is defined under
VCAF
(2) price is monthly closing price,
if available; if not, price at end of previous calendar year.

Availability criterion: current data on all items.

Discussion: This measure of financial leverage dif-
fers from BLEV in that common equity is valued at
market. Ideally, senior securities should also be
valued at market, but data on their prices are not
generally available. Since their prices vary less
proportionately than do stock prices, this omission
is not too costly. In a theoretical analysis, for
fixed business risk, it is leverage at market that
should determine the risk to stockholders, rather
than leverage at book.

69. ECAP  Market Value of Equity

\[ ECAP = \text{market value of common equity} \]
\[ \quad \text{(capitalization) of the bank} \]

Availability criterion: current data.

Discussion: This descriptor has a complex history.
Briefly, in an analysis of the joint distribution of
security returns, it can be shown that the spec-
ific variance of each bank contributes a small amount
to its beta with respect to a market index in which
it is included. The contribution from its own var-
iance to its beta, with respect to a value-weighted
index, is proportional to its market capitalization
times its specific variance. OVAR thus captures
the importance of this contribution to beta. In ad-
dition, OVAR is, of course, another measure of size.

70. PTEQ  Ratio of Plant (Fixed Assets) to Common
Shareholders’ Equity

\[ PTEQ = \frac{\text{bank premises, furniture, and fixtures}}{(\text{price}) \times \text{(shares outstanding)}} \]

Availability criterion: current data.

Discussion: The ratio of fixed assets to total assets
has been proposed as a measure of the "fixity" of
assets. Banks with high fixity should have high
fixed costs and hence a greater dependence of earn-
ings upon economic events. This relationship would
suggest that a higher value of PTEQ would imply
higher risk. However, in the presence of an im-
perfectly competitive market with freedom to vary
prices, this effect might be offset by the reduc-
tion in risk associated with more stable operations.

71. YILD  Dividend Yield

\[ YILD = \begin{cases} 
\text{common dividends, last fiscal year} \\
\text{shares outstanding \times price/share} \\
0.3 \text{if YILD would otherwise be } > 0.3.
\end{cases} \]

where price is: (1) price at end of latest
month, if available; if not,
(2) price at end of previous
calendar year.
where price is: (1) latest monthly closing price, if available; if not, (2) price at end of previous calendar year.

Availability criterion: current data.

Discussion: This is the reciprocal of the ratio commonly used in the financial press. The more usual price/earnings ratio has conceptual disadvantages, since it approaches extreme positive values when earnings are near zero, and then discontinuously becomes negative when earnings are negative. In contrast, the E/P ratio behaves smoothly when earnings fall. Low E/P stocks (those that are "expensive" when scaled against earnings) are presumably priced in this way because investors expect future earnings to be higher; implying that earnings recovery or future growth is expected. Thus, a low E/P ratio is indicative of expected growth in earnings.

66. ETP5 Typical Earnings Price Ratio, Last 5 Years

\[
\text{ETP5} = \frac{\text{average over last 5 years of \{earnings available for common \}}}{\text{total shares outstanding}} \div \frac{\text{average over last 5 years of \{closing stock price\}}}{\text{shares outstanding}}
\]

Availability criterion: at least one data point must be available for each of the "average" calculations.

Discussion: This is a measure of the typical earnings/price ratio over the last 5 years. The ratio of the means is taken, instead of the mean of the ratios, because of its smaller sensitivity to extreme fluctuations in stock price.

67. LIQU Liquidity of Current Financial Position

\[
\text{LIQU} = \frac{\text{[(cash) + (receivables)] - (current liabilities)}}{\text{(shares outstanding) \cdot (price)}}
\]

where: (1) price is for latest month, if available; if not, price is for the end of the previous calendar year

(2) cash + receivables = maximum of \([0], \\text{[(federal funds sold and securities purchased under agreements to resell)] - (federal funds purchased and securities sold under agreements}}\)
**Availability criterion**: current data.

**Discussion**: Previous studies (e.g., Rosenberg and Marathe [7]) have confirmed that high dividend yield has been associated with low levels of systematic risk and specific risk throughout the past 50 years. In part, this relationship presumably arises from the fact that a high-yielding stock is typically high in payout also, so that the arguments previously advanced in connection with payout apply here as well. Also, high-yielding stocks are often identified as "income stocks" and purchased with this goal in mind by a group of investors who may be more risk-averse than the investment community at large; to the degree that this is the case, management, in response to the preferences of their investors, may pursue conservative policies. Again, we do not judge on the rationality of this behavior, but merely suggest that it may exist.

**72. YLD5**

**Dividend Yield, Normal Value for Last 5 Years**

\[
YLD5 = \frac{\text{average over last 5 years of} \left\{ \frac{\text{adjusted common dividends}}{\text{adjusted shares outstanding}} \right\}}{\text{average over last 5 years of} \left\{ \text{annual closing stock price} \right\}}
\]

**Availability criterion**: at least one data point must be available for each of the "average" calculations.

**Discussion**: This descriptor measures the typical yield over the last 5 years, as distinct from the yield indicated by current dividends and current prices. As such, it is an alternative measure of the same aspect of the firm as measured by current yield.
References


