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The risk premium for minority banks altruistic portfolios in underserved communities

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Abstract

Motivated by behavioural asset pricing theory, we introduce a statistical risk accounting model to characterize the compensating risk premium required to sustain minority banks' (MBs) altruistic motive to provide credit in underserved communities. Our model predicts that increased bank capitalization, and brokered deposit (BD) exceptions, compensate risk when the incremental internal rate of return they induce is negatively correlated with the internal rate of return on extant MB loan portfolios. Thus implying, paradoxically, that loan portfolios levered by increased capital, and brokered deposits, militate against altruistic motives. This suggests that for a given amount of altruism, minority banks are better served by tactical portfolio allocation in an expanded investment opportunity set. Using Federal Reserve Statistical Release (12/2011) on select FFIEC Form 031 (``Call Report'') data, we fit a risk-return function for minority banks and estimate the compensating risk premium for return on assets. We provide back of the envelope formula for estimating minority bank profitability based on loan loss ratio, leverage ratio, and operating expense. There, we find that Hispanic and Caucasian Women owned banks are the only profitable ones left after brokered deposits are factored out. We also extrapolate crude estimates of the price of risk for minority banks--adjusted for loss aversion index extrapolated from the behavioural economics literature.

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