Table 3.8

Simple Average Annual Pre-Tax Rates of Return

(Ten years from Dec. 31/71 to Dec. 31/81)

	Capital Appreciation	+	Dividend Yield	=	Total Annual Rate of Return	less	Average Inflation Rate[1]	=	Pre-Tax Real Return
To an investor in Chartered Bank Common Shares	6.3%		4.7%		11.0%		9.0%		2.0%
From the TSE "300" in general	8.9%		4.0%		12.9%		9.0%		3.9%

[1] Consumer Price Index.
Source: Burns, Fry Limited

To illustrate, the increase in the cost of capital to a bank raising new equity in the current equity markets (Table 3.9, supplied by the Canadian Bankers' Association) has been updated to reflect the current share price of bank stocks in today's economic environment. The C.B.A. submitted the book values of bank shares as of October 31, 1981, relating these to the market value of these stocks as of the same date. At the time, every publicly traded bank stock was trading at a discount to its stated book value per share. The book value of a Canadian chartered bank is basically break-up value in the form of common shareholders' equity and accumulated appropriations for losses. Depending on how investors perceive a bank, they will accord the bank either a market premium or a discount to the book value of the bank's shares. As of October 31, 1981, the banks were trading at a discount to their book value of anywhere between 1 per cent and 64 percent. On average, on that date, (based on a simple averaging of prices and book values per share) they were trading at a discount to book value of 25 per cent. On updating the share prices to reflect the position as of June 30, 1982, it can be noted that the share prices have fallen by almost 30 per cent and, consequently, the banks are now trading at a discount (on a simple average basis) of approximately 47 per cent from their book value stated October 31, 1981.

The attitude of investors, therefore, is reflected in their evaluation of the banks' share prices in the equity markets. It focuses on concerns over a lower rate of earnings' growth and higher potential loan losses that would, in effect, reduce the banks' book value per share (because, as previously noted, all losses are deducted from capital if they are in excess of the banks' five-year average). Investors also bear in mind what other, more attractive, returns are available to them, and what other securities have less potential risk.

At current low market prices for bank shares, there is an average price-earnings ratio of four to one. The effective after-tax cost of issuing new common equity at current market prices is thus over 25 per cent for most banks. Such financing costs make it almost prohibitive for a bank to issue new common equity in the current market. In addition, it is detrimental to the existing shareholders, since the new capital would be issued so substantially below the current book value. It would dilute the shareholders' invested interest in the bank, and, as well, require the bank to earn a substantially higher rate of return on the new capital than what it was earning on the current shareholders' capital.