BANK RISK ASSESSMENT

A QUICK AND PRACTICAL GUIDE

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What is a bank?

- Financial Intermediary
- Matches sources of liquidity to uses of liquidity
- Highly leveraged business
- Highly regulated, given outsize impact on all aspects of the economy
- Usually the source of financial crises !!

Differences in Corporate & Bank Risk

BANKS	CORPORATES
"Interest" is income	"Interest" is an expense
Cashflow are relatively less important for a banks ability to meet its obligations	Cashflows are critical – profitable businesses with cashflow problems can go bust
Banks are usually highly leveraged – and that is a good thing	Excess leverage may be fatal for a corporate
Banks have minimum capital requirements dictated by regulatory authorities	Companies usually have limited regulatory oversight as opposed to banks
Proportion of Fixed Assets, Inventories etc is negligible in a banks balance sheet	Fixed Assets and Inventories form a major component of corporate balance sheet
Banks have a "mutliplier effect" on money supply	Corporates have a multiplier effect on demand for goods and services

A Bank’s Balance Sheet

	12/31/2011	% of Assets
Assets		
Cash	**50**	**2%**
Securities	**500**	**22%**
Loans	**1,500**	**67%**
Other Assets	**200**	**9%**
Total Assets	**2,250**	**100%**
Liabilities & Equity		
Deposits	**1,400**	**62%**
Borrowings	**600**	**27%**
Shareholder's Equity	**250**	**11%**
Total Liabilities and Equity	**2,250**	**100%**

Main questions to ask….

- Capital Strength & Structure?
- Sources of funding?
- Asset Quality?
- Liquidity?
- Efficiency & Profitability?

Capital Strength

- The strength of a bank's capital base determines its ability to:
  - Absorb losses on loan book
  - Meet its obligations on time
  - Fund long-term/short-term
  - Get an acceptable credit rating

Main Ratios – Capital Strength

- Tier-1 or Regulatory Capital Ratio
  - Tier-1 or Core Capital / Risk-weighted Assets
  - Most important capital strength indicator
  - Minimum level varies from country to country
- Total Capital Ratio
  - Tier-1 & 2 Capital / Risk-weighted Assets
  - Includes core capital plus supplementary capital like subordinated debt, hybrid instruments, revaluation reserves etc
- Equity as a % of (Total Assets or Net Loans)
  - The above two ratios indicate the strength of the Equity position of a bank, as well as provides an idea of the main driver of the banks funding

Capital Structure – what to look out for

- Does the Asset-Liability structure match?
- Does the funding structure match the lending structure?
- What are the main sources of capital?
- Is there excessive reliance on hybrid/exotic instruments?
- Does the bank have access to sources of capital like equity markets/interbank markets?

Sources of Funding – ratios

- Loans as a % of Deposits
  - Will indicate to what extent the bank is reliant on Loans in order to fund deposits
  - Also gives a good picture of what kind of a business model the bank uses (interest income vs fee income)
- Interbank Assets as % of Interbank Liabilities
  - Indicates level of reliance on interbank funding, and systemic importance
- Customer Deposits as a % of Total Funding
  - Indicates level of reliance on customer deposits to carry out lending operations

Why are Sources of Funding important?

- Longer-term money (term deposits, equity, long-term subordinated debt) gives a bank a stronger, stable base of capital
- Short-term money (interbank lending) may prove dangerous in times of low economic confidence
- Assessing sources of funding is important in order to understand the asset-liability match as well

Asset Quality

- **Loans** are a bank's assets
- Asset quality gives an idea of the quality of credit risk management in a bank
- Bad Asset Quality can cripple even large, liquid, banks with huge capital bases
- Asset Quality not only ensures profitability, but also longevity of a bank

Asset Quality - Ratios

- Impaired loans as a % of Gross Loans (NPL Ratio)
  - Most Important indicator of quality of a banks loan book
- Reserves for Impaired loans as a % of Gross Loans
- Reserves for Impaired loans as a % of Impaired Loans
  - The above two ratios indicate the provisioning policy of bank
- Impaired Loans as a % of Equity
  - Indicates to what extent the bank is able to absorb losses using core capital

Asset Quality - Other factors to consider

- What is the bank's provisioning policy?
- What is the bank's portfolio split?
- Where are the non-performing assets coming from (sector/line of business)?
- What is the bank's write-off policy?

Liquidity - Ratios

- Interbank Ratio
  - Calculated as Balance with banks / Due to Banks
  - This ratio indicates whether the bank is parking liquidity or partaking liquidity
- Net Loans as a % of Total Assets
- Net Loans as a % of Deposits
- Liquid Assets as a % of Deposits
  - The above ratios indicate the level of liquidity of the bank
  - This factor becomes crucial during times of low economic confidence
  - The more liquid the bank, the easier it is for the bank to cater to any loss of confidence by meeting needs of depositors
  - The liquidity ratios can also be used as precursor to understanding the business strategy of a bank

Profitability & Efficiency

- Net Interest Margin
  - Calculated as a % Interest Bearing Assets
  - Indicates the “Spread” the bank earns between the cost of its funds and the price it earns on its loans
  - NIM is an important indicator of profitability of a bank
- Cost to Income Ratio
  - Calculated as a Total expenses and provisions divided by Total Income
  - The CIR ratio is a key ratio for assessment of a bank’s efficiency in managing its costs vis-à-vis its income
- Non-Interest Income to Total Income
  - This metric indicates the extent to which the banks revenues are driven by Non-interest income, and therefore, the extent to which the bank is vulnerable to interest rate risk

Profitability & Efficiency

- Return on Average Equity
- Return on Average Assets
  - Calculated by dividing Net Income with the appropriate divisor
  - The above metrics will indicate the efficiency of the bank in generating returns on the back of its assets and equity base, for its shareholders

A few other considerations…

- Does the bank have excessive contingent liabilities?
- What is the quality of the bank's management?
- What is the shareholder structure of the bank?
- Does the bank enjoy a good reputation in the market?
- Does the bank know what it wants to do and how to do it?
- Is the bank transparent in its financial statements?
- Does the bank operate in a strong regulatory regime?

Final thoughts….

- Bank Assessment is usually more straightforward than that for corporates, with higher levels of information made available
- In case financials are not available on the website, check the regulator's website
- Bankscope is usually a very good source for detailed, standardized information
- And last but not the least, Read the Notes to the Financial Statements…

THANK YOU

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