BANK ANALYSIS

Basics

Commercial banks are notoriously hard and difficult to analyze, as most of the tools and approaches used in assessing corporates simply don't work. That has not only to do with the representation of financial statements of financial institutions, but even more with the fundamentals and principles of a bank´s business model.

In its most basic configuration, a bank borrows funds from individuals and institutions who deposit funds with the bank, and in turn the bank lends funds to individuals and corporates in the form of loans.

The reason, why banks are so delicate and fragile are two-fold: On the one hand, banks usually lend medium- to long-term, whilst on the other hand their funding base – alas: the deposits held – are short-term. Hence, a bank´s balance sheet is in essence a maturity transformation from short term liabilities towards long-term assets. Therefore, the ability of a financial institution to re-fund itself smoothly on an ongoing basis is essential. – And, further, a bank´s balance sheet is compared to any ordinary industrial corporate extremely highly levered. These two basic observations already explain why trust in a financial institution´s asset base, its liquidity, risk management, general management, systems and technology is of the essence. And they also explain why a bank will not survive lack of trust in its abilities by the public for long: Once a larger number of holders of bank deposits demand their funds back, the financial institution will collapse, often within days, or even hours.

This fragility has also led to banks being thoroughly supervised and regulated, by frameworks such as Basel III, both on a national as well as an international level. Next to licensing requirements, banks have to meet rigorous standards, such as minimum liquidity or capitalization. Also, the regulators require a fair amount of public disclosure and transparency as well as corporate governance standards.

A vast range of concepts applied in general corporate analysis will just not work for financial institutions: For example, a bank´s income statement will in essence not show a classic revenue line. Instead the revenues of a bank are for one interest payments received from funds lent (e.g. loans) and services provided (e.g. advisory or basic services). Costs, on the other hand, will foremost be interest payments made to depositors, possibly also other creditors as well as costs for personnel and for technology. Besides, the bank has to set aside on a regular basis provisions for loans which eventually will only be partially paid back, or in the worst case: not at all.

Consequently, also certain balance sheet concepts commonly used for assessing industrial corporates will equally fail in the world of financial institutions: For example, the concept of working capital as well as analytical ratios linked with it cannot be applied for a bank. For instance, a bank does not have an inventory. And most of its liabilities will actually be some sort of payables (with the obligation to pay interest, though). Fixed assets do hardly play any role, neither therefore does depreciation. Whilst a corporate combines its inventory and labor to manufacture a product, the raw material to produce a bank´s service is in essence cash it has collected.

Therefore, parameters such as EBITDA or EBIT do not exist for banks, RoA as used for corporates does not make sense, corporate liquidity ratios or a cash conversion cycle can simply not be applied either. – At the same time, tools for assessing the risk profile of a bank´s loan portfolio will be of the essence, as well as identifying ways to optimally match assets and liabilities of a financial institution´s balance sheet. Latter not least so that a bank is always in a position to meet liquidity requirements, in essence: Having sufficient cash available when a depositor wants his cash back, which can in most cases be any time.

In conclusion: Only by applying a specially tailored, unique set of tools can the health of a financial institution be reasonably assessed.

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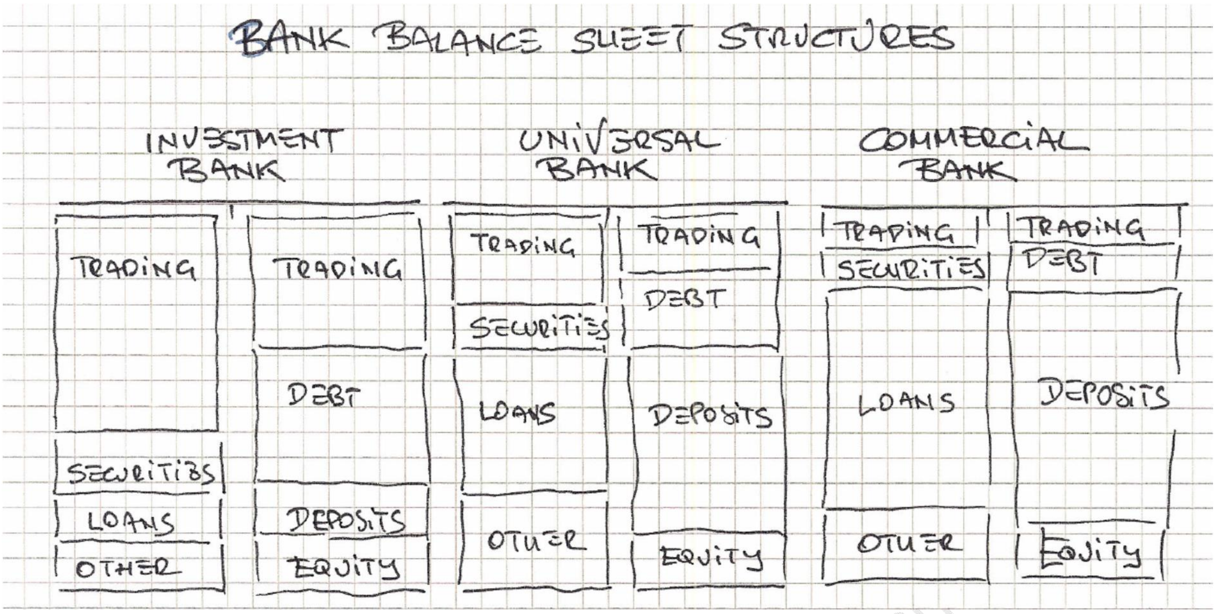

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