BANK ANALYSIS

CAMELS – Asset Quality

Poor asset quality is actually the major cause of most bank failures. Thereby, the greatest risk facing a bank originates from losses of delinquent positions within the loan portfolio. Hence, asset quality determines the healthiness of financial institutions against loss of value in the assets.

The quality of a loan portfolio can – among others - be assessed by using trend analysis and peer comparison: However, measuring a bank´s asset quality is difficult because it is mostly derived on a highly subjective basis.

In that context, a major focus is on nonperforming loans (NPLs) and its related ratios as well as the allowance or provision to the loan losses reserve. Basically, loans can be categorized staggered in decreasing quality as: standard, special mention, substandard, doubtful and loss. Now, NPLs are regarded as the three lowest categories which are past due or for which interest has not been paid for at least 90 days. In some countries regulators allow a longer period, such as for 180 days. - For bad debts adequate loan loss provisions have to be provided to the loan loss reserve account.

Of course, most banks will also have other assets than loans on their balance sheets, such as securities, possibly ranging from secure government bonds to near-default junk bonds. Therefore, an asset quality rating reflects the quantity of existing and potential future credit and investment risk associated with both, the loan and investment portfolios. In addition the concept of asset quality also assesses real estate owned as well as other assets held, next to off-balance sheet transactions.

In an ultimate consequence, the quality of assets is linked to how well all bank assets have been managed: If, for example, management is able to improve the quality of a bank´s assets, the institution is expected to benefit from a higher degree of liquidity, greater risk capacity, and also lower cost of funds.

Focus areas in assessing a bank´s asset quality are – among others:

- Trends in loan concentrations, intra-group lending, and real-estate exposure: For example, high concentrations towards specific business sectors and/or business entities and lack of diversification will make a loan portfolio vulnerable
- Loan growth: In particular competitive pressures may lead to loan standards becoming lax
- Non-performing loans: Amount, composition, causes for large increase or decreases as well as how NPLs are defined
- Reserves: Focus is on the level of reserves in relation to total loans and NPLs

Asset quality is therefore driven by the risk management practices in a bank, such as:

- The ability of bank personnel to underwrite, monitor, manage and control risks under current and stressed market conditions
- Internal loan review processes that help identifying problem assets early
- Policies, procedures and risk limits that guide lending decisions and reflect risk appetite

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ASSET QUALITY

NPL | TOTAL LOANS

NPL | TOTAL EQUITY

ALLOWANCE FOR LOAN LOSS | TOTAL LOANS

PROVISION FOR LOAN LOSS | TOTAL LOANS

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