BANK ANALYSIS

CAMELS – Earnings Quality

Earnings quality mainly focuses on the profitability and productivity of a bank, but also helps to explain sources of growth and suggests the sustainability of future earnings capacity. Earnings and profitability are at the same time the prime source of increase in a bank´s capital base, and are to be examined with regards to interest rate policies and adequacy of provisioning.

Of course, a bank also relies on its earnings momentum to support activities such as funding dividends, maintaining adequate capital levels as well as providing for investments in growth or in new activities. Thereby, level, trend and stability of earnings according to their respective sources are all of relevance and subsumed under the term of earnings quality: Especially if earnings fluctuate, the causes of these volatilities have to be well understood. This is, because earnings momentum or volatility could, for instance, have been caused by nonrecurring events or – strategically intended - by redirecting the loan portfolio or securities held and along with this having substantially increased their respective risk profiles. Or, in another example, a commercial bank will see its earnings momentum accelerate or decelerate within a changing interest rate environment. Or, along with a changing macro-economic environment, allowances for loan losses may have to be adapted accordingly.

Now, mentioned allowances for loan losses also play a major role in identifying changes in the quality and the risk profile of a bank´s loan portfolio, usually representing a major part of an institution´s assets. – And the provisioning of this allowance can at times severely impact a bank´s earnings: Now, despite broad provisioning standards are regulated, their implementation still leave plenty of flexibility which management can (and often does) take advantage of.

For instance: If a hurricane (or some other crisis) is anticipated to hit, then the institution can only make provisions, once the disaster has actually struck, but not before-hand. Subsequently, once the adverse event has materialized, losses should not be accrued until the moment that such can also be reasonably estimated. Whereby, loss estimations will certainly also depend on the type of loan, the borrower, and the time passed between a loss event and the eventual discovery of which borrower has suffered and how badly. – This simple example already illustrates how difficult it is to assess a bank´s asset quality as well as its earnings quality.

Besides, a bank cannot be simply analyzed by applying those sets of relatively straight-forward tools available for assessing corporates amid a bank´s unique nature and business model: For example, whilst return on equity can – with some reservations – be applied for both, banks and corporates, such is not the case for return on assets (RoA): RoA for firms serves as a threshold marker whether operations shall be continued or not, by benchmarking RoA against the lowest cost of funding, the cost of debt. Now, as banks have an entirely different asset as well as funding structure, their income statements are consequently also represented in an entirely unique structure. RoA for financial institutions is therefore based on net income, instead of on earnings before interest and taxes: Therefore the RoA for banks has only limited value and scope for further interpretation.

As earnings are at the front line of defense against erosion of capital base from losses, the need for high earnings and profitability can hardly be overemphasized: Not least this is why RoA appears the best and is also the most widely used indicator.

Bank earnings analysis requires uniquely tailored tools, such as the earnings spread: As a bank´s core task is a maturity transformation from short-term liabilities towards long-term assets, the earnings spread measures the yield of earnings generated on its (core) earning assets compared to the interest paid and expensed on its financial liabilities. A similar, comparably relevant ratio is the net interest margin which has as a basis only a bank´s earning assets. Having said this, neither adequately provides a reference in regards to the riskiness of a bank´s overall assets, in particular its loan portfolio.

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EARNINGS QUALITY

NET INTEREST INCOME | EARNING ASSETS

OPERATING EXPENSES | INCOME (INTEREST + NON-INTEREST)

ROA = NET INCOME | TOTAL ASSETS

ROE = NET INCOME | EQUITY

DIVIDENDS | NET PROFIT

INTEREST INCOME | TOTAL INCOME

$$\frac{\text{INTEREST INCOME}}{\text{EARNING ASSETS}} - \frac{\text{INT EXPENSES}}{\text{EARNING ASSETS}} = \text{NET INT MARGIN}$$

$$\frac{\text{INTEREST INCOME}}{\text{EARNING ASSETS}} - \frac{\text{INT EXPENSES}}{\text{INT BEAR LIABS}} = \text{SPREAD}$$