Bank Analysis - Basics

Due to their unique business model, banks are notoriously difficult to analyze, with most of the tools available for assessing corporates simply not applicable.

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

Banks are delicate and fragile entities for two reasons:

1. A bank usually lends medium- / long-term, whilst its funding base (i.e. deposits held) is vastly short-term. Hence, a bank´s balance sheet mirrors a maturity transformation from short-term liabilities towards long-term assets. This makes a bank´s ability to re-fund its liabilities smoothly and on an ongoing basis essential.
2. Compared to any ordinary corporate, a bank´s balance sheet is extremely levered.

Both observations explain why trust in a financial institution´s asset base, its liquidity, risk management, general management, systems and technology are all essential. And it also explains, why a bank will not survive for long, once public´s trust is lost: With holders of bank deposits demanding their funds back, a financial institution will collapse, often within days, perhaps even hours.

This fragility has also led to banks being thoroughly supervised and regulated, both on a national and an international level (e.g. Basel III). Next to licensing requirements, banks have to meet rigorous standards, such as concerning minimum liquidity, capitalization or implementation of risk management procedures. Also, regulators require a fair amount of public disclosure and transparency as well as a bank following strict corporate governance standards.

The vast majority of tools and concepts applied in general corporate analysis will not work for financial institutions: To start with, on top of a bank´s income statement one can´t even find a proper, ordinary revenue line. Instead, a bank´s revenues are composed of interest payments received from funds lent (i.e. loans) and services provided (e.g. advisory or transfer services). A bank´s incurred costs, on the other hand, will foremost be composed of interest payments made to depositors or other creditors as well as costs related to personnel and technology. Besides, a major focus will be on provisions set aside for loans unlikely to be (fully) redeemed.

Also, a bank´s balance sheet structure differs entirely from that of corporates in industrial or other service sectors: For instance, none of a typical corporate´s working capital positions do play any relevant role on a bank´s balance sheet (inventory, payables, receivables). Or, and in contrast to a corporate, the vast part of a bank´s liabilities are current, its (tangible) fixed assets do hardly matter, therefore neither does depreciation. And, whilst a corporate combines inventory and labor to manufacture a product, a bank combines cash it has collected with service provided by its staff. – Besides, whilst like ordinary corporates also banks hold equity in their respective balance sheets, regulators and investors rather focus on a bank´s so-called capital position: This is composed of equity, equity-linked securities and additional instruments which can absorb losses. Regulators classify these instruments into Tier 1, 2 and 3 capital.

Therefore, items such as earnings before interest and taxes, also before depreciation and amortization cannot be found in a bank´s financial statement. And in consequence, calculations of a standard corporate-related performance ratios, such as Return on Assets (a benchmark whether to sustain a corporate´s operations) simply do not work. Corporate liquidity ratios or a cash conversion cycle cannot be applied either for a bank.

On the other hand, tools for assessing the risk profile of a bank´s loan portfolio are key in understanding an institution´s solidity and in managing it, as are mechanisms for optimally matching cash flows, liquidities or maturities of assets and liabilities. Especially latter, as a bank must be in a position to meet liquidity requirements any time.

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

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BALANCE SHEET STRUCTURES

INVESTMENT BANK

TRADING	TRADING
SECURITIES	DEBT
LOANS	DEPOSITS
OTHER	EQUITY

UNIVERSAL BANK

TRADING	TRADING
SECURITIES	DEBT
LOANS	DEPOSITS
OTHER	EQUITY

COMMERCIAL BANK

TRADING	TRADING
SECURITIES	DEBT
LOANS	DEPOSITS
OTHER	EQUITY

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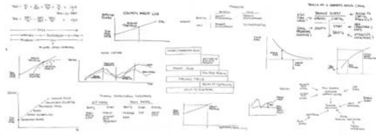

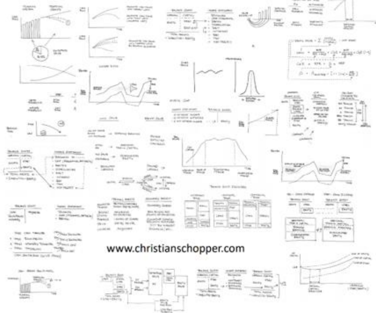

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