Basics

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

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 enterprises for two reasons:

- First, 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 the maturity transformation from short-term liabilities towards long-term assets. This makes a bank´s ability to re-fund its liabilities smoothly on an ongoing basis essential.
- Second, 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, even hours.

This fragility has also led to banks being thoroughly supervised and regulated, both on a national as well as 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.

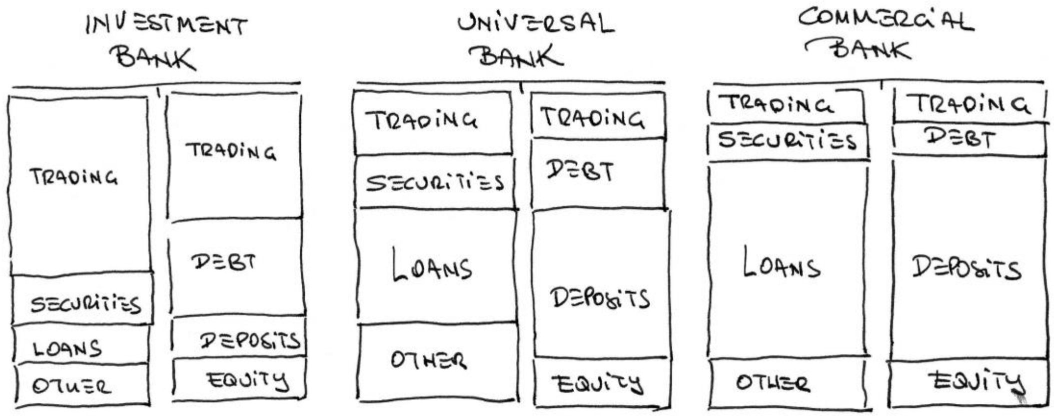
A vast range of tools and concepts applied in general corporate analysis will not work for financial institutions: For example, to start with, on top of a bank´s income statement one can´t even find an ordinary revenue line. Instead, a bank´s revenues are composed of interest payments received from funds lent (i.e. loans) and services provided (e.g. advisory 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 a corporate in the industrial or service sectors: For instance, none of a typical corporate´s major working capital positions play any relevant role on a bank´s balance sheet (inventory, payables, receivables). Further, whilst, contrary to a corporate, the vast part of a bank´s liabilities are current, its (tangible) fixed assets do hardly play any role either, neither therefore does depreciation, for instance. And, whilst a corporate combines inventory and labor to manufacture a product, the raw material to produce a bank´s service is in essence cash it has collected and service provided by its staff. – Besides, whilst, like ordinary corporates, banks also hold an equity position, 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, in a bank´s financial statement items such as earnings before interest and taxes, also before depreciation and amortization cannot be found, the calculation of a standard corporate-related Return on Assets (RoA, a benchmark whether to sustain a corporate´s operations) does not make sense, corporate liquidity ratios or a cash conversion cycle cannot be applied. – At the same time, tools for assessing the risk profile of a bank´s loan portfolio are key, as well as mechanisms for optimally matching cash flows, liquidities or maturities of assets and liabilities. Especially latter, as a bank constantly has to be in a position to meet liquidity requirements.

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

BALANCE SHEET STRUCTURES



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