

## CAMELS – Asset Quality

**Poor asset quality is the major cause of bank failures, most frequently originating from losses of delinquent positions in the loan portfolio.**

The quality of a loan portfolio can be assessed by trend analysis and peer comparison: However, fairly measuring the quality of a bank's assets poses a challenge, not least as some input parameters rely on a subjective basis.

Naturally, special focus is on a bank's Non-Performing Loans (NPLs), not least in relation to the institution's allowance or provision of loan losses (accrued in the loan loss reserve). Whereby, staggered in decreasing quality, loans are typically categorized as:

- Standard
- Special mention
- Substandard
- Doubtful
- Loss

Whereby, it is the three lowest categories, which are referred to as NPLs: They are past due or 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 provisions have to be allocated to the account of loan loss reserves. Estimates for these provisions are determined by a loan's probability of default, a bank's exposure at default (i.e. outstanding amount) and the loss expected given default. A loan loss provision (a non-cash cost item) acts as a shock absorber to offset probable future losses and increases the loan loss reserve: This is a negative asset on the bank's balance sheet representing the amount of principal that is not expected to be recovered. – Once a loan is recognized uncollectable, it is written off against loan loss reserves and removed from the outstanding portfolio. Hence, in this ultimate step both, the reserve and the outstanding portfolio are decreased.

Next to loans, most banks will also have other assets on their balance sheets, such as securities, possibly ranging from secure government bonds to near-default junk bonds. Whilst exceptions exist, such

assets have to be marked to market, in essence in line with current market values. Whilst such approach provides a realistic financial snapshot, in times of crises values may be distorted or inaccurate.

Therefore, an asset quality rating has to reflect the quantity of both, existing and potential future credit and investment risk. Whereas such will be associated with both, the loan as well as the investment portfolio. Further, the concept of asset quality also extends to other assets held, such as real estate owned, next to off-balance sheet transactions and exposures.

Therefore, the quality of assets is a measure how well a bank's portfolio of assets has been managed: If 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 in consequence also of lower cost of funding.

With a focus on lending, particular attention in assessing a bank's asset quality deserve, 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.
- NPLs: 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 and a result of a bank's risk management practices, such as:

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

## ASSET QUALITY

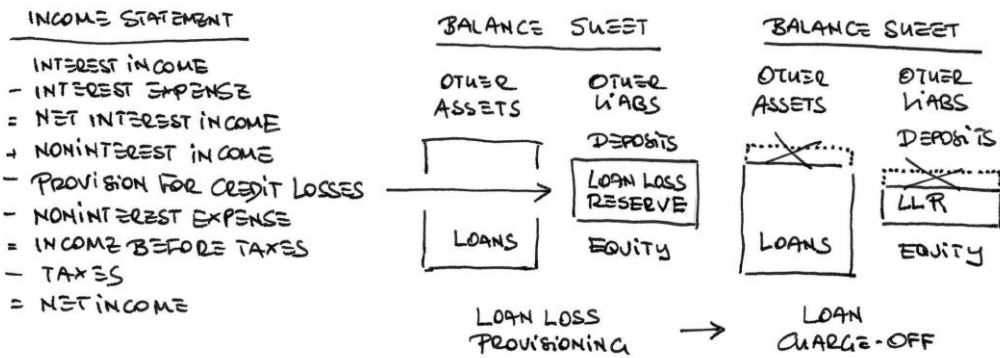
NPL | TOTAL LOANS

NPL | TOTAL EQUITY

ALLOWANCE FOR LOAN LOSS | TOTAL LOANS

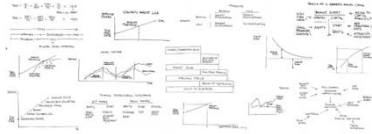
PROVISION FOR LOAN LOSS | TOTAL LOANS

### LOAN LOSS PROVISIONING



COPYRIGHT WWW

For more concepts click on:



### Corporate Finance Concepts

Christian Schopper



COPYRIGHT [www.christianschopper.com](http://www.christianschopper.com) - DO NOT COPY OR PASTE