CAMELS – Earnings Quality

Earnings quality focuses on a bank´s profitability and productivity. Also, it helps to explain sources of growth and estimates the sustainability of future earnings capacity. As earnings and profitability are the prime source of increase in a bank´s capital base, an institution´s loan and provisioning policy deserves special attention.

Every bank relies on its earnings momentum to support the funding of 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: Should earnings fluctuate widely, then the origins of these volatilities have to be understood.

Often, such fluctuations are to a lesser extent due to some nonrecurring events. Instead, earnings volatility may have its origin in a strategically intended redirecting of the bank´s loan portfolio or securities held, having led to an increase in the institution´s overall risk profile. Or, earnings momentum may simply accelerate or decelerate in an environment of changing interest rates. Or, within a volatile macro-economic environment, allowances for loan losses were frequently adapted.

Especially in analyzing commercial banks, trends in the allowances for loan losses play a major role in identifying shifts in the quality or risk profile of a bank´s loan portfolio. Despite frameworks of provisioning standards are extensively regulated, their implementation leaves plenty of judgement and flexibility to management. Even though, also a strict application of rules may sometimes lead to awkward results.

Until recently, for instance, the incurred-loss model had to be applied: If a hurricane (or similar disaster) were anticipated to hit, then an institution was only allowed to make provisions, once the disaster had actually also occurred, with the damage visible, not before-hand, though. And even then, with the adverse event having now materialized, losses should not be accrued until they could also be reasonably estimated (such as on the basis of an expert opinion). Whereby, loss estimations certainly also depended on the type of loan, the borrower, and the time passed between a loss event and its eventual discovery.

This has since changed, now the rule of the current expected credit loss has to be applied: Expected future losses have to be forecast already with the issuance of a loan. With this standard giving a greater direction in its application, earnings volatility across the banking sector is expected to increase.

To gain insights into the earnings quality of financial institutions, analytical tools applied for assessing corporates are to a large extent not applicable, with others having to be adapted accordingly: To start with, Return on Equity (RoE) can – with some reservations – be applied for both, banks and corporates. Once RoE exceeds cost of equity, the respective bank is a viable investment for shareholders. - Return on Assets (RoA), a threshold whether to continue a corporate´s business, on the other hand, needs to be adapted for financial institutions: With earnings before interest and taxes not found in a bank´s balance sheet, net income has to be used instead. However, as earnings are at the front line of defense against a potential erosion of a bank´s capital base from losses, applying an adapted RoA is reasonable.

More widely used and precise are specially tailored ratios, such as the earnings spread: As a bank´s core task is the maturity transformation from short-term liabilities towards long-term assets, it measures the yield of earnings generated on its (core) earning assets and compares that to the interest paid and expensed on its financial liabilities. A similar, comparably relevant ratio is the net interest margin, which uses as a basis only a bank´s earning assets, though. Having said this, neither provides an adequate reference to the riskiness of a bank´s overall assets, in particular its loan portfolio.

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

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

$$\frac{\text{INTEREST INCOME}}{\text{EARNING ASSETS}} - \frac{\text{INTEREST EXPENSES}}{\text{INTEREST BEARING LIABILITIES}} = \text{SPREAD}$$

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