EVALUATING BANK QUALITY

BEYOND THE SSG –

MEASURING THE QUALITY OF A POTENTIAL BANK INVESTMENT

BY: ROSS A. MEREDITH JR.
ROCKY MOUNTAIN CHAPTER
BETTER INVESTING

1

EVALUATING BANK QUALITY

PREMISE:

The quality of a bank as a long term investment is based on the safety of its operation and on its sustainable profitability, not simply the speed of its earnings growth.

2

EVALUATING BANK QUALITY

PREMISE (CONT.):

Banks have not historically grown rapidly.

Growth of assets leads to the growth of revenues and earnings.

The quality of assets (loans) leads to sustained earnings growth.

The safest and most profitable banks will do the best over the long term

3

EVALUATING BANK QUALITY

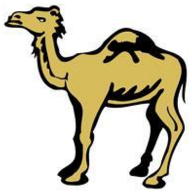
About the presenter:

- FDIC examiner for 37 years.
- Consultant to select small bank clients since 2005.
- Member of NAIC/BI for 30+ years, lifetime member now.
- Live in Salt Lake City, ski in the winter, golf in the summer.
- Lifelong Chicago Cubs fan.

4

EVALUATING BANK QUALITY

- What's an Examiner?
- Examiners evaluate CAMELS.



EVALUATING BANK QUALITY

- Capital adequacy
- Asset quality (loans mostly)
- Management
- Earnings quality
- Liquidity
- Sensitivity to risk

EVALUATING BANK QUALITY

- Safety orientation
- Banks can be good long term investments
- Long term investors

EVALUATING BANK QUALITY

- The most important aspect of safety and soundness in a bank is Loan Quality.
- Loan Quality = quality loans are ones that are repaid timely and in full.

EVALUATING BANK QUALITY

What banks do:

- Take deposits for safekeeping
- Loan money to businesses, consumers and others
- Make investments in certain securities
- Offer other financial services
- Banks earn income on the spread between interest paid for deposits and earned on loans.

EVALUATING BANK QUALITY

What banks do:

Loans are assets to a bank.

Deposits are liabilities to a bank.

Note that a bank's assets and liabilities are monetary.

EVALUATING BANK QUALITY

The Importance of Loans:

80% or more of the assets of the average bank today are loans.

Unpaid loans are PAINFUL!

Loss of the loan principal, as well as unpaid interest, diminish a bank's earnings.

EVALUATING BANK QUALITY

EXAMPLE:

- Bank has $1,000,000 in assets.
- The bank has $100,000 in capital.
- Its Capital Ratio is therefore 10%
- The bank's average loan size is $25,000
- The bank earns about $12,500 annually.
- The bank experiences a total loss on one loan.
- Its earnings are reduced by $25,000 producing a loss for the year and its assets are reduced to $975,000.

EVALUATING BANK QUALITY

EXAMPLE (CONT.)

- Current low rates give banks little margin for lending error.
- It takes just four such loans to wipe out the bank's capital.
- If the bank loses its capital and cannot replenish it fully in short order, the regulators will close the bank.

EVALUATING BANK QUALITY

ROSS'S RULE OF THUMB #1:

LOOK FOR BANKS WITH ANNUAL LOAN LOSSES < 1% OF LOANS

EVALUATING BANK QUALITY

Example:

BANK A	2007	2008	2009	2010	2011	2012
Loans ($mil)	$518.7	$570.0	$583.1	$571.2	$583.0	$586.6
Loss Provision	$0.4	$1.1	$1.6	$3.4	$2.9	$3.1
Provision/Loans	0.07%	0.19%	0.27%	0.60%	0.50%	0.53%
Earnings/share	$1.82	$1.96	$2.06	$2.24	$2.54	$2.55

BANK B	2007	2008	2009	2010	2011	2012
Loans ($mil)	$735.5	$682.1	$583.9	$498.5	$443.6	$481.8
Loss Provision	$2.1	$12.1	$26.6	$8.0	$2.7	$2.1
Provision/Loans	0.29%	1.77%	4.55%	1.60%	0.61%	0.44%
Earnings/share	$4.30	($1.20)	($17.25)	($6.42)	$0.45	$0.92

EVALUATING BANK QUALITY

BANK INDUSTRY

- The 2008-2010 downturn is the worst since the 30's.
- Banking is heavily regulated
- More capital.
- The best banks have capital of 11% or greater.
- Banks report to the FDIC and SEC.

EVALUATING BANK QUALITY

BANK INDUSTRY (cont.)

- Artificially low current interest rates impair margins.
- Rates cannot stay this low forever.
- Not all markets are created equal.
- Economic recovery will happen.

EVALUATING BANK QUALITY

BANK INDUSTRY (CONT.)

- Return on Average Assets (ROAA) is a good measure of bank management and strength.
- Why ROAA rather than Return on Equity (ROE)?
- Answer: Regulators.
- The best banks will earn a good return on average assets (at least 1.0%).

EVALUATING BANK QUALITY

- ROSS'S RULE OF THUMB #2: Look for Banks earning 1.25% on assets or higher.

EVALUATING BANK QUALITY

Example:

BANK A	2007	2008	2009	2010	2011	2012
ROAA	1.43%	1.45%	1.46%	1.52%	1.65%	1.61%
Assets ($mil)	$887.6	$935.4	$982.4	$1,022	$1,067	$1,104

BANK B	2007	2008	2009	2010	2011	2012
ROAA	0.69%	-0.02%	-2.93%	-0.07%	0.34%	0.70%
Assets ($mil)	$949.0	$879.6	$884.4	$884.9	$905.0	$902.3

EVALUATING BANK QUALITY

OTHER INFORMATION SOURCES

- Bank's website.
  - May contain peer group comparison information
  - 10Q and 10K available
- The FDIC website.
  - www.FDIC.gov

21

EVALUATING BANK QUALITY

RECAP

Two STRONG measures of bank quality

- Very good credit (loan) quality with losses less than 1.0% of loans annually.
- Strong return on average assets (or total assets) of 1.25% or more.

22

EVALUATING BANK QUALITY

QUESTIONS?

MY E MAIL: ROSSMEREDITHJR@MSN.COM

23