Understanding a Bank through its Financial Statements

SOURCES

- Published Bank Financial Statements
  - Public v. privately held banks and bank holding companies (BHCs)
  - More information is available for publicly held banks and BHCs through SEC and bank agency securities filings
  - Financial statements are prepared for investors and creditors.
- Reports of Condition ("Call" Reports)
- Banks are required by law to prepare these for regulators and the public.
  - FFIEC
    - http://www2.fdic.gov/ubpr/UbprReport/SearchEngine/Default.asp
  - FDIC Institution Directory
    - http://www2.fdic.gov/idasp/main.asp

SOURCES

- Publically Held Bank Holding Companies
  - BHCs file with the Securities and Exchange Commission:
    - Financial statements and comprehensive comments annually on Form 10-K
    - Quarterly on Form 10-Q (not audited, less comprehensive)
  - https://www.sec.gov/edgar/searchedgar/companysearch.html
  - Form 10-K includes “Regulation and Supervision” discussion – a must read for bank regulatory lawyers

BASIC FINANCIAL STATEMENTS

- Balance Sheet or Statement of Condition
  - "Solvency" presentation
- Income Statement
  - "Profitability" report

Balance Sheet

PROTOBANK, N.A.
Statement of Condition

Assets			Liabilities & Capital	
		(Billions)		
Cash & Due from Banks		$ 0.8	Deposits	
Investments		2.2	Demand Deposits	$ 2.0
Loans			NOW Accounts	1.4
Gross	6.65			
ALLL	0.15		Money Market Accounts	2.3
Net Loans		6.5	Savings & Time Deposits	2.5
Trading Account Assets		.2	Total Deposits	8.2
Premises, Equipment & Other Assets		.2	Trading Liabilities	.5
OREO		0	Other Borrowing	.5
Goodwill		.1	Total Liabilities	9.2
			Capital	0.8
Total Assets		$10.0	Total Liabilities & Capital	$10.0

Ratios	
Allowance/Gross Loans	2.25%
Loans/Deposits	81.10%
Leverage Capital Ratio (Capital/Total Assets)	08.00%

General Premises

N.A. stands for "National Association" and indicates that the bank is a national bank, a commercial bank chartered by the federal government and supervised by the Comptroller of the Currency. Most banks are subsidiaries of bank holding companies in which cases the banks' financial statements are consolidated into those of the parent BHCs. BHCs' names often include such descriptive words as "Bancorp" and "Bancshares".

The **Statement of Condition** is the bank's balance sheet.

a. The assets on the left side of the balance sheet include the bank's funds and other property used in its business.

b. "Liabilities & Capital" on the right side of the balance sheet indicate the source of the bank's funds: borrowed in the case of liabilities and supplied by shareholders or earned in the case of capital. Investments and loans are the bank's principal assets, and deposits are its principal liabilities.

c. A deposit is a loan to the bank by a depositor, and depositors are creditors of the bank. Contrast with a money market mutual fund where the customer is a shareowner of the fund. A deposit represents the liability of the bank to repay the depositor, either on demand or at the time agreed.

d. The funds deposited are assets of the bank. The depositors' assets are their claims against the bank. The bank invests the deposited funds, and relends them to its borrowers, or puts them into its liquidity reserve. The investments, the loans, and the cash belong to the bank, not to the depositors.

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Cash & Due from Banks

This is the bank's **primary liquidity reserve**, the cash in its vaults, in its tellers' drawers, or on deposit with other banks (including Federal Reserve Banks). These are the funds that are immediately available to pay deposit and other obligations.

a. "**Liquidity**" refers to a bank's ability to meet its deposit and other obligations as they become due. No bank is liquid in the sense of being able to meet all of its obligations if they were all presented at one time, but in fact they are not likely to be presented at one time.

b. The law of large numbers, reinforced by deposit insurance and the safety net of the Federal Reserve System, makes it possible for banks to operate with fractional reserves (reserves that are only a small fraction of their liabilities).

c. Up until 2020, all depository institutions had to maintain a certain percentage of “transaction account” deposits as fractional reserves, set aside at the local Federal Reserve Bank as required by Regulation D. In 2020, the Federal Reserve determined that we were operating in an “ample reserve environment” and reduced reserve requirements to zero.

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Investments

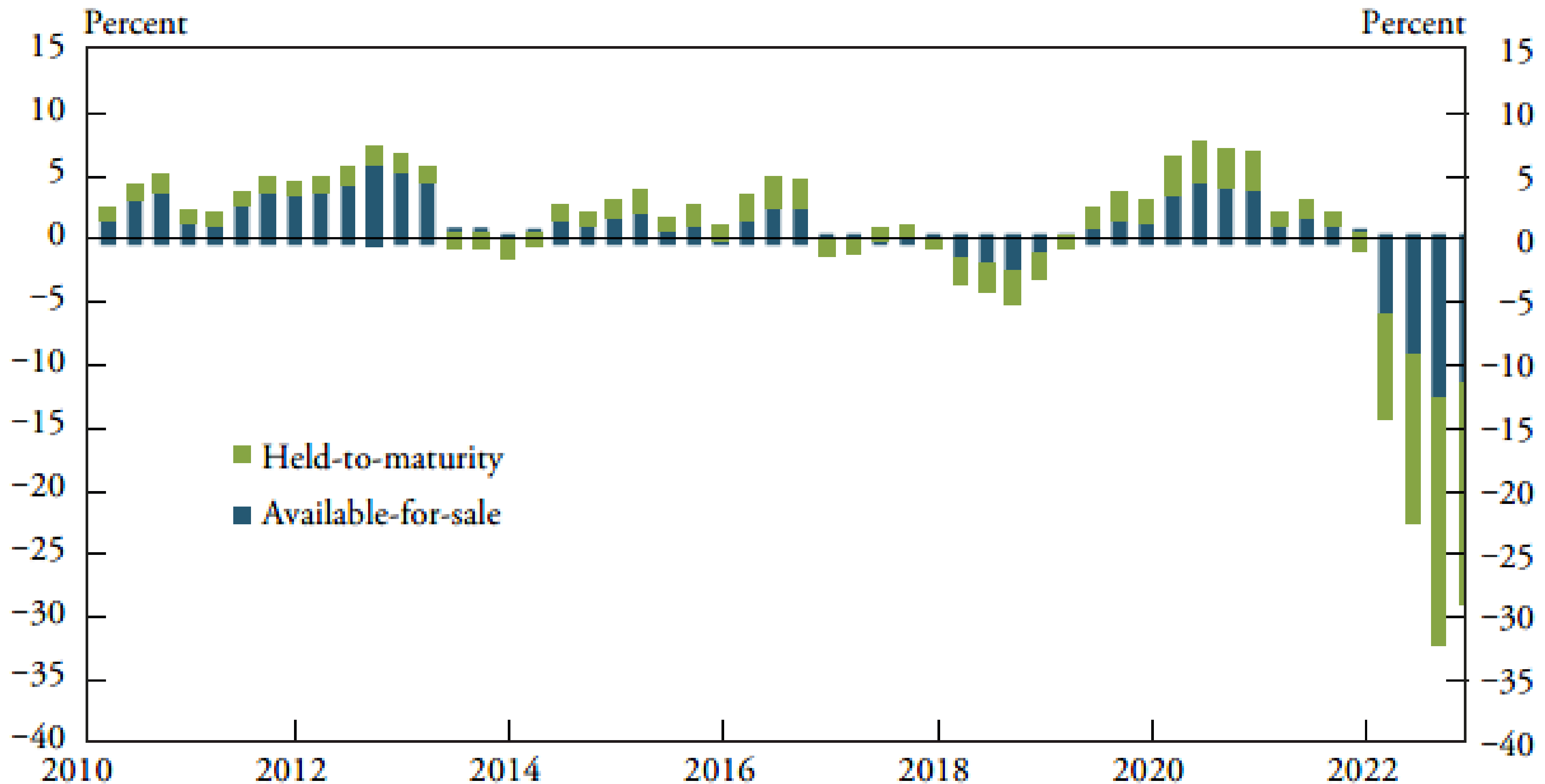
The investment portfolio is the bank's secondary liquidity reserve because it consists, or should consist, of investments that, for the most part, may he quickly liquidated and converted to cash to pay deposit and other obligations.

a. With few exceptions, the investments will be **debt instruments**, such as bonds or notes that are regularly quoted and readily marketable. They will usually be government obligations: federal, state, or municipal. They may also include high-grade corporate debt instruments.

b. With some exceptions, they do not include stock or other equity investments.

c. The three most important aspects of a bank's investment portfolio for regulatory purposes are: (1) the size of the portfolio relative to the bank's liabilities, (2) the credit quality of the obligors, and (3) the average maturity or duration of the instruments. The shorter the maturity, the nearer the market value of the investment or loan will be to its book value and the more likely it will be that it can be liquidated without substantial loss. Investments are grouped as "available for sale" and "held to maturity". The former are marked-to-market on an ongoing basis while the later may be valued using a more flexible measure.

Unrealized Losses on Securities



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Investments and Loans

In a basic sense, bank investments and bank loans are really the same thing, loans by the bank to borrowers.

a. However, a loan is usually a "one of a kind" transaction, with the amount, maturity and other terms worked out by agreement between the bank and the borrower. Its value is a matter of judgment, which depends on the credit worthiness of the borrower, the maturity, and other factors. It is not readily marketable and therefore illiquid.

b. In the case of an investment, the bank lends its money by purchasing bonds, notes, or other debt securities issued by the borrower, which is usually a government or a business corporation. The debt obligations are issued in standard denominations, such as $10,000. Investments are a source of liquidity, while loans generally are not, although loans may be turned into securities through securitization.

Loans. Both "gross" and "net" loans appear on the balance sheet. The difference is the amount that the bank has set aside for anticipated credit losses (the "Allowance for Loan and Lease Losses").

Allowance for Loan and Lease Losses. (Also called loan loss reserve, bad debt reserve, for credit losses, etc.) Loan and lease losses are charged against the Allowance, and the Allowance is replenished from the "Provision for Loan and Lease Losses," which appears on the Income Statement.

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Premises, Equipment & Other Assets

Fixed assets usually make up only a small part of a bank's assets, only 4% in ProtoBank's case.

a. Bank's have legal limitations on the fixed assets they may own, typically only as necessary for the operation of the business.

b. They may only own real property for their main offices and branches and, to some extent, for future growth. While some state banks and savings and loan associations may legally own real estate to develop, it is on a limited basis and the general rule is they may not speculate on land.

c. "OREO" means Other Real Estate Owned. This is property the bank forecloses on and they may hold it for approximately 3 years, with the possibility of extensions.

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Deposits

Deposits are the bank's principal liability and its principal source of funds. Different types of deposits have different maturities and other terms, may pay different interest rates, and may require different reserves. If a bank is liquidated, deposits have priority over other unsecured liabilities.

a. Demand deposits (regular checking accounts) are corporate and individual transaction accounts. They permit immediate withdrawal and are used for payments.

b. NOW (Negotiable Order of Withdrawal) is a special type of transaction account. Like a savings account it pays interest, and like a checking account it can be used for payments. It is not available to businesses.

Both are considered “transaction accounts”.

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Non-Transaction Deposits

Because of historical reserve requirements on "transaction accounts," Regulation D includes definitions for other accounts, with the intent that they not require reserves. Banks must specify that it may take up to 7 days to pay these types of accounts.

Money Market Accounts. A special type of savings account historically permitting a limited number (6) of transactions and originally intended, when interest rates were controlled, to permit the payment of a rate competitive with the return on money market mutual funds.

Savings & Time Deposits. Includes deposits that permit withdrawal but not checking – savings accounts- and deposits that have fixed maturities – certificates of deposit.

In the new "ample reserves environment," these definitions are irrelevant and have been deleted from Regulation D. Nevertheless, banks may maintain the requirements by contract.

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Other Borrowing

Other borrowing includes

a. long-term borrowing that for some regulatory purposes may count as capital, and

b. short-term borrowing (such as "federal funds" transactions and other money market borrowing).

c. Borrowing may enable a bank to make loans and investments when deposits are insufficient or to repay deposits if cash reserves are inadequate.

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CAPITAL

Capital or Net Worth is the difference between the bank's assets and its liabilities. These funds have been supplied by the bank's shareholders or retained from earnings. If the bank's assets shrink, its capital provides a "cushion" to absorb losses and protect the bank's depositors, other lenders, and the FDIC.

a. Note that the amount of ProtoBank's capital, like that of most banks, is small in relation to its total assets. Thus, if the bank loses as little as 8% of its assets (through imprudent investments or loans, or a mismatch between the interest rates for assets and liabilities, etc.), its capital will be exhausted and it will be on the verge of insolvency. Any further deterioration will result in loss to depositors or lenders, or the FDIC to the extent that deposits are insured.

b. Capital may be classified into subcategories such as capital, paid-in surplus, earned surplus, and retained earnings; or into common stock and one or more classes of preferred stock. These categories can be important for the purposes of corporate law and the relative rights of different classes of shareholders.

Capital Calculations
Balance Sheet (in $000's)

Subordinated Capital Notes due four years (1/3), five years (1/3), six years (1/3/)	990,000
Shareholders Equity	
Preferred Stock	
8% non-cumulative perpetual - $25 par value; issued 500,000 shares	12,500
8% cumulative perpetual - $25 par value; issued 1,750,000 shares	42,750
Common Stock, $1 par value – authorized 10,000,000 shares, issued 6,500,000 shares	6,500
Surplus	81,000
Retained Earnings	62,500
Shareholders Equity	205,250

Consider

- What are the primary threats to a bank's financial stability?
- What are the primary protections from those threats as shown on the balance sheet?
- What can a bank do to improve its financial stability?

Income Statement

PROTOBANK, N.A. Income Statement

(Millions)

Interest Income on Earning Assets		$640
Interest Expense		
Interest on Deposits	150	
Interest on Other Borrowing	40	
Total Interest Expense		(190)
Net Interest Income		450
Provision for Loan and Lease Losses		
For increase in loans outstanding	10	
For credit losses	15	
Total Loan Loss Provision		(25)
Net Interest Income after Provision for Loan Losses		425
Non-Interest Income (Fees, etc.)		190
Net Interest Income plus Non-Interest Income		615
Non-Interest Expense		(450)
(Employee compensation and benefits, occupancy, services, depreciation, etc.)		
Income before taxes		165
Federal and State Taxes (33%)		(55)
Net Income		$110

General Premises

Note the structure of the **Income Statement**.

a. **The first half of it focuses on the bank's income and expense from its main business of buying and selling money.**

b. Interest Income less Interest Expense equals Net Interest Income. Net Interest Income less the Provision for Loan and Lease Losses equals Net Interest Income after the Provision.

c. The second part of the Income Statement adds Non-Interest Income and subtracts Non-Interest Expense to arrive at Income before Taxes. Finally, taxes are subtracted to arrive at Net Income.

Interest Expense

The cost of borrowing the funds that the bank lends and invests.

Interest on Deposits: Interest on time and savings deposits. (The costs the bank incurs in servicing non-interest-bearing demand deposits (most checking accounts) are not included in "Interest Expense," but are a general operating expense and included in "non-interest expense.")

Interest on Other Borrowing. Note that the cost of these funds is much higher than the cost of deposit funds, 4% ($40 million/$1 billion) as compared with 2.4% ($150 million/$6.2 billion). The costs of servicing deposits and deposit insurance account for some of the difference.

Net Interest Income is the difference between "Interest Income" and "Interest Expense". "Net Interest Margin" is the difference between the average interest rate earned by the bank on all of its loans and investments ("earning assets") and the average interest rate paid by the bank on all of its interest-bearing deposits and borrowed funds.

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Provision for Loan and Lease Losses

This is a deduction from "Net Interest Income" that provides for anticipated losses. The Provision appears on the income statement and is added to the Allowance for Loan and Lease Losses, which appears on the balance sheet, and against which losses are charged. The "provision" is added to and replenishes the "allowance".

a. The size of the allowance reflects both external and internal considerations. **The new accounting method, Current Expected Credit Losses ("CECL'), is changing the way in which banks must assess future losses**. A bank in an area where the economy is strong may not need as large an allowance as one in an area where the economy is showing signs of stress. A bank with inadequate management and loan information systems will need a higher allowance than a bank with a good system. If loans have grown from one period to the next, the Allowance will need to be increased if its ratio to outstanding loans is to be maintained at the previous level.

b. Similarly, if loans have been charged off, the Allowance will need to be replenished if it is to be restored to its previous level. ProtoBank's Provision reflects both an increases in the level of loans outstanding since the last accounting period and replenishment of the Allowance to compensate for credit losses that have been charged against it. (There has been some disagreement between bank regulators and the SEC about how certain or probable losses should be before they are provided for.)

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Non-Interest

Non-Interest Income. In addition to interest income, ProtoBank earns income from other sources. This appears as "Non-Interest Income" on the Income Statement. Some examples are service fees for account maintenance, fees for trust and custodial services, fees for commitments to extend credit, and rent from the leasing of space not currently needed by the bank.

Non-Interest Expense. This is the expense of running the bank. The greatest part of it consists of employee compensation and benefits. Other costs are administrative expenses, account maintenance, rental payments for premises and equipment, and depreciation.

Net Income. Banks don't make much money relative to their size. Historically, a 1% return on assets has been a respectable performance, one often not achieved by large banks.

Concepts of Capital

Why Do We Need to Understand Capital?

- Almost every aspect of our clients' businesses will be dependent on how much capital they hold. Capital levels will determine:
  - whether they can pay dividends to shareholders;
  - whether they can repurchase stock;
  - whether they can accept brokered deposits;
  - whether they can branch and merge across state lines;
  - whether they can engage in new activities;
  - what kind of applications they will need to file; and
  - the extent to which they can make capital distributions and pay discretionary bonuses to executive officers.
- Capital is also critical to calculations of lending limits, loans to insiders, affiliate transactions, and investments in certain types of instruments and subsidiaries. If our client is capital-deficient, enforcement actions will ensue. If capital dissipates completely, our client will fail.
- We render legal advice in connection with each of these matters. That means, in a nutshell: capital colors our world.

CAPITAL BASICS

- Who is subject to Basel III?
- What is capital?
- How important is capital?
- How is it measured?
  - Ratios
    - Numerator
    - Denominator
  - Capital Adequacy
    - Minimums
    - Plus buffers
    - Objective: "Well-capitalized"

Who is Subject to Basel III?

- All FDIC-insured depository institutions
- All holding companies on a consolidated basis (Collins amendment to Dodd-Frank)
  - Except, holding companies with assets of $3 billion or less and securities not registered with the SEC (Small BHC/THC Policy Statement)
  - Insurance companies are a problem – Fed proposing appropriate measures
  - Resulted in many issues for exotic instruments issued by BHCs (e.g., trust preferred securities)

What is Capital?

- Economic: Plant and equipment/fixed assets
- Corporate: Funds received for sale of stock
- Accounting: Excess of assets over liabilities
- Banking regulators:
  - Cushion against losses
  - Net worth of the financial institution
  - Funding that does not have to be repaid

How Important is Capital?

- CAMELS rating: banks & depositories
  - Capital
  - Assets
  - Management
  - Earnings
  - Liquidity
  - Sensitivity to risk
- Holding Companies: RFI/C(D): risk, financial condition, impact on the sub banks, composite for the BHC and rating of each insured depository
- Stress testing and CCAR process for largest and most complex BHCs

Consequences of Low Capital Levels

- Actions by Regulators
  - Lose FHC Status
  - Capital directive to increase capital (plan)
  - Rejection of capital plans under CCAR
  - Other actions: dividend limits, consult with regulators, no acquisitions, no bonuses
- Regulatory Requirements
  - Limits on repurchase of stock
  - No expedited application procedures
  - Limits on transactions with affiliates
  - Apply to make nonbank acquisitions
- Reputational Harm

How is Capital Measured?

- Capital is measured as a ratio of capital to assets. There have been three key ratios:
  - Leverage ratio: Tier 1 capital to book assets
  - Tier 1 ratio: Tier 1 capital to risk-weighted assets
  - Total capital ratio: Total capital to risk–weighted assets
- Basel III added Common Equity Tier 1 (CET1) to risk-weighted assets

The Numerator: the Elements of Tier 1 Capital

- Tier 1 capital, formerly “primary” or “core” capital includes:
  - Common shareholders equity
  - Certain preferred stock
    - Perpetual: no fixed term, not redeemable at the option of the holder
    - Noncumulative: may eliminate dividends w/o paying later
    - No adjustable rate based on issuer’s condition

The Numerator: Tier 2 Capital

- Tier 2 or Supplemental Capital includes:
  - Preferred stock that does not qualify as Tier 1
    - Limited term
    - Cumulative
    - Dodd-Frank phase out of certain preferred from even Tier 2 by 2015 for larger banks
- Adjustable rate based on issuer, not general factors
- Sub Debt- up to 50% of Tier 1and a 20% discount from face amount in each of last five years to maturity
- Allowance for Loan and Lease Losses (ALLL) up to (x) 1.25% of the risk-weighted assets of standardized banks or (y) 0.6% (with slightly different formulation of ALLL) of credit risk-weighted assets for advanced banks

The Numerator: CET1 Capital

- Common Equity Tier 1 Capital (Cet 1):
  - Primarily common stock, related surplus (net of treasury stock), retained earnings
    - 13 tests to assure stock does not get repaid and dividends are not required
    - Most loss absorbing form of capital
  - Common Equity Tier 1 minority interests subject to certain regulatory adjustments.

The Denominator: Assets

- Leverage ratio uses book assets, no conversion or weighting is necessary
  - Use average over the quarter rather than quarter-end
  - Look to call report or FRY-9

The Denominator: Risk-Weighted Assets (Example under old law)

- Basel I Standardized Risk Weighting (much more complicated under Base III):
  - 0% includes cash, claims on gov'ts of OECD countries, agencies of US with full faith & credit of US gov't
  - 20% includes claims against US depository institutions and OECD banks, general obligation muni bonds, GSEs, World Bank
  - 50% includes 1-4 family mortgage loans, certain multifamily mortgage loans, muni revenue bonds
  - 100% includes general corporate and consumer exposures

The Denominator: Risk-weighted assets

- Standardized versus Advanced Approaches
  - Standardized is a floor for all covered companies
  - Advanced Approaches is for the largest companies (over $250 billion) and is based on Basel II models
- Basel III Standardized Risk Weighting
  - Much more complex and calibrated than Basel I
  - Must look up the asset in Regulation Q
  - Acts as a binding constraint on risky activities – must hold the required amount of capital for the asset

THE DENOMINATOR: OFF-BALANCE SHEET

- For Standardized, off-balance sheet items were converted at four different rates and then placed into one of the four risk-weighted categories
  - 0% conversion factor for unused portions of commitments of less than a year but only if unconditionally cancellable
  - 20% conversion factor for short term, self liquidating trade contingencies, commercial letter of credit
  - 50% conversion for bid bonds, performance bonds, standby letter of credit for a particular transaction; commitments of more than a year (home equity lines)
  - 100% conversion for guarantees, financial standby letter of credit; repo-style transactions

Required Ratios

- Basel III required minimum capital ratios beginning January 1, 2015, as follows:
  - 4.5% - ratio of minimum Common Equity Tier 1 equal to risk-weighted assets;
  - 6% - Tier 1 Capital to risk-weighted assets;
  - 8% - Total Capital (Tier 1 plus Tier 2) of risk-weighted assets; and
  - A minimum leverage ratio of Tier 1 Capital to total adjusted average quarterly assets equal to 4% in all circumstances.

Capital Conservation Buffer

Maximum payout amount for capital distributions and discretionary bonus payments to executive officers

Common Equity Capital Conservation Buffer (as a percentage of risk-weighted assets)	Maximum payout ratio (as a percentage or eligible retained income)
> 2.5%	No payout limitation applies
> 1.875% and <= 2.5%	60%
> 1.25% and <= 1.875%	40%
> 0.625% and <= 1.25%	20%
<= 0.625%	0%

Required Ratios

- Factoring in the fully phased-in conservation buffer increases the minimum ratios depicted above to:
  - 7% for Common Equity Tier 1,
  - 8.5% for Tier 1 Capital and
  - 10.5% for Total Capital.
- It is possible under Basel III to be well-capitalized while remaining out of compliance with the capital conservation buffer.

Prompt Corrective Action Framework

Capital Category	Total Risk-Based Capital Ratio	Tier 1 Risk-Based Capital Ratio	Common Equity Tier 1 Risk-based Capital Ratio	Tier 1 Leverage Ratio	Supplementary Leverage Ratio (Advanced) Starting 2018*
Well Capitalized	**10%**	**8%**	**6.5%**	**5%**	**N/A**
Adequately Capitalized	**8%**	**6%**	**4.5%**	**4%**	**≥3%**
Undercapitalized	**< 8%**	**< 6%**	**< 4.5%**	**< 4%**	**<3%**
Significantly Undercapitalized	**< 6%**	**< 4%**	**< 3%**	**< 3%**	**N/A**
Critically Undercapitalized	**Tangible equity to total assets ratio is <= 2% regardless of other capital ratios**				

*Does not reflect enhanced SLR requirements for G-SIBS

REQUIRED RATIOS

- Well-capitalized after Basel III:
  - 6.5% CET1 risk weighted ratio (new): CET1 Capital to risk weighted assets
  - 8% (was 6%) Tier 1 risk weighted ratio: Tier 1 Capital to risk weighted assets
  - 10% total risk weighted ratio: Tier 1 & 2 Capital to risk weighted assets
  - 5% leverage ratio: Tier 1 Capital to average book assets
  - 3% supplementary leverage ratio for Advanced Approaches and "enhanced" supplementary leverage ratio for 8 US G-SIBs and their IDI subsidiaries (generally 5% of FHC Level and 6% for IDI subs)

Relief for Community Banks

- CBLR – Community Bank Leverage Ratio
  - Basil III "off-ramp" for institutions with total consolidated assets of less than $10 billion (Section 201 of the Regulatory Relief Act).
  - The banking agencies set the CBLR at 9% of tangible equity to total assets for a qualifying bank to be well-capitalized. (Covid delays in place)
  - Eligible to elect the framework if:
    - less than $10 billion in total consolidated assets, limited amounts of certain assets and off-balance sheet exposures, and a CBLR greater than 9%.
  - No need to calculate the existing risk-based and leverage capital requirements of Basel III or to risk weight assets for purposes of capital calculations.