Module 3
Financial Services

Seminar Objectives:

After the completion of this Module you will be able to obtain:

1. A basic understanding of the structure and regulatory framework of the bank's financial system.
2. Understand the major guidelines for a financial institution performance from a regulator's perspective
3. Analyze the major components of the financial standing of a financial institution: capital, asset quality, management, earnings and liquidity.
4. Obtain a basic understanding of how to assess bank's management, including the examination of management's long term strategies and the adequacy of the financial information provided.
5. Assess the level and extent of risk in the financial institution: Interest rate, liquidity and credit risk

Module 3
Financial Services

Seminar Objectives:

After the completion of this Module you will be able to obtain:

6. Examining the new generation financial services sector, its products and services

7. Study the emerging trends in banking technology

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The FDIC Regulators describe the steps to assess a financial institution's liquidity adequacy as the evaluation of:

The current liquidity position,

Present and anticipated asset quality,

Present and future earnings capacity,

Historical funding requirements,

Anticipated future funding needs, and

Options for reducing funding needs or obtaining additional funds.

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In order to obtain funding to meet the liquidity needs the financial institution will have to:

- Sell assets
- Borrow funds on a short term basis
- Increase long term liabilities
- Increase its capital via a capital injection or the issuance of additional stock

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Bank Regulators provide the following indicators when an institution may have a potential serious liquidity problem:

- Rating sensitive providers, such as money managers and public entities, abandon the bank.

- The institution receives requests from depositors for early withdrawal of their funds

- Transaction sizes are decreasing, and some counterparties are even unwilling to enter into short-dated transactions.

- An increasing spread paid on deposits relative to local competitors, or national or regional composites.

Source: FDIC Risk Management Manual Examinations Policy

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What determines liquidity in a financial institution?

1.Ability to meet obligations

2.Critical in all banks to compensate for expected and unexpected fluctuations in the balance sheet

What is considered liquidity risk for a financial institution?

-Defined by the regulators as:" *Inability to obtain funds at a reasonable price within a reasonable time period to meet obligations as they become due*"

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The evaluation of liquid asset components is assessed based on two (2) approaches:

1. Review of the financial institutions financial performance on an individual basis
2. Comparison of the financial institution’s performance against its Peer Group

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What are the individual components of liquidity for a financial institution ?

Cash accounts:

- Include local and foreign currency and coin on hand or in transit, clearings, and cash items.
- Every financial institution must maintain a certain amount of local and/or foreign currency and coin on hand.
- Each financial institution establishes a policy to maintain cash balances at the minimum levels necessary to serve its customers.
- The amount depends on the anticipated needs of customers.

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What are the individual components of liquidity for a financial institution ?

Cash accounts:

Include balances maintained at the Central Bank or other local or foreign financial institutions .

Could be demand deposits and/or interest bearing and is part of portfolio diversification of liquid assets

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What are the individual components of liquidity for a financial institution ?

Investments-Securities:

- **An investment portfolio could provide liquidity to a financial institution by**:

1. Maintaining securities available for trading
2. The liquidation of an investment portfolio
3. The use of the investments as collateral for borrowed funds

- The investment portfolio for a financial institution has three main (3) categories:

1. Investments held to maturity
2. Investments available for sale (AFS)
3. Trading securities

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When assessing liquidity there are some important financial indicators/ratios that could be used:

1. **Loans to deposits (%): Total loan portfolio /Total Deposits:** Ratio used to determine ability of the financial institution to cover withdrawals made by customers.

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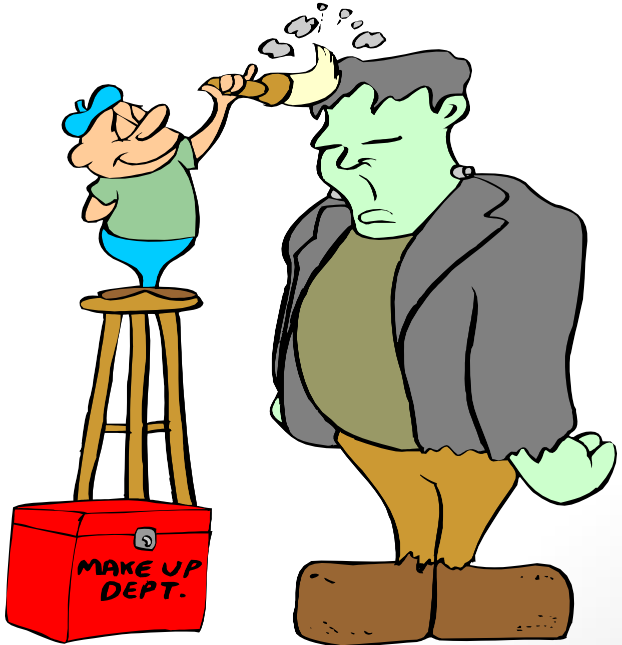
Loans to deposits (%):

- If the ratio is high the financial institution will not be able to cover an unforeseen liquidity crisis

- Shortfall in liquidity may have to be covered with Borrowed funds



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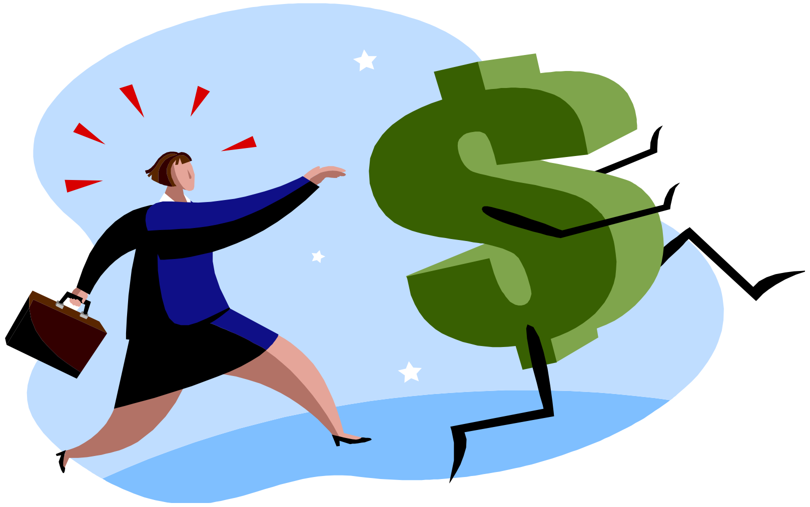
Liquid Assets/Total Assets:

- This financial indicator determines the level of liquid assets with respect to the total asset base
- It answers the question: Are there sufficient assets to cover a potential liability run-off?



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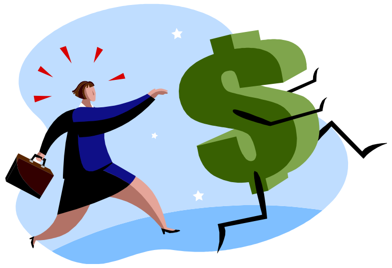
What can create a liability run-off in a financial institution?

- Negative media may impact the financial institution's reputation and the perception of the client base
- Lack of trust of the clients may triggered the withdrawal of deposits
- Weak operating performance of the financial institution and concerns arising from the ability to withdraw funds when needed may motivate clients to move deposits to other financial institutions



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Earnings Analysis:

Earnings:

- The main purpose of the earnings in the financial institution’s operating statement is to absorb losses given incremental capital via accumulation of profits
- Earnings are the first defense against capital deterioration
- It allows the financial institution to remain competitive
- The financial institution’s earnings performance has an impact on the credit rating assessment. It is considered a critical component

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Earnings Analysis:

Earnings:

- The assessment of earnings and its quality requires an understanding of the financial institution’s core business, strategic initiatives and product profile

- Analysis of the strength of earnings performance needs to exclude profitability components associated with non-recurring events

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Earnings Analysis:

Earnings:

When completing an earnings performance assessment it is critical to review and have a clear understanding of:

-The marketplace in which the financial institution operates.

- The institution's market share with respect to its competitors

- In foreign financial institutions the degree of autonomy from the Country's central government it is considered crucial.

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Earnings Analysis:

Earnings:

When evaluating the financial institution's earnings performance there are two (2) different approaches

1. **Trend Analysis**
2. **Level Analysis**

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Earnings Analysis:

Earnings:

- When evaluating the financial institution’s earnings performance there are two (2) different approaches

1. **Trend Analysis:** Assessment of the financial institution’s historical performance as it operates/progresses throughout the years.

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Earnings Analysis:

Earnings:

When evaluating the financial institution's earnings performance there are two (2) different approaches

2. **Level Analysis :**

- Analysis of the Bank's performance as of a specific date using ratios and financial calculations
- Comparison of performance against a peer group

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Earnings Analysis:

When assessing Bank's performance it is important to review each revenue component separately:

- Net Interest Income
- Income
- Non-Interest Expense
- Provision for losses

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Capital Adequacy

- The level of capital varies according to the level of risk of the financial institution
- The higher the risk, the greater the level of capital required by the financial institution.
- In the assessment of capital adequacy the tendency is to compare the capital position of the financial institution with the Peer Group
- Peer Group comparisons do not consider the specific financial institution’s risk profile

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Capital Adequacy

- Everything that impacts the financial institution impacts the needs for more or less capital

- In order to preserve the financial institution's capital base an international standard was created to ensure that the institutions can can absorb a reasonable level of losses before becoming insolvent
- The application of minimum capital adequacy ratios serves to protect depositors and promote stability and efficiency in a country's financial system

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Capital Adequacy
In this process there are two (2) types of capital adequacy ratios as follows:

-**Tier 1**: Capital that can absorb losses without stopping the financial institution’s normal trading activities. The main purpose is to protect depositors. Depositor funds rank in priority with respect to the financial institution’s capital. As such depositors only losses will be in the event of the amount of capital cannot support a significant operating loss.

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Capital Adequacy
In this process there are two (2) types of capital adequacy ratios as follows:

Tier 2: Capital that can absorb losses in the event of a major financial catastrophe. This capital which is usually subordinated debt offers less protection to depositors

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Capital Adequacy: Issues to consider…..
- Minimum capital requirements for Tier 1 and Tier 2 capital called reserves are established by the country's bank supervision authorities.

- **Management Assessment:** In the review of the financial institution the assessment of management is critical. Some of the elements to consider are:
  - Under-staffing
  - Poor professional credentials
  - Relative inexperienced staff

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Capital Adequacy: Issues to consider…..
Profitability Performance:
- Are earnings consistently positive?
- Is earnings growth resulting from core business?
- Is the growth an internal earnings growth or it was a result of portfolio acquisitions or mergers ?
- Are the financial institution's earning subject to exposure to a volatile interest rate market?
- Senior management's ability to react to emerging risks

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Ratings for Financial Institutions/Capital Adequacy:
1 Rating: Indicates a strong capital position relative to the institution's risk profile

2 Rating: Satisfactory capital position in comparison to the risk profile

3 Rating: Indicates a less than "satisfactory" capital position that does not support adequately the risk profile. The Bank needs improvement. This is true even if the capital ratio is higher that regulatory requirements

4 Rating: Indicates Deficient level of capital. The viability of the Bank as a "going concern is threatened. There is a strong need for additional capital assistance/contribution

5 Rating: Critically deficient level of capital. Viability as a going concern is seriously threatened. Immediate assistance for capital will be required

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ASSET QUALITY AND OTHER CONSIDERATIONS

Balance Sheet Review:

Asset Quality:

- When evaluating asset quality it is important to determine present and future loss exposure

- This assessment will include the:
- 1. Loan Portfolio
- 2. Investments
- 3. Other potential losses in other assets

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Asset Quality:

- When evaluating quality issues to consider…

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ASSET QUALITY AND OTHER CONSIDERATIONS

Balance Sheet Review:

- Loan Portfolio is usually the largest asset in a financial institution's balance sheet

- The highest risk is loan losses/defaults

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ASSET QUALITY AND OTHER CONSIDERATIONS

Balance Sheet Review:

Asset Quality:

1. Reviewing past due and criticized loans
2. Assessing trends in the asset portfolio
3. Identify any credit , geographical and industry concentrations
4. Management’s ability in the underwriting and management of the loan portfolio

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Bank Examinations:

- Federal and State regulators perform regular examinations of all banks.
- Many functions of financial institutions are examined. One of the most important segments in an examination is the safety and soundness evaluation.
- Financial soundness is tested by reviewing loans granted by the financial institution.
- The financial soundness review is completed by assessing the timeliness in the repayment of the loans and the review of internal controls to prevent fraud and embezzelment.

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Bank Examinations:

- In order to assist the financial institution’ safety and soundness an examiner relies on the CAMELS rating system.
- During the examination financial institutions are given a score that fluctuates from 1 (Best) to 5.
- An average score of less than 2 is considered a benchmark for safety and soundness

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The analysis of the financial standing of a financial institution is performed by Bank regulators using a criteria denominated as ***"CAMEL"***

C apital adequacy

A sset quality

M anagement efficiency

E arnings quality

L iquidity

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Expansion of financial services:

- In recent years largest banks have become complex financial organizations offering a wide variety of services and products
- These banks have expanded into international markets and control billions of dollars
- With the introduction of technology over the years financial institutions have identify market niches, created customized services for the customers and implement strategies for market expansion

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Expansion of financial services:

- Due to de-regulation in financial services in recent years activities in the investments and banking sectors have converged.
- This has created a diversification of business and financial institutions are now offering investments, securities underwriting, portfolio management and insurance services.

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Expansion of financial services:

- Growth and diversification in the banking sector has transcended boundaries globally
- There is innovation and diversification in the business of commercial banks
- Some of the banks have expanded their product scope and now offer mutual funds, consumer credit, credit cards, leasing options, online and phone banking.

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Expansion of financial services:

- IT and e-banking a setting the way for financial institutions to go into virtual financial services.
- Product offerings via advertising remain the undisputed promotional resource for financial institutions
- Consumer expectations are growing. Consumers are now more educated in the topic of financial services, they are demanding more and are ready to pay a premium for it

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Expansion of financial services:

- Mobile banking has brought financial services to consumers that have difficulty visiting a branch. This innovation has brought down the costs of providing financial services.
- Social media has also become an excellent resource for the marketing of financial services. Social media has assisted financial institutions in the communication with customers and remain competitive.

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Expansion of financial services:

- Presently almost all financial institutions have websites and customers can access them via internet