



*Integrity. Commitment. Performance.*

# PMA 2009 Bank Credit Seminar

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# Opening Remarks

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- Perspectives on U.S. financial crisis
    - How did we get into this mess?
    - First, toxic assets, then spiraling economy
  - Ramifications on public sector investments
    - Failed and/or impaired investments
  - Lessons learned for the public sector
    - Risk management paradigm
    - Role of the public fund officer
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# Quote to Invest By...

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“I am more concerned about return  
OF my money than return ON my  
money” - Will Rogers

# Prudent Man Rule

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- "Those with responsibility to invest money for others should act with prudence, discretion, intelligence, and regard for the safety of capital as well as income."
- It originates from the 1830 ruling of the US judge Samuel Putnum.

# History of Prudent Man Analysis

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- The acronym PMA stands for Prudent Man Analysis
- The PMA report was created by Dr. Robert English in 1984 near the beginning of the Savings & Loan Crisis
- The report went beyond simple ratio analysis and was available to public entities nationally

# Seminar Goals

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- Gain perspective on banking industry
  - Bank Accounting 101
  - Understand key ratios
  - Learn how to find bank data
  - Perform trend and peer analysis
  - Discover common themes among failed banks
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# State of the U.S. Banking Industry

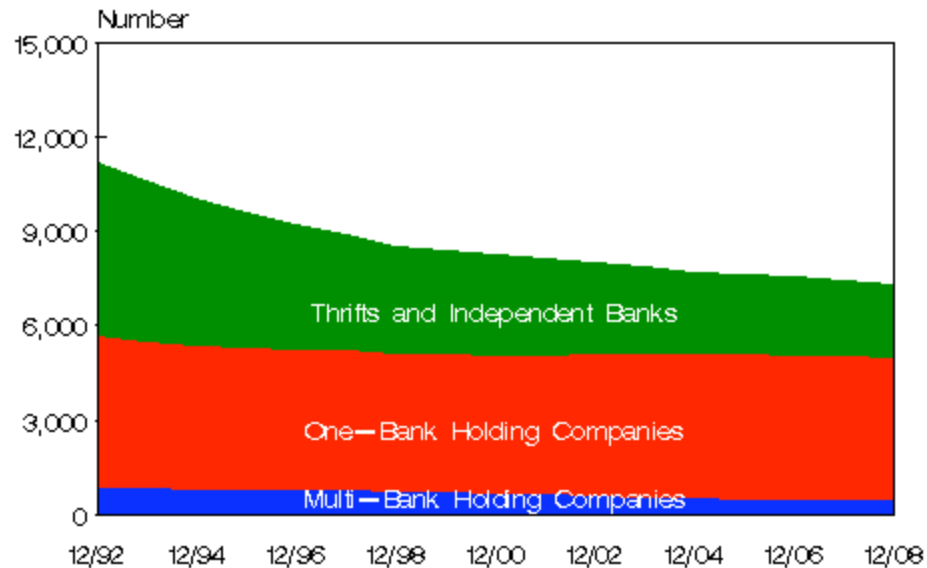
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- Large banks
    - Large write-downs in 2008
    - Outcome of “Stress Tests” generally favorable
    - Private capital beginning to enter the system
    - Government aid available to some institutions
  
  - Smaller banks
    - Recession now affecting community banks
    - Higher bank failures expected through 2011
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# Declining Number of Banks

## Number of FDIC—Insured Banking Organizations

1992 — 2008

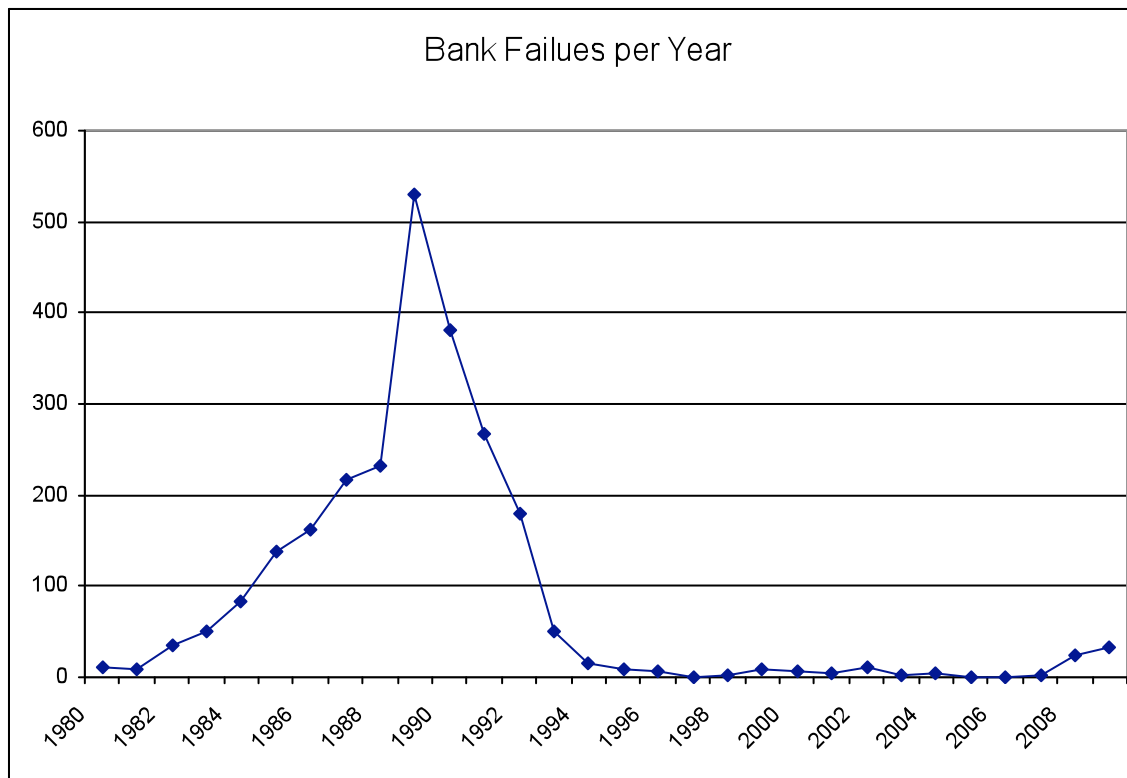


8,305 banks

\* Includes thrifts owned by unitary thrift holding companies or multi-thrift holding companies.



# Bank Failures

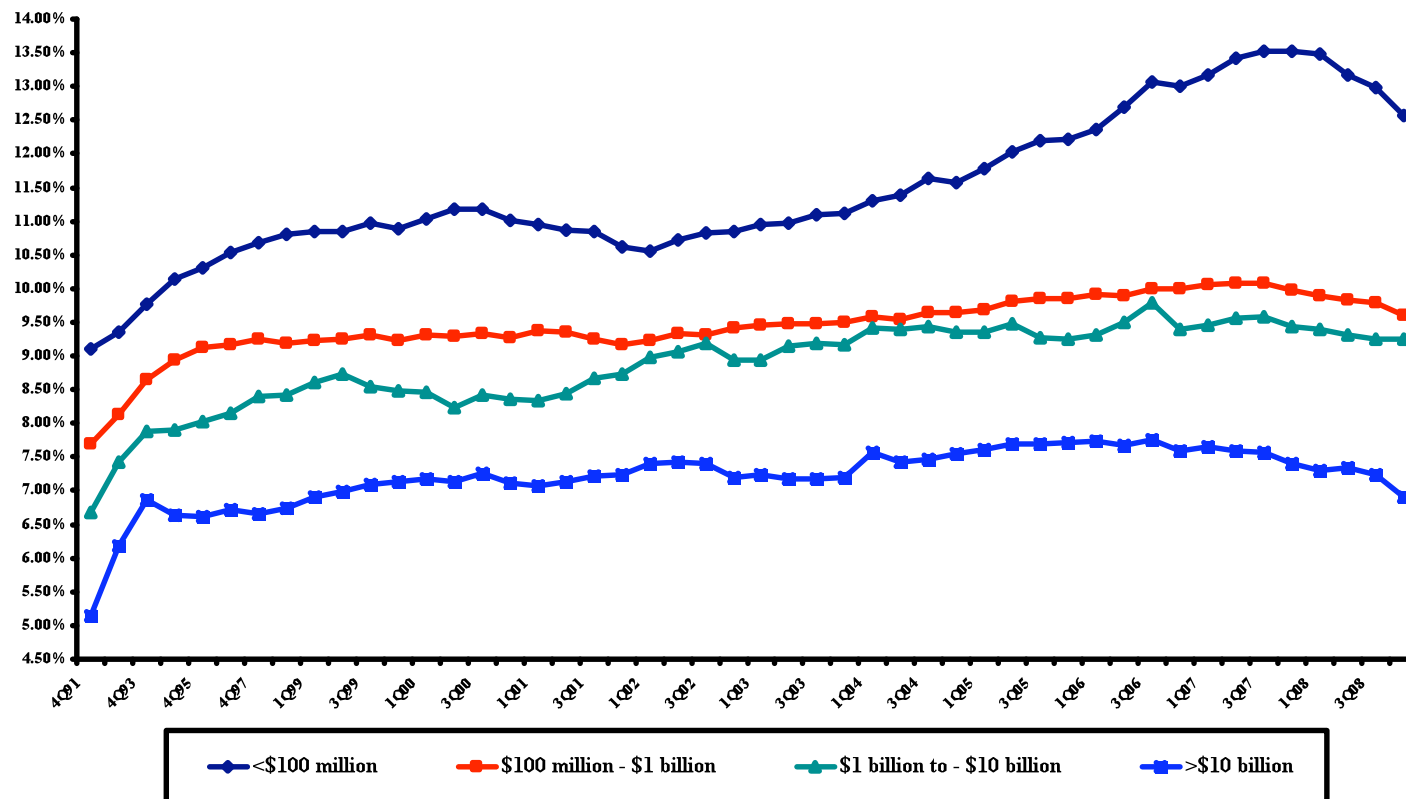


33 in 2009

# Core Capital

## All Institutions - Core Capital

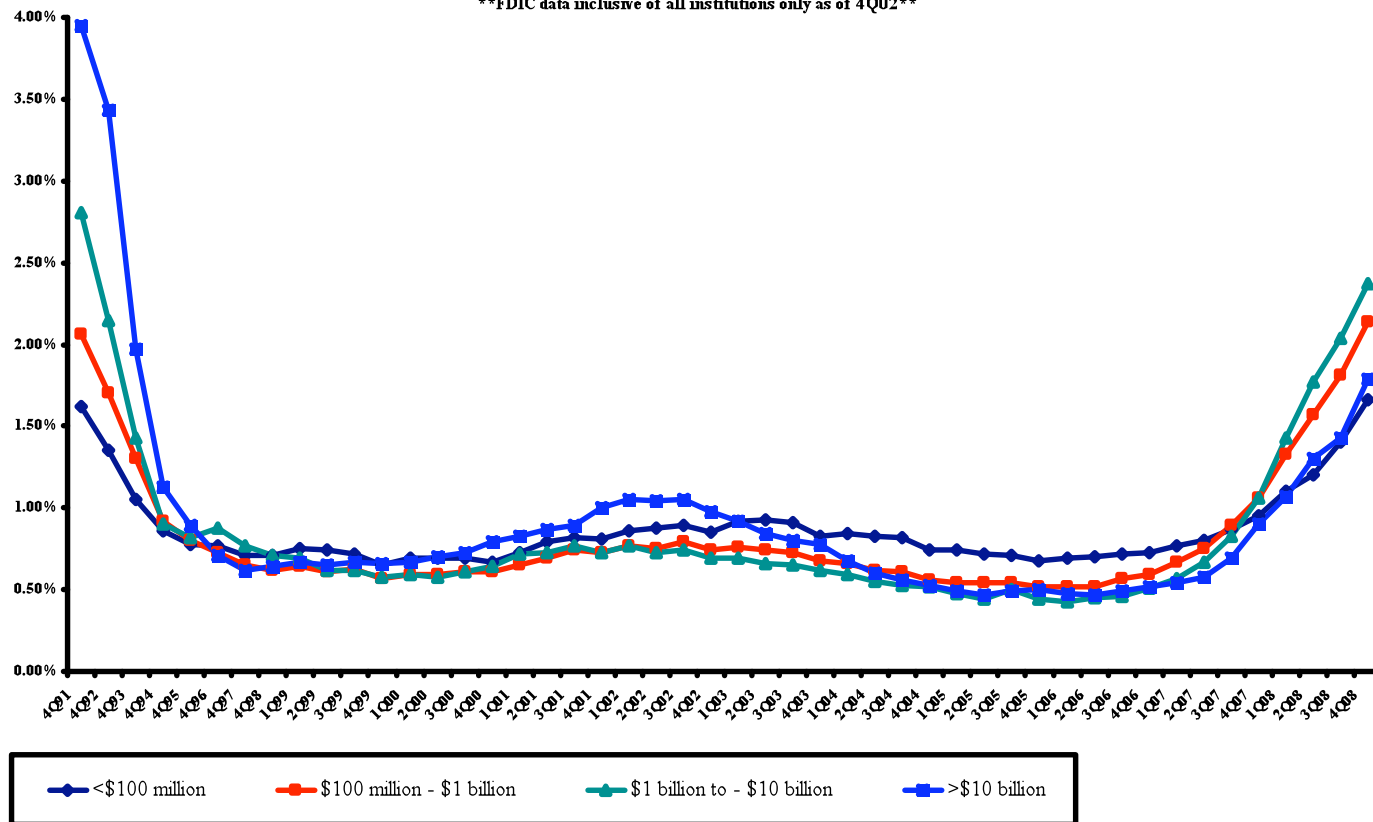
\*\*FDIC data inclusive of all institutions only as of 4Q02\*\*



# Nonperforming Assets

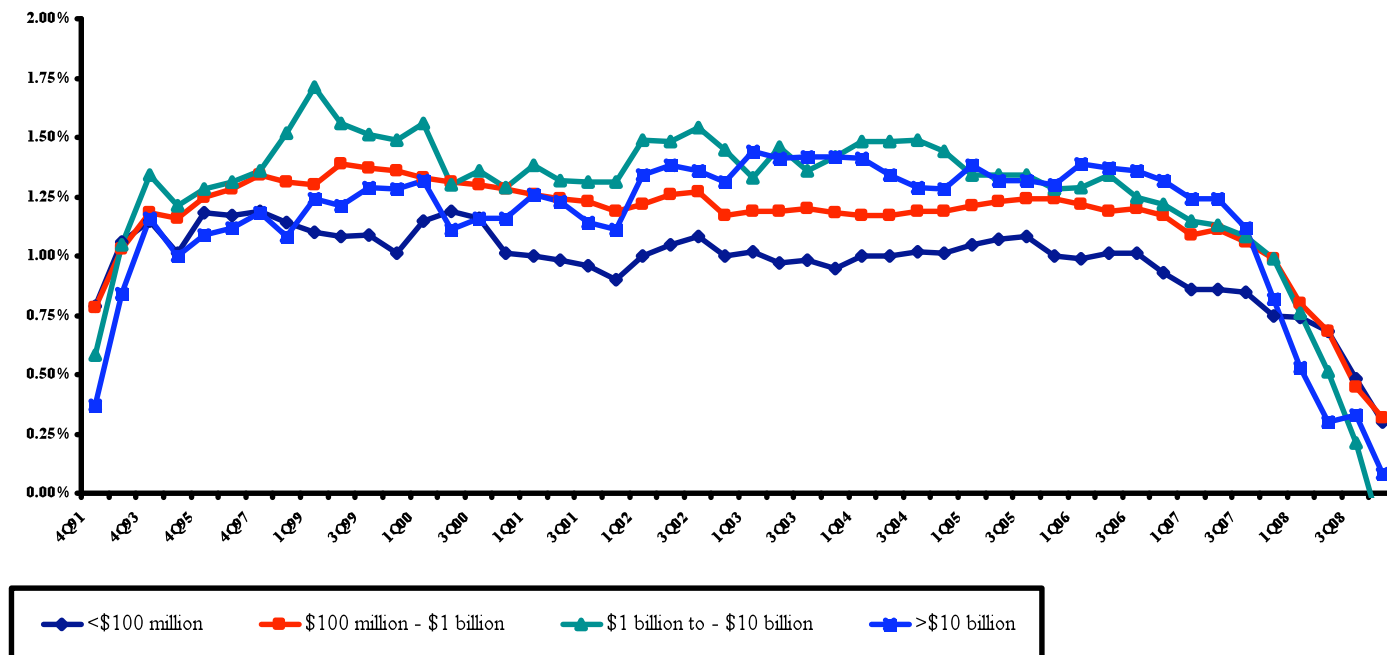
## All Institutions - Nonperforming Assets

\*\*FDIC data inclusive of all institutions only as of 4Q02\*\*



# Return on Assets

## All Institutions - ROA



# Bank Accounting 101

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Balance Sheet:

Assets = Liabilities + Shareholders Equity

Assets

Cash

Securities

Loans

Liabilities

Deposits

Long-term Debt

Equity

Preferred Stock

Common Stock

# Bank Accounting 101

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- How banks make money
    - Lend (loans) at a higher rate than borrow (deposits) – Net Interest Margin
      - Commercial loans typically generate higher yields than residential mortgages
      - Deposits include interest and non-interest bearing accounts
    - Fee income
      - Transaction fees (checking accounts, ATM)
      - Trust fees
      - Mortgage origination fees
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# Bank Accounting 101

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- Bank costs
  - Provision for loan losses (charge-offs)
  - Personnel expenses
  - Premises expenses
  - One-time charges (goodwill write-downs)

# Bank Accounting 101

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- Calculating Ratios
    - Core Capital
    - Total Risk-based Capital
    - Nonperforming Assets
    - Net Interest Margin
    - Return on Average Assets (ROAA)
    - Loans / Assets
    - Free Capital
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# Bank Analysis

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- Regulatory Examinations
  - Capital
  - Asset Quality
  - Management
  - Earnings
  - Liquidity
  - Sensitivity to changes in interest rates

# Performing Credit Analysis

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- 1) Find the data
- 2) Ratio analysis
- 3) Qualitative analysis
- 4) Recent developments
- 5) Assess credit risk

# Finding Bank Data

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- Bank and S&L/Thrift Reporting
  - Essentially the same data
  - Slightly different format
- Banks – Call Report
- S&Ls/Thriffs – Thrift Financial Report (TFR)

# Finding Bank Data

- Call and Thrift Financial Reports
  - Hard data on Balance Sheet and Income Statement
  - Extensive additional information (e.g. nonperforming loans, reserves, capital)

[www.fdic.gov](http://www.fdic.gov)
- Uniform Bank Performance Report (UBPR)
  - Ratios already calculated
  - Trend analysis
  - Peer analysis

[www.ffiec.gov](http://www.ffiec.gov) (or a link from FDIC website)

# Ratio Analysis

- Regulatory data
  - Call Report – you calculate ratios
  - UBPR calculates ratios
  - PMA Ratio Page includes multiple ratios over 5 years
- Audited financials
  - SEC filings – EDGAR ([www.sec.gov](http://www.sec.gov))
  - Private banks may provide you audited financials including the Balance Sheet and Income Statement
- Compare ratios to:
  - Historical / trends
  - Benchmarks
  - Peers

# Performance Benchmarks

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- Core Capital 9%
- Total Risk-based Capital 12%
- Free Capital (PMA) 5%
- Net Interest Margin 4.00%
- Return on Assets 1.00%
- Nonperforming Assets 3.00% (max.)
- Loans / Assets 85% (max.)

# Qualitative Analysis

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- Balance sheet and loan portfolio composition
  - Concentrations
    - Type of loans and geographic
  - Trends
  - Quality
- Discussions with management
  - Compare notes on management predictions to actual results
- Review SEC Filings (10-Q, 10-K)

# Qualitative Analysis

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- Holding company support
  - Federal Reserve – Source of Strength Doctrine
  - Institution Directory ([www.fdic.gov](http://www.fdic.gov))
- Systemic support
- Rating agency ratings
- Stock price performance



# Recent Developments

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- Enforcement Actions
    - Federal Reserve ([www.federalreserve.gov](http://www.federalreserve.gov))
    - FDIC ([www.fdic.gov](http://www.fdic.gov))
    - OCC ([www.occ.treas.gov](http://www.occ.treas.gov))
    - OTS ([www.ots.treas.gov](http://www.ots.treas.gov))
  - Other developments
    - Management changes
    - Acquisitions
    - New market entry
      - All could be found in SEC filings and/or internet searches
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# Assess Credit Risk

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- Assign deposit limits as necessary/prudent
  - For certain institutions, you may want to:
    - Assign aggregate exposure limits
    - Assign day limits
    - Assign special collateral requirements
    - Not allow collateralized deposits
    - Not allow any future deposits pending improvement
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# FDIC Website Summary

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- Call Report and Thrift Financial Report Data
- Uniform Bank Performance Report (UBPR)
- Institution Directory
- FDIC Enforcement Decisions & Orders

[www.fdic.gov](http://www.fdic.gov)

(image of FDIC website/logo)

# Group Project

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- Analyze 2 banks using the 5 steps to performing credit analysis
  - 1) Find the data
  - 2) Ratio analysis
  - 3) Qualitative analysis
  - 4) Recent developments
  - 5) Assign credit limits

# PMA Perspective

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- Bank of the Ozarks
- Tattnall Bank
- Commerce Bank, NA
- Orrstown Bank

# Bank Failure Themes

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- Bank failure causes
  - Insolvency (assets < liabilities)
  - Illiquidity (run on the bank)
- Three common themes
  - Mortgage lenders
  - Construction lenders
  - Liquidity runs

# Predicting Bank Failures

- Most banks take 2-3 years to fail after breaching the following ratios:
  - Core capital < 5%
  - Nonperforming assets > 3%
  - ROAA < 0%
- Not all banks with performance weakness fail
- Must understand the qualitative factors to differentiate (e.g. balance sheet composition)
- Not all bank failures can be predicted
  - Fraud
  - Bank runs

# Concluding Remarks

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- FDIC Update
  - Extension of \$250K limit
  - Coverage on transaction accounts
- Why bank credit important?
  - Administrative risk
  - Interest rate risk
  - Headline/political risk
    - 20/20 hindsight



# FDIC Collateral Requirements

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The Agreement must be:

- In Writing
- Signed by the Proper Parties
- Approved by Bank's Board of Directors

*\*Collateral Must be Held by a Custodian*

# Why is a Third Party Necessary?

- Oakwood Deposit Bank
  - Failed in 2004
  - Bank had pledged securities as collateral
  - The CEO was accused of posting the same assets for multiple accounts
  - Schools, villages and hospitals all lost money in the failure



# Collateral Documents

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- Pledge Agreement
  - Bank and Custodian
    - Custodian agrees to hold pledged securities in a segregated account
    - Custodian agrees to provide Pledgee with monthly collateral statements

# Collateral Documents

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- Pledge Agreement
  - Bank and Custodian
    - Control
      - 1) Depositor (Pledgee) must approve all withdraws and substitutions of collateral
      - 2) Pledgee can waive this right, but the agreement must state that in the event that the Pledgee notifies the Custodian that the Bank has defaulted on its obligations, the Custodian must follow only instructions of the Pledgee

# Collateral Documents

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- Security Agreement
  - Depositor and Bank
    - Grants Pledgee a “Perfected Security Interest”
    - Describes:
      - Types of acceptable collateral
      - Amount of collateral (e.g. 102% of deposits)
    - Should reference the Pledge Agreement

# Common Collateral Mistakes

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- Board minutes not received
- Executed agreements not held by client
- Monthly collateral statement not received
- Collateral statement not reconciled to deposits
- Pledged collateral is not allowed per investment policy
- No third party custodian

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