Is Your Bank Safe?

Do You Know? You Should!

Earl R. Hoenes

How safe are your local government dollars in a bank or savings and loan? How do you know? As the local government manager, you are responsible for making sure that your government's assets are protected and that you will have access to its money at all times. One of the things you can do to protect the local government is to analyze the fiscal health of banks. You will need to determine whether your local government has an investment policy and, if it does, exactly what it contains. To protect yourself and your local government, you should work from a simple but comprehensive policy. Here is a sample.

Selection Criteria for Banks

The local government can evaluate a bank's safety and soundness by using publicly available financial information obtained from the release of preliminary reports of condition and income from the federal government. This information, explained in more detail on pages 8 and 9, should include:

- Capital adequacy
- Asset quality
- Earnings
- Liquidity.

This is the same information that federal regulators use to assess the soundness of all financial institutions.

Minimum Criteria for Selection

The local government manager or chief financial officer may select a bank if all of the following criteria are met:

1. The financial institution must be insured by the Bank Insurance Fund (BIF) or the Savings Association Insurance Fund (SAIF).
2. Only banking corporations incorporated under the laws of each state or of the United States may be appointed as depositories of funds for local governments.
3. The bank must meet the following financial guidelines (to be determined by your local government):

   - Core capital of at least $2 million
   - A predetermined rating standard by a rating service, or core capital as a percentage of total assets of 3.00 percent.

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Core capital is a key ratio in determining a bank's ability to absorb loan losses, and a bank's ability to grow. Managers and staff members can calculate ratios, and most bank presidents will provide key ratios if you ask for them.

How a Rating System Works

Rating systems use quarterly data from the federal agencies to analyze capital, assets, earnings, and liquidity at all U.S. banks and savings and loans. Each institution is given a percentile score, whereby 99 is the best and a score of 0 is the worst. For example, a score of 50 says that half the banks scored worse

Earl R. Hoenes is the director, Cash Management Services, Sheshunoff Information Services Inc., Austin, Texas. He is a former city treasurer and finance director of Austin, Texas.

on this factor than did this particular institution.

Peer-group ratings show the differences in the total asset size of banks. For example, there can be 10 different peer group sizes ranging from 1 (with $10+ billion assets), 2 (with $5 to $9.9 billion assets), to 10 (with $0 to $9 million assets). In the sample investment policy, a peer group rating of 30 points or better automatically eliminates the lower 30 percent of the banks from qualifying, and on average qualifies 70 percent of the country's banks. But by creating a capital ratio, if a bank is not rated 30 points or better, a bank in the lower 30 percent ratings group could still be selected. This is certainly not an overly restrictive rating. You must determine your own peer group rating "comfort level" (e.g., 20, 30, 50 points, etc.).

The Sheshunoff Information Services rating system includes an annual survey of the presidents of all U.S. banks and S&Ls to get their views on safety and soundness. Their perspectives on what makes an institution healthy are used to weigh ratings for greater accuracy. The most recent survey results show that four factors should be weighted: 25 percent (34 percent) for capital adequacy, 37 percent (32 percent) for asset quality, 24 percent (22 percent) for earnings adequacy, and 14 percent (12 percent) for liquidity management (savings and loans in parentheses). After these weights are assigned, an overall peer group rating for each bank or S&L is calculated.

Ratings are given in many ways. Two ways are: a rating is based on how this bank compares with all other banks in the United States, and a rating is applied based on asset size peer groups. You will probably want to use peer group ratings.

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How Well Do the Ratings Predict Bank Performance?

From January 1, 1990, through December 31, 1990, 160 banks failed in the United States. Of these, 152 banks had been rated 0 to 9; 3 had been rated 10 to 19; 3 had been rated 20 to 29; and *only* 2 had been rated higher than a 30. No rating system can detect a major defalcation or fraudulent financial statements until the hidden factors become public knowledge and the bank's financial statements have been adjusted.

The Meaning of a Bank's "CAMEL" Rating

To fully understand the bank rating system, you need to understand the federal regulatory CAMEL rating system. Periodically, each bank receives a detailed examination by a team of federal bank examiners. At the end of each examination, the team will assign a CAMEL rating to the bank. A rating of 1 is what each bank strives for—it says that this is a clean, well-managed, and profitable bank that is worthy of the highest CAMEL rating. A rating of 2 suggests that the bank is not a problem bank, but it is not as well-managed and as clean as other banks and there is definitely room for improvement. A rating of 3, 4, or 5 says that the bank is a problem bank, with 3 suggesting that the problems have not become too serious and 5 indicating the problems are very serious indeed. A bank's CAMEL rating is known only by the federal regulators, the bank's board of directors, and its CEO, and it is a serious breach of regulations for any of these people to divulge a bank's CAMEL rating—even to city officials.

CAMEL is an acronym for capital adequacy, assets quality, management, earnings, and liquidity. During a bank examination, the team concentrates on determining five things: (1) Does the bank have an adequate capital base? (2) What is the quality of the bank's assets? (3) How well managed is this bank? (4) Is the bank producing adequate earnings? and (5) Is the bank maintaining sufficient liquidity? We need to examine these five questions.

Capital

When a new bank is formed, federal regulators will require that a specific amount of capital be invested in the bank. Usually this is on the order of $1 million, but it is not unusual for a bank to start with capital of $2 million, $5 million, or even $10 million. For the first three years of its existence, the bank has to maintain capital that equals at least 10 percent of its total assets; as the bank becomes well established, this requirement gradually slides to a capital requirement of about 6 percent of total assets.

Capital is the amount of money the owners have at risk in the bank. It is a cushion for problem loans, for hard times, for poor earnings, for defalcations, and for all forms of unprofitable operations. It is also the cushion that keeps the FDIC insurance fund from taking a loss when a bank must be closed.

Two-thirds of a bank's capital must be in the form of owner equity; the other third can be preferred stock or subordinated debentures.

Assets
A bank's assets consist of (1) loans made to its customers, (2) investments in bonds and money market instruments, and (3) nonearning assets such as buildings, furniture, fixtures, equipment, and the like. Problem loans are the primary cause of a bank's getting a poor CAMEL score. If a bank's loan portfolio is clean, this factor is rated a 1, but if there are too many problem loans this factor is given a lower score depending on the severity of the problem loans. A poorly managed investment portfolio can also contribute to a poor asset score in the CAMEL rating.

Management
The examiners seldom give the management factor a score that is out of line with the other factors. In other words, if the bank is well capitalized, has quality assets, and is making money and maintaining sufficient liquidity, it seldom gets marked down on management. The management factor looks at such things as the adequacy of the bank's written policy and procedures manuals, how the board functions, the quality of its data processing system, the experience and training of the bank's staff, and similar kinds of issues.

Earnings
A bank that has good earnings can retain enough money to keep itself well capitalized. Earnings can also cover mistakes in the loan portfolio and in liquidity management. A highly profitable bank can work its way out of almost any kind of a situation, whereas an unprofitable bank is in trouble no matter what else is happening at the bank.

Liquidity
All banks must maintain the capability of funding loans needed by their customers and all deposit withdrawals. As long as a bank can do these two things, it has sufficient liquidity. As soon as a bank cannot fund deposit withdrawals, it must close its doors. All banks must have a system of managing liquidity so that they will always have sufficient cash to cover deposit withdrawals and customer loan demand. During each bank examination, this system is closely monitored by the examining team and the bank receives a liquidity CAMEL score.

Please note that the bank examiners' scoring of these five factors is always a *secret* that is known only by federal regulatory officials and a few insiders at the bank. As a private citizen or a public finance official, you will not have access to this information. But also note that four of the five factors can be scored based on a careful analysis of a bank's financial statements. (The factor that does not show up in financial statements is management.)

A Healthy Bank

Sound investment policies and a healthy bank are critical to sound financial management. If you do your homework and take the time to find out all you can about your bank and how it stacks up, then you have done your job to protect your local government's assets. **PM**