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## Contents

Preface to the New Edition vii

<table>
<thead>
<tr>
<th>CHAPTER</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>The Credit Decision</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>The Credit Analyst</td>
<td>37</td>
</tr>
<tr>
<td>3</td>
<td>The Business of Banking</td>
<td>87</td>
</tr>
<tr>
<td>4</td>
<td>Deconstructing the Bank Income Statement</td>
<td>155</td>
</tr>
<tr>
<td>5</td>
<td>Deconstructing a Bank’s Balance Sheet</td>
<td>215</td>
</tr>
<tr>
<td>6</td>
<td>Earnings and Profitability</td>
<td>261</td>
</tr>
<tr>
<td>7</td>
<td>Asset Quality</td>
<td>337</td>
</tr>
<tr>
<td>8</td>
<td>Management and Corporate Governance</td>
<td>415</td>
</tr>
<tr>
<td>9</td>
<td>Capital</td>
<td>449</td>
</tr>
<tr>
<td>10</td>
<td>Liquidity</td>
<td>493</td>
</tr>
<tr>
<td>11</td>
<td>Country and Sovereign Risk</td>
<td>551</td>
</tr>
<tr>
<td>12</td>
<td>Risk Management, Basel Accords, and Ratings</td>
<td>641</td>
</tr>
</tbody>
</table>
n early 1997, Jonathan Golin applied for a position of bank credit analyst with Thomson BankWatch. He had limited experience in financial analysis, let alone bank financial analysis, but Philippe Delhaise, then president of BankWatch’s Asia division, had long held the view that outstanding brains, good analytical skills, a passion for details, and a degree of latent skepticism were the best assets of a brilliant bank financial analyst. He immediately hired Jonathan.


After the crisis erupted, Philippe made countless presentations on all continents, and he conducted, with some of his senior analysts, a number of seminars on the Asian crisis. This led to a contract with John Wiley & Sons for Philippe to produce a book on the 1997 crisis that was very well received, and which we hope the reader will forgive us for quoting occasionally.

When in 1999 John Wiley & Sons started looking for a writer who could put together a comprehensive bank credit analysis handbook, Philippe had neither the time nor the courage to embark on such a voyage, but he encouraged Jonathan to take the plunge with the support of unlimited access to Philippe’s notes and experience, something Jonathan gave him credit for in the first edition of the Bank Credit Analysis Handbook, published in 2001.

Meanwhile, Thomson BankWatch—at one point renamed Thomson Financial BankWatch—merged with Fitch in 2000, but Philippe and Jonathan quit prior to the merger. Philippe carried on teaching finance and conducting seminars on bank risk management in a number of countries. Recently, in Hong Kong, Philippe cofounded CTRisks Rating, a new rating agency using advanced techniques in the analysis of risk. Jonathan moved to London, where he founded two companies devoted to bank and company risk analysis.

During the 2000s, the risk profile of most banks changed dramatically. Many changes took place in the manner banks had to manage and report their own risks, and in the way such risks shaped a bank’s own credit risk, as seen from the outside. Jonathan’s book needed an overhaul rather than a cosmetic update. This is how eventually Jonathan and Philippe joined forces to present this new, expanded edition to our readers.

In the preface of the first edition, Jonathan thanked Darren Stubing for his substantial contribution to several chapters, and most likely some of Darren’s original input still pervades this new version of the book. The same applies to texts contributed by Andrew Seiz in the first edition, and there is no doubt that research done by the Thomson BankWatch Asia team, together with some of their New York–based
colleagues, permeates the analytical line adopted both in Jonathan’s first edition and in the present new edition of *The Bank Credit Analysis Handbook*. The only direct outside contribution to this edition is coming from Richard Lumley in the chapter on risk management. We are thankful to all direct and indirect contributors.

**DRAMATIC CHANGES**

The crisis that started in 2007 is still on at the time of writing. Banks and financial systems should share the blame with profligate politicians, outdated socioeconomic models, and a shift of the world’s center of gravity toward newcomers.

However deep the resentment against banking and finance—often fanned by otherwise entertaining political slogans—banks are here to stay.

Banks remain a major conduit for the transformation of savings into productive investments. It is particularly so in emerging countries where capital markets are still not sufficiently developed and where savers have limited access to direct credit risk opportunities. Even in advanced economies, access to market risk often involves dealing with banks whose contribution as intermediaries is sometimes—and often justifiably—questionable.

More than most other financial intermediaries, banks do carry substantial credit and market risks. They act as shock absorbers by removing from their depositor’s shoulders—and charging, alas, hefty fees for the service—some of that burden.

As we shall point out in this book, weak banks actually rarely fail—they often merge or get nationalized—or at least their problems rarely translate into losses for depositors or creditors. Major disasters do occur, though, and we should not dismiss the view that the mere possibility of such an occurrence is enough for state ownership or state control of banks to gain respect in spite of the huge inefficiencies such models introduce. At the very least, banks should be submitted, within reason, to better regulatory control.

Banks, however, cannot survive unless they take risks. The trick for them is to manage those risks without destroying shareholder value—the fatter the better, from a creditworthiness point of view—and without endangering depositors and creditors.

**STRUCTURE OF THE BOOK**

This book explores the tools available to external analysts who wish to find out for themselves whether and to what extent a bank or a group of banks is creditworthy.

It is a jungle out there. A wide range of theoretical research is available. Extreme opinions exist on most topics, making it difficult to reach a consensus on a middle ground where depositors, creditors, and regulators should confine the banking systems’ risk analysis.

Our book is a modest attempt at balancing the wealth of research and opinions within a useful handbook for analysts, regulators, risk assessment offices, and finance students.

Dividing bank credit analysis in separate chapters was a headache. Asset quality has an impact on earnings and on capital adequacy, liquidity on asset quality and earnings, management skills on asset quality, earnings on capital, accounting rules on earnings and capital—all on convoluted Möbius strips.
The first three chapters explore the notions associated with the credit decision, with the tools used in creditworthiness analysis and generally with the business of banking, more specifically with those activities that expose banks to risk.

Chapters 4 and 5 explore the earnings—or income, or profit and loss—statement and the balance sheet of a bank, together with the increasingly important off-balance sheet. Those documents are the first documents an analyst will be confronted with. Except for the reader already familiar with bank financial statements, those chapters are essential to understand how the various activities of the bank find their way into the final published documents that disclose—and sometimes conceal or disguise—the facts, figures, and ratios that should shape the analyst’s opinion on the bank’s creditworthiness.

The two accounting chapters pave the way for the introduction, in separate chapters, of the five basic elements of CAMEL, the mainstream model for assessing a bank’s performance and financial condition. Each of those five chapters relates back, in some way, to the two accounting chapters.

Chapter 6 discusses earnings and profitability, with their many indicators. Chapter 7 is the most important as it attempts to describe how the analyst can assess the asset quality of a bank, and how the bank monitors its assets and deals with nonperforming loans and with its exposure to other impaired assets or transactions.

Management and corporate governance are covered in Chapter 8, where the analyst will, among other things, learn how to appraise a bank’s overall management skills, which, in spite of tighter external regulations, remain a critical factor.

Chapter 9 is about capital and its various definitions and indicators. This is where a first round of comments touches on the Basel Accords, because the earlier versions of those accords focused almost exclusively on capital adequacy.

Liquidity, which is in Chapter 10, has become a major issue in the wake of the 2007–2012 crisis. It is also a very difficult parameter to analyze. No single indicator is able to describe a bank’s liquidity position, to the point where even the proposed liquidity requirements under Basel III do not bring much light to the debate.

Chapter 11 is about country and sovereign risks, which used to be relevant only to emerging markets but came to the fore during the 2011–2012 debt crisis in Europe. Globalization and the free circulation of funds around most of the world have now pushed the analysis of country and sovereign risk way beyond the traditional ratios describing such basic factors as inflation or balance of payments. Bank creditworthiness is more than ever influenced by macroeconomic factors.

Risk management is analyzed in Chapter 12, together with the second part of our exploration of the Basel Accords, to which we added a section on ratings. Risk management is no doubt the topic that saw the most changes over the past few years.

The banking regulatory regime is explored in Chapter 13, with its structural and prudential regulations as well as its impact on systemic issues.

The regional and worldwide crises of the past 20 years have generated considerable research on the causes of, and remedies to bank crises, financial crises, debt crises, sovereign crises, and their various combinations. Those crises are described and explained in Chapter 14, while Chapter 15—our last chapter—is devoted to the resolution of banking crises specifically.

We decided against offering a glossary of financial terms, as the book is already heavy and, in this day and age, the reader will no doubt find excellent glossaries on the Internet.
In our attempt to render the reader’s task easier by dividing the book into 15 chapters, we created the need for many cross-references to other chapters. We believed that the reader would have neither the courage nor the need to swallow many chapters in one sitting, and we wanted, as much as possible, our chapter on, say, asset quality to cover most or all of what the reader would want to know when reading that chapter in isolation. Inevitably, as a result, there is a—small—degree of duplication here or there.

We would like to beg our readers’ forgiveness for offering many examples from Asia. Both authors are thoroughly familiar with banking systems in that region—which admittedly is no justification in itself—while, more importantly, Asia is by far the largest financial market outside of the EU and the United States. In addition, whatever the definition of an emerging market, Asia without Japan arguably harbors the biggest emerging market banking system in the world, a fertile ground for dubious banking practices.

Considerable research is available on banking systems, banking crises, and other topics relevant to the bank credit analyst. As a matter of fact, so much information and so many opinions are offered that the analyst would need to invest a year of her life just to get acquainted with the existing literature on bank creditworthiness. Our modest ambition was to distill academic research into something palatable, to pepper our findings with information gathered over our many years of experience in bank credit analysis, and to offer our reader a useful reference handbook.

London and Port Arthur
September 2012

NOTES

1. Malaysia’s Prime Minister Mahathir produced an interesting opinion in a speech on September 20, 1997 reported by the Manila Standard newspaper on September 22, 1997: “Currency trading is unnecessary, unproductive and immoral. . . . It should be illegal.” As reported in French by Le Parisien newspaper on January 12, 2012, socialist François Hollande said on that day in a meeting during his campaign for the French presidency “Dans cette bataille qui s’engage, mon véritable adversaire n’a pas de nom, pas de visage, pas de parti, mais il gouverne; cet adversaire c’est le monde de la finance,” which freely translates as: “In the battle that is starting, my true opponent has no name, no face, no party, but it reigns; this opponent is the world of finance.”

2. Especially so where deposit insurance schemes exist.
The Credit Decision

CREDIT. Trust given or received; expectation of future payment for property transferred, or of fulfillment or promises given; mercantile reputation entitling one to be trusted;—applied to individuals, corporations, communities, or nations; as, to buy goods on credit.

—Webster’s Unabridged Dictionary, 1913 Edition

A bank lives on credit. Till it is trusted it is nothing; and when it ceases to be trusted, it returns to nothing.

—Walter Bagehot

People should be more concerned with the return of their principal than the return on their principal.

—Jim Rogers

The word credit derives from the ancient Latin credere, which means “to entrust” or “to believe.” Through the intervening centuries, the meaning of the term remains close to the original; lenders, or creditors, extend funds—or “credit”—based upon the belief that the borrower can be entrusted to repay the sum advanced, together with interest, according to the terms agreed. This conviction necessarily rests upon two fundamental principles; namely, the creditor’s confidence that:

1. The borrower is, and will be, willing to repay the funds advanced
2. The borrower has, and will have, the capacity to repay those funds

The first premise generally relies upon the creditor’s knowledge of the borrower (or the borrower’s reputation), while the second is typically based upon the creditor’s understanding of the borrower’s financial condition, or a similar analysis performed by a trusted party.

DEFINITION OF CREDIT

Consequently, a broad, if not all-encompassing, definition of credit is the realistic belief or expectation, upon which a lender is willing to act, that funds advanced will