Defining Key Performance Indicators for Banks

How do we determine the financial health of our construction lenders? All U.S. banks are regulated and required to submit their financials and industry standard performance metrics to the FDIC. While there are a number of key performance indicators that can be monitored, we have scrutinized the financial health of our lending and banking relationships in our preferred equity and common equity portfolios, using ratios defined below:

Capital Adequacy Ratios: The most important metrics in assessing a bank's financial condition, these metrics show whether a bank has enough of its own capital to absorb losses. We focus on Tier 1 capital, which is common share capital that can absorb losses without requiring the bank to cease operations. **Tier 1 common capital ratio** measures a bank's core equity capital against all the assets the bank holds that are methodically weighted for credit risk. The **Tier 1 leverage ratio** measures the degree to which a bank can leverage its capital base, but it does not weight the relative risk of assets. Larger financial institutions are required to maintain a minimum Tier 1 common capital ratio of 6%; 8% is considered healthy. Banks must maintain a leverage ratio of at least 5% to be considered well capitalized.

Performance Ratios: A bank's **loan-to-deposit ratio** measures what percentage of its deposits are lent out in longer-dated commitments. If the ratio is too high, the bank may not have adequate liquidity to cover unforeseen deposit redemptions. If this number is close to 100% or above, it is cause for concern and further investigation. **Net interest margin** looks at the bank's profit potential by measuring the spread the bank captures between the interest paid to depositors and the interest rate received on loans.

Asset Quality Ratios: A **nonperforming asset** refers to a classification for loans or advances that are in default or in arrears. A higher **loan loss reserve ratio** means a lower collection/loan repayment (from the total loans issued); a lower ratio means a higher estimated collection by the bank. Since banks establish loan loss reserves independently, it is difficult to compare ratios among banks.

Additional Risk Analysis: Many of SVB's assets were tied up in long-duration bonds whose market value declined as interest rates climbed. Regulations put in place after the Great Recession were intended to limit banks' ability to borrow short to lend long, but these regulations only apply to the largest U.S. banks (typically described as "systemically important financial institutions"). As such, we are reviewing the investment practices of our smaller regional and community bank lenders.