

FINANCE 306

BANK 01 EXECUTIVE SUMMARY

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Bank 01 Stock Price USD 51/share as of Y2Q3

The fundamental purpose of this brief summary is to demonstrate the progress of our bank and to identify the major problem areas. We will also suggest a means of improving our position in the coming quarter.

I. Operating Activities

Loan Pricing: We pursued an aggressive loan pricing policy. Stockholders anticipate benefits from an aggressive policy only if a bank completely fulfills its obligations, that is, is able to raise sufficient capital and to fund its operations with a good deposit collection policy. A major difficulty we faced was forecasting the loan demand in an unstable economy. Although we charged significantly above market rates on our loans, we still ended up with USD 150 million new loans in the last quarter (exhibits 16, 18-21).

Capital Adequacy: The most important burden we faced was the equity of the bank. The inadequacy of the bank's capital significantly undermined the operating flexibility of the management. (exhibits 12-15). We gave emphasis to our regulatory ratios. As the ratios put constraints on the interest rates we offered to time- and demand deposits, we paid attention to improve our capital position. However, attempts to improve the capital position were not strong enough to balance our bank. While experiencing these fatal issues virtually constantly we ended up squaring our bank's position by selling off consumer and real estate loans, by increasing the interest rates on our commercial loans high above market and also selling a portion of our State and Local Bonds portfolio.

Interest Rate Risk: The constantly rising interest rates increased our exposure to risk at the side of our risk sensitive liabilities. A -39 GAP was very risky to maintain as interest rates jumped 50 basis points in each quarter. In order to minimize the effect of rising interest rates we decided to implement long-swap transactions and significantly reduced our GAP from a negative 39% to a negative 22%. (exhibit 22).

Consequent to these developments our bank's stock price fell to USD 50/share from USD 75/share. The inefficient loan price-volume relationship, the destructive capital inadequacy along with other financial burdens, to a large extent lowered our Stock Price Quality Factor. (exhibit 23).

II. General Financial Health

Liquidity

While our bank's liquidity shows fluctuations over time, at the end of year 2, quarter 3 (Y2Q3) we are in a better condition when compared with the first decision of Y1Q2. Since a more liquid bank can be accepted as less risky, we feel that we have brought our bank in a less riskier position. (exhibits 1-3).

Profitability

Even though our profitability shows a downward trend until the first quarter of the second year - mainly because of concentrating too much on CIA and TIER 1 ratios to satisfy regulatory requirements-, we managed to increase them in the last two quarters. We focused more on our expenses, and it started to pay off. (exhibits 7-9)

Leverage

Generally speaking, our leverage ratios show that we are a conservative and well-capitalized bank. We do not want to put our shareholders in risky situations with high leverage.

Efficiency: Non Interest Expenses

This is the part where our efforts to reduce our expenses can be seen easily. One of our executive management's major objectives is to reduce our expenses to enjoy higher profits for our bank and for our shareholders. From Y2Q1 to the Y2Q3, our (non interest expenses)/(total operating expenses) went down as much as 12% while our (non interest expenses)/(total operating income) also decreased more than 6%.

(exhibits 4,5).

Efficiency: Non Interest Income

There is no significant change in our non interest income over the time. This is one of the weak parts of our bank's performance and unfortunately because of this, our net income did not come up as high as we have expected in spite of the significant decrease in our non interest expenses. However, one major factor contributing to this static trend is that we did not increase fees and service charges as much as market did to attract more customers and to maintain our current customers. (exhibits 6,7).

Productivity: Asset Utilization

We are satisfied with our asset utilization. Starting from the Y1Q2, our asset utilization either increased or stayed virtually the same. From Y1Q2 o Y2Q3 our ratio increased 12% which can be considered as a satisfactory upward trend.

ROA

As far as the trend in ROA is concerned, we can identify some major fluctuations. During the first three quarters the trend was moving upward, whereas from then on it was fluctuating on a continuous basis. This was due partly to the fact that coast efficient management was missing hence reflecting a low profit margin and partly to the fact that asset utilization was low reflecting some inefficient choices in asset management. Our group was more concerned with the declining trend in efficiency measures of Bank 1 because of the high interest and operating expenses. Compared to the industry average, ROA of Bank 1 was considerably above it in Y1Q2 and Y1Q3. After that period, as identified above the downward trend took its toll thus resulting in figures from slightly to considerably below the average. (exhibit 11).

CROA

Core ROA is declining during a four-quarter period until Y2Q2, where we can observe a slight upward trend. The trend resembles the ROA trend with the mere exception of year 1, quarters 1 and 2 were the two trends are inversely related to each other. This might as well reflect a greater change in the Bank's expected gains compared to its expected losses. (exhibit 10).

Stock Price

As far as the stock price is concerned, we can observe an overall downward trend, with the exception of Y2Q2. In conducting a quality factor analysis, we came to the conclusion that Bank 1 encountered considerable problems with loan losses, liquidity, productivity, CIA and ROA. Since these factors constitute a great influence to the overall picture that the bank provides to investors, thus influencing among other elements the stock price. (exhibit 23).

III. Improvement Suggestions

Number one priority should be given to capital requirements. The alternative ways to raise capital are

Issue stock

Issue capital notes

Combination of both alternatives

The issue of stock only might bring about a dilution problem. On the other hand issuing notes would increase the already high cost of capital. We at this point absolutely believe in increasing our inadequate capital. The value of the bank's balance sheet exceeded USD 1 billion. We would like to suggest a plan which mainly comprises the two financing alternatives. The most important point we must focus our attention is the weighted average cost of capital of our bank. An increase of USD 10 million in the bank's capital would bring significant financial relief to a USD 1 billion size bank without diminishing our rate of return assuming that the weighted average cost of capital would not increase in a very short run.

Our next suggestion is to implement more solid pricing policies for our commercial loans. In the past we have not quite successfully priced our commercial loans. Special attention should be given to the US Government Securities portfolio. With long term financial instruments we are

exposed to interest and consequently price risk. Consistency to our policy implies that we should avoid to invest in long term securities.

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