Financial Institutions

Sector coverage · Financial Institutions · interview preparation summary

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INT.BC.1.a · Financial institutions: economics and metrics

Classify a financial institution as a balance-sheet or a fee-based model, and explain why that choice decides the valuation method, the financing and the pitch.

A coverage banker in financial institutions names the business model first, because the model decides the valuation method, the financing and the pitch. Banks take deposits and lend, so they earn a spread and carry credit and funding risk. Insurers collect premiums now and pay claims later, so they earn an underwriting result plus investment income on the float. Specialty lenders earn a yield on loans funded mostly with wholesale borrowing. These three are balance-sheet models, where interest and claims are the cost of goods and EBITDA means very little. For them, equity is the scarce resource, and the regulator rations it through capital ratios. Value is therefore built on earnings, tangible book value and return on equity, and the price quoted is an equity value, not an enterprise value. Asset and wealth managers charge a fee on client assets and hold little capital of their own. Brokers and advisers earn commission and fees for placing insurance or products. Exchanges earn fees on trading, clearing and data, and payments firms earn a small take rate on the value they process. These are fee-based, asset-light models, where profit turns into cash and enterprise value to EBITDA is the normal lens. A quick test is whether interest or claims are an operating cost, and the answer sorts almost every firm. Some firms straddle the line, such as a broker that also carries underwriting risk, so say which part earns the profit. The common mistake is to apply an EBITDA multiple or a leverage ratio to a bank or an insurer. A second mistake is to treat every fee model as safe, because asset managers follow markets and flows, brokers follow the pricing cycle and processors follow volumes. Regulation shapes the deal as well, since capital, dividends and a change of control all need regulatory comfort. A good answer states the model, says who holds the risk, and then says which number is the price.

WORKED EXAMPLE: ONE LENS DOES NOT FIT A BANK AND A WEALTH MANAGER

A client asks how you would first look at two targets. Hartwell Bank has average loans of 30,000m, net interest income of 1,200m, fee income of 300m, costs of 900m, loan impairments of 150m and tangible equity of 3,000m. Lindane Wealth has revenue of 160m, costs of 112m, capital expenditure of 2m and net debt of 40m. Conventions: tax 25%, annual figures, and Lindane costs are 80% fixed and 20% variable with revenue.

Answer: Hartwell earns 11.25% on tangible equity and drops to 7.5% if cost of risk doubles to 1.0%. Lindane has 48m of EBITDA, converts 95.8% to cash, and loses 57.3% of EBITDA in a 20% market fall.

> **Interview tip:** Say the model first, then the lens, then the stress: for a bank, return on tangible equity and cost of risk, for a fee business, EBITDA and market sensitivity.

INT.BC.1.b · Financial institutions: economics and metrics

Calculate and read the first metrics of each financial model, and say what a normal range looks like and what makes a reading misleading.

Each financial model has a handful of first metrics, and a banker reads direction and cause before level. For a bank, start with net interest margin, which shows the spread earned on interest-earning assets. Net interest margin = net interest income ÷ average interest-earning assets. It often sits between 1.5% and 3% in developed markets and moves with the rate path and the mix of funding. Cost to income is operating costs divided by income and is often in the 50% to 65% range for retail banks. Cost of risk is the impairment charge divided by average loans, often a few tenths of a percent in normal years and above 1% in stress. The common equity tier one ratio is core capital divided by risk-weighted assets, and the useful number is the headroom over the requirement. Return on tangible equity = profit ÷ average tangible equity. It is compared with the cost of equity, which is often 9% to 12%, because a bank earning below it destroys value. For an insurer, the combined ratio is claims plus expenses divided by premiums, and a figure below 100% means an underwriting profit. Strip out reserve releases

and unusual catastrophe claims to see the underlying ratio. The solvency ratio shows capital against the requirement, and investment yield shows what the float earns. For an asset manager, read assets under management, net flows as a share of opening assets, the fee margin in basis points and the operating margin. For a payments firm, read processed volume, take rate and merchant churn. Take rate = revenue ÷ processed volume. The usual mistakes are to read a high return on tangible equity without checking how thin the capital is, and to read rising margin without asking why. A nuance generalists miss is that a bank can raise its capital ratio by shrinking assets, which flatters the ratio and weakens growth. State each metric, give a rough normal, and say what moves it.

WORKED EXAMPLE: READING A BANK'S FIRST FIVE NUMBERS

Marrow Bank is an invented retail bank. Average interest-earning assets are 50,000m, average loans are 36,000m, net interest income is 1,250m, other income is 450m, operating costs are 986m, impairments are 108m, average tangible equity is 4,200m, core capital is 4,000m and risk-weighted assets are 28,000m. Cost of equity is 10%. Conventions: tax 25%, annual figures.

Answer: Marrow earns a 2.5% margin, a 58.0% cost to income ratio, a 0.30% cost of risk and a 14.3% capital ratio, giving a 10.8% return on tangible equity that falls to 9.0% if the margin loses 20 basis points.

> **Interview tip:** Say the five numbers in order, compare the return with the cost of equity, then name the one assumption that would break it.

INT.BC.1.c · Financial institutions: valuation and deals

Choose the valuation measure that fits each financial model, justify price to tangible book from return and cost of equity, and build a sensible trading and precedent set.

Valuation in financial institutions starts from the model, because balance-sheet firms are valued on equity and fee-based firms on enterprise value. For banks, the two anchors are price to earnings and price to tangible book value. Price to tangible book is not arbitrary, because it follows from the return the bank earns on that book. Justified price to tangible book = (return on tangible equity − growth) ÷ (cost of equity − growth). A bank earning more than its cost of equity deserves a premium to tangible book, and one earning less deserves a discount. Property and casualty insurers are valued the same way, on price to earnings and price to book against return on equity. Life insurers are valued on embedded value, which adds the present value of profit on in-force policies to adjusted net assets, with price to earnings as a cross-check. Asset managers are valued on price to earnings and enterprise value to EBITDA, with enterprise value to assets under management as a cross-check that depends heavily on the fee margin. Brokers, exchanges and payments firms use enterprise value to EBITDA on organic and acquisition-adjusted figures, and fast-growing fintechs may be shown on gross profit multiples. Multiples that mislead include price to earnings on peak-cycle bank earnings, price to book without the return, and enterprise value to revenue across different fee margins or revenue definitions. A trading set should share the model, the regulatory regime, the rate sensitivity and a similar growth and return profile. A precedent set differs by sector, with banks priced on price to tangible book and earnings, insurers on price to earnings and embedded value, and asset managers on enterprise value to EBITDA and assets. Each deal price carries a control premium and a view on cost synergies, which can be large in bank mergers. Diversified groups call for a sum of the parts. The common mistake is to call a bank cheap on price to book without first comparing its return with peers. Say which multiple fits, explain what return it assumes, and test that against the evidence.

WORKED EXAMPLE: IS CORVANE BANK CHEAP, AND WHAT COULD A BUYER PAY

Corvane Bank is an invented bank with tangible book value of 8.00 a share, a return on tangible equity of 12%, a cost of equity of 10% and long-run growth of 3%. The share price is 9.20. Fenwick Bank has a return of 8% on the same assumptions. A bidder offers a 25% premium to Corvane's price and could lift Corvane's return to 14% through cost savings. Conventions: perpetual growth model, pounds per share, no tax detail beyond the stated returns.

Answer: Corvane is justified at 1.29x or 10.29, trades at 1.15x, and a 25% premium is 1.44x. The bidder's justified value after savings is 12.57, so it leaves 1.07 a share of headroom.

> **Interview tip:** Say the multiple, the return behind it, the comparison with the market, and what has to be true for the bid to work.

INT.BC.1.d · Financial institutions: valuation and deals

Explain what drives M&A, equity and debt issuance in financial institutions, judge a bank deal on tangible book and earn-back, and bring pitch ideas suited to each model.

Activity in financial institutions is driven by capital, regulation and scale, so the banker's pitch ideas start from the constraint that binds. In bank M&A, the rationale is cost savings, deposit scale and capital efficiency. A bank deal is judged on earnings per share accretion, tangible book value dilution and the earn-back period. Earn-back = tangible book dilution per share ÷ annual earnings per share accretion. A short earn-back, often a few years at most, makes a premium to book acceptable, and regulators must also approve the deal. Buyers pay in shares or cash, and goodwill is deducted from common equity, so the capital ratio often decides the structure. Insurers reshape portfolios by selling closed or run-off books, buying reinsurance, adding bolt-on distribution and exiting subscale lines, all to release capital or sharpen focus. Asset managers consolidate for scale, product gaps such as private markets, and distribution, with earn-outs to keep key people. Broker platforms are bought and rolled up by sponsors and strategics, because recurring commission, high cash conversion and bolt-ons at lower multiples support leverage. Exchanges and payments firms trade on data, clearing, scale and antitrust limits. In equity markets, banks raise capital through placings and rights issues, and fee-based names list on growth and cash conversion. An IPO investor asks whether the return is sustainable, how credit and flows behave in a downturn, and what the firm can distribute. In debt markets, financial institutions are among the most regular issuers, with senior preferred, senior non-preferred, covered, Tier 2 and additional Tier 1 bonds meeting funding and loss-absorbing requirements. Leverage capacity is set by regulatory capital and rating thresholds, not by debt to EBITDA, except for brokers and asset managers. The common mistake is to pitch a debt-funded deal to a firm whose real limit is common equity. Name the binding constraint, then match the idea to it.

WORKED EXAMPLE: JUDGING A BANK DEAL ON BOOK AND EARN-BACK

Ashlar Bank is an invented bank with tangible book of 4,000m, 400m shares, a share price of 12.00 and earnings of 480m. It proposes to buy Dunmere Bank, with tangible book of 800m and earnings of 72m, by issuing shares. Cost savings are 100m before tax a year at full run-rate. Conventions: tax 25%, savings fully phased, transaction costs ignored, tangible book per share for Ashlar is 10.00 and earnings per share 1.20.

Answer: At 1.5x the deal is 4.0% dilutive to book, 4.5% accretive to earnings with savings and takes 7.4 years to earn back. At 1.3x it takes about 1.6 years.

> **Interview tip:** Say the offer, the book dilution, the earnings accretion with and without savings, and the price at which the earn-back becomes acceptable.

INT.BC.1.e · Financial institutions: risks and sub-sectors

Identify the cycle, the risks and the accounting traps in each financial model, and run a compact end-to-end analysis of an invented institution.

Each financial model has its own cycle and its own accounting traps, and the coverage banker's task is to see through reported profit. Banks follow the credit and rate cycle, so cost of risk is the swing item, often low for years and then several times higher in a downturn. Normalised earnings should use through-the-cycle cost of risk, not the latest year. Check the migration of loans into the watch category, often called stage two under IFRS 9, because it warns before impairments rise. Check unrealised losses on securities held at amortised cost, since they sit outside reported capital until the securities are sold. Funding and liquidity matter too, because deposits that leave quickly can turn a solvent bank into a failing one. Insurers follow the pricing cycle, in which competition softens premium rates and a shock hardens them. Reserve releases and a light catastrophe year flatter the combined ratio, while reserve strengthening warns of earlier underpricing. Life insurers add assumptions on mortality, lapses and discount rates, and embedded value moves a lot with them. Asset managers follow markets and flows, and their trap is annualising performance fees or ignoring fee compression on new money. Brokers and platforms can show high reported growth that is largely acquired, so organic growth, pro forma EBITDA and cash conversion matter. Payments firms often report gross revenue that includes pass-through costs, so net revenue is the fair base for margin and multiples. Fintech lenders can look profitable before their loan losses have appeared, because losses lag growth. The common mistake is to capitalise a reported figure that is flattered by a cycle low point or a one-off. A compact analysis runs in order, from model to metrics to normalised earnings to valuation, then to what the client should do. Always say which adjustment moves the answer most.

WORKED EXAMPLE: KESTREL BANK, END TO END

Kestrel Bank is an invented bank with loans of 30,000m, tangible equity of 3,000m and a market value of 4,200m. Reported net profit is 400m. It includes a one-off disposal gain of 60m before tax, and the cost of risk was 0.20% against a through-the-cycle 0.40%. It also holds securities of 6,000m at amortised cost with an unrealised loss of 4%. Cost of equity is 10%, growth 3%, tax 25%.

Answer: Kestrel's 13.3% reported return is 10.3% when normalised for the gain and for credit costs. That supports about 1.05x tangible book, not 1.4x, and the securities loss is a further 6% of tangible equity.

> **Interview tip:** Say the model, the headline, the two adjustments, the normalised return and multiple, and the one hidden item that matters most.

INT.BC.1.f · Financial institutions: risks and sub-sectors

Use the sub-sector map of financial institutions to place a company, name its driver and first metrics, spot the common misread, and say which product group meets it.

The sector divides into eleven sub-sectors, and a banker names the sub-sector before choosing a metric. Practice differs on grouping, and some desks combine brokers with advisers or separate reinsurers from primary insurers. Retail and commercial banks earn a spread on deposit-funded loans, so read net interest margin, cost of risk and capital first, beware a high return built on thin capital, and expect consolidation M&A and capital debt. Capital markets and broker-dealer firms earn fees and trading income that swing with activity, so read return on equity, revenue mix and risk-weighted assets first, beware peak-year trading gains, and expect capital and funding work. Specialty and consumer lenders earn a yield on loans funded in wholesale markets, so read yield, loss rate and funding cost first, beware growth that hides losses not yet visible, and expect securitisation and secured funding. Property and casualty insurers sell cover and invest the float through a pricing cycle, so read the combined ratio, reserve development and solvency first, beware reserve releases, and expect reinsurance, Tier 2 debt and portfolio M&A. Life and pension insurers write long-dated contracts driven by savings demand and interest rates, so read new business margin, embedded value and solvency first, beware assumption changes, and expect book disposals and reinsurance. Insurance brokers and distributors earn commission on placed premiums, so read organic growth, margin and retention first, beware acquired growth and producer attrition, and expect sponsor sales, roll-ups and leveraged loans. Asset managers earn fees on assets that move with markets and flows, so read net flows, fee margin and operating margin first, beware performance fees and fee compression, and expect scale M&A and listings. Wealth managers advise on client assets for a fee, so read net new money, margin in basis points and adviser retention first, beware clients who leave with their advisers, and expect bolt-ons and sponsor deals. Exchanges and market infrastructure earn fees on trading, clearing and data driven by volumes and volatility, so read the recurring revenue share, volume and margin first, beware treating cyclical trading income as recurring, and expect strategic M&A with antitrust review. Payments firms and processors earn a take rate on the value they handle, so read volume, net take rate and merchant churn first, beware gross revenue and pricing pressure, and expect strategic M&A, take-privates and leveraged loans. Fintech lenders, neobanks and software providers grow fast on technology, so read unit economics, loss rates and funding cost first, beware profit before losses have appeared, and expect growth equity, listings and convertibles. Use the map by naming the sub-sector first, then the driver, then the two or three numbers.

WORKED EXAMPLE: THREE COMPANIES, THREE MAPS

A banker is shown three invented companies and asked to place each one. Pelham Underwriting has premiums of 1,000m, claims of 640m, expenses of 330m and 3 points of reserve releases in the year. Wrenfield Payments has processed volume of 18,000m, gross revenue of 220m including 130m of pass-through costs, and EBITDA of 36m. Sorrel Wealth has client assets of 12,000m at the start of the year, revenue of 84m and net new money of 480m.

Answer: Pelham is an insurer at 97.0% reported and 100.0% underlying. Wrenfield is a payments firm with a 0.50% net take rate and a 40% margin on net revenue. Sorrel is a wealth manager with 70 basis points and 4.0% organic growth.

> **Interview tip:** Say the sub-sector first, then one driver, then the first numbers, then the thing most often misread.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.