ONLINE STOCK STUDY SERIES
COMMUNITY BANK SYSTEMS
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GLOSSARY OF TERMS

1. Interest income - interest earned on a bank's income generating assets. Interest income can come from loans, securities held and certain balances maintained as deposits with other banks.
2. Net Interest Income – The difference between interest earned on income generating assets and the cost of interest paid to acquire funds. Sources of funds can include deposit accounts on which interest may be paid, and borrowings.
3. Non-interest income – Banks charge fees for an increasing range of services. Any such service including charges for non-sufficient (returned check) funds, fees for new account issuance, credit card issuance, document generation fees, research fees and the like are included as non-interest income.
4. Reserve for loan losses – Funds placed in this liability account on the bank's books are used to offset the cost of an uncollectible loan. Regulators and accountants watch this account closely. It should be of an amount sufficient to offset one year's EXPECTED loan losses. Regulators often expect an amount in excess of one year's losses and at least 1.25% of total loans.
5. Provision for loan losses – amounts placed in the Reserve for Loan Losses are put there through charges to this expense account. Clearly, of a bank's management has done a poor job of making quality loans and the bank experiences large losses, this expense can have a material impact on the bank's profitability. Credit quality, or the collectability and strength of a bank's loans, is therefore the single strongest measure of the quality of a bank, in my opinion.
6. Tax Equivalent Adjustment (TEA) - the TEA was devised by bank stock analysts and regulators in the early 1980s to adjust bank earnings in certain instances. In periods of very high interest rates, such as those that prevailed in the early eighties when the prime rate reached 14-15%, banks find few qualified borrowers. They acquire bonds and similar interest-paying securities to add needed earning assets. Many bonds issued by States, Counties and Municipalities are not taxable. Income from these securities can sometimes become significant if a bank holds a large volume of them. To adjust earnings to what they would be if such securities WERE taxable, the TEA is added to income. This is largely a fictional number and is not actually earned or received by the bank. In periods of low interest rates, such as the current period, when loans are more readily available, banks will often not hold any securities at all. As

such the TEA is largely moot and, if it is included, its effect is minimal. I recommend that the TEA be ignored and that if a particular data source is used, rather than ascertain if that source includes or excludes TEA, that the original source be used for subsequent analysis. The number may become pertinent again if rates rise to the point that banks must acquire securities to fill earning asset needs.

7. <u>Assets – </u>Assets for a bank are amounts owed the bank and securities or property owned by the bank.
8. <u>Liabilities -</u> Are obligations the bank owes others. Deposits are amounts due to those who place the funds in the banks care and are therefore obligations of the bank.
9. <u>Judging quality in a bank -</u> a number of factors affect bank quality. The first of which, I contend, is credit quality. Good credit quality is the defining characteristic of strong banks. Banks protect against loan losses with loan diversity, conservative underwriting and aggressive collections. Credit quality is measured by trends in loan losses and non-performing loans. The bank's ability to create a large interest spread stems from the provision of good service, cost controls and sound credit quality. Good profitability is better than rapid asset growth in the long term. Rapid growth by acquisition may make goodwill. As investors, we want to see the bank expand its franchise in a safe and profitable manner. Net equity (book value) is net assets divided by shares outstanding. Book value is dependent on the quality of the bank's assets. Sound credit quality adds value to the primary assets. Credit quality depends on conservative lending practices, and strong risk management. The value of the bank as a business franchise is better measured by the quality of book value than by cash flow analysis such as DCF or intrinsic value calculations. Regulators closely monitor a bank's capital.
10. Specific bank quality measures: 1. A "well capitalized bank" is one with tangible equity of over 8%. Average equity to avg. assets would be 10% and "risk based capital" should be at least 12.5%. 2. A quality bank has a loan loss reserve above its peer group and one which exceeds annual loan losses. A bank that losses .33% of loans per year should have a reserve of 1.25% of loans. 3. A good interest spread is 3.25%. Anything higher is strong. A 5% spread maintained over several periods is best. 4. Return on average assets (ROA) is a good measure of management's ability to squeeze profits from assets. A 1.25% ROA is good; 2.00% is very strong. 5. Ask the investor relations person what the bank's philosophy of lending is. 6. Credit quality is best measured by three numbers. The ratio of net charge-offs to total loans should be less than .25% to be good. The ratio of non-performing loans to total loans should be less than .75%. Any levels less than these are indicative of good credit quality and good collection effort. 7. The loan loss provision is the amount set aside to cover future loan losses. A provision over 100% of charge offs is good.
11. Use of the FDIC website is not intuitive. The best piece of information to have in advance is the bank's certificate number. The FDIC issues a

Certificate of Insurance when it insures a bank and each office of every insured bank is required by law to displace the certificate. The certificate contains a five-digit number under which the FDIC stores mountains of information about each insured bank. It's tantamount to a social security number for a bank. Alternatively, one may ask the Investor Relations Officer of the bank for its number. The FDIC requires all banks to submit quarterly Call Reports of 30 plus pages detailing every aspect of the bank's finances and operations. Call Report information is validated regularly by the FDIC's army of field examiners. And so its accuracy is fairly assured. I find data here that can't be found elsewhere. But it will take patience and a willingness to experiment to access it all.

12. Some names of banks that may be worthy of further study:

Bank of the Ozarks	OZRK
Commerce Bancshares	CBSH
First Financial Bancshares	FFIN
Glacier Bancorp	GBCI
Hancock Holdings	HBHC
Idaho Independent Bank	IIBK.OB
Lakeland Financial	LKFN
Westamerica Bancorporation	
FirstBank Holding Co.	
Bank of Hawaii	BOH