

## INTRODUCTION

The financial stability and health of the companies in a holding company enterprise can have a direct impact on the financial condition of the subsidiary thrift. Holding companies are frequently managed on a consolidated basis with their subsidiaries. The benefits of such integration are key incentives for establishing a holding company. However, integrated operations may mean that one entity's problems become problems for other affiliated entities, including the thrift. Therefore, the purpose of this Section is to assist you in evaluating the financial performance and stability of the holding company enterprise, and evaluating the potential effect on the subsidiary thrift.

You will also need to determine whether the holding company has sufficient sources of funds other than from the thrift. A holding company does not have the access to insured deposits, or Federal Home Loan Bank advances, that a thrift has. Whereas liquidity driven failures are rare among insured depository institutions, cash flow difficulties can be a primary cause for a holding company financial collapse. As such, liquidity and cash flow ratio analysis are important factors to review for holding companies.

## RISK PROFILE

As reiterated throughout this Handbook, the risk profile of a holding company enterprise is a major factor in the overall evaluation of a holding company. The financial condition and earnings performance of the companies in a holding company enterprise are key factors in assessing the risk profile. If, for example, you find that the holding company is entirely dependent on the subsidiary thrift for cash flow, the activities conducted within the enterprise, and corresponding funding needs, have a greater likelihood of being potentially detrimental to the thrift. As a holding company, or other affiliate is confronted with declining financial performance, it may do anything in its power to prevent failure. Therefore, you must be especially attentive in situations where the risk profile of the holding company enterprise

creates an incentive for the thrift to engage in riskier activities or enter into transactions that are not in its best interest.

The actual, or pending, failure of an affiliate may also result in significant financial or operational distress for the thrift. For example, if a holding company pledges the common stock of the thrift as collateral for its debts, a default may result in a change of ownership control. Or, a thrift that is highly or completely reliant on an affiliate's customer base, or upon an affiliate for operational support, may not be able to operate on a stand-alone basis. Furthermore, a thrift could suffer reputational risk that tarnishes its good name as a result of actions taken by, or the financial condition of, its affiliates.

For all of these reasons, you should perform a detailed cash flow and financial analyses to identify emerging weaknesses and other situations where abuses might occur. Early detection will allow OTS to take preventive measures to insulate the thrift.

## RATIO ANALYSIS – EARLY DETECTION

Certain financial ratios can help you identify a bankrupt or financially troubled company prior to the obvious presence of severe financial and legal problems. Ratio analysis provides a benchmark against which you can measure the relative profitability of the company compared to its peers and, tracked over time, it will identify trends and abnormalities that merit further analysis.

Calculate the following ratios to give you a snapshot of financial performance.

*Cash Position:* As the proportion of cash and marketable securities to total assets increases, the likelihood of failure declines – there is more cash available to pay immediate bills when they are due.

**Current Ratio:** As the proportion of current assets<sup>1</sup> to current liabilities<sup>2</sup> increases, the probability of failure declines – more assets can be converted to cash quickly relative to the liability repayments required within one year.

**Operating Cash Flow:** As the cash flow from operations (net income plus depreciation) increases, the likelihood of failure declines – there is more internal operating cash flow to meet long-term debt.

**Debt Ratio:** As the proportion of total liabilities to total assets increases, the probability of failure increases – larger portions of assets are financed by contractual sources of funds that necessitate fixed charges against income.

**Double Leverage Ratio:** Debt proceeds obtained from the holding company are invested in the thrift as equity. This increased capital base allows the thrift to increase its borrowings as well. Generally, as the double leverage ratio increases, so does the pressure on the thrift to maintain earnings to service both levels of debt, as often the parent relies on dividends from the thrift for its debt service requirements. Double leverage and how to measure it is further presented in the debt discussion of Section 300.

**Return on Equity:** As the net income to investors' equity increases, the likelihood of failure declines. Profitability is generally evaluated on a consolidated basis and will typically be expressed in terms of the return on equity (ROE). ROE<sup>3</sup> identifies the percentage of earnings management

<sup>1</sup> Current Assets = Cash or assets that have the ability to generate cash within one year.

<sup>2</sup> Current Liabilities = Liabilities that require payment within one year.

<sup>3</sup> As with any income measure, ROE must be looked at closely. The type of assets generating the profits, as well as the range of accounting assumptions should be considered. External factors often come into play, including pressure from Wall Street. Finally, be aware that the ROE can seem better than it really is if the company recently completed a stock buy-back (and reduced the amount of stock outstanding).

has generated on the capital invested into the business.

As mentioned above, ratio analysis involves two types of comparisons, trend and peer analysis. **Trend analysis** compares a present ratio with past and projected future ratios for the same company. The longer the period analyzed, the more meaningful the trend. **Peer analysis** compares the ratios of one company with another in the same industry at the same point in time. You must apply peer analysis judiciously, since holding companies are not a homogeneous group; it may be difficult to place a company into a relevant peer group. Also, peer data may not be prepared on a consistent basis due to individual reporting and accounting practices.

When using peer or trend analysis, you must carefully interpret the data. For example, a company may show an improving trend but still be very weak. Alternatively, a company may show better results than its peers in its industry, but still be weak because the industry overall is in very poor financial condition.

## EARNINGS ADEQUACY

While ratio analysis can help you determine positive or negative financial trends, you must also analyze earnings adequacy and profitability. You must consider the following questions:

- What are the quality and level of earnings?
- Are nonrecurring sources of earnings relied upon?
- How does the volatility of earnings affect pro forma business plan projections?
- Are projections stress tested?

As you review the financial condition of a holding company enterprise, you must remain flexible. As noted throughout this Handbook, the specifics of each organizational structure will dictate your scope. The majority of thrift holding companies are shells. However, there are many OTS-regulated holding companies that are large busi-

nesses. These holding companies may have a number of noninsured subsidiaries. These industries include securities broker/dealers, insurance underwriters and agents, manufacturing, and retail.

In the case of shell companies, thrift and holding company earnings will be almost identical, and parent only financial statements are appropriate. These holding companies do not engage in significant activities, and, in most cases, you will need to do little more than review the reasonableness of operating expenses and the dividend practices between the thrift and the parent.

For larger diversified operations, thrift earnings typically constitute only a small portion of the total and your analysis can concentrate on consolidated statements. However, to properly analyze consolidated profitability levels and trends, you should obtain a consolidating worksheet that both discloses, and explains, the intercompany accounts that have been eliminated. This will show each entity's contribution to total earnings.

For most nondiversified companies, fully consolidated data can be very misleading as the asset base and earnings of the thrift subsidiary will be large in relation to the consolidated total. Therefore, you will need to do a more in-depth analysis of other companies in the structure. Your analysis should focus on earnings trends and stability. You should identify extraordinary gains and losses that may mask weaknesses in the company's ability to maintain consistent profitability.

The best method to reasonably assess the risks to the thrift posed by its holding company and affiliates is to strip away the impact of the thrift from the financial statements. You can do this by obtaining or preparing statements that are fully consolidated as to the parent and all nonthrift affiliates. Such statements are necessary in order to properly understand the relative health of the nonthrift components within a holding company structure. On such statements the investment in the thrift will be but one line item on the balance sheet, and for earnings, one line item on the income statement. Looking at the financial

statements in this manner will allow you to concentrate your analysis on results and trends not related to the thrift itself. If available, obtain the "parent company only" basis financial statements (required for SEC filers). These statements are also very useful when evaluating cash flow.

In addition to evaluating the level, source and volatility of earnings, you should analyze:

- Financial statements
- Credit ratings
- Stock price
- Business plans and budgets<sup>4</sup>
- Intercompany transactions<sup>4</sup>
- Cash flow.

### Financial Statement Analysis

You can use internally and externally prepared financial statements and reports to evaluate the operations of companies in a holding company enterprise. The holding company's financial statements will provide insight into the financial demands placed on the thrift subsidiary, and the organization's overall strengths and weaknesses.

You should also review the minutes maintained for the audit committee to help identify any financial recordkeeping deficiencies disclosed to the directors by either the independent or internal auditors. You may also find information in the management letter prepared by the auditor, audit reports compiled by the internal auditor, or correspondence with the independent auditor.

Financial statements and supporting schedules should be complete, consistent, and accurate. Independent accountants are typically retained to provide assurance of the accuracy of financial statements prepared by management. You should carefully scrutinize unaudited financial statements

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<sup>4</sup> Refer to Relationship Section 500 for more details.

or financial statements that have been assigned a qualified opinion. Similarly, you should investigate significant changes in financial statements or accounting systems.

Audited statements are typically only prepared annually, and are usually presented on a fully consolidated basis. This means that you will have to rely on internally prepared statements or general ledgers for interim periods. You should also be aware that in some cases, financial statements may be based on the regulatory accounting principles of another industry. Beginning in March 2001, thrifts in a holding company structure began reporting basic holding company financial information on the quarterly Thrift Financial Report. You should check the accuracy of the information reported on Schedule HC.

The following discussion highlights certain areas you should place particular emphasis on during your review of each financial statement.

#### Statement of Financial Condition

You should be particularly alert for affiliates engaged in high risk, cyclical, or off-balance sheet activities, that could adversely impact the company, causing additional pressures to be placed on the thrift. Such activities may include, for example, subprime lending, real estate investments or development, asset securitizations, venture capital funding, and volatile investment activities including derivatives, futures and options.

Distinguish between assets that provide liquidity and those that do not. For example, goodwill, and deferred tax assets are not liquid assets that can be relied upon to generate cash flow. A calculation of capital where these assets are deducted will give a truer sense of the real capital position of a holding company.

In addition, determine an investment's effect on liquidity. For example, leveraged instruments such as futures and options can be volatile and require cash. Commitments to other investments with material cash needs, include major construction projects and other capital-intensive businesses.

Finally, compare intercompany accounts (including investments in subsidiaries and due to or from subsidiaries) with corresponding accounts on the thrift or affiliate financial statements. This step is equally important for both stock and mutual holding companies.

#### Income Statement

Determine whether the business of companies within the holding company enterprise is cyclical. Focus on core earnings or income before extraordinary gains, as obviously extraordinary gains are not recurring. Pay particular attention to securitization revenue; the accounting rules are complicated and involve some subjectivity, as the calculations are assumption-driven. Unreasonable assumptions have led a number of financial institutions to misstate securitization gains.

#### **Credit Ratings**

Analysis of a holding company's financial statements may be supplemented by the market price (yield) and the credit rating of its debt. Bonds issued by holding companies with high yields, relative to U.S. Treasury Bonds, or low grades, may pose additional risks.

The principal rating services include Moody's Investors Services, Standard & Poors, Fitch Investor Service, Inc., and Duff and Phelps. A rating is not a recommendation to purchase, sell, or hold a security. The rating provides an unbiased assessment of the perceived creditworthiness of a debtor for a specific security. Generally, the ratings have been accurate; that is, low-grade bonds default more frequently than high-grade securities. However, these ratings are not infallible, as sudden changes in market conditions have led to even investment grade issues filing for bankruptcy. Also, issuers with a good rating may find that their ratings decline. You should identify whether a holding company's bonds have been rated, and if so, are subject to a downgrade. Typically, the first indication to the public that weaknesses are emerging is a rating downgrade, but ratings changes tend to lag actual credit deterioration. Often, the market price of the bond is adjusted before the rating agencies have a chance

to react. Therefore, market prices should also be considered.

Closely evaluate the financial condition of any holding company whose securities are rated below investment grade. The following **Summary of Rating Categories** identifies the range of letter grades used by the two major rating agencies. An investment grade bond includes the top four categories (for example, AAA to BBB).

#### Summary of Rating Categories

<b>Credit Rating</b>	<b>MOODY'S</b>
<b>Aaa</b>	Strongest Creditworthiness
<b>Aa</b>	Very Strong Creditworthiness
<b>A</b>	Above-average Creditworthiness
<b>Baa</b>	Average Creditworthiness
<b>Ba</b>	Below-average Creditworthiness
<b>B</b>	Weak Creditworthiness
<b>Caa</b>	Speculative, Very Weak Creditworthiness, May be in Default
<b>Ca</b>	Highly Speculative, Extremely Weak Creditworthiness, Often in Default
<b>C</b>	Extremely Speculative, Weakest Creditworthiness, Usually in Default
<b>Credit Rating</b>	<b>Standard &amp; Poors</b>
<b>AAA</b>	Extremely Strong
<b>AA</b>	Very Strong
<b>A</b>	Strong
<b>BBB</b>	Adequate
<b>BB</b>	Speculative Characteristics - Less Vulnerable
<b>B</b>	Speculative Characteristics - More Vulnerable
<b>CCC</b>	Speculative Characteristics - Currently Vulnerable
<b>CC</b>	Speculative Characteristics - Currently Highly Vulnerable
<b>C</b>	Currently Highly Vulnerable to Nonpayment
<b>DDD-D</b>	In Default, Rating Indicates Likely Salvage

A low-grade or a declining rating should serve as an alert to consider expanding your scope to better determine the holding company's financial capacity and capital position.

#### Stock Prices

You may also obtain early warning of a holding company's weakening financial condition by evaluating the trend of its stock prices. Stock prices reflect the perceptions of investors as they evaluate the risk and return profile of a company. However, during periods of high market volatility, changes in stock prices may be more reflective of concerns within a particular industry or the overall market, rather than a specific company. Key ratios for publicly traded companies include:

**Market Value/Book Value:** The ratio of the combined market price of outstanding stock to the accounting book value. You can compare the company's ratio to those of its peers, with higher ratios indicative of greater investor confidence in the company's prospects<sup>5</sup>. A favorable market perception generally allows a company to raise capital at an attractive price.

**Price/Earnings:** The ratio of the price of stock to the prior 12-month earnings. Ratios above market averages reflect expectations of future growth while ratios below market averages reflect uncertainty or less growth.

A holding company should command a higher **Market/Book** or **P/E ratio**, if its ROE exceeds its peers. In addition, a holding company should command a higher **Market/Book** or **P/E ratio** if the ROE exceeds the investors' required return, which is based on risk. This return is an opportunity cost and is sometimes called cost of equity (COE). Further, the market/book ratio should increase as the ROE/COE spread increases above one.

<sup>5</sup> See Monitoring section for more details.

## CASH FLOW

Profitability is an important measure of financial strength and managerial efficiency. However, ultimately a company's ability to generate cash flow will determine whether or not it will be able to meet its fixed obligations, such as debt service and preferred stock dividends, as well as fund dividends to common stockholders from internal operations. You should consider the following questions:

- To what extent does the holding company rely on dividends from the thrift to service holding company debt or fulfill other obligations?
- What sources of liquidity, other than the thrift, does the holding company have?
- What are the quality and quantity of such sources?

The purpose of the cash flow statement is to summarize financing and investing activities and to identify whether funds are being generated from internal or external sources. Generally, audited financial statements provide "parent company only" financial information, which includes a Statement of Cash Flows. The cash flow statement can be used for more than just determining whether or not the company maintains positive cash flow. It can also identify how the company obtains and allocates its funds. Most importantly, this statement can be used to identify and quantify the funds that are provided directly by the thrift, and to what degree the parent relies upon those funds to maintain its operations.

Funds provided by a thrift subsidiary typically take the form of dividends, management fees, expense reimbursements, and tax sharing payments. Ascertain the extent of reliance the holding company places on the thrift by considering the:

- Portion of cash flow from operating and investing activities that is supplied from the thrift subsidiary; and
- Amount of interest expense on parent company borrowings that is paid from thrift subsidiary dividends.

Concentrate on assessing or identifying any operational weaknesses, which could result in the holding company requiring funding from the thrift. In situations where the parent is financially distressed, determine whether the financial condition is linked with the thrift reorienting its business practices towards higher risk activities, or even liquidating assets, to generate support required by the parent.

From time-to-time, all businesses will be confronted with cash flow or funding shortfalls as a normal result of doing business. Your concern should be in determining whether such shortfalls are temporary, or indicative of an overall decline in financial health, and what sources are available to the parent to make up for the deficit. A company can raise cash by:

- Liquidating/selling assets,
- Issuing stock,
- Increasing borrowings,
- Requiring repayment of advances to its subsidiaries, and
- Requiring additional payments of dividends or other cash payments from subsidiaries.

Such sources can only temporarily alleviate the effects of a shortfall, and you must look beyond such events to assess future cash flow needs. Selling income-generating assets will reduce future earnings, and issuing additional debt or equity will increase future funding requirements in the form of debt service or dividend payments. While companies commonly use short-term debt to fund deficit cash flow, this practice may jeopardize its long-term liquidity and earnings by increasing liabilities and related interest costs without a corresponding increase in earning assets. To the extent that systemic funding imbalances are expected to persist, you should comment in the examination report.

To assess the holding company's ability to meet its contractual obligations from current earnings, you should compute the *Fixed Charge Coverage Ratio* which is defined as the parent only after tax

cash income plus interest, lease and rental expenses, divided by fixed contractual obligations, as follows:

Fixed Charge Coverage Ratio:

$$\frac{\text{After tax cash income} + \text{interest, lease, and rental expense}}{\text{Interest, lease, and rental expense} + \text{contractual long-term debt retired} + \text{preferred stock dividend payments}}$$

In general, if this ratio is below 1:1, the company is not generating sufficient internal funds to cover its contractual obligations, much less any dividends to common stockholders, and is cause for concern. Even a ratio that is only slightly greater than 1:1 may be barely adequate and may be a concern if the current level results from a deteriorating trend. Also, keep in mind that in many nondiversified holding company structures, the primary source of cash income will be dividends paid by the thrift to the parent. Any dividend restrictions placed on the thrift will substantially impact the results of this analysis. Furthermore, as noted numerous times above, directed changes to thrift operating practices designed to increase thrift earnings can adversely affect the overall safe and sound condition of the thrift.

### Liquidity

Cash flow is generally defined as the ability to obtain and allocate cash. Liquidity is defined as a company's ability to meet its short-term obligations either through cash on-hand, converting existing assets to cash, or rolling over maturing debt. Generally, short term is viewed as periods of up to a year. Liquidity problems will typically fall within a broad range of severity. On one hand, temporary liquidity problems may mean that a company is unable to take advantage of an immediate desirable business opportunity. Conversely, severe liquidity shortfalls may mean that a company is unable to meet short-term obligations and may be in a position of having to default on its debt obligations. As a worst case, this could result in bankruptcy.

In your financial analysis, you should review the contractual maturity structure of the holding company's assets and liabilities. In cases where liquidity concerns are evident, or emerging, you should develop a maturity matching schedule comparing contractual maturities of assets and liabilities over the near term (up to 90 days), short term (91 days to one year), and long term (over one year). You must also take into account the degree to which funding is reliant upon the recovery of advances to subsidiaries, which themselves may be illiquid. Also, you need to consider whether assets can be sold and converted to cash without incurring substantial loss on the sale.

To the extent that your analysis shows a material imbalance of maturing debt instruments compared to reasonably available resources, you should discuss this with management to determine how they intend to handle the shortfall. This should also be incorporated into the cash flow analysis and discussed in the examination report.

### RATING THE EARNINGS COMPONENT

You will assess the holding company enterprise's risk profile and evaluate the adequacy of earnings on a case-by-case basis. To do so, consider, among other things, profitability, business plans and budgets, peer comparisons, credit ratings, stock price, and cash flow.

You should assign an *earnings component rating of "1"* when operating performance and profitability are above average. Cash flow is routine and sufficient, especially relative to the businesses conducted. Financial indicators equal or exceed forecasted performance.

You should assign an *earnings component rating of "2"* when earning results are comparable to peers with cash flow sufficient to meet debt service.

You should assign an *earnings component rating of "3"* when operating performance is poor or below average, with no expectation of improvement. These companies may be experiencing losses or erratic performance, have insufficient cash flow

to meet debt service, and are largely dependent on the thrift subsidiary.

**SUMMARY**

Profitability is but one of a number of critical factors considered in the regulation of a thrift holding company enterprise. However, profitability must be evaluated in conjunction with a number of other factors.

Financial strengths and weaknesses can be measured by a variety of ratios and market indicators. The holding company and its subsidiaries, including the thrift are often managed on a consolidated basis. While such integration provides advantages to both the thrift and the holding company, there are also potential pitfalls.