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Sovereign Bank Analysis

Introduction

Sovereign Bank is an FDIC insured bank that was founded in 1902. It started in Philadelphia to help textile workers become homeowners through financing. It then expanded into New England by acquiring FleetBoston Financial, one of the largest branch acquisitions ever. Sovereign now offers 750+ branches in New England. In 2005, it began a strategic partnership with Santander Group, a bank located in Spain, and in January 2009, it was acquired by Santander Group in light of the financial crisis.[1]

To analyze Sovereign Bank, it is necessarily to look at a period that covers how Sovereign Bank has done before the financial crisis, during the financial crisis (showing some indicators of why there was an acquisition) and after the financial crisis. While a 5 year analysis would cover the financial crisis and aftermath (2007-2012), an 8 year period from 2005 to 2012, would better show the change in bank's risk position. The data is taken from the FDIC's Statistics on Depository Institutions database[2] and uses Sovereign Bank's and similar banks, which are those with over $10 billion in assets[3].

Interest Rate Risk Exposures

Interest Rate Risk is the risk of assets and liabilities changing in price due to interest rate changes. If the assets and liabilities have maturity mismatches, the rate change would change the prices and thus subject the bank to risk. To measure this, it is necessary to find the repricing gap (rate sensitive assets - rate sensitive liabilities) to total assets ratio.

Sovereign Bank

	Rate Sensitive Assets / Assets	Rate Sensitive Liabilities / Assets	Repricing Gap / Assets
3-12 Months	2.34%	5.13%	-2.79%
1-3 Years	4.46%	4.38%	0.08%
3+ Years	24.73%	1.54%	23.19%

The data only provides information on Sovereign Bank for 2012. But from this information it can be seen the assets and liabilities have a negative repricing gap from 3-12 months, a slight repricing gap from 1-3 years and a very large repricing gap for anything over 3 years.

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[1] http://www.sovereignbank.com/companyinfo/company_information/our_history/company_history.asp
[2] http://www2.fdic.gov/sdi/main.asp
[3] Sovereign Bank has ~$80 billion in assets, which would fall into this group of banks. Similar banks from now on refers to banks with over $10 billion in assets.

What this means is that in the short term if rates were to fall, the rates would reprice the liabilities in the banks favor, but in the long term, it would hurt the bank incredibly as the 3+ years tranche has a major repricing gap.

But looking at this long term, the high repricing gap on assets with 3+ year maturities may be a good idea. Given that United States interest rates are at close to historic lows, they are much more likely to increase on a financial turnaround. With that, the repricing gap on the assets and liabilities of assets with 3+ year maturities being high, the higher rate would result in a profit for Sovereign Bank. Although it is exposing itself to risk, it is doing so smartly to potentially capture growth after this downturn.

Similar Banks

	Rate Sensitive Assets / Assets	Rate Sensitive Liabilities / Assets	Repricing Gap / Assets
3-12 Months	3.10%	2.54%	0.56%
1-3 Years	4.88%	1.64%	3.24%
3+ Years	15.63%	0.86%	14.77%

Banks in the same size bracket as Sovereign Bank also have a similar repricing gap structure, although the average duration is shorter than it is in Sovereign Bank. This indicates that other banks are not taking as big of a risk as Sovereign Bank does with their rate sensitive assets and liabilities.

Overall, Sovereign Bank is taking a slightly larger risk than the market in general, but it seems that the market as a whole is still taking a risk towards longer term assets. This may be because of the record low rates and a belief of a higher interest rate in the future which primes similar banks and Sovereign Bank to capture some growth through interest rate repricing.

Market Risk Exposures

Sovereign Bank has not significantly exposed itself to market risk exposures. While market risk encompasses many different types of risk in regards to commodities, securities, etc., a common measure of an institution's market risk exposure is looking at the trading assets that the firm has.

Sovereign Bank

	2012	2011	2010	2009	2008	2007	2006	2005
Trading account assets	0.00%	0.00%	0.00%	0.00%	0.05%	0.07%	0.08%	0.08%

In the case of Sovereign Bank, that is 0.00%. So currently it is not exposed to market risk exposures in this way. While before 2009 they did have positions in their trading account, they were a tiny part of the firm, only accounting for less than 0.1% of their assets even at their peak.

Similar Banks

	2012	2011	2010	2009	2008	2007	2006	2005
Trading account assets	6.52%	6.87%	7.37%	7.46%	9.45%	9.77%	7.91%	7.33%

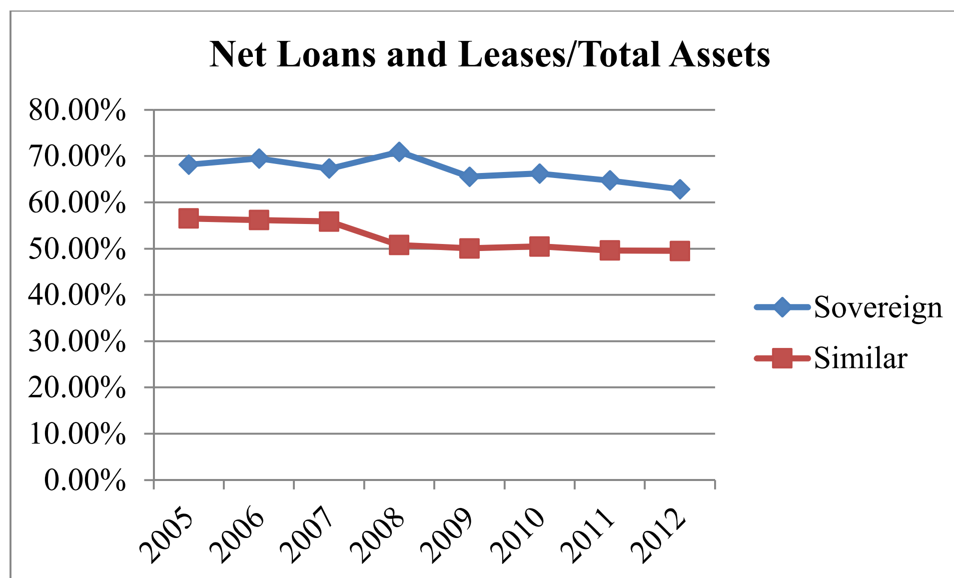
Yet looking at other similar banks in the same size bracket, they use trading account assets much more liberally, accounting for over 5% of their assets. They are thus much more exposed to market risk than Sovereign Bank is.

Overall, this shows that Sovereign Bank is relatively unexposed to market risk exposure, especially as compared to banks in the same size bracket, which have significant exposures through their trading account assets.

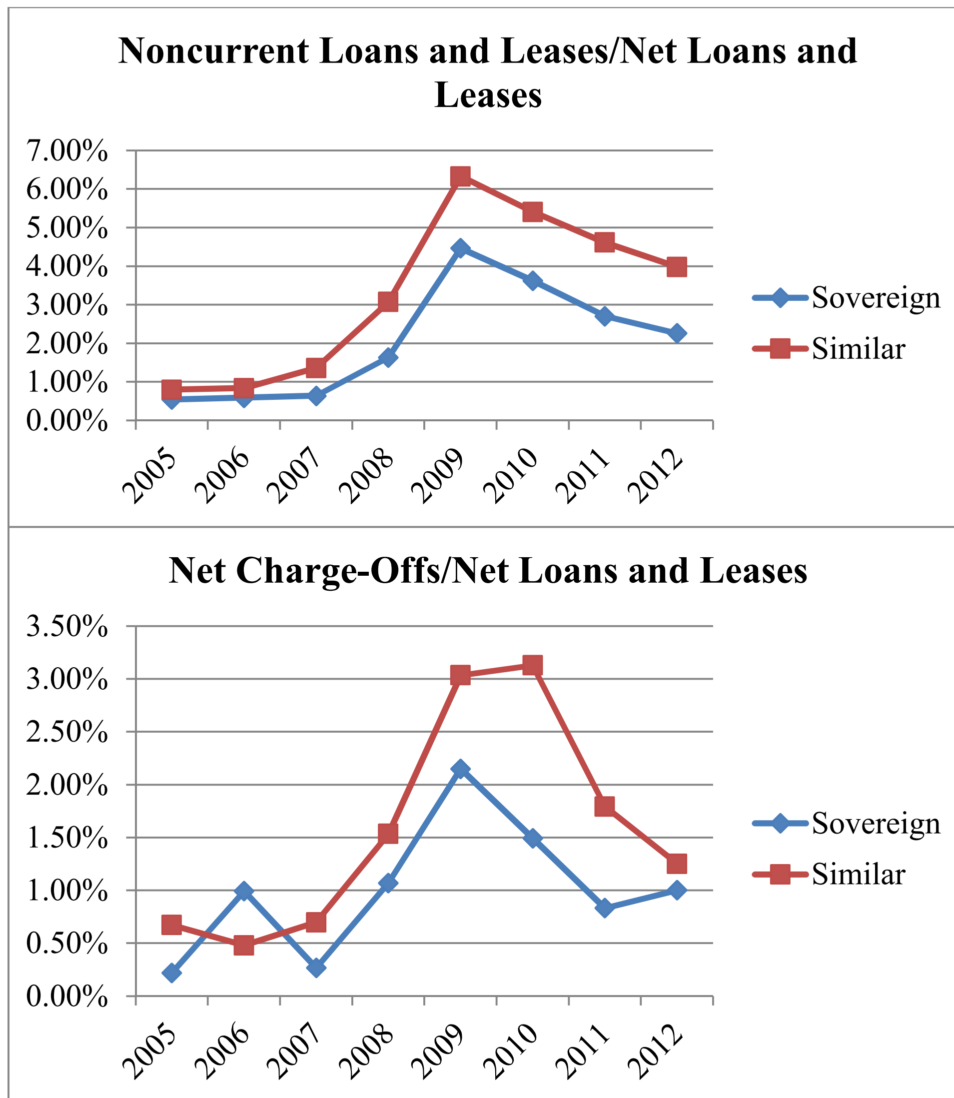
Credit Risk Exposures

Credit risk is primarily the risk in receiving cash flows from loans and other cash flows. Long term assets (5+years) are a specifically more risky asset as the longer the maturity is, the higher risk of default. Another major aspect of credit risk is how many loans the bank has taken on, which can be measured by loans as a percentage of assets. To further measure this risk, the quality of a bank's loan be measured by net charge offs and noncurrent loans over total loans. Net charge-offs indicate loans that are written off as unrecoverable, while noncurrent loans are those that are far overdue or not paying interest and thus highly likely to default.

In the area of long term assets (5+ years), there is only data for 2012 on Sovereign Bank, but that also indicates that Sovereign Bank is more exposed. Sovereign Bank has 33.46% of assets as long-term assets in 2012, whereas the average bank has had consistently less, with an average of 22.19% across the past 8 years. So Sovereign Bank is more exposed than a similar bank of their size.



Looking at net loans and leases over total assets also shows that Sovereign Bank has more credit risk exposure. Sovereign Bank has more positions in loans and leases than a similar bank in the same size bracket. This almost mirrors their increased exposure in long-term assets. Sovereign Bank most likely uses loans and leases more so to generate income as opposed to other banks, which can account for the lack of trading account assets.



Even though Sovereign Bank has a considerable percentage of assets in loans and leases, the quality of the loans tend to be better, with both the net charge-offs and noncurrent loans typically better than a similar bank in the same size bracket. It is particularly telling how much the financial crisis changed the amount of noncurrent loans and net charge-offs as starting in 2007, the amount increased significantly from prior years, tripling to quadrupling within a 2-3 year time frame.

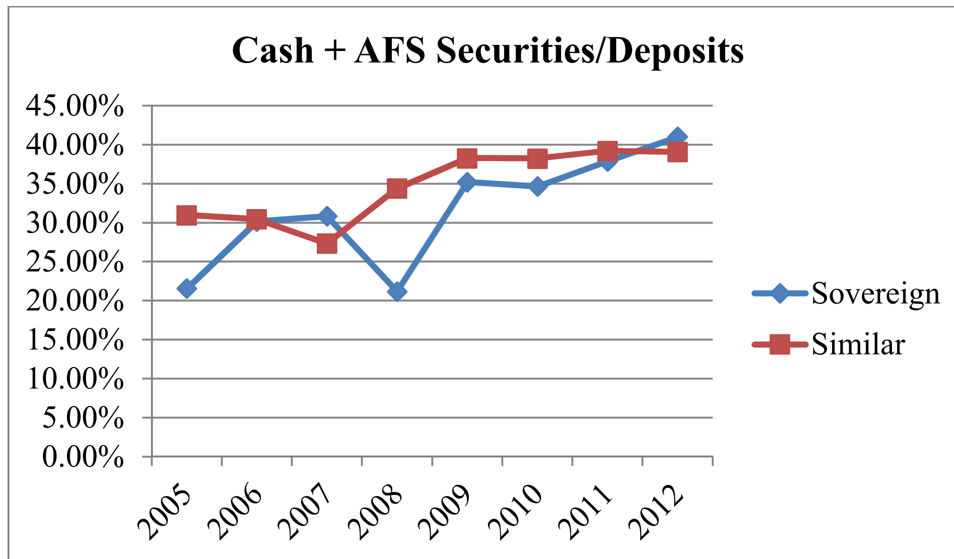
With the financial crisis waning, the numbers are slowly going down from their peak in 2009, indicating that Sovereign Bank's positions in loans are getting better.

Overall, even though Sovereign Bank is more exposed to credit risk because of their higher percentage of long-term assets and loans, it is mitigated by maintaining a higher quality loan portfolio with fewer noncurrent loans and net-charge-offs.

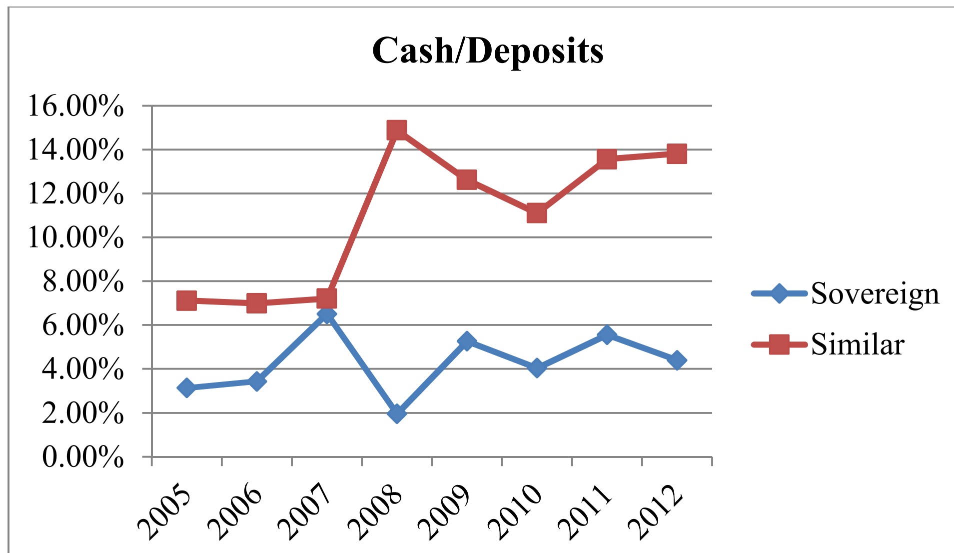
Liquidity Risk Exposures

Banks need to ensure that they have proper liquidity to cover deposits and thus need to manage liquidity risk. To best assess liquidity risk, the ratio of cash to total deposits and cash and available-for-sale securities to total deposits are accurate ways to evaluate this risk.

Cash is the most liquid and thus one of the purest forms of liquidity. Available-for-sale securities are securities that can be sold if necessarily to provide liquidity. While this reflects fair-market and not the sale prices that would most likely needed to sell, it can be a fair source of liquidity.



Looking at this comparison between Sovereign Bank and similar banks, Sovereign Bank is fairly close to similar banks. The major anomaly in this graph is when in 2008, Sovereign Bank's ratio goes down severely, no doubt as a result of the financial crisis and most likely heavily contributed to their acquisition by Santander Group.



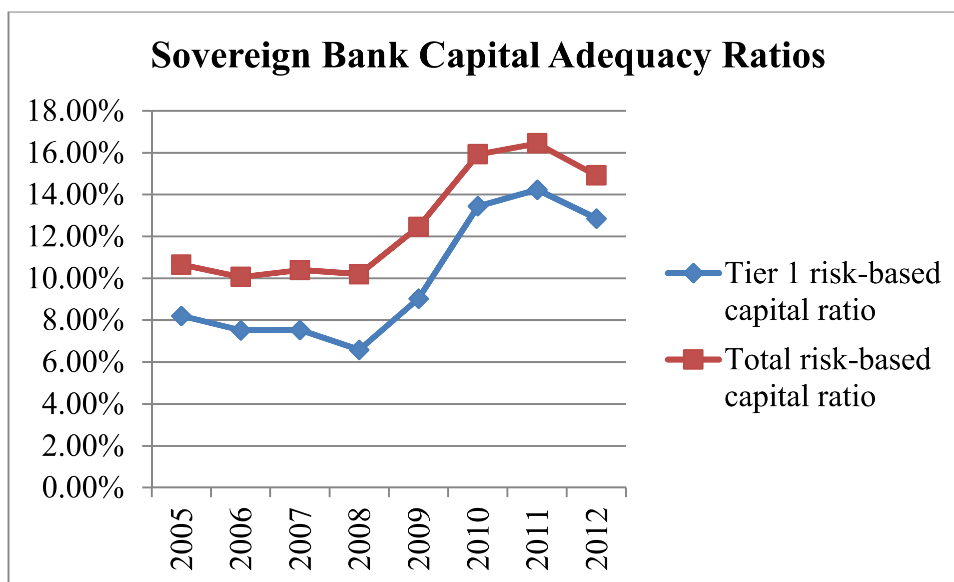
But the measurement of ratio of cash to deposits is a much more different story. So while in 2008, banks were shoring up credit, and hoarding cash, Sovereign Bank's cash stores dropped significantly. Historically and even currently Sovereign holds less cash than similar bank, but the stark difference in 2008 shows the different financial situation Sovereign Bank was from similar banks.

Overall, looking at the big picture with securities factored in, Sovereign Bank's liquidity risk is very similar, but looking at the cash ratio, it is significantly lower by about 10% compared to other similar institutions. This makes them slightly more exposed to liquidity risk, but not severely given the amount of securities they have available for sale.

Capital Adequacy

Capital adequacy is the necessity to hold adequate levels of capital to ensure stability of the bank. Regulators enact these rules to ensure the solvency of banks and to protect creditors and depositors. These capital rules have been under scrutiny because of the recent financial crisis.

Under the Basel Committee's Basel III requirements, banks have to have a Tier 1 capital ratio of at least 6% and a Total risk based capital ratio of at least 8% in order to be considered a well capitalized bank.



The graph shows that for every year since 2005 that Sovereign Bank has been adequately capitalized as dictated by the Basel III. In addition, since the financial crisis and starting from 2008, Sovereign Bank drastically increased its capital adequacy ratios, most likely in response to the financial crisis. While these higher capital adequacy ratios may hurt the relative profitability of Sovereign Bank, given the discussions in Congress to drastically increase the capital adequacy ratios in the wake of the financial crisis, this may be good foresight in preparation for increases.

Sovereign Risk Exposures

Sovereign Bank, although its name includes the word sovereign, actually has very low sovereign risk exposures. It has no foreign branches. The extent of their foreign risk comes from a 0.04% of assets exposure to balances due from foreign banks, 0.63% of deposits held in foreign offices and 2.46% of assets in foreign debt securities. On various other potential metrics, they measure in at 0.00% of assets.

While there are these assets in foreign debt securities that aren't explicitly explained, some of this sovereign risk exposure is most likely mitigated with foreign exchange rate contracts, which are 1.23% of assets.

Other similarly sized banks have more exposure with much more international reach, touching on more common sovereign risk metrics. In the case of foreign debt securities, the average is 2.57%, so slightly more exposed in that area than Sovereign Bank is. In addition, other banks are likely using foreign exchange rate contracts to further expose themselves as the average bank's position in foreign exchange rate contracts is at 258.84% of assets.

Overall sovereign risk is not a big concern of Sovereign Bank given their small international involvement. It has much less exposure than other banks in the same size bracket as it and does not seem to significantly use foreign exchange rate contracts as much as other banks have.

Risk Management

Risk management strategies have been in increasing use since the financial crisis. Sovereign Bank is no new comer to the banking scene and uses multiple forms of risk management, including securitization, derivatives, and loan sales to help mitigate risk.

In the area of securitization, it utilizes mortgage-backed, collateralized mortgage obligations (CMOs), and asset backed securities to protect itself.

	2012	2011	2010	2009	2008	2007	2006	2005
Mortgage-backed securities	14.54%	11.57%	8.48%	3.84%	3.42%	9.20%	8.39%	13.26%
Collaterized mortgage obligations	12.47%	7.69%	3.02%	1.13%	1.39%	2.61%	2.36%	4.39%

In mortgage backed securities, it is fairly telling that after the crisis, in 2008 the amount of mortgage backed securities declined, but as of recent have been increasing. CMOs have also hit a low in 2009, but have also been rapidly increasing, showing that Sovereign has been continuing to use securitization to manage risk.

In terms of asset backed securities, there is no historical information, but as of now, it is only a relatively small part of Sovereign Bank's strategy, consisting of 0.82% of assets.

Compared to banks in the same category as Sovereign Bank, they have more in both categories, but is significantly higher than similar banks in regards to CMOs. They had less for some years during and just after the financial crisis but have then increased past the average.

	2012	2011	2010	2009	2008	2007	2006	2005
Mortgage-backed securities	11.67%	11.38%	10.88%	10.51%	8.84%	8.95%	10.42%	10.47%
Collaterized mortgage obligations	4.03%	4.27%	4.08%	3.32%	2.91%	3.52%	3.24%	3.34%

Sovereign Bank also uses derivatives, but not to the degree that comparable banks have used them. According to the FDIC information, Sovereign Bank has 23.59% of assets in derivatives. But the average bank in their category, has over 2000% , which has been consistent for the past 5 years. While this data may be skewed by some banks overusing derivatives, it is fairly obvious that at least other banks use derivatives much more than Sovereign Bank does. So although Sovereign Bank does employ use of derivatives, it does not to the degree that other similar banks do.

Sovereign Bank also uses loan sales, basically to the same degree as other similar banks. Sovereign Bank has sold 1.02% of loans whereas the average is about 1.14%. While it is a useful tool to mitigate risk, it is not a particularly large or important risk management strategy employed by Sovereign Bank.

Off Balance Sheet Exposures

According to the FDIC[4], many things are considered off balance sheet but the relevant ones in this case are commitments and letters of credit. While there are others, they are typically unused and when used, only in very specific cases which Sovereign Bank either does not fall under or is not in the FDIC report.

Sovereign Bank

	2012	2011	2010	2009	2008	2007	2006	2005
Loan commitments-revolving, open-end lines secured by 1-4's	6.64%	7.04%	7.45%	6.94%	6.45%	5.18%	3.45%	3.59%
Credit card lines	0.95%	0.83%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

[4] http://www.fdic.gov/regulations/safety/manual/section3-8.pdf

Commercial real estate, construction & land development	1.74%	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Commitments secured by real estate	1.42%	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Commitments not secured by real estate	0.32%	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Just looking at Sovereign Bank's data, it has historically not used credit card lines as part of their commitments. Overall commitments didn't really shift because of the financial crisis.

But was is telling is how Sovereign Bank compares to similar banks.

Similar Banks

	2012	2011	2010	2009	2008	2007	2006	2005
Loan commitments-revolving, open-end lines secured by 1-4's	3.23%	3.61%	4.05%	4.52%	5.13%	5.98%	6.35%	6.09%
Credit card lines	21.84%	22.70%	24.41%	26.83%	31.80%	38.19%	39.08%	38.76%
Commercial real estate, construction & land development	1.14%	0.97%	0.90%	1.00%	1.59%	2.51%	2.86%	2.89%
Commitments secured by real estate	0.79%	0.64%	0.58%	0.70%	1.23%	1.96%	2.27%	2.32%
Commitments not secured by real estate	0.35%	0.34%	0.32%	0.30%	0.36%	0.55%	0.58%	0.56%

As shown above the typical bank uses credit card lines much more than Sovereign Bank does. Sovereign Bank also has over double the loan commitments of the average bank. A curious trend that Sovereign Bank does not exhibit is lowering loan commitments as a result of the financial crisis like many other banks.

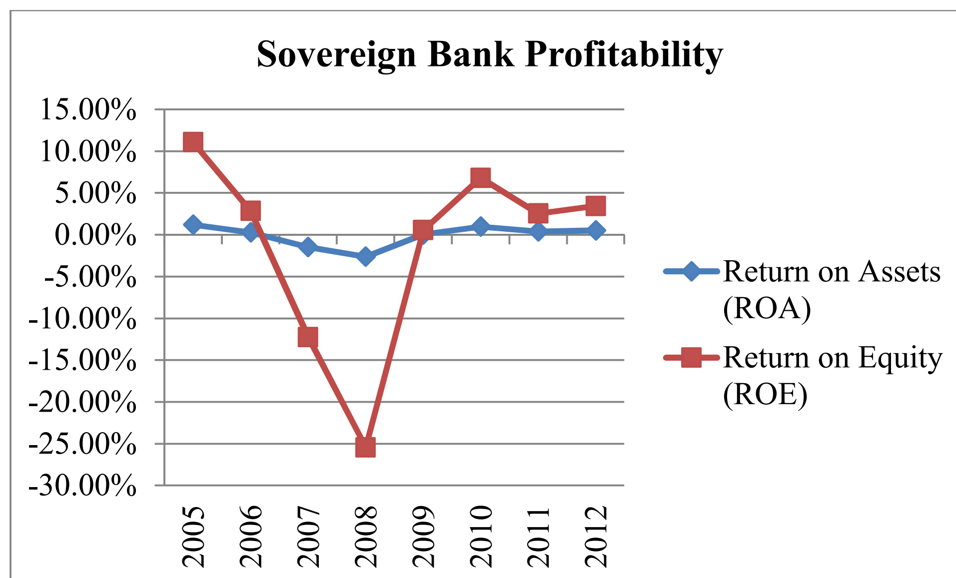
In terms of letters of credit, there is not much information. Sovereign Bank only have information for 2012, where it did have 3% of assets in letters of credit. The average bank was

5.54% in the past year with some historical data that shows a decrease from the peak in 2007 and 2008 at somewhere between 6-7%.

Overall this shows that Sovereign Bank is not too exposed to off balance sheet risks, especially as compared to banks in the same category as it. While Sovereign Bank does expose itself more to loan commitments than similar banks, this is mitigated by the fact that Sovereign Bank has extremely limited commitments to credit card lines and overall less exposed to off balance sheet risk than the average bank.

Profitability

Profitability is simply trying to grow and is a necessity for any firm. While evaluating risk is useful, there needs to be returns tied to that. To determine the profitability of Sovereign Bank, looking at the return on assets and the return on equity give a general snapshot of their profitability.

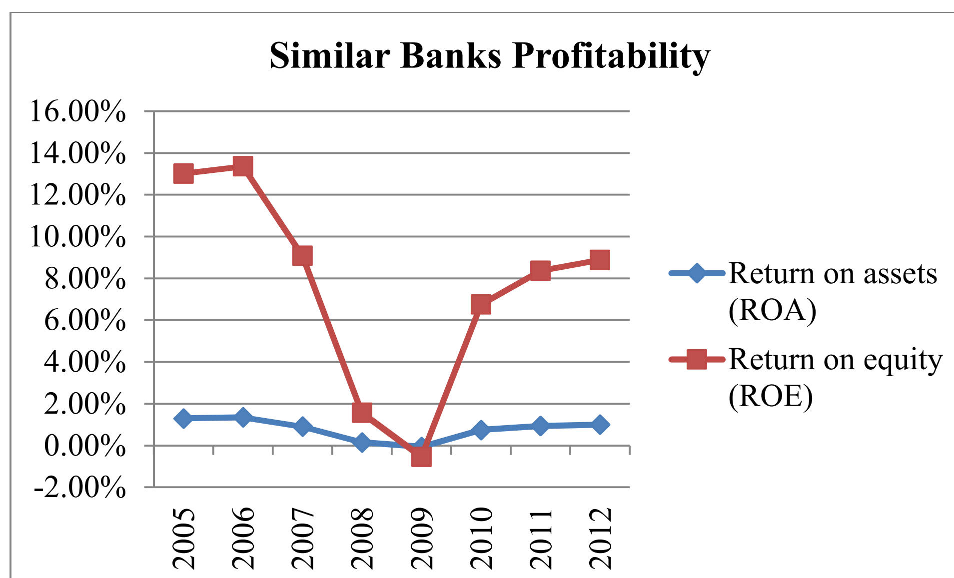


Given their numbers, it is fairly clear that the financial crisis had a big impact on Sovereign Bank's financials. In 2005, they were returning solid numbers with 1.21% return on assets and 11.09% on return on equity.

But with the financial crisis in full force, 2007 and 2008 were catastrophic for their financials. They went down significantly as can be seen by the graph above. This is probably a big factor of why Sovereign Bank was sold to Santander Group (Banco Santander SA) in 2008 for $1.9 billion.[5]

[5] http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a0yVz86Nr0FE&refer=europe

In the years following that, Sovereign Bank has had modest growth, with a positive return on assets and equity. This indicates that Sovereign Bank is once again profitable after weathering the storm that is the financial crisis of 2007.



Looking at similar banks, most of them took losses in 2009. This indicates that although most similar banks had lowered returns throughout, Sovereign Bank took a significant hit in 2007 and 2008, far beyond that of similar banks. While they have pulled back again, they are still significantly beneath the average bank of its size.

Although overall Sovereign Bank is still profitable, its returns are still lower than banks of a similar size. This may be may not be of concern because other banks are taking some more risks than Sovereign Bank is, which could enhance their profitability.

<u>Conclusion</u>

Sovereign Bank is currently in a solid position and is quite similar to its peers. Although it is clearly seen that Sovereign Bank took a huge hit during the financial crisis, which made it get bought out by Santander Group, it is now in a solid financial position, well capitalized, with a well controlled risk portfolio.

Unlike many of the banks of this size, it is very unexposed to certain risks such as market risk, sovereign risk and derivative risk. It seems that many banks use derivatives not only as a risk management tool, but also as a gambling mechanism in itself, which Sovereign Bank does not use. In line with that, they use less off balance sheet tools and thus expose themselves to much less off balance sheet risk that other similar banks expose themselves to.

In addition, the strong credit risk management of Sovereign Bank and smart allocation of rate sensitive assets and liabilities are also useful for Sovereign Bank's future growth. Although Sovereign Bank takes on more loans than a similar bank, they have higher quality loans that

default less so. Their interest rates are also weighted towards later, poised to capture any future interest rate growth from the record lows that they are at right now.

Sovereign Bank does need to be aware of its liquidity risk because Sovereign Bank has a much lower cash to deposits ratio than other similar banks, so much lower that even though securities may be able to cover it, it would be prudent to acquire more cash like similar banks. It should also look more into trading account assets, foreign securities and credit lines. Although that is an element of how they avoid risk, other similar banks are using them much more than Sovereign Bank and it deserves deeper analysis.

Overall, although Sovereign Bank has recently underwent troubles due to the financial crisis, it is a solid, well capitalized, and profitable firm. They have insulated themselves from several forms of risk and have a very strong credit risk control that make Sovereign Bank a bank with potential to grow.

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