



Centre for Advanced Financial Research and Learning

Interpreting financial statements and performance

May 2013

Financial Risk Services

 **ERNST & YOUNG**
Quality In Everything We Do

Agenda

1 Interpreting financial statement metrics

2 Evaluating performance beyond financial statements

3 Financial metrics and capital management

4 Integrating risk and capital management into performance management systems



Relevance of financial statement metrics to stakeholders

What do financial statement metrics tell you?

| | |
|---|---|
| Financial stability | <ul style="list-style-type: none">▪ Adequacy of capital to absorb potential losses▪ Extent to which earnings are being re-invested in the business▪ Manner in which capital is being deployed towards various asset classes |
| Earnings capacity | <ul style="list-style-type: none">▪ Return on assets and capital employed in the business▪ Sources of earnings and the stability that can be expected from these sources▪ Variations in earnings due to materialization of risks▪ Sustainability of net interest margins▪ Cost of doing business |
| Market confidence and riskiness of growth strategy | <ul style="list-style-type: none">▪ Potential liquidity stress and adequacy of liquidity cushions to manage stress▪ Impact of structural movement in interest rates on the earnings capacity of the bank▪ Excess capital kept aside to manage unforeseen risks |
| Asset quality | <ul style="list-style-type: none">▪ Losses on account of defaults and provisions created thereon▪ Potential losses on market risk assets▪ Linkage between earnings and asset quality |

Relevance of financial statement metrics to stakeholders

What financial statement metrics do not reveal?

1

Growth projections and **adequacy of capital to support future growth**

2

Efficiency in allocation of capital across asset classes and management of excess capital

3

Whether **regulatory capital is adequate or excess** in absorbing potential losses

4

Adequacy of provisions and consistency in application of provisioning policies across banks including for contingent liabilities

5

Effectiveness of the asset pricing strategy in maintaining net interest margins

6

Effectiveness of **the asset pricing strategy** in pricing-in perceived risks into the business

7

Adequacy of the leverage strategy in **enhancing return on equity**

8

Risk-adjusted return on assets including impact of restructuring

9

Adequacy of operational risk measures in addressing potential losses

Evaluating performance beyond financial statements

| Financial metrics that matter | Supplementing metrics with information beyond financial statements | Sourcing the information |
|-------------------------------|--|---|
| Return on average assets | <ul style="list-style-type: none"> ▪ Capital consumed per rupee of asset created ▪ Expected growth in assets over 3 years and capital consumption for increased asset base | <ul style="list-style-type: none"> ▪ Pillar 3 disclosures ▪ BASEL III capital projections |
| Return on equity | <ul style="list-style-type: none"> ▪ Tier II capital not likely to qualify under BASEL III ▪ Leverage ratio ▪ Leveraging strategy to enhance return on equity | <ul style="list-style-type: none"> ▪ BASEL III disclosures ▪ ICAAP document |
| Net interest margins | <ul style="list-style-type: none"> ▪ Return over the clean fund transfer pricing rate ▪ Return over the risk-adjusted fund transfer pricing rate | <ul style="list-style-type: none"> ▪ FTP policy and fund transfer pricing rate agreed by ALCO |
| CASA ratio | <ul style="list-style-type: none"> ▪ Real cost of CASA including operational costs of branches | <ul style="list-style-type: none"> ▪ Cost of funds computation |

Evaluating performance beyond financial statements

| Financial metrics that matter | Supplementing metrics with information beyond financial statements | Sourcing the information |
|-----------------------------------|---|---|
| Fee income/ operating income | <ul style="list-style-type: none"> ▪ % of capital consumed by non-credit risk assets ▪ Treasury income excluding interest on SLR securities as a percentage of operating income | <ul style="list-style-type: none"> ▪ Pillar 3 disclosures ▪ Segment reporting |
| Operating costs/ operating income | <ul style="list-style-type: none"> ▪ Split between technology and non-technology costs ▪ Revenue generated per rupee spent on technology | <ul style="list-style-type: none"> ▪ Technology cost budgets and ROI evaluation |
| Capital adequacy | <ul style="list-style-type: none"> ▪ Risk-adjusted return on regulatory capital ▪ Risk-adjusted return on economic capital ▪ Pillar two capital | <ul style="list-style-type: none"> ▪ ICAAP document ▪ Pillar 3 disclosures |
| Non-performing assets | <ul style="list-style-type: none"> ▪ Re-structured assets as a percentage of total assets ▪ Re-structured assets to non-performing assets | <ul style="list-style-type: none"> ▪ Re-structuring data |

Financial metrics and capital management

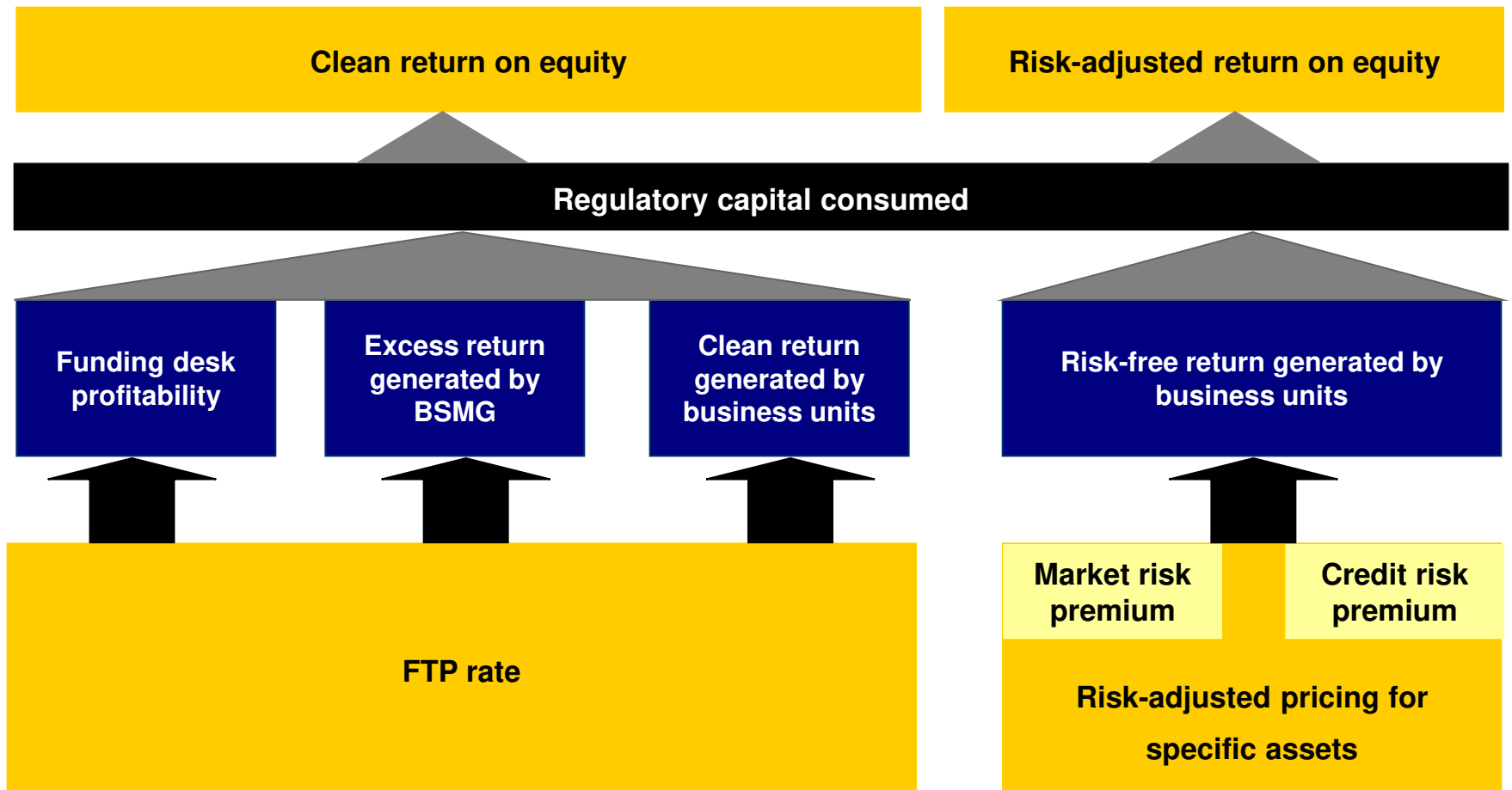
| Key considerations | | Implications |
|--------------------|--------------------------------------|---|
| 1 | Leverage ratio | Minimum leverage i.e. Tier I capital/ Total assets including off-balance sheet exposures = 4.5% |
| 2 | Growth and profitability projections | <ul style="list-style-type: none"> Higher growth and credit off-take is expected to impact capital requirements in general and increase the need for Tier II capital Higher profitability is likely to lead to increase in core equity subject to dividend payout |
| 3 | Dividend pay-out ratio | <ul style="list-style-type: none"> Higher dividend pay-outs lead to a reduction in core equity capital. Dividend pay-out is capped at 40% by RBI. Dividend policy could be used as an effective tool to re-compose capital |

Financial metrics and capital management

| Key considerations | | Implications |
|--------------------|--------------------------|---|
| 4 | Return on equity targets | Higher leverage would lead to higher RoE. However, the inability to raise equity capital at short notice leads to an inherent sub-optimal RoE. |
| 5 | Capital charge on assets | <ul style="list-style-type: none">▪ Market risk capital is expected to increase on transition to IMA▪ Credit risk and operational risk capital under advanced approaches is expected to reduce |
| 6 | Deductions for capital | <ul style="list-style-type: none">▪ BASEL III requires certain deductions from core equity capital as opposed to Tier II capital thereby increasing the need for core equity capital |

Integrating risk and capital management into performance management systems

A robust fund transfer pricing mechanism helps integrate risk management into the performance metrics of business units



Integrating risk and capital management into performance management systems

Managing leverage appropriately is critical to improving return on equity

$$\text{Return on capital} = \frac{\text{BU return using composite FTP rate}}{\text{Tier 1 Capital}}$$

$$\text{Return on capital} = \frac{\text{BU return using basic FTP rate}}{\text{Tier 1 + Tier 2 Capital}}$$

Profitability metric = Return on Tier 1 capital

Profitability metric = Return on total capital

Composite rate passed to business units

=

Basic FTP rate computed through FTP framework

+

Cost of Tier II capital – FTP rate for equivalent maturity

Composite rate passed to business units

=

Basic FTP rate computed through FTP framework

Cost of Tier II capital incorporated in FTP mechanism

Cost of Tier II not considered in FTP mechanism

FTP Framework to determine basic FTP rate

Base rate

Bid-ask rate

Liquidity stress premium

Credit risk premium

Market risk premium

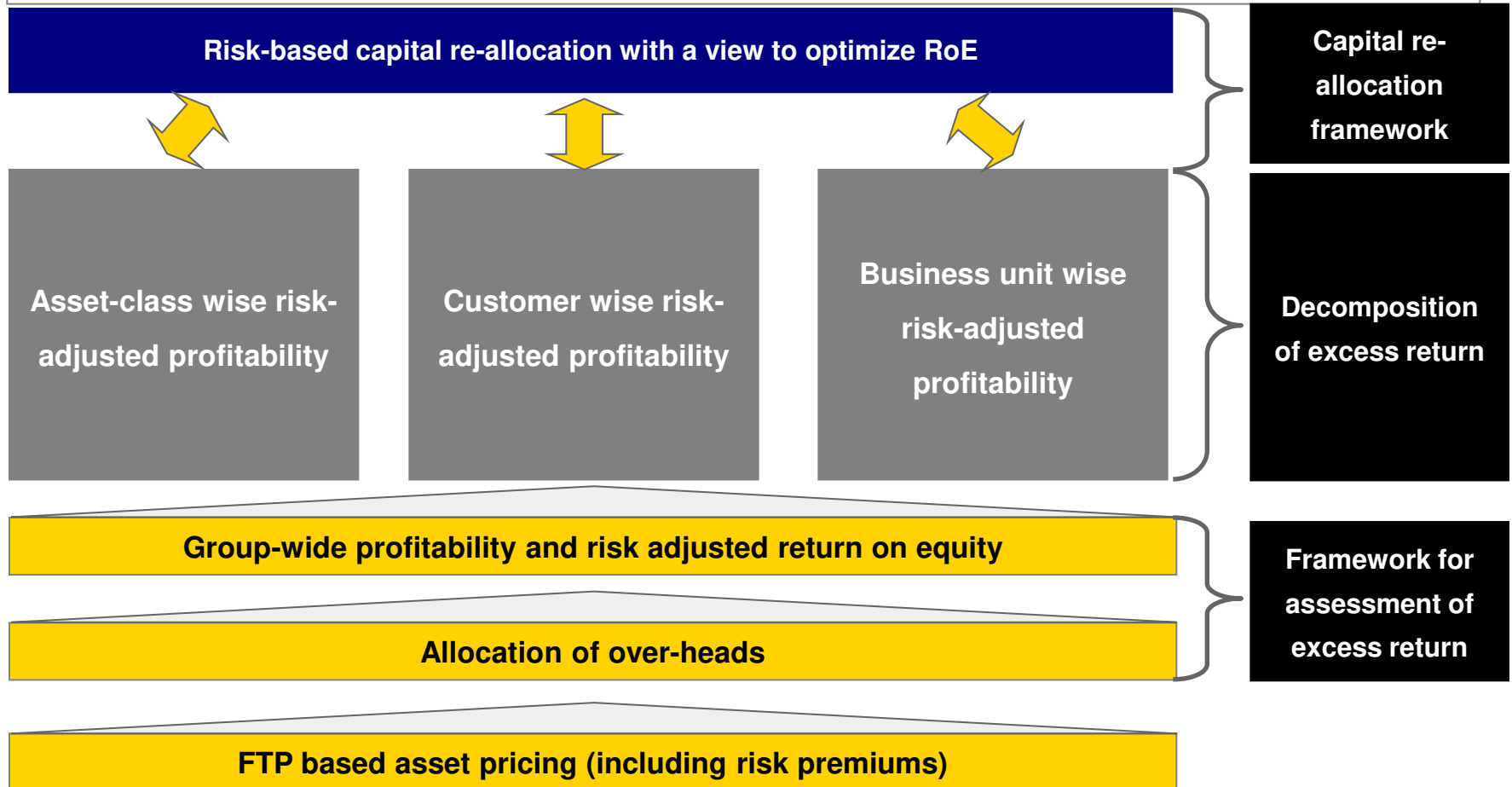
Opportunity cost of capital

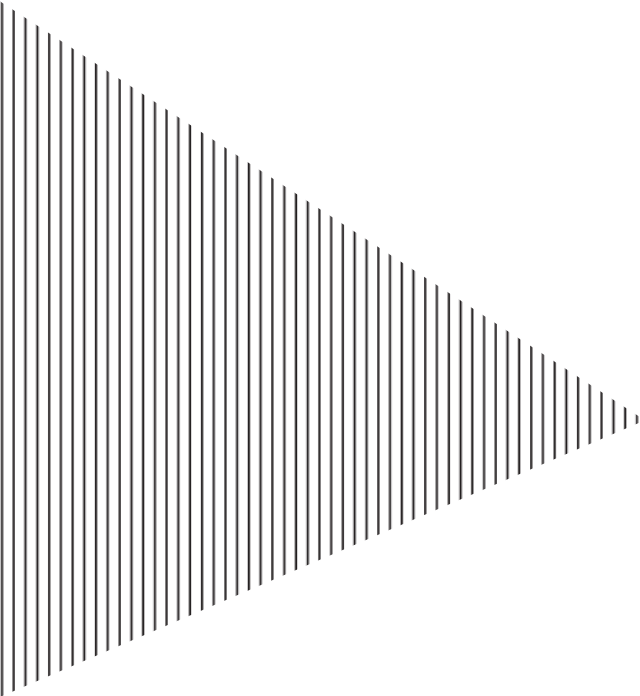
Essential components

Components to strengthen the framework

Integrating risk and capital management into performance management systems

Re-allocating of capital in line with risk-adjusted return helps optimize return on risk capital





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