Banks : Look before you leap !

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ABSTRACT

Is evaluating Indian Banks performance a rather straightforward issue. The answer is No. Actually when one makes an attempt to conduct some kind of Bank analysis to differentiate good banks from the bad ones, there are so many other things which need to be taken care of before the actual analysis can take shape. By merely using the standard ratios for banks financial analysis, one can sometime to reach to conclusions, which could be far from the actual. But at the same time there has to be some mechanism through which banks can be compared and evaluated. The traditional analysis largely focused on parameters like Credit-Deposit Ratio commonly referred to as CD Ratio, level of Non Performing Assets (NPA's), Capital Adequacy Ratios and the other usual earning ratios. Things have changed now and just having a high CD Ratio doesn't mean that you are a sound bank. The basic definition of banking business has changed, largely due to the entry of Private Sector in the banking industry who have given a totally new dimension to the banking business which was never thought of a decade ago. This paper tries to analyse some of the conventional and modern techniques popularly used for bank analysis.

The Indian banking sector is currently in a transition phase. While public sector banks are in the process of restructuring, private sector banks are busy consolidating through mergers and acquisitions (the sector has been recently opened up for foreign investments). With the Finance Minister's announcement of introducing a Bill on Banking Reforms, law on foreclosure and plans to set up an asset reconstruction company (ARC), the sector is likely to witness a significant structural change the coming years. The sector, which was considered dry in the last several years, has caught the investor fancy in expectations of changing regulations and improving business conditions due to opening up of the economy. Entry of private and foreign banks in the segment has provided healthy competition and is likely to bring more operational efficiency into the sector. However, before investing in a banking stock an investor should look at certain key performance ratios.

MODERN TECHNIQUES FOR EVALUATING BANK PERFORMANCE

The modern techniques lay large emphasis on ratios and they have developed certain standard ratios that will analyze banks from various perspectives. Lets look at some of the key ratios that differentiates a good bank from a bad one.

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Ratios for evaluating Operating Performance

1. **Net interest margin (NIM):** For banks, interest expenses are their main costs (similar to manufacturing cost for companies) and interest income is their main revenue source. The difference between interest income and expense is known as net interest income. It is the income, which the bank earns from its core business of lending. Net interest margin is the net interest income earned by the bank on its average earning assets. These assets comprises of advances, investments, balance with the RBI and money at call.

$$\text{NIM} = \frac{\text{Interest income - Interest expenses}}{\text{Average earning assets}}$$

2. **Operating profit margins (OPM):** Banks operating profit is calculated after deducting administrative expenses, which mainly include salary cost and network expansion cost. Operating margins are profits earned by the bank on its total interest income. For some private sector banks the ratio is negative on account of their large IT and network expansion spending.

$$\text{OPM} = \frac{\text{Net interest income (NII) - operating expenses}}{\text{Total interest income}}$$

3. **Cost to income ratio:** Controlling overheads are critical for enhancing the bank's return on equity. Branch rationalization and technology up gradation account for a major part of operating expenses for new generation banks. Even though, these expenses result in higher cost to income ratio, in long term they help the bank in improving its return on equity. The ratio is calculated as a proportion of operating profit including non-interest income (fee based income).

$$\text{Cost to income ratio} = \frac{\text{Operating expenses}}{\text{Nil + non interest income}}$$

4. Other income to total income: Fee based income account for a major portion of the bank's other income. The bank generates higher fee income through innovative products and adapting the technology for sustained service levels. This stream of revenues is not depended on the bank's capital adequacy and consequently, potential to generate the income is immense. The higher ratio indicates increasing proportion of fee-based income. The ratio is also influenced by gains on government securities, which fluctuates depending on interest rate movement in the economy.

From the sample selected here, HDFC Bank tops the list with the best performance ratios. The bank's higher interest margins are on account of it's lending to retail sector, which is considered to be high margins business owing to low cost funds from retail deposits. SBI's high cost to income ratio is on account of its large employee base while ICICI Bank's high cost to income is due to its aggressive spending on expansion.

Comparative operating performance

FY01	NIM	OPM	Cost to income	Other income to total income
HDFC Bank	4.0%	15.6%	44.8%	12.8%
ICICI Bank	2.7%	5.6%	53.5%	15.0%
UTI Bank	1.2%	-3.4%	49.3%	15.5%
SBI	3.1%	3.2%	60.5%	13.4%
Corporation Bank	3.4%	13.3%	39.1%	13.9%
Oriental Commerce Bank	3.2%	11.4%	45.0%	9.7%
BOI	3.1%	4.5%	56.2%	13.9%

Other key financial ratios

1. **Credit to deposit ratio (CD ratio):** The ratio is indicative of the percentage of funds lent by the bank out of the total amount raised through deposits. Higher ratio reflects ability of the bank to make optimal use of the available resources. The point to note here is that loans given by bank would also include its investments in debentures, bonds and commercial papers of the companies (these are generally included as part of investments in the balance sheet).

2. **Capital adequacy ratio (CAR):** A bank's capital ratio is the ratio of qualifying capital to risk adjusted (or weighted) assets. The RBI has set the minimum capital adequacy ratio at 10% as on March 2002 for all banks. A ratio below the minimum indicates that the bank is not adequately capitalized to expand its operations. The ratio ensures that the bank do not expand their business without having adequate capital.

$$\text{CAR} = \frac{\text{Tier I capital + Tier II capital}}{\text{Risk weighted assets}}$$

3. **NPA ratio:** The net non-performing assets to loans (advances) ratio is used as a measure of the overall quality of the bank's loan book. Net NPAs are calculated by reducing cumulative balance of provisions outstanding at a period end from gross NPAs. Higher ratio reflects rising bad quality of loans.

$$\text{NPA ratio} = \frac{\text{Net non-performing assets}}{\text{Loans given}}$$

4. **Provision coverage ratio:** The key relationship in analyzing asset quality of the bank is between the cumulative provision balances of the bank as on a particular date to gross NPAs. It is a measure that indicates the extent to which the bank has provided against the troubled part of its loan portfolio. A high ratio suggests that additional provisions to be made by the bank in the coming years would be relatively low (if gross non-performing assets do not rise at a faster clip).

$$\text{Provision coverage ratio} = \frac{\text{Cumulative provisions}}{\text{Gross NPAs}}$$

5. **ROA:** Returns on asset ratio is the net income (profits) generated by the bank on its total assets (including fixed assets). The higher the proportion of average earnings assets, the better would be the resulting returns on total assets. Similarly, ROE (returns on equity) indicates returns earned by the bank on its total net worth.

$$\text{ROA} = \frac{\text{Net profits}}{\text{Avg. total assets}}$$

Comparative financial performance

FY01	CD ratio	CAR	NPA ratio	Provision coverage	ROA
HDFC Bank	39.8%	11.1%	0.5%	85.9%	1.5%
ICICI Bank	42.9%	11.6%	1.4%	63.4%	0.8%
UTI Bank	53.0%	9.0%	3.4%	19.7%	1.0%
SBI	44.8%	12.8%	6.0%	56.9%	0.6%
Corporation Bank	52.3%	13.3%	2.0%	64.7%	1.4%
Oriental Commerce Bank	44.9%	11.8%	3.6%	36.2%	0.8%
BOI	61.6%	12.2%	6.7%	37.7%	0.4%

Efficiency ratios

1. Interest income per employee
2. Profits per employee
3. Business per employee

These ratios indicate the productivity level of the bank's employees. Since state run banks are operating with large employee base, the productivity ratio for these banks lags behind when compared with new generation private sector banks. Banks can improve these ratios by increasing the technology infrastructure, frequent offering of innovative products and also employee rationalization.

1. Business per branch
2. Employees per branch

A bank's performance cannot be judged only from its large network. It has to be in relation with the bank's ability to capitalize on its network. Large number of branches are sometimes unviable if they are situated at places where the business opportunity is low. Private sector banks are likely to have better ratios vis a vis their PSU peers on account of their concentration on top 100 business centers. Unlike PSU banks, private banks in general lack presence in rural areas. Since state run banks are present in every corner of the country, it impacts their average productivity ratios (as business opportunity differs).

Valuations parameters

1. Price to book value: Unlike other manufacturing/services company, a bank's market valuations cannot be only measured from its price to earnings ratio (P/E ratio). This is due to the reason that a bank's net earnings are influenced by the amount of non-performing assets provision, which again depends on the bank's internal policy. Consequently, the bank could make low provisions to show a better picture. Therefore it's prudent to remove non-performing assets for which no provisions are made from the net worth of the bank to arrive at the adjusted book value.

2. **Market cap to total income:** This ratio helps in judging the market valuations of the bank's total income. It is similar to the market cap to sales ratio for a manufacturing company. It indicates valuations accorded by the market to the total income of the bank.

Productivity comparisons

FY01	Interest income	Profits	Business	Business	Employees *
(Rsm)	Per employee			Per branch	
HDFC Bank	4.6	0.8	59.2	1,243.9	21.0
ICICI Bank	2.8	0.4	52.1	619.3	11.9
UTI Bank	7.5	0.7	117.4	1,617.8	13.8
SBI	1.2	0.1	16.6	392.6	23.7
Corporation Bank	1.7	0.2	23.3	386.9	17.0
Oriental Commerce Bank	2.0	0.2	26.3	383.7	14.6
BOI	1.2	0.1	19.0	329.5	17.4

* absolute number

Comparative valuations

FY01	PBV	P/E	Market cap/ total income
HDFC Bank	6.4	27.4	4.0
ICICI Bank	2.5	17.7	2.0
UTI Bank	4.4	6.2	0.5
SBI	1.9	7.7	0.4
Corporation Bank	1.4	6.3	0.8
Oriental Commerce Bank	0.6	3.8	0.3
BOI	2.6	5.6	0.2

Valuations based on market price as on March 15, 2002

Banking stocks have witnessed a sharp run up in prices in the last few days. Over the last nine months the fundamentals of the sector have been negatively impacted on account of a slowdown in the credit growth resulting in pressure on margins. Private sector banks have however managed to outperform on account of their aggressive retail lending which fueled their total income. Even though valuations of some of the old private banks look attractive, it's worth to look at their financials and some of the ratios given here to determine where they deserve higher valuations. Look before you leap!

FOOD FOR THOUGHT

Some more tools have been developed by analysts who have tried to analyze banks from somewhat different perspective like Economic Value Added Analysis (popularly known as EVA Analysis) which tries to see banks in the light of shareholders wealth and some what social orientation but by and large, still majority of the Bank Analysis is still done by either of the two methods discussed above. The shortcomings with these methods come into picture once one makes an attempt to compare public sector banks with private sector banks. The problem lies primarily in the holding pattern of these banks which largely accounts for their different management style. Public Sector Banks in India are government owned and thereby work under lot of restriction and guidelines, which sometimes does not make any economic sense.

The private banks on the other hand are owned and run by professionals and have much fewer guidelines to adhere to. This results in altogether different approach to Strategic Management issues when it comes to loan approvals/ sanctions, liquidity, dividend and so many other policy decisions. Thus in this light it becomes very difficult to draw any sort of comparison between two although both have some distinct advantages and a better synergy between them can do wonders to both of them.

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