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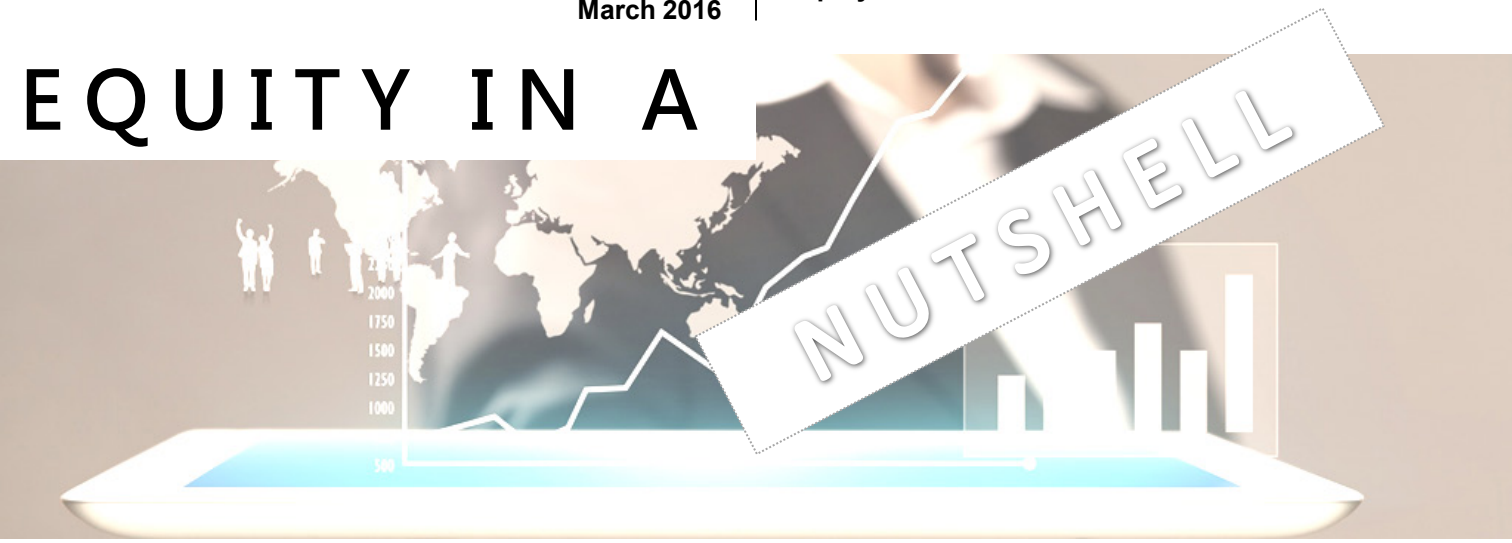
Equity Solutions

EQUITY IN A NUTSHELL



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Banking made easy

As per the dictionary, a bank is "a financial institution that creates credit by lending money to a borrower, thereby creating a corresponding deposit on the bank's balance sheet". In our view, this is a very simplistic definition as the banking sector has come a long way from being a mere deposit taker and lender. In fact the range of activities conducted by a bank has expanded significantly from personal (or retail) and corporate banking to new age and sophisticated services such as investment banking, private banking, insurance, equity and debt sales and trading, as well as trading in commodities, money markets and foreign exchange.

In this publication, we will a) explain how banks differ from a manufacturing or service organisation, b) help you understand and navigate the seemingly complex terminologies that you encounter in a bank's financial statements or publications and c) focus on key topics in the banking industry (regulation, capitalisation and litigation) that have hogged analyst/investor limelight since the 2008 global financial crisis.

How banks differ from a manufacturing/services company

Banks have a high dependence on the monetary policy of the central bank of the country in which they operate and are intrinsically linked to the economic cycle. Due to this, banking is a 'cyclical' business and it plays an important role in monetary policy transmission. Unlike their manufacturing and service sector peers, banking is a 'balance sheet' driven or leveraged business and is highly regulated. On the other hand, a manufacturing or service organisation, is driven by its profit and loss (P&L) statement as the growth in profits allows companies to finance asset purchases, buy raw materials, produce goods, hire employees and pay their general and administrative expenses. In contrast, a bank needs to maintain a minimum amount of equity capital and fulfil compliance requirements to conduct its business.

Business growth in a bank is driven by the growth in loans, deposits and investments (balance sheet items) and then the spread (difference between yield and cost of funds) and non-interest income (brokerage, fees, commissions and profit/loss on trading) determines profitability. Further, cash flows are not important for a bank as it has minimal investment needs (capital expenditure and depreciation) and it is a funding (deposits, loans, bonds) led business. Lastly, in a manufacturing/service company dividends are dependent upon earnings per share (EPS) while in a bank dividends are contingent upon both EPS and capitalisation.

Simplifying a bank's financial statement

As banking is a balance sheet driven business revenue generation starts only when the bank raises deposits and provides loans to borrowers. Other funding sources include debt (local and FX) and bonds (secured and unsecured). Apart from loans, other interest-earning assets are investments (private equity or strategic), loans given to banks, trading securities and treasury bills (T-Bills). Interest-earning assets are multiplied by the yield on funds to derive interest income earned and interest-earnings liabilities are multiplied by the cost of funds to calculate the interest expense paid. This difference between interest earned and interest paid is known as net interest income (NII) which typically accounts for 50-70%of the revenues. In order to determine the profitability of lending and its riskiness, we calculate net interest margin which is NII divided by interest-earnings assets. Generally, a higher NIM reflects riskier lending. Another major source of revenue for a bank is non-interest income which includes commission, fees, brokerage and trading gains. A higher percentage of non-interest income is positive for a bank as it allows more effective utilisation of resources (or higher revenue/assets per employee) and generally leads to a low cost/income (C/I) ratio (as more revenue is spread over the same number of employees).

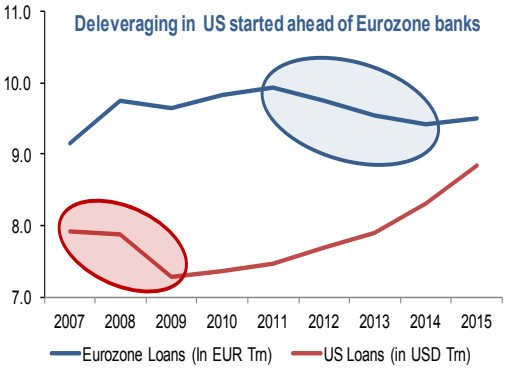
After revenues we move to costs. A bank's operating expenses consists of mainly employee expenses (as it is a service oriented business) and other general and administrative expenses. We note that of late, banks earnings are being pressurised by the increasing share of regulatory and compliance costs, and banking levies share in operating expenses. That said, banks have been focused on containing expenses in order to support earnings growth. This is usually communicated in the form of cost savings and C/I ratio target. A lower C/I ratio generally indicates greater cost-efficiency. We deduct operating expenses from total income to arrive at pre-provisioning operating profit (PPOP).

Another important element of a bank's P&L is loan-loss provisions or credit costs, which reflect a bank's credit quality.

Banks face credit risk which is the likelihood of a borrower defaulting on the loan. This is dependent on the loan book composition, exposure to stressed segments and amount of loans becoming non-performing. Further, if a bank finances long-term loans (project or infrastructure) or unsecured retail loans (personal or credit card) it runs a risk of being hit by higher provisions when the economic cycle weakens. Two key metrics determine a bank's asset quality (a) loan-loss provisions ratio (loan loss provisions/loans) – percentage of loan book provisioned each year and (b) non-performing loans ratio (NPLs/loans) – percentage of loans that are non-performing. We deduct the loan-loss provisions and tax from PPOP to arrive at the net income and EPS.

Once a bank calculates EPS, it has to decide whether to pay dividend or not. Some banks explicitly state their dividend policy (along with a payout ratio target) while others declare it on a discretionary basis. As we said, dividend payment is also dependent on a bank's capital position and whether it believes that is has a sufficient capital buffer to absorb unexpected losses and still meet regulatory requirements. In an economic downturn, banks generally try and conserve capital in anticipation of higher loan-loss provisions while in an economic recovery they try and resume dividend payment as it provides a positive signal to investors that the bank is confident on its capitalisation.

Coming down to the balance sheet, it is often said that a bank has 'deleveraged' or 'de-risked' its balance sheet. What do these terms mean?. Since the global financial crisis or the sovereign debt crisis in Europe, banks have been in deleveraging mode, which means that they have been reducing the size of their loan book driven by either loans repayment, non-renewal of matured loans and decreasing exposure to riskier-segments (i.e. de-risking) by focusing on either secured or collateralised (mortgage, car) loan segments and short-duration (working capital) loans. The following figure denotes that deleveraging at US banks (loans declined from USD 7.91 trn in 2007 to USD 7.28 trn in 2009) started ahead of Eurozone banks (loans declined from EUR 9.94 trn in 2011 to EUR 9.42 trn in 2014).



Source: Bloomberg, SGPB

Another important aspect of a bank's balance sheet is capitalisation which mainly consists of Basel III Common Equity Tier (CET) I ratio and leverage ratio. CET I ratio is calculated by dividing CET I capital by risk-weighted assets (RWA). Risk-weighted assets are calculated by assigning risk-weights to all interest-earnings assets. A personal/credit card loan would have a higher risk-weight in comparison to a mortgage/car loan. However, as there was no standardization on assigning risk-weights, many banks witnessed a huge capital shortfall during the financial crisis. This led to the introduction of the leverage ratio which removes the subjectivity of risk-weights and take a more strict and holistic view of capital. Leverage ratio is calculated by dividing Tier I capital by total assets (on and off-balance sheet).

Key topics that have grabbed eyeballs in the banking sector

Regulation: Regulations have got a facelift since the global financial crisis. Regulators are focused on making banks safer and well prepared for an eventuality by requiring them to hold excess capital, funding and liquidity. This has resulted in a more disciplined approach on risk taking but has hampered their profitability and return ratios owing to higher share of low-risk (and lower return) assets. Further, constraints on risk taking has also impaired liquidity in certain markets such as the fixed income markets.

Capitalisation: Capital requirements have been progressively tightened with the Basel Committee on Banking Supervision (BCBS) focused on improving the quantity and improving the quality of capital. From holding as low as 2% of capital in the form of equity in Basel I the core equity capital requirement has risen significantly to 7% under Basel III i.e. a minimum CET I ratio of 4.5% plus a capital conservation buffer of 2.5%. Further, the leverage ratio was introduced as a backstop measure to CET I ratio and the Financial Stability Board mandated a capital surcharge for large domestic/global banks. We note that Basel IV is in the works with the Basel committee reviewing credit, market and operational RWA.

Litigation: Litigation is supposed to be a one-off phenomenon but unfortunately it has been a regular feature for both, European and the US banks alike. As per a report by Morgan Stanley, US and European banks, have borne a cumulative fine of USD 260 bn since the 2008 global economic crisis. Litigation remains a major risk, but the industry has resolved most of the key cases.

Conclusion

Banks have evolved from being a conduit between savers and borrowers as their range of activities has expanded significantly over the last two decades.

The key metrics to track in a bank are net interest income, net interest margin, non-interest income, cost/income ratio, loan-loss provisions and non-performing loans ratios, composition of loan book, loan and deposit growth, Common Equity Tier I and leverage ratio and dividend payout ratio.

Regulation, capitalisation and litigation risks are key areas of investor focus and worth monitoring to "separate the grain from the chaff" in the banking sector.