

EMERGING

Banks

Avoid being robbed



Global Bank Team

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Determining the best bank is not so easy

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Rules distort regional comparisons

Comparisons and rankings of emerging banks, particularly those measuring profitability, are becoming increasingly popular among investors keen to gain insight into which banks are best managed. However, we question the validity of these approaches because there are two sources of bias that are beyond a bank's control.

The first is the bank's operating environment, i.e. the state of the local economy and competition. Since banking is still largely a domestic affair, significant differences in loan growth rates, interest rates and spreads exist between banking markets.

The second is the bank's regulatory environment. Country-specific rules for loan-loss provisions, reserves for deposits and capital adequacy can have a major impact on a bank's profits. Quantifying this impact is the focus of this section.

Regulations have a direct bearing on profits

Although banks have to deal with a large number of regulations, only a few have a direct and easily measurable impact on earnings. These are shown in Figure 25 and described below:

- ▶ **Cash reserve ratio (CRR):** Banks are required to keep a certain percentage of deposits in the form of cash. In many cases, such reserves do not earn interest and are kept with the central bank.
- ▶ **Liquidity ratio:** Banks are required to keep a certain percentage of deposits in the form of government securities. These securities holdings usually earn a lower interest rate than loans do.
- ▶ **Capital adequacy ratio (CAR):** This is the ratio of equity capital to risk-weighted assets. In general, the risk weightings vary from 0% for cash and government bonds to 50% for housing loans and 100% for ordinary loans.
- ▶ **General provision requirements:** Banks usually set aside funds to deal with problem loans. The general provision is a fixed percentage of total loans outstanding. Specific provisions are also made for loans that have become non-performing.
- ▶ **Tax rates:** Tax rates vary from country to country. In some countries, the rate can be as low as 15%, in others, it can be as high as 50%. This naturally has a large impact on a bank's profits.

Figure 25 The rules affecting banks

	Cash reserve ratio %	Liquidity ratio %	Cap. adequacy ratio %	Gen. provision requirements %	Corporate tax rate %
India	15	31.5	8	1	46
Malaysia	11.5	17	8	1	30
Pakistan	5	25	*13	2	36
Sri Lanka	15	17	8	1	35
Korea	11.5	30	8	1	30
Singapore	—	19	12	1	27
Thailand	** (2)	7	8	—	30
Indonesia	—	2	8	1	35
Philippines	—	17	10	2	25
Taiwan	—	7	8	1	15
Hong Kong	—	—	12	—	33
Argentina	—	—	11.5	1	15
Chile	—	—	5	0.75	30
Peru	—	—	8	0.5	40
Poland	11	—	8	—	35
South Africa	3	5	8	0.5	

* Liabilities cannot exceed 13x equity and reserves

** 2% of the total 7% liquidity ratio is to be kept by way of cash

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Quantifying the rules

To quantify the impact of these five rules on a bank's profitability, we applied them to a generic bank's balance sheet and income statement. Our starting point was to assume a deposit base of 1,000, comprising current, savings and term deposits. We have assumed that current deposits are 15% of total deposits and earn no interest, savings deposits are 25% of total deposits and earn 5% per annum, and term deposits are 60% of total deposits and earn 7% per annum.

On the asset side, we have assumed that fixed assets amount to 2% of total assets. The remaining breakdown of assets is a function of the CRR (the percentage of deposits kept as cash) and the liquidity ratio (the percentage of deposits kept as bonds). We have assumed an interest rate of 0% on cash, 8% on securities and 10% on loans.

Figure 26 Profits according to the rules

Country	Theoretical net income	Pradeep ratio
India	8.7	0.38
Sri Lanka	12.0	0.52
Korea	13.2	0.57
Malaysia	16.2	0.70
Pakistan	17.0	0.74
Poland	18.3	0.79
Philippines	21.9	0.95
South Africa	23.9	1.03
Singapore	27.1	1.17
Indonesia	27.3	1.18
Thailand	27.5	1.19
Taiwan	27.6	1.19
Peru	28.9	1.25
Argentina	29.5	1.28
Chile	32.2	1.39
Hong Kong	38.7	1.67
Average	23.1	1

The amount of equity required to support these assets is based on the CAR. We have assumed a risk weighting of 0% on cash, 0% on securities, and 100% on loans. We have also assumed that all loans are performing.

On the income side, we have assumed that non-interest income is 2% of total assets and operating expense is 3%. The loan-loss provision is based on the general provision requirement, and we have assumed that the annual increment is based on 25% of the loan portfolio (i.e. provisions are made for new loans under the assumption of 30% loan growth).

Figure 26 compares the profits for each country. As can be seen, the profitability of banks in Hong Kong, Latin America, Thailand, Indonesia and Singapore should be quite high, owing to a general lack of rules that reduce profitability. Meanwhile, the profitability of banks in India, Sri Lanka and Korea should be poor, as these banks must hold large quantities of cash and bonds.

The Pradeep ratio

The Pradeep ratio, named after famous Indian equity analyst Pradeep Chokhani, is the ratio of a bank's theoretical rules based profit to the average profits of all banking industries. It can be interpreted either as an adjustment factor to normalise earnings between one country and the next, or as a measure of risk. Banking industries with many restrictive rules (i.e. a low Pradeep ratio) should also have less leeway to get into trouble, or more potential to improve their profitability if the rules are eased.

If one can think long-term enough, the globalisation of the world's capital markets will eventually result in banking regulations and interest rates becoming uniform everywhere. This means that the banks most at risk of seeing their profitability undermined are those in the most lax regulatory environments.