TEST YOUR UNDERSTANDING

The figures below relate to the Return on Equity of four banks. Please match the bank to the figures and guess the name, if you can. What are the key drivers of ROE for each?

Bank	Description of bank
A	A UK commercial and investment bank which is downsizing its investment bank and selling its activities in Africa
B	A leading South African bank with activities in retail, commercial and insurance
C	A US based investment bank which declared bankruptcy in 2008
D	A leading universal bank with a global investment banking franchise and strong retail activities in the US

Bank	WHICH BANK?	Return on Average Equity	Return on Average Assets	Average assets / Average equity	Key Drivers of RoE
		18.5	0.24	77	
		10.2	0.99	10.3	
		14.5	1.1	13.2	
		1.9	0.1	18.6	

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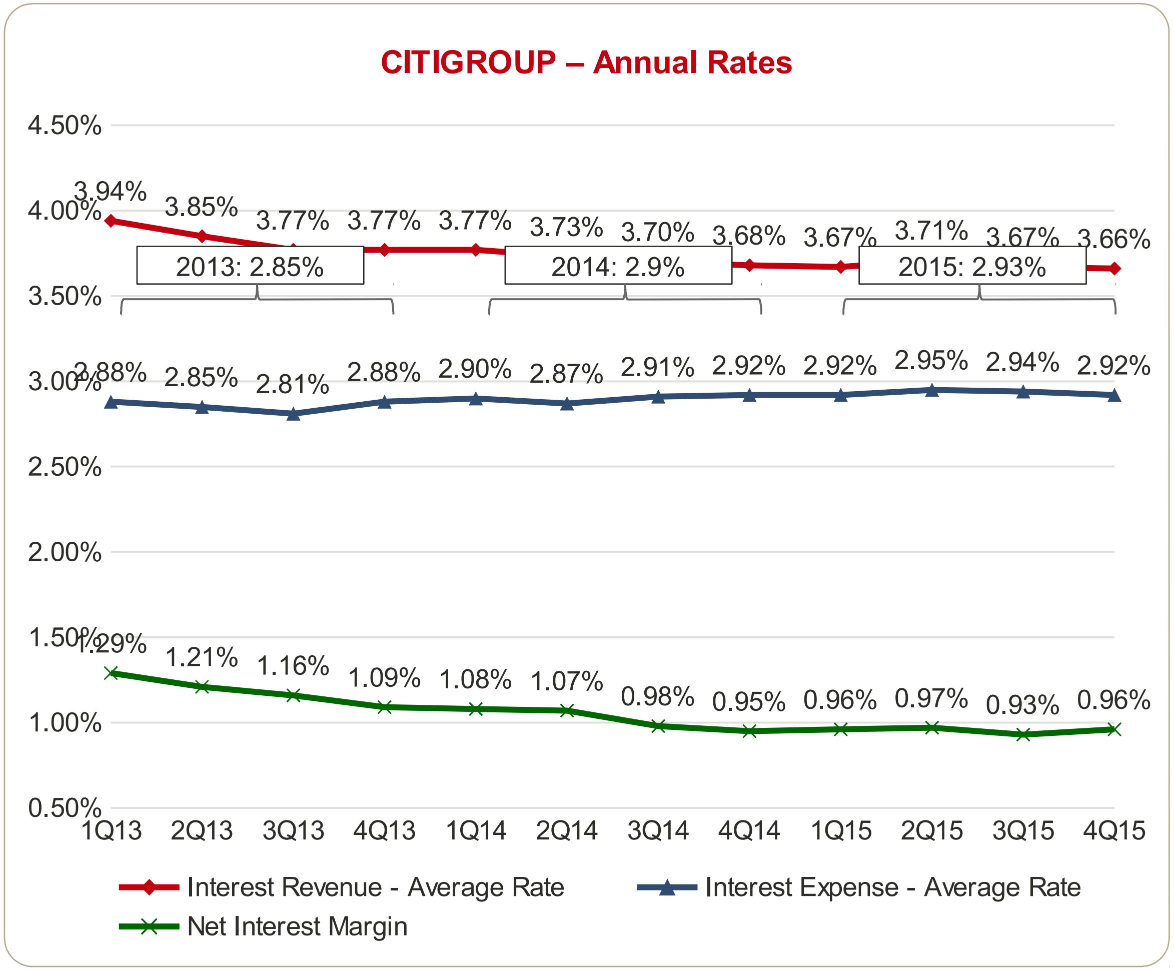
TEST YOUR UNDERSTANDING

CASE STUDY

Banks manage their net interest margin in a number of different ways, all of which could increase the risk profile of the business model.

Questions

1. Citi showed a marginal improvement in NIM over the period – when US interest rates were largely flat. Did this arise from higher yield lending or lower cost borrowing?
2. How can a bank increase the yield on its assets and how could this lead to an increase in risk profile, if managed badly?
3. How can a bank reduce the cost of its funding and how could this lead to an increase in risk profile, if managed badly?



Source: Citigroup 10-K 2015 p102

TEST YOUR UNDERSTANDING

CASE STUDY : DEBRIEF

Small movements in net interest margin such as those shown by Citibank can be driven by any number of factors. The analyst should be wary of significant movements over time and major differences from peers.

Question	Debrief
1. Citi showed a marginal improvement in NIM over the period – when US interest rates were largely flat. Did this arise from higher yield lending or lower cost borrowing?	▪ Both the yield on assets and cost of funding declined. ▪ This suggests Citi did not increase the margin by higher risk lending but rather by reducing funding costs.
2. How can a bank increase the yield on its assets and how could this lead to an increase in risk profile, if managed badly?	▪ Increase in loans to riskier borrowers ▪ Increase in risky loan types e.g. credit cards ▪ Increase in duration of fixed income assets ▪ Lower non-yielding assets such as cash ▪ Lend in foreign currency Above actions all could lead to higher credit risk, market risk and liquidity risk
3. How can a bank reduce the cost of its funding and how could this lead to an increase in risk profile, if managed badly?	▪ Increase lower cost current and savings account (CASA) deposits ▪ Improve the credit rating ▪ Use more short term wholesale funding ▪ Borrowing in foreign currency Short term wholesale funding and foreign currency funding both increase the risk profile of a bank.

TEST YOUR UNDERSTANDING

1. *One of these banks is an emerging market universal bank and another is a global commercial and investment bank. Which is which and how did you work this out?*
2. *For each bank which types of fees and commissions do you believe likely to be most stable and which the least stable?*

Bank A

Net fee and commission revenue	**26,920**
Fee and commission revenue	31,397
Account transaction fees	10,856
Electronic banking fees	2,823
Knowledge-based fees* and commission	2,336
Card-based commission	5,655
Bancassurance	1,767
Documentation and administration fees	1,693
Foregn currentcy service fees	1,925
Other	4,342
Fee and commision expense	(4,477)
% Total Revenues	22%

* Knowledge based fees: advisory fees for corporate transactions

Bank B

Investment banking	3,423
Trading-related	2,345
Credit cards and bank cards	1,786
Trade and securities services	1,735
Other consumer	685
Corporate finance	493
Checking-related	497
Loan servicing	404
Other	480
Total commissions and fees	11,848
% Total Revenues	17%

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KNOWLEDGE CHECK

1. Which of the following items would NOT be included in operating costs for a bank?

- ☐ Staff pension costs
- ☐ Commission expenses
- ☐ Investment in new IT system
- ☐ Impairment on bad loan
- ☐ Regulatory fine

2. Answer true or false to the following statements:

Commercial banks tend to have lower cost to income ratios than investment banks.	True ○	False ○
If a bank generates goodwill by acquiring another bank and paying more than the book value, the goodwill does not need to be amortised unless it is deemed to be impaired (i.e. worth less than the bank paid).	True ○	False ○
The fair value of a bank's own liabilities is shown as an operating cost.	True ○	False ○
Banks which have over-provided for bad loans are allowed to recognise the release of impairment provisions in the income statement.	True ○	False ○

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TEST YOUR UNDERSTANDING

CASE STUDY

1. Match the division to the business line: commercial; retail – branch banking and mortgages; consumer finance – car loans and credit cards

Division			
2015	£m	£m	£m
Net interest income	7,397	2,510	1,287
Other income	1,122	2,066	1,358
Total income	**8,519**	**4,576**	**2,645**
Total costs	(4,573)	(2,167)	(1,488)
Impairment	(432)	22	(152)
Underlying profit	**3,514**	**2,431**	**1,005**
Ratios			
Banking net interest margin	2.40%	2.93%	5.94%
Asset quality ratio (NPL%)	0.14%	0.01%	0.68%
Return on risk-weighted assets	5.30%	2.33%	4.81%
Return on assets	1.11%	1.16%	3.73%
Cost to income ratio (Please calculate)			

Extracted from Lloyds Banking Group Annual Report 2015, p40

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TEST YOUR UNDERSTANDING

CASE STUDY

2. Provide a rationale for the differences across divisions for the following hey earnings indicators

Key Performance Indicators	**Rationale for differences**	
NIM		Consumer finance has very high NIM due to risk profile of credit cards; retail NIM is lower than commercial as the retail business focuses on low risk mortgage lending but commercial is focused on lending to small and medium sized enterprises
Cost to income		Commercial has lower costs as there are lower staffing and branch needs and the commercial business has not had to provide for such large fines for mis-selling
RoA		Key driver of RoA is the net interest margin and so same answers as above
RoRWA		Retail has best RoRWA due to low risk weights attached to residential mortgage lending using internal models. Commercial suffers by comparison from high risk weights applied to corporate and SME lending.

Check Answers

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