

Performance metrics

Benchmarking the benchmarks

With good reason, return on equity has become the main benchmark of banking profitability. But versions of ROE appear to be proliferating as banks fine-tune their chosen variant. This can weaken transparency and make comparisons more difficult. Banks should do more to explain their version of ROE, and what it really says about underlying performance.

There is little question that return on equity (ROE) has become the dominant metric of banking performance. A glance at banks' recently issued 2002 earnings statements confirms how widespread the use of ROE has become across Europe.

Return on assets

ROE has tended to replace other benchmarks. Historically, when banks did little more than lend, return on assets (ROA) was at least as important. However, developments in the industry have left ROA much less reliable during recent years.

First, the Basel capital adequacy regime leaves banks needing to earn a higher return on those assets with a higher risk-weighting. As a result, ROA comparisons across banks become misleading unless allowance is made for differences in risk-weighted assets. Return on risk-weighted assets (ROWRA) adjusts for differences in risk weightings. In recent years this metric has become more popular. But it still assumes that the bank's main business is borrowing and lending money through its own balance sheet. And with lending drifting off balance sheet and a growing proportion of bank income accounted for by other activities, even ROWRA can become misleading.

Return on equity

ROE has clear advantages over the other benchmarks. It has merit of tracking the return earned by a bank for its shareholders irrespective of the mix of activities undertaken. It gained ground during the 1990s as the focus on shareholder value increased and national equity markets became more inter-dependant.

ROE needs careful handling. Above all, comparisons between banks (and analyses of individual banks over time) need to be sensitive to differences in capitalization and capital structures. The volume of capital held above the Basel minimums, and the mix between equity and other forms of capital, may vary significantly between banks. Other things being equal, the more equity a bank holds, the lower its return on that equity. At the margin, a bank with a higher ROE may simply have less equity capital than

its competitors. And if other forms of capital make up the balance of its capital base, its overall return on capital may be no better than its competitors.

Which version of ROE?

These are points to be borne in mind when making ROE comparisons. But a trawl through the recent batch of 2002 earnings statements highlights a more practical problem. Different versions of ROE are appearing as banks make various adjustments to the core measure.

The following table, using examples from some of the largest European banks, shows how headline ROE may be adjusted for factors such as goodwill, or exceptional items, or to isolate the performance of the business units. Adjustments may be made to the numerator (return), the denominator (equity), or both. More than one version of ROE may be quoted.

And the differences can be substantial. Société Générale's Business line ROE after tax in 2002 was almost double its Group ROE after tax. While Deutsche Bank earned a return of only 1.1% on average total shareholders' equity in 2002, its adjusted return on average active equity was 10.2%.

The cynic might conclude that banks are tailoring the ROE calculation to suit their own circumstances. That conclusion is no doubt too cynical. But it points to a real problem of tracking the financial performance of large and complex financial institutions. For example, excluding certain items from the ROE calculation in a bid to capture the underlying return may be legitimate. But in any financial year, most large and complex banking groups will have some such items.

The conclusion is not that ROE calculations have become worthless, for without them it becomes difficult to draw any comparisons and conclusions at all. Nor should the outcome be a benchmarking framework so sophisticated and fine-tuned that it becomes impractical to operate. But there is a debate to be had about what should be included and excluded from the calculation of underlying ROE. And banks should sometimes do more to justify the particular variant of ROE they have chosen to stress.

Calculating ROE – Examples from 2002 Results Statements

Barclays	2002	2001
Post-tax return on average shareholders' funds:		
- on a statutory basis	14.7%	17.4%
- on an operating profit basis	17.7%	20.1%

Note: Operating profit is profit before the restructuring charge, costs directly associated with the integration of Woolwich plc, Woolwich fair value adjustments, goodwill amortisation and exceptional items. Barclays says it believes that identifying operating profit before charging these items assists in the understanding of profit trends in the results.

BNP Paribas	2002	2001
Return on equity:		
- before amortisation of goodwill	14.8%	18.9%
- after amortisation of goodwill	13.5%	18.2%

Crédit Lyonnais	2002	2001
Group ROE (1)	10.4%	10.6%
Business segment ROE (2)	14.6%	12.9%

Notes:

1. Net attributable profit / average shareholders' equity, Group share
2. Net attributable profit / allocated equity (Tier One of 6%)

Deutsche Bank	2002	2001
Return on average total shareholders' equity (2)	1.1%	2.3%
Adjusted return on average active equity (1), (3)	10.2%	7.1%

Notes:

1. Net income used to calculate modified basic earnings per share is adjusted for the reversal of the credit recorded under U.S. GAAP for the change in German tax rates, for the effect of accounting changes, and in 2001, adjusted for amortization of goodwill and other intangible assets.
2. Net income in 2001 is adjusted for amortization of goodwill and other intangible assets.
3. "We calculate an adjusted measure of our return on equity to make it easier to compare us to our competitors. We refer to this adjusted measure as our "active equity". However, this is not a measure of performance under U.S. GAAP and you should not compare our ratio to other companies' ratios without considering the differences in calculation of the ratios. The principal items for which we adjust our ratio are the aggregate unrealized gains and losses in our portfolio of shareholdings in publicly-listed industrial companies and the related tax effect. We include realized gains and losses and the related tax effect in "active equity" from the time the shareholdings are sold and the related gains are employed by our businesses."

Lloyds TSB	2002	2001
Post-tax return on average shareholders' equity	16.7%	18.1%
Excluding changes in economic assumptions and investment variance	23.0%	-

Société Générale	2002	2001
Group ROE after tax	9.4%	15.5%
Business line ROE after tax	18.7%	19.9%

Source: Bank 2002 Earnings Statements

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