

Bank-Specific Ratios

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What are Bank-Specific Ratios?

Bank-specific ratios, such as net interest margin (NIM), provision for credit losses (PCL), and efficiency ratio are unique to the banking industry. Similar to companies in other sectors, banks have specific ratios to measure profitability and efficiency that are designed to suit their unique business operations. Also, since financial strength is especially important for banks, there are also several ratios to measure solvency.



Ratios for Profitability

1. Net Interest Margin

Net interest margin measures the difference between interest income generated and interest expenses. Unlike most other companies, the bulk of a bank's income and expenses is created by interest. Since the bank funds a majority of their operations through customer deposits, they pay out a large total amount in interest expense. The majority of a bank's revenue is derived from collecting interest on loans.

The formula for net interest margin is:

$$\text{Net Interest Margin} = (\text{Interest Income} - \text{Interest Expense}) / \text{Total Assets}$$

Ratios for Efficiency

1. Efficiency Ratio

The formula for the efficiency ratio is:

$$\text{Efficiency Ratio} = \text{Non-Interest Expense} / \text{Revenue}$$

The efficiency ratio does not include interest expenses, as the latter is naturally occurring when the deposits within a bank grow. However, non-interest expenses, such as marketing or operational expenses, can be controlled by the bank. A lower efficiency ratio shows that there is less non-interest expense per dollar of revenue.

2. Operating Leverage

Operating leverage is another measure of efficiency. It compares the growth of revenue with the growth of non-interest expenses.

The formula for calculating operating leverage is:

$$\text{Operating Leverage} = \text{Growth Rate of Revenue} - \text{Growth Rate of Non-Interest Expense}$$

A positive ratio shows that revenue is growing faster than expenses. On the other hand, if the operating leverage ratio is negative, then the bank is accumulating expenses faster than revenue. That would suggest inefficiencies in operations.

Ratios for Financial Strength

1. Liquidity Coverage Ratio

As the name suggests, the liquidity coverage ratio measures the liquidity of a bank. Specifically, it measures the ability of a bank to meet short-term (within 30 days) obligations without having to access any outside cash.

The formula for the liquidity coverage ratio is:

$$\text{Liquidity Coverage Ratio} = \text{High-Quality Liquid Asset Amount} / \text{Total Net Cash Flow Amount}$$

2. Leverage Ratio

The leverage ratio measures the ability of a bank to cover its exposures with tier 1 capital. As tier 1 capital is the core capital of a bank, it is also very liquid. Tier 1 capital can be readily converted to cash to cover exposures easily and ensure the solvency of the bank.

The formula for the leverage ratio is:

Leverage Ratio: Tier 1 Capital / Total Assets (Exposure)

3. CET1 Ratio

The CET1 ratio is similar to the leverage ratio. It measures the ability of a bank to cover its exposures. However, the CET1 ratio is a more stringent measurement, as it only considers the common equity tier 1 capital, which is less than the total tier 1 capital. Also, for the ratio's calculation, the risk level of the exposure (asset) is considered as well. A higher risk asset is given a higher weighting of risk, which lowers the CET1 ratio.

The formula for the CET1 ratio is:

CET1 Ratio = Common Equity Tier 1 Capital / Risk-Weighted Assets

Other Bank-specific Ratios

1. Provision for Credit Losses (PCL) Ratio

The provision for credit losses (PCL) is an amount that a bank sets aside to cover loans they believe will not be collectible. By having such an amount set aside, the bank is more protected from insolvency. The PCL ratio measures the provision for credit losses as a percentage of net loans and acceptances. Looking at it enables investors or regulators to assess the riskiness of loans written by the bank in comparison to their peers. Risky loans lead to a higher PCL and, thus, a higher PCL ratio.

The formula for the provision for credit losses ratio is:

$$\frac{\text{Provision for Credit Losses}}{\text{Net Loans and Acceptances}}$$

Additional Resources

CFI offers the Financial Modeling & Valuation Analyst (FMVA)[™] certification program for those looking to take their careers to the next level. To keep learning and developing your knowledge base, please explore the additional relevant resources below:

[S&P Sectors](#)

[Major Risks for Banks](#)

[Bank Balance Sheet Ratio Calculator](#)

[Bank Mixed Statement Ratio Calculator](#)

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