Financial Ratios – Financial Sector
(Applicable to banks, financial institutions, NBFCs and HFCs)

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Background

Ratios are used to make holistic assessment of financial performance of an entity, and help evaluating its performance against its peers within the industry. Ratios are not an 'end' by themselves but a 'means' to understand fundamentals of an entity. CARE Ratings Limited (CARE Ratings) follows a standard set of ratios for evaluating entities in the financial sector. While critical ratios assessed by CARE Ratings are mentioned, some ratios may be applicable to specific institutions such as banks, non-banking financial institutions / housing finance companies (NBFCs / HFCs) or non-lending financial institutions. These can be divided in five categories:

- Growth ratios
- Capital adequacy and leverage
- Asset quality ratios
- Profitability ratios
- Liquidity ratios

These are given in detail below:

A. Growth Ratios

Trend in growth rates of an entity against the industry reflects its ability to sustain market share, profitability and operating efficiency. In this regard, focus is on growth in interest income, profit after tax (PAT), and loan portfolio/assets under management (AUM). Growth ratios considered by CARE Ratings include the following ('t' refers to the current period, while t-1' refers to the same period in the previous year):

Ratio	Formula	Significance in Analysis
Growth in Interest Income	$\frac{\text{Interest Income}_{(t)} - \text{Interest Income}_{(t-1)}}{\text{Interest Income}_{(t-1)}} * 100$	Interest income growth will be driven by growth in loan portfolio and changes in portfolio yield.
Growth in PAT	$\frac{\text{PAT}_{(t)} - \text{PAT}_{(t-1)}}{\text{PAT}_{(t-1)}} * 100$	PAT is measure of ultimate profitability of a lending institution and its growth is a culmination of all factors impacting income and expenses including taxes.
Growth in Loan Portfolio/ AUM	$\frac{\text{AUM}_{(t)} - \text{AUM}_{(t-1)}}{\text{AUM}_{(t-1)}} * 100$	Growth in AUM reflects the company's ability to grow its business and gain market share, which is looked at on an absolute basis and compared to its industry peers.
Growth in Deposits	$\frac{\text{Deposits}_{(t)} - \text{Deposits}_{(t-1)}}{\text{Deposits}_{(t-1)}} * 100$	Growth in deposits for banks reflects its resource raising ability and helps liquidity profile. This has to be in line with credit growth.
Growth in CASA Deposits	$\frac{\text{CASA Deposits}_{(t)} - \text{CASA Deposits}_{(t-1)}}{\text{CASA Deposits}_{(t-1)}} * 100$	Growth in relatively low cost and stable current account savings account (CASA) deposits for banks reflects its ability to grow stable and low-cost resources.

AUM includes on-balance sheet loan portfolio and off-balance sheet portfolio, which includes securitised / assigned portfolio and portfolio co-originated.

B. Capital Adequacy and Leverage

Capital Adequacy Ratio (CAR) is a measure of the degree to which the company's capital is available to absorb unexpected losses; High CAR indicates the company's ability to undertake additional business. Debt equity ratio is also measure of leverage of the institution. CARE Ratings examines conformity of the entity to regulatory guidelines on capital adequacy norms and further examines capital adequacy based on expected erosion of capital, arising from additional provisioning for non-performing assets (NPAs) among others.

These ratios are explained below.

Ratio	Formula	Significance in Analysis
Overall Capital Adequacy Ratio (CAR)	As reported to the regulator (RBI/NHB) [Tier-I Capital + Tier-II Capital] / Risk Weighted Assets	Higher CAR indicates the lending institution's ability to undertake additional business and higher capacity to absorb unexpected losses. Lower CAR indicates lower loss absorption capabilities. CAR is also viewed from regulatory norms standpoint for each line of business in the financial services space.
Tier-I CAR	As reported to the regulator (RBI/NHB) Tier-I Capital / Risk Weighted Assets	
Common Equity Tier one (CET 1)^	As reported to the regulator (RBI/NHB) CET one Capital / Risk Weighted Assets	It is the primary source of funds for a bank and highest quality of regulatory capital, which indicates extent of support available to banks to absorb losses so that regular business functions are not affected. High CET 1 ratio indicates greater capital cushion to survive adverse impact of economic downturns.
Overall Gearing Ratio	Total Debt / Tangible Net worth	This ratio indicates extent of financial leverage in an entity and is a measure of financial risk. Though higher leverage would indicate higher returns to equity shareholders, degree of risk increases for debt holders in case of uncertainty or volatility in asset quality and earnings.
CASA Ratio^^	(Demand deposits + Savings deposits)/ Total deposits	High CASA Ratio usually means large proportion of a bank's deposits is from low-cost CASA, rather than term deposits. It reflects a bank's ability to raise funds at low costs and therefore contributes to higher net interest margin (NIM), which determines a bank's profitability.
CASA to Liabilities ratio ^^	(Demand deposits + Savings deposits)/ (Total deposits + Borrowings)	High CASA to liabilities ratio means a large proportion of a bank's deposits is from relatively stable sources.
Credit / Deposit^^	Total advances/ Total deposits	Credit-deposit ratio is analysed in conjunction with balance sheet patterns, operational and other financial parameters to understand underlying issues in the entity.
Interest Coverage*	PBILDT / (Total interest and finance charges – Amortization of premium on Debentures – Interest capitalised)	It indicates extent of cover available to meet interest payments. It is a simple indicator of debt coverage and cushion available to secured creditors.
AUM/Net worth	AUM / Tangible Net worth	This ratio is tracked in NBFCs having a sizeable proportion of off-book portfolio including direct assignment (DA) of portfolio or co-lending portfolio.

*Specific to non-lending financial institutions ^Specific to banks under Basel III regulations
^^Applicable for banks

Total Debt

In total debt, CARE Ratings considers all forms of short-term and long-term debt, including redeemable preference share capital, optionally convertible debentures, foreign currency loans, fixed deposits, unsecured loans, commercial paper, inter-corporate borrowings, borrowings from promoters, associates and other group companies. Guarantees extended by the entity (including corporate guarantee given for securitisations) are also added in its total debt.

- Treatment of Hybrid Instruments: Hybrid instruments have characteristics of debt and equity. Examples include preference shares, compulsorily convertible instruments, optionally convertible instruments, including perpetual debt, subordinated debt, Additional Tier I (ATI) bonds, Tier II bonds (including Upper Tier II and Lower Tier II bonds) - these instruments are eligible to be treated as part of Tier I and Tier II capital per RBI/NHB guidelines. These instruments normally carry a fixed rate of coupon/dividend. At times, the coupon/dividend may be deferrable, giving the issuer flexibility to conserve cash in times of stress. However, CARE Ratings treats all these hybrid instruments, except for compulsorily convertible instruments, as debt.

Redeemable Preference Shares	These have a fixed tenure, at the end of which, they are to be redeemed by the issuer. These also carry a fixed rate of dividend. Hence, preference share capital has characteristics of debt and is treated as such by CARE Ratings in its analysis.
Compulsorily Convertible Instruments	Such instruments are compulsorily convertible into equity at the end of a longer time frame, typically 5-7 years. Hence, the company does not have to redeem the instrument at the end of its tenure and as such there is no credit risk. In all such cases, where terms of preference shares/debentures give it equity-like characteristics, CARE Ratings treats such instruments as quasi equity and considers it as part of the company's net worth. However, if the terms of compulsorily convertible instruments are such that investors have an exit option on the company or conversion to equity shares is conditional, CARE Ratings treats these instruments as debt.
Optionally Convertible Instruments	In case of optionally convertible instruments (typically optionally convertible preference shares [OCPS]/ optionally convertible debentures [OCDs]), the investor has the option to convert the instrument into equity shares at the end of a certain time frame at a pre-determined price. In this case, alternative of redemption of the instrument cannot be ruled out till it is actually converted into equity. The instrument thus has debt-like characteristics till the time it is actually converted into equity. Thus, CARE Ratings treats such instruments as debt in its analysis.
Tier II Bonds	Banks/HFC/NBFCs issue Tier II Bonds, which are considered as part of Tier II capital. CARE Ratings considers them as part of debt for calculating overall gearing. In case of banks, per Basel III guidelines, Tier II bonds also have a clause where, on declaration of point of non-viability (PONV) by RBI, it can be written down. However, this is a remote possibility in a going concern, and hence, they are treated at par with Lower Tier II bonds under Basel II, which did not have such clauses.

Basel III AT1 Bonds	Under RBI Basel III norms, banks can issue additional tier I bonds, which are perpetual in nature and are part of Tier I capital. These bonds have loss absorbing features with key features being coupon discretion at all times, non-payment of coupon in the event of breach of minimum CAR, and principal write-down. In case of losses reported by a bank in a financial year, the coupon can be paid out only in the event of availability of credit balance in reserves representing appropriation of net profits. These are treated as debt from analytical perspective.
Upper Tier II Bonds/Innovative Perpetual Debt Instrument under Basel II issued by Banks	These instruments were issued under Basel II guidelines by banks and while these are part of capital adequacy of a bank, CARE Ratings treats them as debt for leverage purposes.
Perpetual Debt Instrument issued by NBFC/HFC	In terms of seniority of claim, claims of investors in perpetual debt instruments (PDIs) shall be superior to claims of equity investors but subordinated to claims of all creditors. These instruments have lock-in clauses leading to deferral of coupon in the event of breach of minimum CAR. These instruments are treated as debt from analytical perspective.

Tangible Net worth

Tangible Net worth of the entity includes equity share capital, all reserves and surplus (excluding revaluation reserve and reserve for bad and doubtful debt), equity share warrants, share application money, employee stock ownership plans (ESOPs) outstanding, minority interest (in case of consolidated financials) and compulsorily convertible instruments (preference shares and debentures).

- **Miscellaneous expenditure not written off and Accumulated Losses:** Both items are deducted to arrive at tangible net worth.
- **Revaluation Reserves:** Revaluation reserves arise from revaluation of fixed assets and are excluded while arriving at an entity's tangible net worth.
- **Treatment of intangible assets:** An intangible asset is one which is not physical. Examples include computer software, patents, copyrights, licenses, intellectual property, trademark, and goodwill among others. Treatment of intangibles is similar to what CARE Ratings follows for the non-financial sector.
- **Treatment of Deferred Tax Liability (DTL) / Deferred Tax Assets (DTA) (Net):** DTA arises due to timing difference between accounting profit and profit per income tax act. CARE Ratings subtracts DTA (net of DTL) from the company's net worth, while calculating tangible net worth.

C. Asset Quality Ratios

Asset quality of a bank/NBFC is the cornerstone of its operational efficiency and a direct reflection of its risk management practices and credit appraisal mechanism. A bank/NBFC's asset quality is also impacted by the state of the economy as a whole. Evaluating asset quality is a significant aspect of analysing banks/NBFCs, as deterioration in credit quality of asset book has dual impact on the entity's profitability considering (i) weakening income profile and (ii) increase in credit costs. Considerably weakening asset quality would also result in higher capital requirements for the entity to support growth and provide stability. CARE Ratings examines following key ratios to determine asset quality.

Ratio	Formula*	Significance in Analysis
Gross NPA Ratio	Gross NPA / Gross Advances (per RBI/NHB Classification)	Gross NPA % denotes percentage of advances turned into NPA against total outstanding loan book. Net NPA % denotes proportion of advances turned into NPA after adjusting for provisions already made for NPA by the bank/financial institution.
Net NPA Ratio	Net NPA / Net Advances (per RBI/NHB Classification)	
Net NPA / Net worth	Net NPA / Tangible Net worth	The ratio denotes coverage available as a percentage of net worth against NPAs net of provisions. The ratio gives an indication of potential erosion of net worth due to Net NPAs.
Provision Coverage Ratio	Provisions for NPA / Gross NPA	It indicates extent of provisioning already done on existing NPAs, indicating future provisioning requirement in the event of no recovery from stock of NPAs
Net Stressed Asset ratio	(Net NPA + Net Restructured Assets + Net SRs) / Net worth	Net Stressed asset denotes proportion of advances, which turned into NPA or are likely to remain vulnerable after adjusting for provisions already made for NPA by the bank/financial institution. This ratio indicates net worth coverage for stressed assets that are unprovided for by the entity.
Write-off ratio	Net write-off (in P&L) / Gross Advances or Loan portfolio	Indicates proportion of loan portfolio that have been written-off in a year. It indicates how much reduction in NPAs is considering write-offs.
Slippages ratio	Addition to NPAs (in) / Opening standard advances/portfolio	Indicates incremental slippages (addition to NPAs) in the period.

* In case of IndAS reporting, Gross Stage 3 and Net Stage 3 Assets may be considered instead of Gross NPA and Net NPA amounts

D. Earnings Ratios

A bank/financial institution's income profile can broadly be divided in two categories: interest income and non-interest income. Interest income is generated by lending funds, while fee-based income (guarantee commission, loan processing fees, and dividend income) and gains from trading/sale of assets form part of non-interest income. The biggest expense for a bank/financial institution is interest expended on deposits and borrowings. Operating expenses of a bank/ financial institution primarily comprise employee cost and administration expenses. Other major charges to the profit and loss account include provision for non-performing assets and provision for diminution in fair value of investments. While analysing earnings profile of a bank, following are key ratios:

Ratio	Formula	Significance in Analysis
Return on Total Assets (ROTA)	PAT / Average Total Assets	ROTA is a single, ultimate indicator of the bank/financial institution's the overall profitability. Impacts of non-interest income, asset quality, fixed cost such as employee cost among others are all factored in this ratio.
Return on Managed Assets (ROMA)	PAT / (Average Total Assets + Average Off-book Portfolio)	This ratio indicates overall profitability on managed assets, where ROMA is analysed.
Return on Net worth (RONW)	PAT / Avg. Tangible Net worth	RONW reflects the return to equity shareholders. It is the final indicator of entity's profitability which is a function of profitability of its assets and financial leverage of the entity.
Interest Spread	(Interest Income / Avg.	An indicator of profitability of the bank/financial

	Interest Earning Assets) – (Interest Expense / Avg. Interest Bearing Liabilities)	institution without considering operational costs. It shows the spread between yield on entity's assets (mainly advances + investments) and cost of funds (deposits & borrowings). It also considers yield on investments, which affects the entity's profitability and forms a significant percentage of assets. It is the spread the entity has to primarily depend on to cover its employee cost, provisions, and tax among others
Net Interest Margin	Net Interest Income / Avg. Total Assets Net Interest Income = Interest Income – Interest Expense	This ratio is similar to Interest Spread and would tend to move in tandem with it. The focus is on overall spread earned on the entity's total assets.
Cost to Income	Operating Expenses / (Total Income – Interest Expense)	Adequacy of financial institution's total income net of interest expenses in covering operational expenses is indicated by this ratio. Alternatively, can be looked at as cost involved in generating a unit of revenue.
Operating Cost / Avg. Total Assets	Operating Expenses / Avg. Total Assets	This ratio shows level of operating expenses, mainly comprising employee and administrative cost, in relation to assets.
Other Income / Avg. Total Assets	Other Income / Avg. Total Assets	The ratio usually indicates diversification of revenue stream. It strengthens earnings profile and contributes to the entity's profitability. However, high ratio indicates greater reliance on fee-based or non-interest income.
Credit Cost	Provisions & Write-offs (in the P&L account) [impairment of financial assets]/ Avg. Total Assets	This ratio indicates credit cost on the entity's average assets. This cost is expected to be built into the pricing of loans and is expected credit cost of overall loan portfolio.
Yield On Advances	Interest Income / Avg. Advances	The ratio gives average lending rate of the portfolio. High yield on advances is an indication that the entity is into financing riskier assets and may see asset quality issues. It also indicates whether the pricing of the loan is in line with underlying risk.
Cost of Borrowing	Interest Expenses / Avg. Borrowings	It highlights cost of borrowed funds for the entity. Cost of funds gives a competitive advantage to the financial institution in terms of its ability to grow, apart from profitability, asset quality, and customer base among others.

E. Liquidity ratios

Liquidity risk has become one of the most important elements of risk management framework in financial institutions. A financial institution's liquidity framework should maintain sufficient liquidity to withstand all kinds of stress events that will be faced. CARE Ratings evaluates liquidity risk by examining stated liquidity policy, assets liabilities maturity (ALM) profile, and collection efficiency and deposit renewal rates (based on empirical evidence), among others. More specifically CARE Ratings measures the following parameters:

Ratio	Formula	Significance in Analysis
Liquidity coverage ratio per RBI	High quality liquid assets / Net cash outflows for next 30 days	RBI stipulates all scheduled commercial banks and NBFCs to maintain a liquidity coverage ratio (LCR) in a phased manner. The ratio indicates on-going ability to meet short-term obligations. The 30-day period allows the entity to have a cushion of cash

		in event of a run on the entity during financial crisis.
Immediate coverage for NBFCs/ HFCs (designated in months)	Liquid assets / Debt obligations for next 12 months per ALM statement	The ratio indicates the period that cash and liquid assets available (as on balance sheet date without considering fresh inflows) cover debt repayment obligations of an NBFC as visible from the ALM statement.
Cash flow debt coverage	(Highly liquid assets + scheduled inflows from credit assets for next 12 months) / Scheduled cash outflows for next 12 months	The ratio indicates cover available for 12 months' scheduled cash outflows (debt obligations and operating expenses) in the form of scheduled inflows from credit assets (adjusted for collection efficiency) in the next 12 months and cash and liquid assets. For NBFCs running a negative ALM mismatch in one year bucket, such cover will typically tend to be below 100%, indicating a potential rollover / refinancing risk.

[For previous version please refer "Financial Ratios – Financial Sector" issued in December 2022]

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