

Return on Equity (ROE) – Why it is an important metric in Stock-based Incentive plan for Senior Leadership in Banks

In our earlier publication¹, we highlighted that Indian Private Sector Banks are slowly pivoting away from “at the money” stock options to Performance Based Restricted Stock Units (PBRSU) structures. An analysis of PBRSU plan structures of banks shows Return on Equity (ROE) as a key metric amongst others that determine either the number of RSUs granted or number of RSUs vested (more commonly used to determine vesting). Four out of five banks have indicated ROE as one of the metrics being considered by the Nomination & Remuneration Committee / Board in the PBRSU program². Globally as well, ROE or a variant of the metric is commonly used by banking / lending institutions in their performance-based plans.

Primarily, this metric shows performance on profitability compared to equity (shareholders’) investment in the Bank. We have attempted to explain in simple terms why this metric matter to shareholders and is being pervasively used by banks in long-term incentive programs. For this, let’s first understand how a bank operates at a basic level:

Assume someone starts a bank by investing ₹100,000 in equity and gets a deposit of ₹900,000. At this point, the Bank has cash of ₹1,000,000. Bank’s promise to depositor is that bank will pay 4% interest per annum on the deposit. If the bank invests ₹1,000,000 at 5.4% in government securities and requires 1% to manage its expenses like salaries, branch network etc., the pre-tax earnings of the bank after paying interest to depositor will be ₹8,000 and assuming a tax rate of 25%, the post-tax earnings will be ₹6,000 i.e., a return of 6.0% on owner’s equity. Now, while the return is positive, it is not beneficial enough for the owner / shareholder to run a bank on those terms. So instead of investing in government securities the bank gives out loan to a borrower who is looking to buy a house. Since this borrower is not as secure as government, bank charges 7.0% interest. Now if we do the same math, we will see that the post-tax earnings of the bank is ₹18,000, which is 18% return on owner’s equity and the banking business becomes quite a lucrative proposition. This obviously is an over-simplistic example but tells us why shareholders will be closely looking at ROE.

While the return goes up, the bank has created three very critical risks. Firstly, there is Credit Risk i.e., what if the borrower stops paying back and defaults (NPA). The bank needs to return the money they have raised from the depositors. Here the underwriting capabilities of the bank becomes extremely critical. Significant defaults can wipe out the owner’s equity in no time. Secondly, there is liquidity risk i.e., while a depositor can withdraw the money at any time, the borrower will be paying back over a period of ten years. This creates an asset liability mismatch for the bank and needs to be managed. While the regulators have defined minimum liquidity to be maintained by banks, it is role of Asset Liability Committee / Risk Monitoring Committee to review the exposures and ensure that the risks are mitigated. The third is duration risk i.e., over a period, the interest rates can change. If the interest rate goes up, the depositors will demand more for their deposits but the terms with borrower may be binding by the contract.

¹ <https://www.linkedin.com/feed/update/urn:li:activity:7331655171610927104/>

² Source: Shareholder notices

The expectation from the shareholders is that the management should be able to deliver strong ROE on a sustained basis while effectively managing all the key risks and hence becomes an integral performance metric in long-term incentive programs in banks. A falling ROE may be a sign of inefficient underwriting / credit function, high cost to income ratio, compressed net interest margins, amongst others. Do note that ROE must be looked at in context of the Bank, you can expect lower ROEs in newer banks or when a bank is transitioning from one strategy to another (e.g., transitioning from a highly leveraged corporate banking to retail banking focusing on current / savings deposits and retail lending).

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