MEASURING WHAT MATTERS:

Effective Performance Indicators

The South African Experience

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national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

Financial and Business Risk indicators

Financial Risk Indicators	Business Risk indicators
Profitability ratios	**Industry prospects**
Return on assets (%)	Operating environment
Return on equity (%)	Regulatory framework
Net interest margin (%)	**Corporate governance**
Efficiency ratios	Adherence to applicable legislation
Cost to income (%)	Management quality
Non-interest income/Total Income (%)	**Market position**
Leverage ratios	Diversification
Debt ratio (%)	Size (Capacity)
Debt to equity (times)	
Liquidity ratio	
Current ratio (times)	
Cash flow adequacy ratio	
Funds from operations/Total debt (%)	
Asset quality	
Non-performing loans/Gross loans (%)	
Credit loss ratio (times)	
Credit Rating	

Business Risk Indicators

Business risk indicators

<u>Industry Prospects</u>

Operating environment refers to the business environment within which the DFIs operate. The factors that should be considered when assessing operating environment include, macroeconomic factors such as inflation, interest rates, currency exchange rates and economic growth, environmental factors such as drought as well as microeconomic factors such as competition within the sector and demand for funding and other product offerings from the DFIs. These factors should be assessed because they affect the business of the DFIs.

Regulatory framework refers to the regulations that govern the sector and the DFIs that operate within it. The main factor that should be considered when assessing this indicator is whether the regulation is not too restrictive that it negatively affects the business of the DFIs.

Corporate Governance

Adherence to applicable legislation

- Whether or not the DFIs adhere to legislation that governs them.
- Over and above compliance by the DFIs, the effect of legislative changes on the performance of the sector should also be considered when assessing this indicator.

Management quality

- Whether or not management is able to take decisions that enable the DFI to meet its mandate and generate profits that enable it to operate without financial support from government.
- Profitability and asset quality of the DFI and the achievement of the strategic objectives of the DFI are the main factors that should be considered when assessing this indicator.

Market Position

Diversification in this methodology refers to whether or not the DFI provides a wide range of products or instruments to its customers as well as whether the markets and customers it services are well diversified.

Size (capacity) refers to whether the DFI's size and capacity enable it to compete successfully in the market as well as expand and take advantage of new markets. The net asset value of the DFI should be considered when assessing this indicator.

Profitability indicators

- **Return on assets** is a financial ratio that shows the percentage of profit a company earns in relation to its total assets. The ratio is calculated as the bank's headline earnings divided by its total assets.

- **Return on equity** is a measure of profitability that calculates how many rands of profit a company generates with each rand of shareholders' equity. The ratio is calculated as the bank's net profit as a percentage of its total equity.

- **Net interest margin** is a measure of the difference between the interest income generated by the bank and the amount of interest paid out to its lenders (for example, deposits), relative to the amount of its interest-earning assets. The ratio is calculated as the bank's net interest income as a percentage of its interest-earning assets.

Efficiency Indicators

- **Costs to income** measures the operating efficiency of a bank. The ratio is calculated as the total operating costs of the bank as a percentage of its total operating income.

- **Non-interest income to total income** is a financial ratio that shows the percentage of the bank's non-interest income in relation to its total income. The ratio is calculated as the bank's non-interest income divided by its total income

Leverage Indicators

- **Debt to assets** measures the extent of the entity's leverage. The indicator is calculated as the bank's total liabilities as a percentage of its total assets.

- **Debt to equity** measures the relative proportion of the bank's total debt to shareholders' equity used to finance the bank's total assets. The indicator is calculated as the bank's total debt divided by its total equity.

- **Leverage** refers to the amount of debt (as opposed to equity) used to finance a firm's assets. A firm with significantly more debt than equity is considered to be highly leveraged.

Liquidity Indicators

- **Current ratio** measures the short term liquidity of a DFI by determining the ability of the DFI to service its short term debt obligations with short term assets.

- The ratio is calculated as the DFI's current assets as a percentage of current liabilities.

Cash Flow adequacy ratios

- **Funds from Operations (FFO) to total debt** is a metric comparing earnings from net operating income plus depreciation, amortization, deferred income taxes and other non-cash items to long-term debt plus current maturities, commercial paper and other short-term loans.

- Costs of current capital projects are not included in total debt for the purposes of this ratio.

- The lower the FFO to total debt ratio, the more highly leveraged the company is and the lower its ability to pay its debts from operations.

- The higher the FFO to total debt ratio, the stronger the position the company is in to pay its debts from its operating income.

Asset Quality

- **Credit loss ratio**
  - this ratio measures the credit risk to which the bank is exposed as a result of its loan book.
  - The ratio is calculated as the bank impairment charge as a percentage of its loans and advances.

- **Non-performing loans to gross loans ratio**
  - measures the bank's credit risk exposure emanating from its loan book.
  - The ratio is calculated as the bank impairment losses (or non-performing loans) as a percentage of its gross loans and advances.

Credit Rating

- The DFI's ability to pay back debt and the likelihood of default as determined by Credit Rating Agencies (CRA). The rating of government related entities such as DFIs by Standard and Poor's, Fitch Ratings Ltd and Moody's Investors Service is a useful point of reference for investors/practitioners when selecting a DFIs' instruments to invest in.

- In terms of the credit ratings, a weight is assigned in consideration of their importance to investors as they consider the credit ratings before investing.

- Compared to the internal risk rating methodology, the CRA consider more or less the same indicators in assessing DFIs. However, the credit rating is still regarded as a useful criterion in assessing a DFI as it might have captured other credit risk related issues that might not have been taken into consideration by the analyst.

Risk Rating Table

Risk ratings	Extent of risk exposure	Likelihood of materialisation
1	Extremely low risk	Remote
2	Low risk	
3	Moderate risk	
4	Marginal risk	
5	Special attention	Possible
6	Substandard	
7	High risk	Probable
8	Very high risk	
9	Eminent default / In default	

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Financial risk indicator rating guidelines

Risk rating	1	2	3	4	5	6	7	8	9
Extent of exposure	Extremely low risk	Low risk	Moderate risk	Marginal risk	Special attention	Substandard	High risk	Very high risk	Eminent default/ in default
Likelihood of materialisation	Remote				Possible		Probable		
Return on Assets (%)	>2	1.75-1.9	1.50-1.74	1.25-1.49	0.9-1.24	0.8	0.7	0.6	0.5>
Return on Equty (%)	>21	17.4-20	14.7-17.3	12-14.6	9.3-11.9	6.6-9.2	3.9-6.5	1.3-3.8	1.2>
Cost to Income (%)	<45	47.4-45	49-47.5	55-50	61-56	67-62	73-68	79-74	80<
Net-interest Margin (%)	>4.5	4.1-4.5	3.6-4.0	3.1-3.5	2.6-3.0	2.1-2.5	1.6-2	1.1-1.5	1>
Non-interest Income/ total income (%)	>61	57-61	53-56	49-52	43-48	39-42	35-38	31.-34	30>
Debt to Assets (%)	<67	68-74	75-82	83-89	90-91	92-93	94-95	96-97	98<
Debt to Equity (times)	<9	9-9.9	10-10.9	11.9-11	12.9-12	13.9-13	14.9-14	15.9-15	16<
Current ratio (%)	>3.1	2.8-3.1	2.4-2.7	2.0-2.3	1.7-1.9	1.4-1.6	1.0-1.3	0.6-0.9	0.5>
Funds from operations/Total debt (%)	>50	46-50	41-45	35-40	29-34	23-28	17-22	11-16	10<
Non-performing Loans (%)	<0.5	0.6-0.8	0.81-1.0	1.1-2.1	3.3-2.2	4.5-3.4	5.7-4.6	6.9-5.8	7<
Credit loss (%)	<0.5	0.6-0.8	0.8-0.9	1-1.7	1.8-2.5	3.3-2.6	4.1-3.4	4.9-4.2	5<
Credit Ratings	Aaa	Aa2	A2	Baa2	Ba2	B2	Caa2	Ca	C

THANK YOU