National Bank of the Republic of Macedonia
Supervisory Policy Manual

Title: E-1 Earnings Performance

Date: FINAL

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Contents:

1. Introduction

1.1. This guidance is designed to assist in evaluating the reasonableness and reliability of an institution's earnings performance. The major sources for earnings analysis include the institution's income statement as well as general and subsidiary ledgers, financial budgets and underlying assumptions, reports to the Supervisory Board (Board) and Board of Directors (Directors), and regulatory reports submitted to the NBRM. Additionally, an understanding is needed of current economic conditions, and any cyclical or seasonal factors (nationally, regionally, and locally) including general industry conditions. The analysis involves a comparison of account balances and statistical data (ratios) on a period-to-period basis rather than a systematic examination of the transactions comprising the account balances.

1.2. Earnings are important because they are an institution's first line of defense against losses and support of asset growth. Earnings are the primary means for institutions to increase capital internally and pay dividends to shareholders. A comprehensive analysis of earnings involves a review and evaluation of past, current, and future earnings; and an understanding of the underlying reasons for the level, reliability, trend and stability of an institution's performance. The analysis focuses on the ability of earnings to meet the following primary purposes:

- Cover expenses,
- Provided for loan and other losses,
- Support growth, and
- Pay dividends.

1.3. The stability of earnings relates to the quality, composition, and constancy of income and expense flows relative to internal factors such as credit risks, interest rate risks, or accounting practices; and external factors such as general economic or competitive forces. An institution's income stability depends on proper management of its sources of income and expense and the influence of internal and external factors on those sources. Recurring income sources, such as net interest on loans or investment portfolios, are obviously preferable to nonrecurring income sources, such as significant income derived from the sale of assets. Relying too heavily on nonrecurring sources of income could severely affect an institution's future viability.

1.4. Earnings quality is the ability of an institution to continue to realize strong earnings performance. It is quite possible for an institution to register impressive profitability ratios and high volumes of income by assuming an unacceptable degree of risk. An inordinately high level of earnings is often an indication that the institution is engaged in higher risk activities. For example, management may have taken on loans or other investments that provide the highest return possible, but are not of a quality to assure either continued debt servicing or principal repayment. Short-term earnings will be boosted by seeking higher rates for earning assets with higher credit risk. Eventually, however, earnings may suffer if losses in these higher-risk assets are recognized.

1.5. It is also important to understand the diversification of an institution's income and expense streams. Ideally, an institution should have a broad customer base in a wide variety of industries and geographic areas to ensure its income flows are not interrupted with changes in the economy. From a funding perspective, institutions should not become overly reliant on a small number of depositors or other funding sources. The institution could experience funding interruptions that would potentially lead to earnings problems (not to mention liquidity concerns).

1.6. International accounting standards require institution's to maintain income and expenses on an accrual basis, which allows income to be recorded before it is actually received and requires expenses to be recorded before they are actually paid. Accrual accounting is a method of acknowledging the continuous nature of income and expenses, whatever the payment schedules may be. In a real economic sense, income is earned and expenses are incurred continuously. In actuality, of course, payments are made only at discrete intervals of time, depending on the contractual requirements of various transactions. Accrual accounting reduces the erratic affects of the actual payment of income and expenses.

1.7. It is important to put erratic or unusual events (e.g. litigation, seasonal fluctuations, merger activity, etc.) into proper perspective by analyzing earnings over multiple accounting periods. Like many companies, financial institutions are subject to events that may have a significant positive or negative effect on earnings in only one particular reporting period. For example, an institution may have reached a legal settlement requiring it to pay out a large sum of money. That would have a negative effect on profits for that one period, but it is unlikely to be repeated. As another example, an institution may record an unusually large loan loss provision expense or actual loss on loans during a particular period, perhaps in response to a client's bankruptcy. It would be inaccurate to base a judgment of the institution's profitability on only that one negative event.

1.8. In evaluating profitability, opinions are made primarily on past performance, but consideration is also given to projections of earnings for the near future. Often times, however, projections are given little weight because they are based on assumptions that may, or may not, be realistic or valid. Though, there are reasons when it may be appropriate to assume that future earnings will be better than or worse than past performance. For example, suppose an institution has experienced heavy losses over the last two years on a portfolio of construction loans that no longer exists on the balance sheet. In the future, the institution will not be burdened by losses from these loans. In forming a judgment about profitability, it would be correct to criticize the institution for the losses incurred on the construction loans, but it should be noted that profitability is likely to improve. This institution would not normally be rated as harshly as another institution that has not dealt with such problems.

1.9. The Income Statement is the accounting report of an institution's profitability over a specific accounting period. Because banking is a specialized business, the terminology associated with an institution's income statement is different from that of other companies. Below is the general structure of a commercial bank's income statement. This information will serve as a point of reference for following discussions:

Interest Income
\- <u>Interest Expense</u>
Net Interest Income

\+ Non-interest Income
\- <u>Non-interest Expense</u>
Net Operating Income

\- <u>Provision Expense</u>

Pre-tax Operating Income

- <u>Applicable Income Taxes</u>
Net Income

1.10. For ease of analysis, income and expense categories are displayed using component percentages, i.e. in relation to Average Asset (AA). (Component percentages are used to express each item on a particular statement as a percentage of a single base amount, the denominator of the ratio.) This puts earnings components into perspective with regard to the asset size of the institution and allows the comparison of earnings between periods and against peer/industry performance. [*Note that AA is a year-to-date average. Additionally, income and expense items are annualized before conducting any meaningful analysis. Annualizing is the projection of results for periods of less than one year, out to the full year. For example, assume an institution's year-to-date income on May 31 is 1,000. One formula for annualizing is: (1,000/5) X 12 = 2,400.*]

1.11. Comparing month-to-month or quarter-to-quarter results using Denar equivalents will not easily allow for drawing meaningful conclusions. As mentioned above, significant variations in income and expense items can occur in an accounting period because of non-reoccurring events, seasonal fluctuations, merger activities and/or rapid growth. These events are taken into consideration when determining the adequacy of earnings, but the basis of the analysis relies on component percentages in identifying important relationships and trends.

1.12. In using component percentages, earnings can be evaluated using a "Decision Tree" analysis approach. This approach is an attempt to explore how ratios are interrelated and how one ratio can affect other ratios, thus allow for determining the source of a particular performance characteristic to its root cause. For example, the interplay of rates earned on assets or paid on liabilities and the volume or mix of such assets and liabilities is segregated in the decision tree analysis. Appendix A charts the systematic process one might follow in analyzing an institution's net income to average assets ratio. This process is effective because it allows for an understanding of all relevant components and a better judgment as to the adequacy of earnings.

2. Earnings Evaluation and Ratios

2.1. Evaluating the key components of an institution's earnings as outlined above ensures a thorough understanding of relationships and trends. It is important to keep in mind that not one ratio or performance indicator reflects the quality and quantity of earnings. For example, Return on Assets (ROA) is probably the most widely used single indicator of the level of earnings. However, Directors can exercise some discretion in their funding of the Provision for Loan Losses and, thus, overstate or understate net profits. By looking at Net Operating Income or adjusting the ROA by substituting net charge-offs for the Provision Expense, a better understanding can be gained of the institution's core earnings performance.

2.2. Below is a discussion of and analytical approach for each earnings component:

2.2.1. <u>Net Income</u> (to Average Assets), also known as the Return on Average Assets (ROAA), is the institution's earnings after accounting for all sources of income and expense. It is a common starting point for analyzing earnings because it gives an indication of the return on the institution's overall activities. The ROAA reflects how much profit an institution generated for each Denar in assets and measures an institution's earnings in relation to all of the resources it has at its disposal (capital plus short- and long-term funding sources). This is often the primary ratio that supervisors consider when analyzing the strength of an institution's net income. The ROAA is a better measure of profitability for comparisons among institutions than the Return on Equity (ROE), because the ROE is highly dependent not only on the profit of the institution, but also on the amount of capital relative to assets.

2.2.2. *Return on Equity* measures how effectively money invested by shareholders is used to generate income. In essence, it tells how effective the institution is in using both its resources (assets) and its financing (leverage) in creating wealth for shareholders. To avoid shareholder dissatisfaction, institutions have a particular need to meet earnings expectations, and failure to do so may result in shareholder attempts to replace management or inhibit the institutions ability to raise capital. For these reasons, supervisors monitor the ROE in an attempt to identify potential management and ownership issues.

2.2.3. *Interest earning assets / total assets* is an important ratio used in analyzing the structure of in institution's earnings potential. There are several types of earning assets and there should be a clear understanding of the volume, mix and yield of each type. For most institutions, the loan portfolio comprises the majority of earning assets and inherently has more risk, resulting in a greater contribution to overall interest income. Thus, there should not only be an understand of the volume, mix and yield of each type of earning asset, but also an understanding of the risk/reward attributes for the major components of earning asset portfolios.

2.2.4. *Net Interest Margin (NIM)* (sometimes simply referred to as the margin) represents the difference between interest income on earning assets and the interest expense (cost) of interest-bearing funds expressed as a percent of Average Earning Assets. More specifically: **net interest income / average earning assets**. The denominator is average earning assets because the analysis focuses on how much income earning assets are producing and what it costs to fund them. This ratio reflects the profitability of the institution's primary operation. A thorough understand of an institution's NIM allows for identifying the degree to which changes in interest rates, volume and mix affect net interest income. (Some analysts prefer to use net interest income as a percent of *average assets*. This provides similar results, but complicates the analysis because *average assets* include non-interest earning assets, such as cash, fix assets, etc.)

2.2.4.1. <u>Net Interest Income</u> is the difference between interest income and interest expense, and thus, represents an institution's net revenues from its primary operation/business activities. Put another way, if an institution's primary business is to obtain funding sources and invest them in loans and other interest earning assets, then net interest income represents the profit from those operations. There are two primary ratios used in analyzing Net Interest Income, i.e. Spread and Net Interest Margin.

2.2.4.2. <u>Interest Expense</u> represents the cost of interest-bearing liabilities and is usually the institution's largest expense item. An institution's funding can come from both core business sources (such as deposits) and non-core business sources (such as borrowings and subordinated debt). The funding mix that Directors chooses plays a key role in determining the institution's overall interest expense. Like interest income, there should be a clear understanding of the volume, mix and cost of the type and major components of each funding source.

2.2.5. *Spread* represents the percentage difference between the yield on earning assets and the cost of interest-bearing funds. More specifically: (**interest income / average earnings assets) minus (interest expense / average interest-bearing liabilities)**. The spread is probably the most commonly used (and misused) ratio in determining an institution's earnings efficiency. Analyzing the spread helps provide an understanding of pricing practices and the impact of interest rate changes and, possibly, mix changes; but does not allow a reliable determination of the affect of volume changes. While rare, it is possible for the spread to increase, while the level of net interest income (in Denar) may actually decrease.

2.2.6. There are two ratios which help in understanding the structure of revenues:
2.2.6.1. Interest income to total revenues and
2.2.6.2. Gains or losses on foreign exchange transactions + gains or losses on the sale of securities to (total revenues).

2.2.7. Non-interest Income (to Average Assets) is typically the second largest source of revenue and consists of income that is not directly related to interest earning activities, such as:

- Service charges on current accounts and time deposits;
- Foreign exchange operations;
- Gains/losses on trading account assets;
- Rental and lease income;
- Trust income;
- Safety Deposit rental and fees for other custodial activities;
- Fees received from approved non-banking activities and/or non-deposit investment products; and/or
- Fees from cross border wire transfer systems (Western Union, etc.)

2.2.7.1. Because of competitive factors and, sometimes, insufficient quality loan demand, institutions seek to diversify their earnings through non-interest income sources. Moreover, depending on an institutions' structure and operations, non-interest income can represent a significant portion of total revenue. As a result, it is important to understand the sources and stability of non-interest income for those institutions that rely heavily on such revenues.

2.2.7.2. Changes in non-interest income may indicate new product/business development activity, income from non-reoccurring transactions or events, and/or changes in management's risk profile. For example, a major increase in income from trading operations may indicate expansion of riskier trading activities, which require a higher level of expertise and competency. These changes warrant further investigation to ensure a thorough understanding behind the activity generating the income.

2.2.7.3. *Fee Income.* Institutions perform many services for customers, other than the basic banking business of making loans and taking deposits, that generate income in the form of fees. These services include foreign exchange transactions, letters of credit, wire transfers, debit/credit card services, safe deposit boxes, deposit withdrawals and many other services.

The fees charged for these services may be a significant source of income and potentially offset the cost of interest bearing funds if interest income is low.

2.2.7.4. A determination must be made as to whether the sources of fees are predictable, reliable and stable. Fees and commissions from safe deposit boxes, wire transfers and deposit service charges can usually be considered stable sources since they are connected with an institution's core business and will not fluctuate significantly with changes in the overall economy. (Note: fees earned on loan activities are normally included in the interest income earned on loans. This more accurately reflects the overall earnings of credit operations.) However, fees from foreign exchange trading, or other trading activities, are often outside of the institution's control and could fluctuate considerably from period to period. Another potentially volatile source of fee and commission income is the revenue generated from government contracts. These contracts can be highly lucrative to the institution, but the political environment may change and the institution may lose the contracts. Substantial fee income from such volatile sources may raise concern about the stability and reliability of an institution's earnings performance.

2.2.8. Earnings Coverage of Net Loss – Net Interest Income divided by Net Loan Losses. Gives an indication on coverage of net loan loss by interest income. Net interest income/ (acc.907 30.09.2006-31.12.2005).

2.2.9. <u>Operating expenses</u> (to Average Assets), also known as overhead or administrative expenses, represents expenses that are not directly related to an institution's cost of funding. These expenditures are typically the second largest expense category on an institution's income statement and can be categorized into three groups: personnel, occupancy and other. Specific examples of non-interest expense include:

- Salaries, employee benefits, pensions, and other costs of maintaining a qualified staff;
- Expenses of premises and fixed assets including depreciation, rent, utility payments, and maintenance costs; and
- Fees (for legal, accounting, marketing, other professional services and fees paid to Board members); expenses for equipment, computers, automobiles; and/or losses from non-reoccurring transactions or events; etc.

2.2.9.1. If an institution's total non-interest expense ratios are similar to its peer's or the industry's, then there is little need to look closely at individual components. However, if total expenses are unusually high or low, then it should be determined what component of total non-interest expenses such as personnel expense, rents, depreciation, etc. is the cause. This can be done by calculating the ratio of each component of net-interest expense to average assets and comparing the ratios to peer/industry averages.

2.2.9.2. One should be particularly concerned about high non-interest expense because it could represent an inefficiently operated institution. A direct measure of efficiency should specify some relationship between income produced on average assets, and expenses incurred. It is also important to remember that institutions can influence all income and expense components by their actions, but only non-interest expenses can be truly controlled. The extent to which an institution can earn net interest income, fee income, or profit from financial operations is limited by the demand from customers for its products and services. Therefore, an institution that is suffering from high credit losses cannot instantly and automatically produce higher income to offset those losses. The only immediate option is to cut non-interest expenses.

2.2.9.3. On the other hand, non-interest expense can vary significantly from institution to institution, depending on size and activity. Although even two institutions of the same size and engaged in the same activities can have dramatically different levels of non-interest expense. Institutions that operate inefficiently can easily offset most, or all, of their revenue from net interest income, fees, and other sources.

2.2.10. *Operating expenses / Gross Income* is calculated by dividing overhead expenses by the sum of net interest income and non-interest income. The lower the ratio the fewer the resources needed to produce a given amount of income. Conversely, institutions with a ratio approaching or exceeding 1.00 are spending a considerable amount of money to generate too little income.

2.2.11. *Average Assets / Number of Employees.* Normally, personnel expenses will be the largest component of total administrative expenses. If personnel expenses are relatively high or low, it should be determined if this is caused by the number of employees or average salary. This ratio indicates if the institution is overstaffed or understaffed, given its level of assets compared to peer/industry averages. A high level compared to peer/industry may indicate the institution is efficiently operating, provided this is a historical pattern. If the institution is experiencing significant asset growth and/or is beginning to engage in labor intensive activities, a high level may indicate management has not adequately anticipated personnel needs. This brings into question whether or not the institution possesses sufficient staff and expertise to handle the growth. On the other hand, a low level of average assets per employee as compared to peer/industry automatically raises concerns about the institution's operating efficiency and should be thoroughly investigated and understood. It could be historical and caused by the nature of the institution's business lines, or a low level could be maintained in anticipation of rapid growth or the introduction of new products.

2.2.12. *Personnel Expense / Number of Employees* indicates if salaries and benefits provided to employees are reasonable when compared to peer/industry averages. Increases in this ratio may be indicative of a competitive market place for qualified personnel, or the institution is acquiring high paying specialists to deliver new product lines. Decreases in this ratio may indicate a growth in the number of entry level personnel or major changes in the institution's human resource policies.

2.2.13. *Net Income / Number of Employees* measures the average income generated by each staff member. Note that this ratio will be significantly different for a wholesale institution with relatively few but highly paid staff compared to a retail institution with a large branch network and many low paid clerical staff.

2.2.14. <u>Net-Operating Income</u> (to Average Assets) represents the essence of an institution's earnings performance. In this case loan loss provisions should be excluded from calculation (net interest income + other operating income – other operating expenses). Some believe net-operating income is less susceptible to manipulation by management than net income, and thus, a better indicator of an institution's true earnings performance.

2.2.15. Impairment Losses (to Average Assets) is the accounting method institutions use to add to the Reserve for Loan Losses. Poor asset quality results in increased impairment losses (provision expense) and decreased earnings. Provision expense is the earnings component in which an institution's credit quality typically has the most discernible impact. Because management exercises some discretion in its funding of the Reserve for Loan Losses, provision expense has the potential to distort an institution's earnings. If provisions are excessive or insufficient, net income will be understated or overstated, respectively. However, the NBRM deals with this issue by requiring institutions to strictly adhere to the Loan Loss Classification Regulation. Unfortunately, strict adherence often causes erratic swings in the level of provision expenses from period to period, especially when the institution is experiencing high loan growth. There should be a thorough investigation of any trends in the level of adversely classified assets and related reserves to gain a better understand of how the provision expense affects, or will affect, overall earnings performance.

2.2.16. Pre-tax Income (to Average Assets) simply represents all income net of all expenses before income taxes are calculated and paid (or accrued). Since each institution may experience different taxable income and tax-deductible expenses, many analysts prefer to compare this component to previous accounting periods and industry averages to eliminate the tax affect on earnings performance. This is especially useful when tax regulations allow certain advantages and disadvantages depending on business activity.

2.2.17. Applicable Income Taxes (to Average Assets). All profitable institutions pay income tax. It is important to judge whether applicable income taxes seem appropriate and whether a shift in the effective tax rate has occurred. Applicable income tax may appear abnormal due to management's failure to adequately accrue for income tax expense on a current basis. Appropriate tax accruals should be made on a regular basis and at least with enough frequency to allow for the preparation of accurate regulatory reports.

3. Interest Rate Risk and Foreign Exchange Risk

3.1. A thorough understand of an institution's interest rate risk profile is important when analyzing earnings performance. Interest rate risk is the risk to earnings or capital arising from movement of interest rates. It arises from differences between the timing of rate changes and timing of cash flows (re-pricing risk); from changing rate relationships among yield curves that affect an institution's activities (basis risk); from changing rate relationships across the spectrum of maturities (yield curve risk); and from interest-rate-related options embedded in the institution's products (option risk). See MR-1 for a more thorough discussion of interest rate risk.

3.2. Each financial transaction that an institution completes may affect its interest rate risk profile. Institutions differ, however, in the level and degree of interest rate risk they are willing to assume. Some institutions seek to minimize their interest rate risk exposure by matching the maturities and re-pricing dates of their assets and liabilities. Other institutions are willing to assume a greater level of interest rate risk by choosing to take more open interest rate positions. An institution can alter its interest rate risk exposure by changing investment, lending, funding and pricing strategies; and by managing the maturities and re-pricing of portfolios.

3.3. Fluctuations in interest rates generally affect reported earnings through changes in an institution's net interest income. However, in a rising rate environment, loan customers may not be able to meet interest payments because of the increase in the size of the payment or a reduction in earnings. The result will be a higher level of problem loans and higher provision expense. For an institution that is predominately funded with short-term liabilities, a rise in rates may decrease net interest income at the same time credit quality problems are on the increase. Therefore, it is important to gain a wide perspective of the affects high interest rate risk may have on all income/expense components.

3.4. Like for interest rate risk, it is important to have a thorough understanding of an institution's foreign exchange risk profile when analyzing earnings performance. Foreign exchange risk is the current or prospective risk to earnings and capital arising from adverse movements in currency exchange rates. See MR-2 for a thorough discussion of foreign exchange risk.

3.5. Foreign exchange risk arises when there is a difference between the amount and/or maturities of assets and liabilities denominated in currencies other than Denar. For example, an institution has assets of a certain maturity denominated in Euros and liabilities of the same maturity denominated in Denars. If the value of the Euro declines relative to the Denar, the interest income that is received by the institution in Euros would be converted for fewer Denars. The interest expense in Denars, on the other hand, would not change. Accordingly, the institution's net interest income would decline. (There is also an effect of the Euro depreciation on the value of the principal of the assets and liabilities as discussed earlier.)

3.6. For another example, an institution has long-term assets and short-term liabilities for the same amount denominated in Euros. If the Euro depreciates, the institution's interest earned on assets and the cost of the liabilities will both decline relative to the Denar. However, when the liabilities mature, they are usually replaced at higher interest rates to compensate for the devaluation of the Euro, resulting in a narrowing of the net interest margin.

4. Non-accrual Loans and Accrued Interest Income

4.1. As a part of any analysis, it is important to understand an institution's policy of accruing interest on delinquent loans. According to international accounting standards and regulations of the NBRM, it is permissible to accrue interest, even though it is not being paid, on loans that are delinquent up to 90 days; however, interest <u>should</u> <u>not</u> be accrued on loans that are delinquent more than 90 days. Instead, interest should be recorded as income only when received. The institution may have chosen or be required to adopt an even more conservative policy. Loans on which interest is no longer being accrued, or non-accrual loans, are not included in interest-earning assets. A high level of non-accrual loans is one of the most common causes of a poor net interest income position.

4.2. Under accrual accounting, an institution credits "interest income" on the income statement and debits "accrued interest earned not received" (a receivable) on the balance sheet. This receivable account should be reviewed thoroughly if it appears to be out-of-line with peer/industry norms. According to International Financial Reporting Standards, an institution is required to periodically test, for impairment, the underlying asset that generates interest income. If it is determined that the credit quality of the asset has deteriorated significantly, the institution is required to establish an appropriate loan loss reserve and reduce the "accrued interest earned not received" (and interest income) by the amount of interest accrued on the asset. If credit quality problems exist and "accrued interest earned not received" is high, it is possible the institution has failed to place loans on non-accrual and/or appropriately reduced the accrued interest reported on those assets. (Note: the reason for placing impaired or significantly past due loans on non-accrual and backing out accrued interest (and interest income) goes to the logical assumption that if a borrower cannot repay principle, they obviously cannot pay interest. And since preservation of principle is paramount over income earned, the principle amount of a loan is always collected first.)

5. Credit Losses and Collateral Acquired Through Foreclosure

5.1. Credit losses caused by an inability or refusal by borrowers to repay their loans can quickly offset net operating income through high provisioning expenses and threaten the institution's viability. Credit losses can be extremely volatile and often appear unexpectedly, therefore making it sometime difficult to conclude whether or not net operating income will be more than sufficient to cover credit losses in the near future. Credit losses illustrates an overlap between the analysis of earnings and the analysis of asset quality (credit risk). Whether credit losses are expected to increase, decrease, or remain relatively constant, greatly influences the analysis of earnings.

5.2. If a loan is identified as loss and written off, the amount of the loan principal is charged to the loan loss reserve and entered into an appropriate off-balance sheet account. Any remaining accrued interest is backed out of the interest earned not received account and interest income account. When written off loans are recovered, the amount of recovery increases the loan loss reserve account and reduces the off-balance sheet account. The institution can then take a negative provision to reduce the loan loss reserve to more accurately reflect the current risk in the loan portfolio. Once all the principle on a written off loan is recovered, any remaining funds are taken into interest income (on a cash basis).

5.3. In instances when an institution repossesses collateral to repay a loan, partly or fully, the collateral is carried at "net realizable value" as an asset on the institution's balance sheet. Net realizable value is the present market value of the collateral minus all the expenses related to its foreclosure; and is determined by an independent appraiser. If the net realizable value is less than the net value of the loan (book value plus all accrued interest minus all write offs and loan loss provisions), the difference is expensed through loan loss provisions. If net realizable value is higher than the net value of the loan, the collateral is carried at the net realizable value of the loan. In other words, assets acquired through debts previously contracted cannot be carried on the institution's books at a greater value then the net realizable value of the original asset. When the collateral is sold, the gain or loss on the sale is treated as a capital gain item on the income statement.

6. Future Operating Results

6.1. After reviewing the stability of operating results and the historic trends of revenues and expenses, it is possible to make an estimate and evaluation of an institution's probable future earnings performance. Key tools in making this evaluation are obviously the institution's profit plan and budget (and their underlying assumptions).

6.2. A profit plan is an overall forecast of the income statement for the period based on management's decisions, intentions, and their estimation of economic conditions. It addresses such things as the anticipated level and volatility of interest rates, local economic conditions, funding strategies, asset mix, pricing, growth objectives, interest rate and maturity mismatches, etc. The accuracy of any such plan is susceptible to the attainability and realization of the underlying assumptions.

6.3. Within the profit plan is a budget, which is essentially an expense control technique where management decides how much is intended to be spent during the period on individual overhead expense items. The budget should be consistent with the overall business or profit plan. All institutions, regardless of size, should prepare a profit plan and budget that addresses the current year and the next operating year. The degree of sophistication or comprehensiveness of a budget and profit plan may vary considerably based on the size of the institution and the complexity of the assets and income sources.

6.4. The key to evaluating the budget and profit plan is to understand the reasonableness of the underlying assumptions and the probability of projected goals. Forecasts and assumptions should be consistent with what is known about the institution such as the volume of classified assets, non-accrual and renegotiated debt levels, the adequacy of the loan loss reserve, and other facts that have earnings implications. Comparison between the institution's forecast for the previous periods to actual performance as displayed in the institution's own reports (variance reports) can provide a reasonableness check. Any material unexplained discrepancies may result in forecast adjustments to determine the effect of more reasonable assumptions.

6.5. Although comparing the operating budget with prior period data is necessary, prior data does not provide meaningful information if the focus of the institution is changing. For example, if an institution introduces a new credit product, the crucial evaluation of the budget would not come from comparison with prior period data. Instead, the focus would be on the reasonableness of projected loan originations and yields compared with current market conditions.

7. Risk Management Process

7.1. The institution’s risk management processes should ensure a periodic evaluation and ongoing monitoring of earnings, thereby ensuring that earnings are sufficient to maintain adequate capital and reserves. At a minimum, the analysis of earnings should:

- Compare recent earnings trends relative to equity, assets, or other commonly used benchmarks to the institution’s historical results and those of its peers/industry;
- Evaluate the adequacy of earnings given the size, complexity, and risk profile of the institution’s assets and operations;
- Assess the source, volatility, and sustainability of earnings, including the effect of nonrecurring income or expenses;
- Take steps to ensure that earnings are sufficient to maintain adequate capital and reserves after considering asset quality and growth rate; and
- Provide periodic and accurate earnings reports with adequate information for the Supervisory Board and Board of Directors to assess earnings performance.

8. Reported Earnings

8.1. Directors are responsible for reporting earnings that are consistent with economic substance. Acceptable accounting standards allow for some flexibility and latitude to effectively communicate the financial position and results of an institution’s operations. Accordingly, management may implement certain reporting strategies, make certain accrual, deferral, or allocation decisions, or exercise other managerial discretion when reporting earnings. Therefore, it is not only important to look at individual income and expense components, but also at the techniques and strategies management uses to report earnings.

8.2. The strategies management uses should fall within acceptable accounting standards, and not mask the economic condition of the institution. Management should not manipulate earnings or misuse accruals or underlying assumptions of a transaction such that it misreports income, and thus capital. Nor should management manipulate earnings in any way that causes users of the financial statements to change or alter judgments or decisions about the condition of the institution.

9. Supervisory Process

9.1. The NBRM adopts a risk-based supervisory approach that includes continuous supervision of institutions' earnings performance through a combination of risk-focused CAMEL rating on-site examinations and off-site reviews. See SF-1 for details of the NBRM risk-based supervisory methodology.

9.2. Where necessary, the NBRM may request individual institutions to provide additional information on their earnings performance. For example, institutions with significant foreign exchange business may be required to submit separate earnings scenario analyses on their foreign currency positions.

9.3. The NBRM rating of an institution's earnings performance (under the CAMEL Rating System) is based upon, but not limited to, an assessment of the following evaluation factors:

- Reliability of financial information and adherence to appropriate accounting standards, procedures and standards.
- Scope and adequacy of internal controls and audit function as it relates to control and accurate reporting of income and expenses.
- Appropriateness of the budgeting process including assumptions.
- Compliance with laws and regulations relevant to the treatment of income and expenses.
- Level of earnings, including trends and stability.
- Ability to provide for adequate capital through retained earnings.
- Quality and sources of earnings.
- Level of expenses in relation to operations.
- Adequacy of provisions to maintain the reserve for loan and lease losses and other valuation reserve accounts.
- Earnings exposed to market risk such as interest rate and foreign exchange.

9.4. CAMEL Rating - The rating of earnings performance reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the reserve for loan and lease losses, or by high levels of market risk that may unduly expose an institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on non-reoccurring gains, nonrecurring events, or unfavorable tax effects.

1. A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and loan loss reserve levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.
2. A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and loan loss reserve levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.
3. A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and loan loss reserve levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.
4. A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and loan loss reserve levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.
5. A rating of 5 indicates earnings that are critically deficient. An institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

Appendix A - Decision Tree