



Rethinking Bank Efficiency



**The failings of the
cost/income
efficiency ratio**



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Executive Summary

- The cost/income ratio or efficiency ratio is the standard benchmark of bank efficiency. It measures a bank's operating costs as a proportion of its total (ie net interest and non-interest) income.
- Most banks refer to the ratio in their annual reports and earnings statements. Many have explicit targets for the ratio.
- Despite its intuitive appeal and widespread use, the benchmark is an unreliable and often inaccurate measure of bank efficiency.
- An analysis of UK banks' 1999 results shows little correlation between bank profitability (as measured by return on equity) and apparent efficiency as measured by the cost/income ratio. Other bank costs, notably provisions for loan losses, do not explain or account for the lack of correlation.
- The value of a bank's cost/income ratio is crucially dependent on the mix of borrowing, lending and other activities it undertakes. The activity mix often has a far greater impact on the value of a bank's cost/income ratio than the efficiency with which those activities are undertaken.
- There is a positive correlation between bank cost/income ratios and net interest margins. This reflects variations in the income and cost intensity of different deposit and loan types.
- Though it varies by activity, high levels of non-interest income (as a proportion of total income) are often positively correlated with high cost/income ratios.
- Performance targets for banks and comparisons between banks based on the ratio are often of questionable value. They may actually be harmful if false conclusions are drawn about the efficiency of a bank over time or the relative efficiency of the banks compared.
- The cost/assets ratio, the other main bank efficiency metric, suffers from many of the same defects as the cost/income ratio.