

# THE KAFAFIAN GROUP

**Are Your Management  
Reports Just an Illusion?**

**December 11, 2020**

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Performance  
Measurement



Strategic  
Management



Profit & Process  
Improvement



Management  
Advisory



Financial  
Advisory



# Are Your Management Reports Just an Illusion?

## THE KAFAFIAN GROUP

December 11, 2020

9:00 am – 10:00am

**Presented by:**



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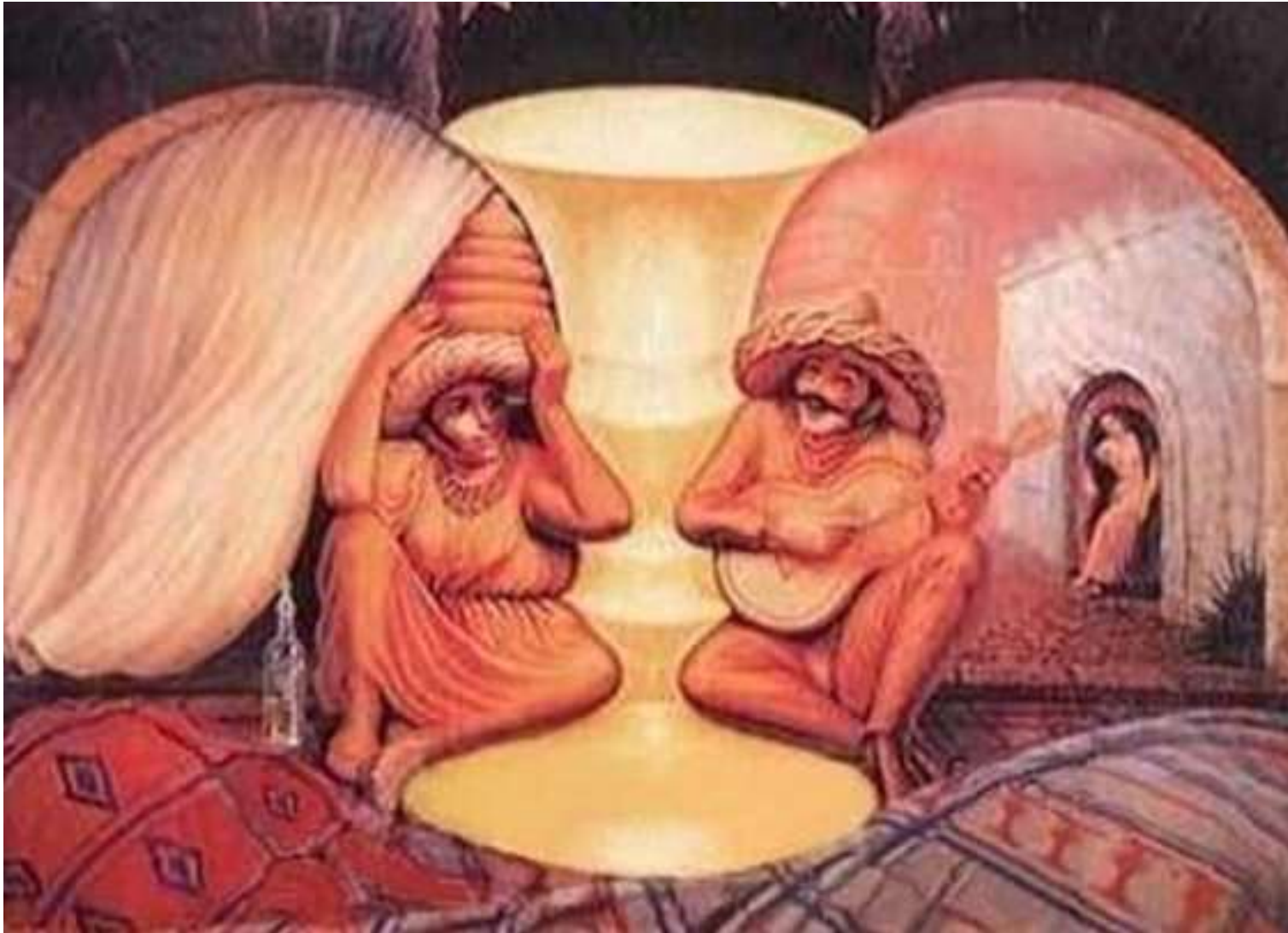
Financial  
Advisory



**“Harness The Power Of Your Financial Data To Help Your Bank Make Smarter, More Confident Decisions That Drive Performance”**

**Go beyond your general ledger to produce more meaningful, decision generating financial reports.**

## Are Your Management Reports Just an Illusion???



Using only general ledger data to provide data for your management reports is just an **ILLUSION!**



Adding **“Performance Measurement” data** will help transform these reports into a “Clear” picture of your performance!

**SAMPLE INSTITUTION  
RETAIL BRANCH PROFITABILITY REPORT  
Q2 2020**

**"Without" Performance Measurement Data**

	Balance Sheet	Total Branches
1	Deposits	298,000
2	Loans	73,000
3	Net Funds Provided (Used)	225,000

	Income Statement	
4	Interest Income	703
5	Interest Expense	480
6	Total Interest Spread	223
5	Provision for Credit Loss	24
6	Marginal Inc (Loss) After Prov.	199
7	Non-Interest Income	234
6	Total Income	433
7	Direct Expense	672
8	Pretax Profit (Loss)	(239)

**Is this  
just an  
Illusion?**

- On a "direct basis", the branch network of this bank is operating at a loss!
- Calculating profit on a direct basis does not tell the true profitability story of the branch network.
- Basing decisions on this information may lead to unintended results!

**SAMPLE INSTITUTION  
RETAIL BRANCH PROFITABILITY REPORT  
Q2 2020**

	Balance Sheet	Total Branches
1	Deposits	298,000
2	Loans	73,000
3	Net Funds Provided (Used)	225,000

	Income Statement	
4	Interest Income	703
5	Cost of Funds	?
6	Net Asset Spread	703
7	Credit for Funds	?
8	Interest Expense	480
9	Net Liability Spread	480
10	Total Interest Spread	223
11	Provision for Credit Loss	24
12	Marginal Inc (Loss) After Prov.	199
13	Non-Interest Income	234
14	Total Income	433
15	Direct Expense	672
16	Indirect Support &	
17	Allocated Overhead	?
18	Total Non-Interest Expense	672
19	Pretax Profit (Loss)	(239)

To provide a true picture of the profitability of the branch network, you must include the following items:

***Funds Transfer Pricing***

***Allocate Indirect Expenses and Overhead Expenses from support centers throughout the institution***



# Transfer Pricing - Definition

Without Transfer Pricing, Deposits would only have interest expense and Loans & Investments would only have interest income.

Transfer pricing provides “Interest Income” for deposits and “Interest Expense” for Loans.

## Deposit Transfer Pricing:

Provides a “Credit to Deposited Funds” to reward a branch for providing funding at a lower rate than if the institution had to fund only through the FHLB.

## Loan Transfer Pricing:

Provides a “Cost of Funds” to charge loans interest expense to match the actual maturity and interest rate characteristics of each loan in your portfolio.

## Funds Transfer Pricing (FTP) – Definition

*Transfer pricing is tied to an external benchmark (“FHLB Fixed Rate Advance Curve”) for interest rates. This eliminates the influence of other decisions not under the control of the management responsible for each product.*



## Transfer Pricing - Definition

Without Transfer Pricing, Deposits would only have *interest expense* and Loans & Investments would only have *interest income*.

1	Savings Deposit "Without" Transfer Pricing	
2	Savings Deposit w/rate of 0.19%	
3		0.00%
4	Interest Expense	0.19%
5	Interest Spread	-0.19%

1	Loan "Without" Transfer Pricing	
2	5 Year Commercial Loan w/rate of 4.50%	
3	Interest Income	4.50%
4		0.00%
5	Interest Spread	4.50%

Transfer pricing provides "Interest Income" for deposits and "Interest Expense" for Loans.

# Transfer Pricing - Definition

## Deposit Transfer Pricing:

Provides a "Credit for Funds" to reward a branch for providing funding at a lower rate than if the institution had to fund only through the FHLB.


1	Savings Deposit "With" Transfer Pricing	
2	Savings Deposit w/rate of 0.19%	
3	Credit for Funds ("Blended" FHLB Rate)	2.47%
4	Interest Expense	0.19%
5	Interest Spread	2.28%

## Loan & Investment Transfer Pricing:

Provides a "Cost of Funds" to match the actual maturity and interest rate characteristics of a loan and investment.

1	Loan "With" Transfer Pricing	
2	5 Year Commercial Loan w/rate of 4.50%	
3	Interest Income	4.50%
4	Cost of Funds (FHLB 5 Year Advance Rate)	1.61%
5	Interest Spread	2.89%

## Transfer Pricing - Deposit Methods

Deposit Product	Pool Priced/Blended Rate
Non-Interest Bearing Demand - Retail	10% 3 Month + 30% 1 Year + 60% 7 Year <i>(10% X 3 Months) + (30% X 12 Months) + (60% X 84 Months) = 54.3 Months</i>
Non-Interest Bearing Demand – Business	30% 1 Month + 30% 3 Month + 40% 7 Year <i>(30% X 1 Month) + (30% X 3 Months) + (40% X 84 Months) = 34.8 Months</i>
Interest-Bearing Demand	10% 3 Month + 30% 1 Year + 60% 7 Year <i>(10% X 3 Months) + (30% X 12 Months) + (60% X 84 Months) = 54.3 Months</i>
Money Market	10% 3 Month + 10% 6 Month + 20% 1 Year + 60% 3 Year <i>(10% X 3 Months) + (10% X 6 Months) + (20% X 12 Months) + (60% X 36 Months) = 24.9 Months</i>
Savings	20% 6 Month + 30% 3 Year + 50% 7 Year <i>(20% X 6 Months) + (30% X 36 Months) + (50% X 84 Months) = 54 Months</i> 
Certificates of Deposit	Matched Maturity by instrument
Borrowings	Pool Priced @ Actual Cost or Matched Maturity by instrument

## Funds Transfer Pricing - Savings

2nd Quarter 2020

The Funds Transfer Pricing Method used to calculate the Credit for Funds for Savings Accounts (and other core deposits) is the "Blended Rate" method:






	6 Month FHLB "Rolling Average" Borrowing Rate	3 Year FHLB "Rolling Average" Borrowing Rate	7 Year FHLB "Rolling Average" Borrowing Rate	Credit for Funds
1				
2	FHLB Rolling Avg. Rate	0.98%	2.23%	2.47%
3	Factor	20%	30%	50%
4	Credit for Funds	0.20%	0.67%	1.26%
				2.12%



	20% Factor	30% Factor	50% Factor	Savings Account Average Life (Months)
5				
6	Months	6	36	84
7	Factor	20%	30%	50%
8	Factored Months	1.20	10.80	42.00
				54.00

# SAMPLE INSTITUTION FUND PROVIDING PRODUCTS 2ND QUARTER 2020

Non-Int Bearing Demand	Interest Bearing Demand	Money Market	Savings	CD's
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1 Credit for Funds	1.88 %	2.00 %	1.79 %	2.12 %	1.85 %
2 Interest Expense	0.00 %	0.75 %	0.90 %	0.26 %	1.81 %
3 Total Interest Spread	1.88 %	1.25 %	0.89 %	1.86 %	0.04 %
					

SAMPLE INSTITUTION Branch Deposit "Credit for Funds" Calculation Q2 2020				
	Average Quarterly Balance	Total Branches	Credit for Funds	Credit for Funds \$
1	Checking (Non-Int)	\$ 58,000,000	1.88%	\$ 271,000
2	Interest Checking	77,000,000	2.00%	383,000
3	Money Market	56,000,000	1.79%	249,000
4	Savings	70,000,000	2.12%	369,000
5	Certificates of Deposit	37,000,000	1.85%	190,000
6	Total Branch Deposits	\$ 298,000,000		\$ 1,462,000



SAMPLE INSTITUTION RETAIL BRANCH PROFITABILITY REPORT Q2 2020		
Balance Sheet		Total Branches
1	Deposits	298,000
2	Loans	73,000
3	Net Funds Provided (Used)	225,000
Income Statement		
4	Interest Income	703
5	Cost of Funds	-
6	Net Asset Spread	703
7	Credit for Funds	1,462
8	Interest Expense	480
9	Net Liability Spread	982
10	Total Interest Spread	1,685
11	Provision for Credit Loss	24
12	Marginal Inc (Loss) After Prov.	1,661
13	Non-Interest Income	234
14	Total Income	1,895
15	Direct Expense	672
16	Indirect Support & Allocated Overhead	?
18	Total Non-Interest Expense	672
19	Pretax Profit (Loss)	1,223





# FUNDS TRANSFER PRICING - LOAN EXAMPLE

## Transfer Pricing: Actual Loan Example: Commercial Real Estate

1	Loan #	404774
2	Settlement Date	1/12/2018
3	Maturity Date	1/12/2038
4	Next Reprice Date	1/12/2023
5	# Days to Reprice Date	1,825 days (5 yrs)
6	Original Loan Amount	\$500,000
7	Interest Rate	5.13%
8	Cost of Funds	2.6068%
9	Net Spread	2.52%

**Next Repricing Date of loan  
is 5.0 Years = 2.61% Cost of  
Funds**

Rate Source: FHLB\_PITT Date: 01/12/2018

Rate Type	Description	Rate Value
FHLB_PITT_D01	FHLB Pittsburgh Overnight	1.5900
FHLB_PITT_M01	FHLB Pittsburgh One Month	1.6300
FHLB_PITT_M03	FHLB Pittsburgh 3 Month	1.7150
FHLB_PITT_M06	FHLB Pittsburgh 6 Month	1.8580
FHLB_PITT_M09	FHLB Pittsburgh 9 Month	1.9820
FHLB_PITT_Y01	FHLB Pittsburgh 12 Month	2.0960
FHLB_PITT_Y02	FHLB Pittsburgh 2 Year	2.2755
FHLB_PITT_Y03	FHLB Pittsburgh 3 Year	2.3962
FHLB_PITT_Y04	FHLB Pittsburgh 4 Year	2.5012
FHLB_PITT_Y05	FHLB Pittsburgh 5 Year	2.6068
FHLB_PITT_Y06	FHLB Pittsburgh 6 Year	2.7254
FHLB_PITT_Y07	FHLB Pittsburgh 7 Year	2.8332
FHLB_PITT_Y08	FHLB Pittsburgh 8 Year	2.9465
FHLB_PITT_Y09	FHLB Pittsburgh 9 Year	3.0432
FHLB_PITT_Y10	FHLB Pittsburgh 10 Year	3.1136
FHLB_PITT_Y20	FHLB Pittsburgh 20 Year	3.5275
FHLB_PITT_Y30	FHLB Pittsburgh 30 Year	3.6947



## SAMPLE INSTITUTION FUND USING PRODUCTS 2ND QUARTER 2020

	Residential Mortgage	Home Equity Loans	Home Equity LOC	Auto Loans	Personal Loans
1 Interest Income	4.06 %	4.51 %	2.91 %	3.34 %	3.49 %
2 Cost of Funds	2.23 %	1.98 %	0.48 %	1.97 %	0.50 %
3 Total Interest Spread	1.83 %	2.53 %	2.43 %	1.37 %	2.99 %



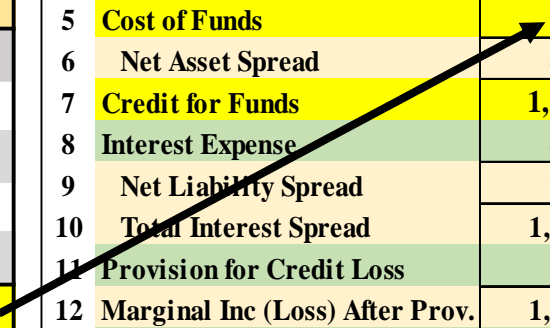
	Sample Institution Branch Loan "Cost of Funds" Calculation Q2 2020			
	Average Quarterly Balance	Total Branches	Cost of Funds	Cost of Funds \$
1	Residential Mortgage	\$ 27,000,000	2.23%	\$ 151,762
2	Home Equity Loans	14,000,000	1.98%	69,870
3	Home Equity Lines of Credit	19,000,000	0.48%	22,987
4	Auto Loans	10,000,000	1.97%	49,655
5	Personal Loans	3,000,000	0.50%	3,781
6	Total Branch Loans	\$ 73,000,000		\$ 298,055



## SAMPLE CREDIT UNION RETAIL BRANCH PROFITABILITY REPORT Q2 2020

Balance Sheet		Total Branches
1	Deposits	298,000
2	Loans	73,000
3	Net Funds Provided (Used)	225,000

Income Statement		
4	Interest Income	703
5	Cost of Funds	298
6	Net Asset Spread	405
7	Credit for Funds	1,462
8	Interest Expense	480
9	Net Liability Spread	982
10	Total Interest Spread	1,387
11	Provision for Credit Loss	24
12	Marginal Inc (Loss) After Prov.	1,363
13	Non-Interest Income	234
14	Total Income	1,597
15	Direct Expense	672
16	Indirect Support &	
17	Allocated Overhead	?
18	Total Non-Interest Expense	672
19	Pretax Profit (Loss)	925



## COST ALLOCATION METHODS

### DIRECT EXPENSE - Method

Controllable expense associated with day-to-day operations within a responsibility center (e.g., Compensation, Benefits, Occupancy, Equipment Expense, Other Expense, etc.). Data is from the bank's general ledger system.

### INDIRECT SUPPORT - Method

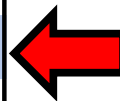
Expense invoiced to Line Organizations ("Profit Centers") for services provided by administrative support areas (Deposit Operations, Appraisal Review, Audit, etc.). Allocations determined utilizing an objective basis based on interviews.

### ALLOCATED OVERHEAD- Method

Expense invoiced to Line Organizations ("Profit Centers") for services provided by administrative areas that provide support to the general enterprise (Example: Office of the CEO). Allocations are uniform and "broad-brush"; based upon amount of Direct/Indirect Expense in Line Units.

*The median cost of "Indirect" + "Overhead" costs per branch from our clients = 0.97% of Total Deposits*

	Branch Deposits
Branch Deposits	\$ 298,000
The Kafafian Group "PEER" Median Total Indirect & Overhead Cost per Branch	0.97%
Indirect & Overhead Expense	\$ 721



## SAMPLE INSTITUTION RETAIL BRANCH PROFITABILITY REPORT

Q2 2020

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12	Marginal Inc (Loss) After Prov.	1,363
13	Non-Interest Income	234
14	Total Income	1,597
15	Direct Expense	672
16	Indirect Support & Allocated Overhead	721
17		
18	Total Non-Interest Expense	1,393
19	Pretax Profit (Loss)	204



## SAMPLE INSTITUTION RETAIL BRANCH PROFITABILITY Q2 2020

**"Without" Performance Measurement Data**

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6	Total Income	433
7	Direct Expense	672
8	Pretax Profit (Loss)	(239)

By adding Transfer Pricing and Cost Allocations, you now have a true picture of the profitability of the branch network.

*Which statement do you want to use as the basis for your decisions?????*

Is this just an Illusion?

## SAMPLE INSTITUTION RETAIL BRANCH PROFITABILITY REPORT Q2 2020

"With" Performance Measurement Data	
Balance Sheet	Total Branches
1 Deposits	298,000
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14	Total Income	1,597
15	Direct Expense	672
16	Indirect Support & Allocated Overhead	721
18	Total Non-Interest Expense	1,393
19	Pretax Profit (Loss)	204

You now have clear vision!

## SAMPLE INSTITUTION RETAIL BRANCH PROFITABILITY REPORT

### FUNDS FLOW:

- 1 Deposits  
2 Loans  
3 Net Funds Provided (Used)  
8

Total Branches	% of Deposits	Branch A	% of Deposits	Branch B	% of Deposits	Branch C	% of Deposits	Branch D	% of Deposits	Branch E	% of Deposits
298,000	100.00 %	121,000	100.00 %	54,000	100.00 %	46,000	100.00 %	19,000	100.00 %	58,000	100.00 %
73,000	24.50 %	36,000	29.75 %	13,000	24.07 %	9,000	19.57 %	5,000	26.32 %	10,000	17.24 %
225,000	75.50 %	85,000	70.25 %	41,000	75.93 %	37,000	80.43 %	14,000	73.68 %	48,000	82.76 %

### 9 P & L:

- 10 Interest Income  
11 Cost of Funds  
12 Net Asset Spread  
13 Credit for Funds  
14 Interest Expense  
15 Net Liability Spread  
16 Total Interest Spread  
17 Provision for Credit Loss  
18 Marginal Inc (Loss) After Prov.  
19 Non-Interest Income  
20 Total Income  
21 Direct Expense  
22 Indirect Support &  
23 Allocated Overhead  
24 Total Non-Interest Expense  
25 Pretax Profit (Loss)

	% of Deposits		% of Deposits		% of Deposits		% of Deposits		% of Deposits		% of Deposits
703	0.95 %	341	1.13 %	126	0.94 %	82	0.72 %	53	1.12 %	101	0.70 %
298	0.40 %	145	0.48 %	56	0.42 %	33	0.29 %	22	0.47 %	42	0.29 %
405	0.55 %	196	0.65 %	70	0.52 %	49	0.43 %	31	0.66 %	59	0.41 %
1,462	1.97 %	590	1.96 %	265	1.97 %	225	1.97 %	92	1.95 %	290	2.01 %
480	0.65 %	193	0.64 %	94	0.70 %	78	0.68 %	30	0.64 %	85	0.59 %
982	1.33 %	397	1.32 %	171	1.27 %	147	1.29 %	62	1.31 %	205	1.42 %
1,387	1.87 %	593	1.97 %	241	1.79 %	196	1.71 %	93	1.97 %	264	1.83 %
24	0.03 %	10	0.03 %	8	0.06 %	2	0.02 %	-	0.00 %	4	0.03 %
1,363	1.84 %	583	1.94 %	233	1.74 %	194	1.70 %	93	1.97 %	260	1.80 %
234	0.32 %	101	0.34 %	44	0.33 %	32	0.28 %	25	0.53 %	32	0.22 %
1,597	2.16 %	684	2.27 %	277	2.06 %	226	1.98 %	118	2.50 %	292	2.02 %
672	0.89 %	182	0.60 %	110	0.81 %	115	0.99 %	90	1.88 %	175	1.20 %
721	0.97 %	293	0.96 %	131	0.96 %	111	0.96 %	46	0.96 %	140	0.96 %
1,393	1.87 %	475	1.56 %	241	1.77 %	226	1.95 %	136	2.84 %	315	2.16 %
204	0.29 %	209	0.72 %	36	0.29 %	(0)	0.02 %	(18)	(0.34)%	(23)	(0.13)%

26 Pretax Profit "ILLUSION"	(239)	(0.32)%	57	0.19 %	(42)	(0.31)%	(81)	(0.71)%	(42)	(0.89)%	(131)	(0.91)%
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27 Difference	443	0.60 %	152	0.51 %	78	0.58 %	81	0.71 %	24	0.51 %	108	0.75 %
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## Earning Asset Spreads - Trends

	Q4 2006	Q4 2007	Q4 2008		Q4 2014	Q4 2015	Q4 2016	Q4 2017	Q4 2018	Q4 2019	Q2 2020
Fed Funds Rate	5.25%	4.25%	0.25%	→	0.25%	0.50%	0.75%	1.50%	2.50%	1.75%	0.25%

Earning Assets - PEER									
	Q4 2006	Q4 2008	Q4 2010	Q4 2012	Q4 2014	Q4 2016	Q4 2018	Q4 2019	Q2 2020
2 Yield	6.37%	5.73%	4.81%	4.29%	4.10%	3.82%	4.17%	4.18%	3.80%
3 Cost of Funds	4.72%	3.86%	2.52%	1.85%	1.60%	1.63%	2.32%	2.26%	1.83%
4 Net Spread	1.65%	1.87%	2.29%	2.44%	2.50%	2.19%	1.85%	1.92%	1.97%

→ → →

- Fed decreased Fed Funds Rate 500 basis points in 15 months (2006-2008)!
- The decrease in Fed Funds Rates increased the spread on earning assets.
- It took the Fed 2 years to increase the Fed Funds Rate 225 basis points (starting in 2017).
- The increase in Fed Funds Rates lowered the spread on earning assets back to 2006 levels in 2018.
- But the recent 225 bp drop in rates has once again begun to increase the spread on earning asset.



## Commercial Mortgage Spreads - Trends

Commercial Mortgages-PEER									
	Q4 2006	Q4 2008	Q4 2010	Q4 2012	Q4 2014	Q4 2016	Q4 2018	Q4 2019	Q2 2020
1 Yield	7.13%	6.31%	5.96%	5.50%	5.02%	4.42%	4.77%	4.78%	4.60%
2 Cost of Funds	4.69%	3.74%	2.81%	2.14%	1.58%	1.68%	2.32%	2.29%	2.02%
3 Net Spread	2.44%	2.57%	3.15%	3.36%	3.44%	2.74%	2.45%	2.49%	2.58%

Commercial Mortgages - PEER			
	Q4 2006	Q4 2014	Change
11 Yield	7.13%	5.02%	-2.11%
12 Cost of Funds	4.69%	1.58%	-3.11%
13 Net Spread	2.44%	3.44%	1.00%

- The Fed decreased the Fed Funds Rate 500 basis points (2006-2008), but institutions did not lower loan rates 500 bp. This resulted in institutions increasing their spread on commercial mortgages.

- Commercial mortgages benefited from the 500-point decrease in the Fed Funds Rate by increasing net spread by 100 basis points at Q4 2014.
- But even though the Fed Funds Rate has increased by 225 basis points through 2018, the spread on Commercial Mortgages was already back to the 2006 level when the Fed Funds Rate was 5.25%? Why? The answer is **"COMPETITION"**.
- The recent 225 drop in the Fed Funds Rate has once again helped the spread on Commercial Mortgages to increase.

## Funding Spreads - Trends

	Q4 2006	Q4 2007	Q4 2008		Q4 2014	Q4 2015	Q4 2016	Q4 2017	Q4 2018	Q4 2019	Q2 2020
Fed Funds Rate	5.25%	4.25%	0.25%	→	0.25%	0.50%	0.75%	1.50%	2.50%	1.75%	0.25%
Deposits & Borrowings-PEER											
	Q4 2006	Q4 2008	Q4 2010	Q4 2012	Q4 2014	Q4 2016	Q4 2018	Q4 2019	Q2 2020		
2 Credit For Funds	5.04%	3.60%	2.35%	1.79%	1.52%	1.59%	2.43%	2.36%	1.91%		
3 Interest Expense	3.14%	2.55%	1.27%	0.76%	0.54%	0.52%	0.95%	1.09%	0.80%		
4 Net Spread	1.90%	1.05%	1.08%	1.03%	0.98%	1.07%	1.48%	1.27%	1.11%		

- Fed decreased Fed Funds Rate 500 basis points in 15 months (2006-2008)!
- The decrease in Fed Funds Rates decreased the spread on deposits & borrowings. The spread on deposits & borrowings was reduced by half as of Q4 2014.
- It took the Fed 2 years to increase the Fed Funds Rate 225 basis points (2016-2018).
- The 225 rise in Fed Funds Rates beginning in 2016 increased the spread on deposits & borrowings, but not back to “normal” spreads.
- Intense competition for deposits and lower rates decreased the deposit spread trend in 2019.
- The 150 bp decrease in rates in 2020 has once again decreased the spread on deposits & borrowings.

## Money Market Spreads - Trends

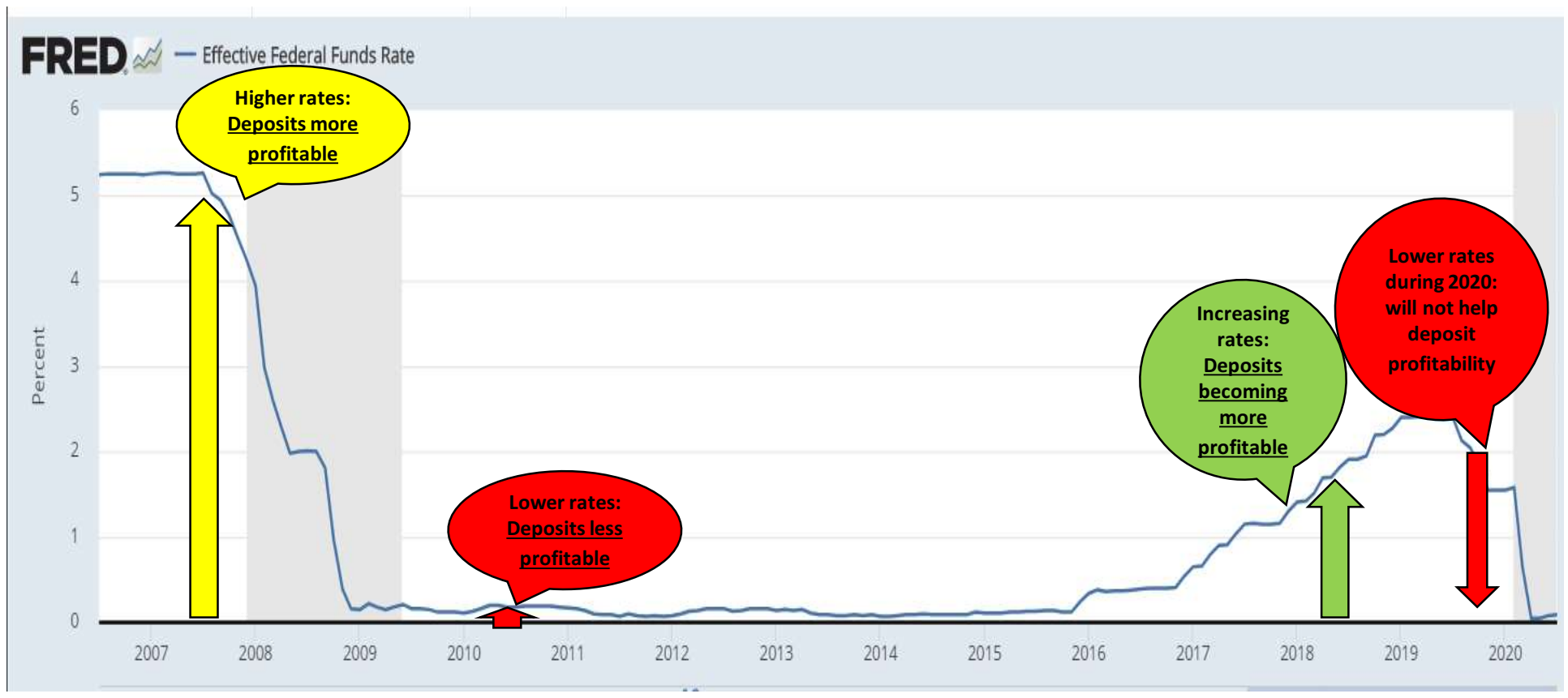
Money Market - PEER									
	Q4 2006	Q4 2008	Q4 2010	Q4 2012	Q4 2014	Q4 2016	Q4 2018	Q4 2019	Q2 2020
1 Credit For Funds	5.01%	3.73%	1.83%	1.08%	0.88%	1.29%	2.32%	2.29%	1.88%
2 Interest Expense	3.20%	2.00%	0.78%	0.39%	0.29%	0.36%	1.06%	1.14%	0.62%
3 Net Spread	1.81%	1.73%	1.05%	0.69%	0.59%	0.93%	1.26%	1.15%	1.26%

Money Market - PEER			
	Q4 2006	Q4 2014	Change
4 Credit For Funds	5.01%	0.88%	-4.13%
5 Interest Expense	3.20%	0.29%	-2.91%
6 Net Spread	1.81%	0.59%	-1.22%

- While the Fed decreased the Fed Funds Rate 500 basis points, banks were limited in how far they could lower deposit rates.

- Money Market spreads were hurt by the 500 decrease in the Fed Funds Rate since banks could not lower rate less than 0.00%.
- But even though the Fed Funds Rate has increased by 225 points, the spread on Money Market accounts did not fully benefit due to the increase in MM rates related to competition for deposits in 2019.
- As a result of the 150 bp decrease in Fed Fund Rates in 2020, banks aggressively reduced rates during Q2 2020. The projected spread on money markets should fall as rates should remain low for the foreseeable future.

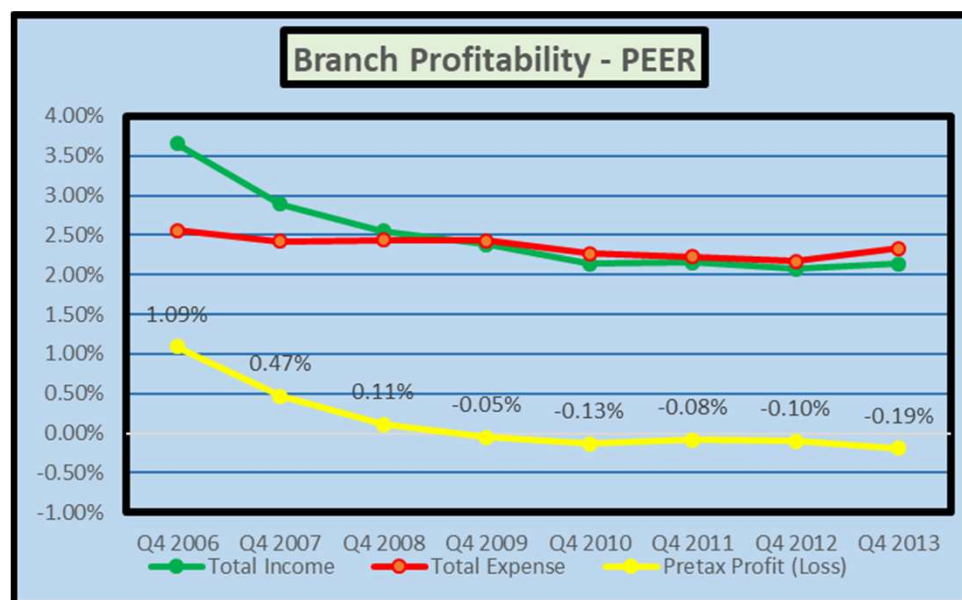
## HISTORICAL FEDERAL FUNDS RATE



## Branch Organizational Profitability - Trend

Branch Organization - PEER								
	Q4 2006	Q4 2007	Q4 2008	Q4 2009	Q4 2010	Q4 2011	Q4 2012	Q4 2013
1 Total Income	3.65%	2.89%	2.55%	2.38%	2.14%	2.15%	2.07%	2.14%
2 Total Expense	2.56%	2.42%	2.44%	2.43%	2.27%	2.23%	2.17%	2.33%
3 Pretax Profit (Loss)	1.09%	0.47%	0.11%	-0.05%	-0.13%	-0.08%	-0.10%	-0.19%

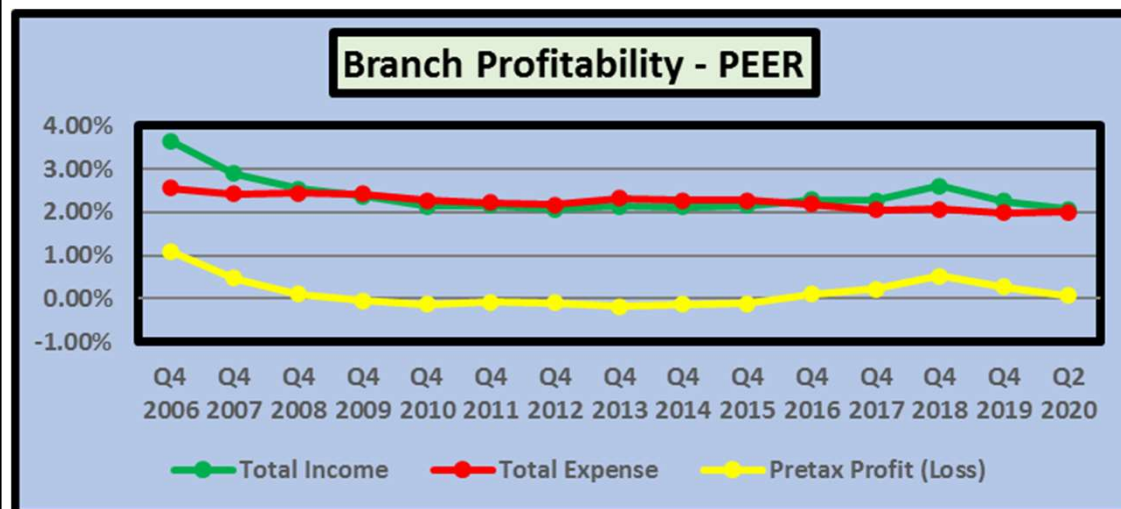
- As a result of the reduction in Deposit Spreads, branches began to realize losses beginning in 2009.
- Institutions began reducing costs within their branch networks, primarily by “right sizing” them.
- But they could not reduce costs fast enough and branches hit their low earnings point in 2013.



## Branch Organizational Profitability - Trend(cont.)

Branch Organization - PEER															
	Q4 2006	Q4 2007	Q4 2008	Q4 2009	Q4 2010	Q4 2011	Q4 2012	Q4 2013	Q4 2014	Q4 2015	Q4 2016	Q4 2017	Q4 2018	Q4 2019	Q2 2020
1 Total Income	3.65%	2.89%	2.55%	2.38%	2.14%	2.15%	2.07%	2.14%	2.13%	2.16%	2.29%	2.27%	2.61%	2.25%	2.07%
2 Total Expense	2.56%	2.42%	2.44%	2.43%	2.27%	2.23%	2.17%	2.33%	2.27%	2.27%	2.19%	2.05%	2.08%	1.98%	2.00%
3 Pretax Profit (Loss)	1.09%	0.47%	0.11%	-0.05%	-0.13%	-0.08%	-0.10%	-0.19%	-0.14%	-0.11%	0.10%	0.22%	0.53%	0.27%	0.07%

- As a result of the rise in Deposit Spreads and the continued reduction in branch expenses, branches began to recover beginning in 2014.
- Branches reached profitability in 2016 through the increase in deposit spreads and cost controls.
- The impact of the lower Fed Funds Rates decreased deposit spreads in 2019 and branch expenses hit a wall resulting in lower branch profits. Will the decrease in branch Pretax Profits be the beginning of another significant “right sizing” of branch networks?



## Branch Organizational Profitability - Trend (cont.)

- The total branch reduction in income was due to the fact the Total Income as a % of deposits decreased by 111 basis points. This reduction was primarily due to the decrease in the spread on deposits.
- While financial institutions decreased expenses by \$0.55 per \$100 of branch deposits, it was not enough to offset the reduction in deposit spread.
- Pre-Tax Profit decreased \$92,000, or 19% from 2006 to 2018. During this period, "Deposits per Branch" increased \$30.4 million, or 67%

Branch Pre-Tax Profit Comparison			
	Q4 2018	Q4 2006	Change
1 Total Income	2.54%	3.65%	-1.11%
2 Total Expense	2.01%	2.56%	-0.55%
3 Pre-Tax Profit	0.53%	1.09%	-0.56%
4 Average Branch Deposits	\$ 75,640,000	\$ 45,246,000	\$ 30,394,000
5 Pre-Tax Profit	\$ 400,892	\$ 493,181	\$ (92,289)



## Branch Organizational Profitability - Trend (cont.)

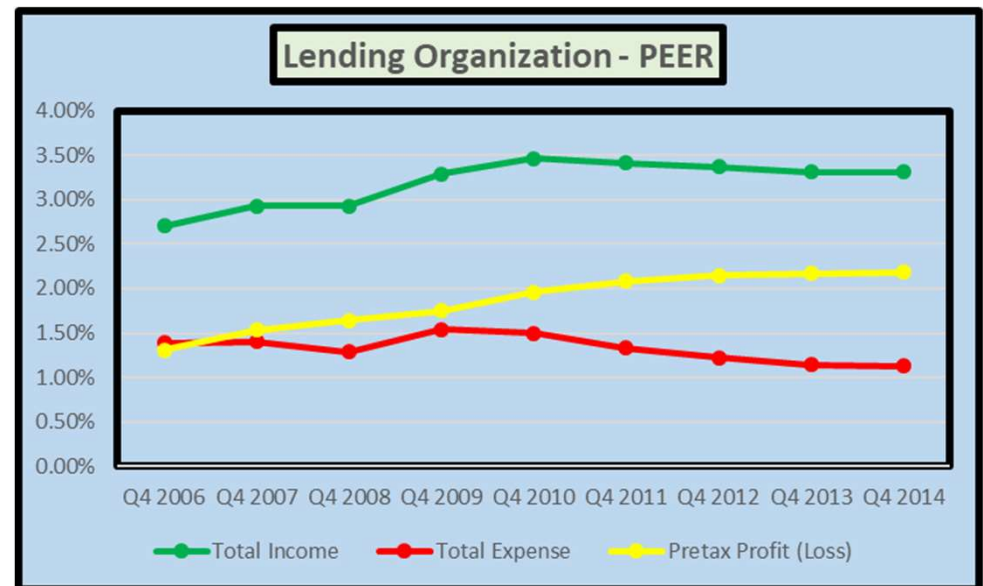
- Since Q4 2018, the total branch reduction in income was primarily due to the 41- basis point reduction in net interest spread. This was the result of the decrease in the Credit for Funds rate, partially offset by the reduction in rates paid to depositors.
- Note the \$349,000 reduction in Branch Pre-Tax Income in only 18 months!
- What strategies do you have to reduce branch costs in 2021 & in future years? It may be a long time until we see an improvement in deposit spreads.

Branch Total Income Comparison			
	Q2 2020	Q4 2018	Change
1 Net Interest Spread	1.79%	2.20%	-0.41%
2 Non-Interest Income	0.28%	0.34%	-0.06%
3 Total Income	2.07%	2.54%	-0.47%
4 Total Expense	2.00%	2.01%	-0.01%
5 Branch Pre-Tax Income	0.07%	0.53%	-0.46%
6 Average Branch Deposits	\$ 73,529,000	\$ 75,640,000	\$ (2,111,000)
7 Branch Pre-Tax Income	\$ 51,470	\$ 400,892	\$ (349,422)

## Lending Organizational Profitability - Trend

Lending Organization - PEER										
		Q4 2006	Q4 2007	Q4 2008	Q4 2009	Q4 2010	Q4 2011	Q4 2012	Q4 2013	Q4 2014
1	Total Income	2.70%	2.93%	2.93%	3.29%	3.46%	3.41%	3.37%	3.31%	3.31%
2	Total Expense	1.39%	1.40%	1.29%	1.54%	1.50%	1.33%	1.22%	1.14%	1.13%
3	Pretax Profit (Loss)	1.31%	1.53%	1.64%	1.75%	1.96%	2.08%	2.15%	2.17%	2.18%

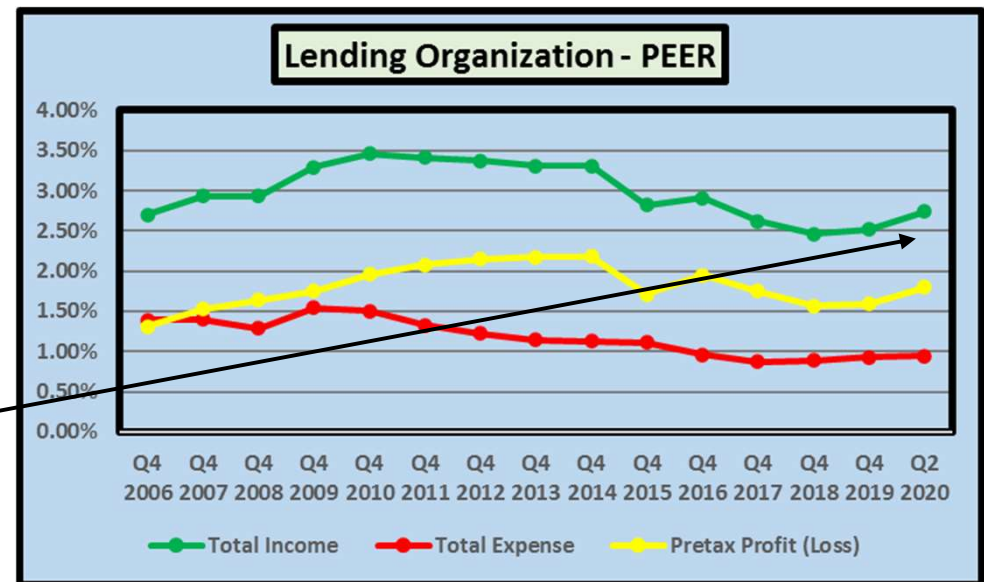
- As a result of the increase in Loan Spreads, the Lending Organization realized stronger earnings through 2014.
- Institutions also began to lower costs within the Lending Organization to provide additional earnings.
- Between 2006 & 2014 Banks added **87 basis points** of pre-tax profits to their Lending Organization.



## Lending Organizational Profitability - Trend (cont.)

Lending Organization - PEER		Q4 2006	Q4 2007	Q4 2008	Q4 2009	Q4 2010	Q4 2011	Q4 2012	Q4 2013	Q4 2014	Q4 2015	Q4 2016	Q4 2017	Q4 2018	Q4 2019	Q2 2020
1	Total Income	2.70%	2.93%	2.93%	3.29%	3.46%	3.41%	3.37%	3.31%	3.31%	2.82%	2.91%	2.62%	2.46%	2.52%	2.74%
2	Total Expense	1.39%	1.40%	1.29%	1.54%	1.50%	1.33%	1.22%	1.14%	1.13%	1.11%	0.96%	0.87%	0.89%	0.93%	0.94%
3	Pretax Profit (Loss)	1.31%	1.53%	1.64%	1.75%	1.96%	2.08%	2.15%	2.17%	2.18%	1.71%	1.95%	1.75%	1.57%	1.59%	1.80%

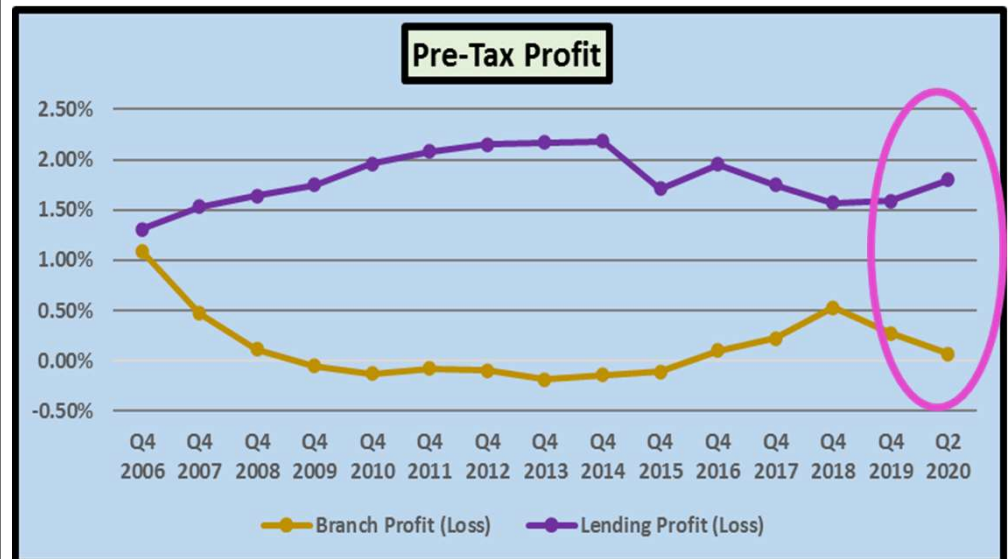
- As a result of the decrease in Loan Spreads related to the rise in fed funds rates, the profit of Lending Organizations began to decrease in 2015.
- Earnings would have fallen more steeply if organizations did not continue to become more efficient.
- The decrease in the Fed Funds Rate during the last 18 months helped increase the net spread of the lending organizations.



## Trend Summary - Branches vs. Lending

- Branch Organization are negatively impacted by lower interest rates.
- Lending Organizations benefit from lower interest rates.
- The increased profit in lending organizations could not make up for the decrease in profits within Branch Organizations.
- The large reduction in branch profits during this period has impacted the overall profitability of commercial banks. The 5-year average ROA for commercial banks ending in 2006 was 1.33%, well ahead of the 1.20% in 2019 and the projected ROA in 2020 of well under 1.00%.

Pre-Tax Profit Comparison			
	Q2 2020	Q4 2006	Change
1 Branch Organization	0.07%	1.09%	-1.02%
2 Lending Organization	1.80%	1.31%	0.49%



To provide a true picture of the profitability of your deposit products, you must include the following items to the calculation of profit:

- **Funds Transfer Pricing**
- **Allocate Indirect and Overhead from support centers throughout the institution**

**SAMPLE INSTITUTION  
DEPOSIT PRODUCTS  
Q2 2020**

	Non-Interest Checking	% of Product	NOW Accounts	% of Product	Money Market	% of Product	Savings	% of Product	CDs	% of Product
1 Deposit Balance	\$ 58,000		\$ 77,000		\$ 56,000		\$ 70,000		\$ 37,000	
<b>Income Statement</b>										
2 Credit for Funds	?	0.00 %	?	0.00 %	?	0.00 %	?	0.00 %	?	0.00 %
3 Interest Expense	-	0.00 %	143	0.75 %	125	0.90 %	45	0.26 %	167	1.81 %
4 Total Interest Spread	-	0.00 %	(143)	(0.73)%	(125)	(0.89)%	(45)	(0.26)%	(167)	(1.79)%
5 Non-Interest Income	61	0.42 %	42	0.22 %	1	0.01 %	9	0.05 %	1	0.01 %
6 Total Income	61	0.41 %	(101)	(0.52)%	(124)	(0.88)%	(37)	(0.21)%	(166)	(1.78)%
7 Non-Interest Expense	?	0.00 %	?	0.00 %	?	0.00 %	?	0.00 %	?	0.00 %
8 Pretax Profit (Loss)	61	0.41 %	(101)	(0.52)%	(124)	(0.88)%	(37)	(0.21)%	(166)	(1.78)%

**SAMPLE INSTITUTION**  
**Branch Deposit "Credit for Funds" Calculation**  
**Q2 2020**

	<b>Average Quarterly Balance</b>	<b>Total Branches</b>	<b>Credit for Funds</b>	<b>Credit for Funds \$</b>
1	Checking (Non-Int)	\$ 58,000,000	<b>1.88%</b>	\$ 271,000
2	Interest Checking	77,000,000	<b>2.00%</b>	383,000
3	Money Market	56,000,000	<b>1.79%</b>	249,000
4	Savings	70,000,000	<b>2.12%</b>	369,000
5	Certificates of Deposit	37,000,000	<b>1.85%</b>	190,000
6	Total Branch Deposits	<b>\$ 298,000,000</b>		<b>\$ 1,462,000</b>

**Funds Transfer Pricing**

*Provides a "Credit for Funds" for providing funding at a lower rate than if the bank had to fund only through the FHLB.*

**SAMPLE INSTITUTION**  
**DEPOSIT PRODUCTS**  
**Q2 2020**

	<b>Non-Interest Checking</b>	<b>% of Product</b>	<b>NOW Accounts</b>	<b>% of Product</b>	<b>Money Market</b>	<b>% of Product</b>	<b>Savings</b>	<b>% of Product</b>	<b>CDs</b>	<b>% of Product</b>
1 Deposit Balance	\$ 58,000		\$ 77,000		\$ 56,000		\$ 70,000		\$ 37,000	
	<b>Income Statement</b>									
2 Credit for Funds	<b>271</b>	1.88 %	<b>383</b>	2.00 %	<b>249</b>	1.79 %	<b>369</b>	2.12 %	<b>190</b>	1.85 %
3 Interest Expense	-	0.00 %	143	0.75 %	125	0.90 %	45	0.26 %	167	1.81 %
4 Total Interest Spread	271	1.88 %	240	1.26 %	124	0.89 %	324	1.86 %	24	0.04 %
5 Non-Interest Income	61	0.42 %	42	0.22 %	1	0.01 %	9	0.05 %	1	0.01 %
6 Total Income	332	2.30 %	282	1.48 %	125	0.90 %	332	1.91 %	25	0.05 %
7 Non-Interest Expense	?	0.00 %	?	0.00 %	?	0.00 %	?	0.00 %	?	0.00 %
8 Pretax Profit (Loss)	<b>332</b>	2.30 %	<b>282</b>	1.48 %	<b>125</b>	0.90 %	<b>332</b>	1.91 %	<b>25</b>	0.05 %

## Deposit Product Profitability - No longer an illusion!

### SAMPLE INSTITUTION DEPOSIT PRODUCTS Q2 2020

	Non-Interest Checking	% of Product	NOW Accounts	% of Product	Money Market	% of Product	Savings	% of Product	CDs	% of Product
1 Deposit Balance	\$ 48,000		\$ 28,000		\$ 66,000		\$ 60,000		\$ 96,000	
<b>Income Statement</b>										
2 Credit for Funds	271	1.88 %	383	2.00 %	249	1.79 %	369	2.12 %	190	1.85 %
3 Interest Expense	-	0.00 %	143	0.75 %	125	0.90 %	45	0.26 %	167	1.81 %
4 Total Interest Spread	271	1.88 %	240	1.26 %	124	0.89 %	324	1.86 %	24	0.04 %
5 Non-Interest Income	61	0.42 %	42	0.22 %	1	0.01 %	9	0.05 %	1	0.01 %
6 Total Income	332	2.30 %	282	1.48 %	125	0.90 %	332	1.91 %	25	0.05 %
7 Non-Interest Expense	388	3.25 %	86	1.24 %	61	0.37 %	223	1.49 %	128	0.54 %
8 Pretax Profit (Loss)	(56)	(0.95) %	196	0.24 %	64	0.53 %	110	0.42 %	(103)	(0.49) %
9 Number of Accounts	3,058		878		502		4,512		2,853	
10 Average Balance per Acct.	\$15,695		\$31,901		\$131,500		\$13,299		\$33,644	
11 Annualized Cost per Account	\$510.17		\$394.78		\$489.04		\$198.51		\$180.00	
12 Annualized Net Income per Acct.	(\$72.98)		\$887.00		\$508.15		\$96.51		(\$143.35)	



To provide a true picture of the profitability of your loan products, you must include the following items to the calculation of profit:

- **Funds Transfer Pricing**
- **Allocate Indirect and Overhead from support centers throughout the institution**

**SAMPLE INSTITUTIION  
LOAN PRODUCTS  
Q2 2020**

	Residential Mortgage	% of Product	Home Equity Loans	% of Product	Home Equity Lines of Cr.	% of Product	Commercial Real Estate	% of Product
<b>1 Loan Balance</b>	\$ 63,000		\$ 27,000		\$ 15,000		\$ 114,000	
<b>Income Statement</b>								
<b>2 Interest Income</b>	617	3.94 %	297	4.43 %	145	3.89 %	1,307	4.61 %
<b>3 Cost of Funds</b>	?	0.00 %	?	0.00 %	?	0.00 %	?	0.00 %
<b>4 Total Interest Spread - FTE</b>	617	3.94 %	297	4.43 %	145	3.89 %	1,307	4.61 %
<b>5 Provision for Credit Loss</b>	31	0.20 %	17	0.26 %	11	0.29 %	252	0.89 %
<b>6 Marginal Inc (Loss) After Prov.</b>	586	3.74 %	280	4.17 %	134	0.06 %	1,054	3.72 %
<b>7 Non-Interest Income</b>	22	0.14 %	5	0.07 %	2	0.06 %	26	0.09 %
<b>8 Total Income</b>	608	3.88 %	285	4.24 %	137	0.12 %	1,080	3.81 %
<b>9 Non-Interest Expense</b>	?	0.00 %	?	0.00 %	?	0.00 %	?	0.00 %
<b>10 Pretax Profit (Loss)</b>	<b>608</b>	3.88 %	<b>285</b>	4.24 %	<b>137</b>	0.12 %	<b>1,080</b>	3.81 %
<b>Pretax Profit (Loss)</b>								
<b>11 without Provision</b>	<b>639</b>	4.08 %	<b>302</b>	4.50 %	<b>147</b>	0.41 %	<b>1,332</b>	4.70 %

**Sample Institution**  
**Branch Loan "Cost of Funds" Calculation**  
**Q2 2020**

**Funds Transfer Pricing**

*Provides a "Cost of Funds" to match the actual maturity & interest rate characteristics of a loan using FHLB borrowing rates.*

	Average Quarterly Balance	Total Branches	Cost of Funds	Cost of Funds \$
1	Residential Mortgage	\$ 63,000,000	2.17%	\$ 340,000
2	Home Equity Loans	27,000,000	2.19%	147,000
3	Home Equity Lines of Credit	15,000,000	0.64%	24,000
4	Commercial Loans	114,000,000	2.00%	567,000

**SAMPLE INSTITUTION**  
**LOAN PRODUCTS**  
**Q2 2020**

	Residential Mortgage	% of Product	Home Equity Loans	% of Product	Home Equity Lines of Cr.	% of Product	Commercial Real Estate	% of Product
<b>1 Loan Balance</b>	\$ 63,000		\$ 27,000		\$ 15,000		\$ 114,000	
<b>Income Statement</b>								
<b>2 Interest Income</b>	617	3.94 %	297	4.43 %	145	3.89 %	1,307	4.61 %
<b>3 Cost of Funds</b>	340	2.17 %	147	2.19 %	24	0.64 %	567	2.00 %
<b>4 Total Interest Spread - FTE</b>	277	1.77 %	150	2.24 %	121	3.25 %	740	2.61 %
<b>5 Provision for Credit Loss</b>	31	0.20 %	17	0.26 %	11	0.29 %	252	0.89 %
<b>6 Marginal Inc (Loss) After Prov.</b>	246	1.57 %	133	1.98 %	110	2.96 %	488	1.72 %
<b>7 Non-Interest Income</b>	22	0.14 %	5	0.07 %	2	0.06 %	26	0.09 %
<b>8 Total Income</b>	268	1.71 %	138	2.05 %	113	3.02 %	513	1.81 %
<b>9 Non-Interest Expense</b>	?	0.00 %	?	0.00 %	?	0.00 %	?	0.00 %
<b>10 Pretax Profit (Loss)</b>	268	1.71 %	138	2.05 %	113	3.02 %	513	1.81 %
<b>11 Pretax Profit (Loss) without Provision</b>	299	1.91 %	155	2.31 %	123	3.31 %	765	2.70 %

## Loan Product Profitability - No longer an illusion!

### SAMPLE INSTITUTION FUND USING PRODUCTS Q2 2020

	Residential Mortgage	% of Product	Home Equity Loans	% of Product	Home Equity Lines of Cr.	% of Product	Commercial Real Estate	% of Product
<b>1 Loan Balance</b>	\$ 63,000		\$ 27,000		\$ 15,000		\$ 114,000	
<b>Income Statement</b>								
<b>2 Interest Income</b>	617	3.94 %	297	4.43 %	145	3.89 %	1,307	4.61 %
<b>3 Cost of Funds</b>	340	2.17 %	147	2.19 %	24	0.64 %	567	2.00 %
<b>4 Total Interest Spread - FTE</b>	277	1.77 %	150	2.24 %	121	3.25 %	740	2.61 %
<b>5 Provision for Credit Loss</b>	31	0.20 %	17	0.26 %	11	0.29 %	252	0.89 %
<b>6 Marginal Inc (Loss) After Prov.</b>	246	1.57 %	133	1.98 %	110	2.96 %	488	1.72 %
<b>7 Non-Interest Income</b>	22	0.14 %	5	0.07 %	2	0.06 %	26	0.09 %
<b>8 Total Income</b>	268	1.71 %	138	2.05 %	113	3.02 %	513	1.81 %
<b>9 Non-Interest Expense</b>	132	0.83 %	164	2.41 %	103	2.71 %	152	0.53 %
<b>10 Pretax Profit (Loss)</b>	<b>136</b>	<b>0.88 %</b>	<b>(26)</b>	<b>(0.36)%</b>	<b>10</b>	<b>0.31 %</b>	<b>361</b>	<b>1.28 %</b>
<b>Pretax Profit (Loss)</b>								
<b>11 without Provision</b>	<b>167</b>	<b>1.08 %</b>	<b>(9)</b>	<b>(0.10)%</b>	<b>21</b>	<b>0.60 %</b>	<b>613</b>	<b>2.17 %</b>
<b>12 Number of Accounts</b>	<b>335</b>		<b>546</b>		<b>282</b>		<b>163</b>	
<b>13 Average Balance per Account</b>	<b>\$188,185</b>		<b>\$49,487</b>		<b>\$53,129</b>		<b>\$697,537</b>	
<b>14 Non-Interest Income per Account</b>	<b>\$65.50</b>		<b>\$8.61</b>		<b>\$7.93</b>		<b>\$156.09</b>	
<b>15 Annualized Cost per Account</b>	<b>\$1,575.27</b>		<b>\$1,203.01</b>		<b>\$1,452.31</b>		<b>\$3,720.45</b>	
<b>16 Annualized Net Income per Account</b>	<b>\$1,625.11</b>		<b>(\$194.07)</b>		<b>\$143.42</b>		<b>\$8,835.98</b>	
<b>17 Annualized Net Income per Account</b>								
<b>18 without Provision</b>	<b>\$1,999.42</b>		<b>(\$66.11)</b>		<b>\$296.65</b>		<b>\$15,010.13</b>	

## Mortgage Product Performance

2020 & 2019 ROA's are stable, but the Profit per Loan increased due to the higher average loan balance in 2020.

Portfolio		
	Profit per Loan	Mortgage Portfolio ROA
Total 2019	\$ 1,843	1.28%
Q1 & Q2 2020	\$ 1,956	1.29%

Decrease in Profit per Loan Serviced is the result of adjustments to Mortgage Servicing Rights related to increase in loans paid off.

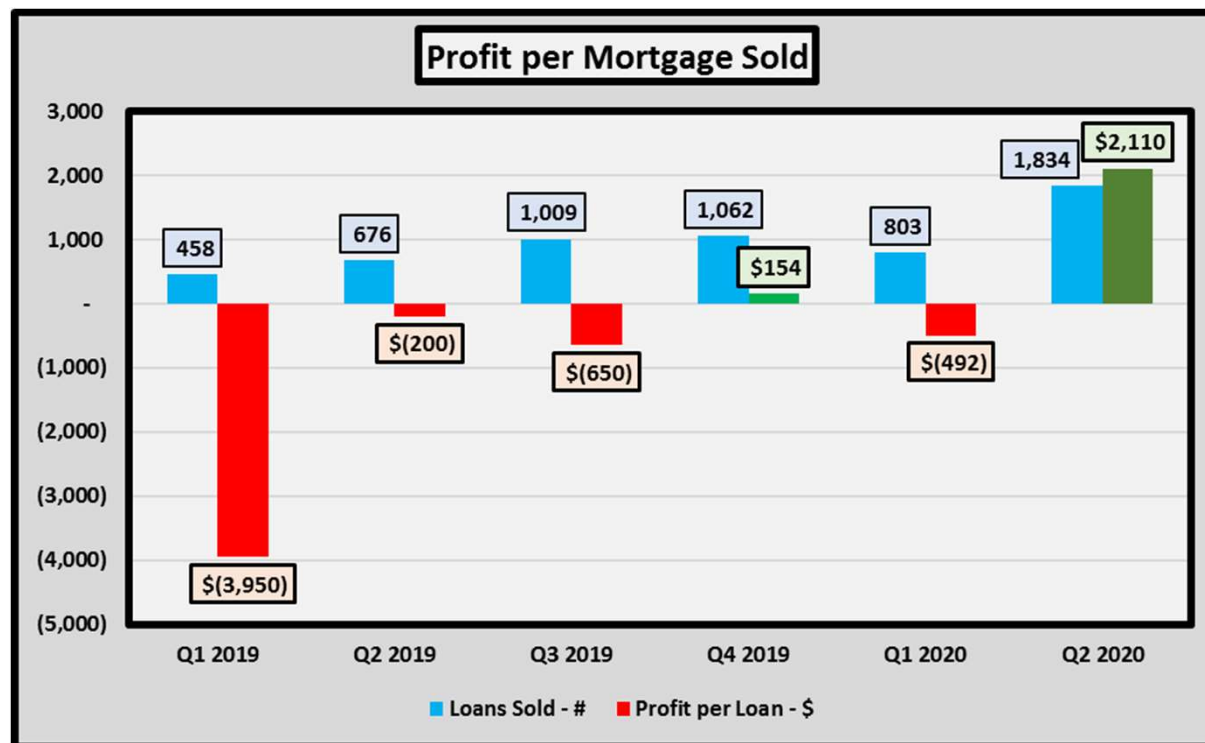
Improved earning in 2020 is the result of a reduction in origination cost related to the increase in new loan volume.

Secondary Market Loans Sold	
	Profit per Loan Sold
Total 2019	\$ (601)
Q1 & Q2 2020	\$ 1,318

Loans Serviced	
	Profit per Loan Serviced
Total 2019	\$ 6
Q1 & Q2 2020	\$ (53)

### Secondary Market - Mortgage Sold


	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020
Loans Sold - #	458	676	1,009	1,062	803	1,834
Profit per Loan - \$	\$ (3,950)	\$ (200)	\$ (650)	\$ 154	\$ (492)	\$ 2,110



Do you have excess capacity  
within your Mortgage  
Department?

#### 2019 Mortgage "COST" Analysis

Q1 2019 "Cost to Originate"			Q2 2019 "Cost to Originate"			Q3 2019 "Cost to Originate"			Q4 2019 "Cost to Originate"		
	Origination Cost per Loan	Total Loans Originated		Origination Cost per Loan	Total Loans Originated		Origination Cost per Loan	Total Loans Originated		Origination Cost per Loan	Total Loans Originated
PEER	\$ 8,435	1,064	PEER	\$ 6,444	1,556	PEER	\$ 4,961	2,088	PEER	\$ 4,669	2,386



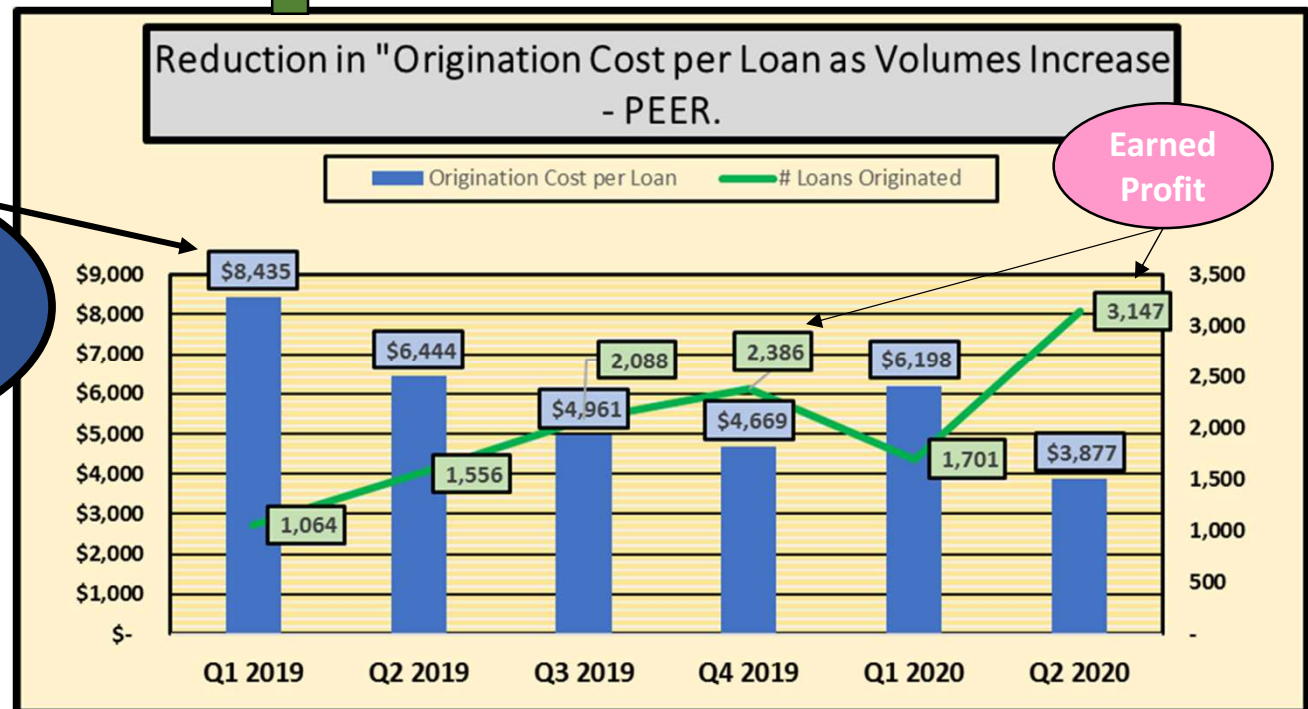
## 2020 Mortgage "COST" Analysis

Q1 2020 "Cost to Originate"		
	Origination Cost per Loan	Total Loans Originated
PEER	\$ 6,198	1,701

Q2 2020 "Cost to Originate"		
	Origination Cost per Loan	Total Loans Originated
PEER	\$ 3,877	3,147

Is your Mortgage Department built to originate 100 loans per month or 50 loans? What is your normal # of originations?

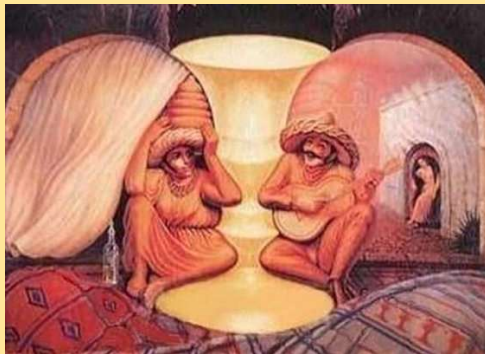
Do you have excess capacity? How do you manage your capacity?





**“Harness The Power Of Your Financial Data To Help Your Bank Make Smarter, More Confident Decisions That Drive Performance”**

**Using only general ledger data to provide data for your management reports is just an ILLUSION!**



**Adding “Performance Measurement” data will help transform your management reports into a “Clear” picture of your performance!**



Questions???

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