Profitability Reporting As a Strategic Tool

By Jeffrey P. Marsico

A quantitative assessment of performance can change a bank's understanding of its strategic strengths.

Community banks have not yet caught the fever of developing a profitability reporting system that measures true profitability of business lines, products or customers. The reasons for this can be as unique as each individual bank but usually center around a common theme: too much other stuff to do and the regulators do not require it.

There are 21 percent fewer Federal Deposit Insurance Corporation (FDIC)–insured banks and thrifts today than there were 10 years ago. That is a decrease of more than 2,300 financial institutions. There are many reasons for the decline, but the lack of financial performance by community banks has been a key factor. Regulators are far more concerned with financial condition than financial performance. Certainly the regulators want banks to be profitable—that is the basis for the "E" in the CAMELS rating—but only to the extent that earnings adds to capital and improves the underlying financial condition.

Shareholders, on the other hand, are equally concerned with financial condition and financial performance. Their interests are in reverse order to the regulators. Stockholders are interested in financial condition so far as it does not adversely affect financial performance. Spend all of your resources satisfying the regulators, and you will only partially satisfy the shareholders. If you had to choose between improving the financial condition and improving the financial performance, what result would you expect?

The minority of community banks that have implemented profitability measurement reporting have typically done so in one of several ways: (1) supplemented their general ledger systems with funds transfer pricing (FTP) and expense allocations, (2) purchased profitability performance software for use in-house or (3) outsourced profitability measurement to a third party. In my experience, the majority have done nothing at all.

For those that have profitability measurement reporting, the trail is littered with sweat and tears. Once a bank finance department builds the financial model, staffers are frequently dismayed by the lack of action based on the reported results. The single most predominant reason for failure, in my opinion, is that the model is designed in such fine detail that only the builders understand the content and significance of the reports. Bewildered and confused, business-line and product managers become defensive and constantly challenge the underlying assumptions of the model. Meanwhile, managers of profitable functions miss the clues in the numbers that would further improve and enhance their own performance.

Profitability Reporting Should Measure Results of the Bank's Strategy

Perhaps you agree that your bank should measure the profitability of lines of business, branches, products and customers. Or, perhaps you are one of the few that currently measure profitability. The next question would be what to measure.

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When discussing with your bank's senior management "what to measure," go beyond the obvious lines of business, products, *etc.* Think about using profitability reporting to formulate strategy, develop measurable goals to manage strategy execution and to hold business-line managers accountable.

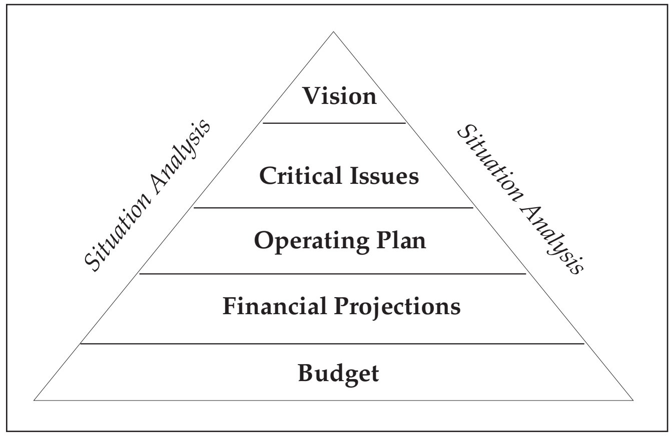
Aside from the obvious (lines of business, products, *etc.*), profitability reporting should be designed to measure your bank's strategy. Strategy has received little regard in banking. As recently as the 1970s, regulators pretty much determined what banks could and could not do. Now bankers must determine what course to chart, within regulatory confines, of course. Because so many leaders have cut their teeth under the old regulatory scheme, banks tend to ignore strategy and focus on budgets. This has led to a homogenization of the industry, where one bank is barely distinguishable from another.

For banks to survive, they must develop a strategy that provides an answer to the question: "Why bank with us?" Good strategy is developed from good information. Exhibit 1 depicts a typical strategic planning model.

Sun Tzu, the legendary Chinese general, wrote in The Art of War, "He who knows the enemy and himself will never in a hundred battles be at risk." This speaks to the situation analysis to gain an understanding of internal strengths and weaknesses and the external opportunities and threats.

When performing a situation analysis, honest self-assessment is critical. Profitability reporting is a key component in determining your bank's internal strengths and weaknesses.

Exhibit 1. Strategic Planning Model



Do Numbers Back up Qualitative Impressions?

For example, a bank determined that its branch network was a strength because of the average deposits per branch and geographic reach. Based on profitability reporting, however, the branches were declining in profitability (Exhibit 2).

It should be noted that the combined indirect and corporate overhead expenses exceeded The Kafafian Group (TKG) peer banks by 42 basis points (discussed further below). As a result of profitability reporting, this bank needed to change its thinking and see that branch profitability was a weakness.

To turn around branch performance, the bank needed to elevate all branches greater than three

Exhibit 2. Branch Profitability

	Q4	Q3	Change	Q2	Q1	Q4	Change
SELECTED RATES:	**All percentages are % of average deposits**						
Credit for Funds	4.85 %	4.73 %	**0.12 %**	4.55 %	4.40 %	4.30 %	**0.55 %**
Interest Expense	2.42 %	2.24 %	**0.18 %**	2.06 %	1.91 %	1.77 %	**0.65 %**
Net Liability Spread	2.43 %	2.49 %	**(0.07)%**	2.49 %	2.48 %	2.53 %	**(0.10)%**
Provision for Credit Loss	0.15 %	0.13 %	**0.01 %**	0.09 %	0.13 %	0.11 %	**0.04 %**
Noninterest Income	0.74 %	0.78 %	**(0.05)%**	0.86 %	0.79 %	0.73 %	**0.00 %**
Direct Expense	1.13 %	1.07 %	**0.07 %**	1.04 %	1.01 %	0.97 %	**0.16 %**
Indirect Expense	1.11 %	1.05 %	**0.05 %**	0.94 %	0.87 %	0.88 %	**0.23 %**
Corp. Overhead Expense	0.85 %	1.01 %	**(0.16)%**	1.08 %	1.04 %	1.24 %	**(0.39)%**
Total Noninterest Expense	3.09 %	3.13 %	**(0.04)%**	3.06 %	2.92 %	3.10 %	**(0.01)%**
Pretax Profit (Loss)	1.35 %	1.49 %	**(0.13)%**	1.63 %	1.66 %	1.50 %	**(0.14)%**

years old to profitability. Without profitability information, the bank may have pursued an aggressive branch expansion plan without first addressing profitability problems in its existing network. In this example, profitability reporting provided needed data to make an honest situation analysis that could lead to positive action.

Are Plans Implemented Effectively?

Another aspect of strategy is the operating plan. Profitability reporting can help measure strategic execution. Take the bank described above. A clear strategic objective would be to improve the profitability of branches. Holding regional and branch managers accountable for achieving some level of profitability over a certain period of time should result in positive behaviors that will elevate the performance of individual branches and, thus, the entire bank.

To ensure managers at your bank use profitability reporting, make it affect their paychecks.[1] For example, at one TKG client, regional managers were held accountable for increasing revenues in their region, using coterminous FTP (Exhibit 3). Coterminous FTP is providing a cost of funds (for assets) or a credit for funds (for a liability) for each account or instrument using a market rate of the same duration. In Exhibit 3, this regional manager was succeeding in increasing the net asset spread (difference between actual interest income received on consumer loans less the transfer price) and net liability spread (difference between the transfer price credit for deposits less actual interest expense). However, fee income dropped, reducing the increase in total income.

Imagine the behavioral changes within your organization if business-line managers were held accountable for improving net revenues in their lines of business. In the example depicted in Exhibit 3, regional and branch managers would survey their markets to determine the best available means to drive revenue through their branches. Does your bank use deposit balances alone to determine branch success? If so, you could be overstating—or understating—branch success.

Profitability Reporting Should Balance to Accounting Results

Connecting profitability reporting to actual bank performance is critical. A system that shows a different bottom line than is reported either in your 10Q or your call report immediately calls the results into question. Business-line managers and product managers that didn't fare too well with profitability results will attack your credibility.

Therefore, you must develop a system that matches your bank's bottom line. When reviewing profitability results, we recommend peeling back the layers like an onion, starting at overall performance. Reviewing overall bank performance is critical to gaining credibility and identifying key financial strengths and weaknesses of the

Exhibit 3. Incentives Based on Profitability Reporting

	Q4		Q3		Change		
P & L:	**($000)**	**% of Deposits**	**($000)**	**% of Deposits**	**($000)**	**% of Deposits**	**Net Revenue Increase (Decrease)**
Net Asset Spread	538		521		17	0.02%	**17**
Credit for Funds	3,869	4.20%	3,928	4.19%	(59)	0.01%	
Interest Expense	1,924	2.09%	2,056	2.19%	(132)	-0.10%	
Net Liability Spread	1,945	2.11%	1,872	2.00%	73	0.11%	**73**
Provision for Credit Loss	33	0.04%	26	0.03%	7	0.01%	
Noninterest Income	540	0.59%	566	0.60%	(26)	-0.01%	**(26)**
Total Income							**64**

Exhibit 4. Overall Financial Performance

(Percentage of Average Assets:)	Current Quarter	CQ -1	CQ -2	CQ -3	CQ -4
Interest Income—FTE	6.90 %	6.79 %	6.54 %	6.33 %	6.26 %
Interest Expense	2.63 %	2.45 %	2.27 %	2.13 %	1.97 %
Net Interest Spread—FTE	4.27 %	4.34 %	4.27 %	4.20 %	4.29 %
Provision for Credit Loss	0.17 %	0.16 %	0.19 %	0.21 %	0.16 %
Noninterest Income	2.49 %	2.53 %	2.50 %	2.36 %	2.49 %
Noninterest Expense	4.39 %	4.52 %	4.39 %	4.27 %	4.45 %
ROA - Pretax	**2.20 %**	**2.19 %**	**2.20 %**	**2.08 %**	**2.17 %**
Tax Equivalent Adjustment	0.20 %	0.22 %	0.21 %	0.22 %	0.22 %
Income Taxes	0.62 %	0.58 %	0.58 %	0.48 %	0.56 %
ROA—After Tax	**1.37 %**	**1.40 %**	**1.40 %**	**1.39 %**	**1.39 %**
ROE—After Tax	**13.65 %**	**13.61 %**	**13.72 %**	**13.72 %**	**13.68 %**
Efficiency Ratio	**65.76 %**	**66.34 %**	**65.49 %**	**65.42 %**	**65.86 %**
Noninterest Income/Total Income	**36.04 %**	**36.33 %**	**36.37 %**	**35.53 %**	**36.51 %**
Loans/Deposits	**96.06 %**	**96.11 %**	**93.96 %**	**94.81 %**	**95.84 %**
Equity/Assets	**10.07 %**	**10.28 %**	**10.20 %**	**10.15 %**	**10.16 %**

Exhibit 5. Testing the Spread Assumption

	Current Quarter	CQ -1	Change	CQ -2	CQ -3	CQ -4	Change
PRODUCTS—COST BASIS							
Yield on Earning Assets—FTE	7.72 %	7.60 %	0.12 %	7.35 %	7.10 %	7.01 %	0.71 %
Rate Paid on Total Deposits and Borrowings	3.05 %	2.85 %	0.20 %	2.64 %	2.45 %	2.25 %	0.80 %
Spread - FTE	4.67 %	4.75 %	(0.08)%	4.71 %	4.65 %	4.76 %	(0.09)%
PRODUCTS—MARKET BASIS							
FUNDS USING PRODUCTS							
Yield on Earning Assets—FTE	7.72 %	7.60 %	0.12 %	7.35 %	7.10 %	7.01 %	0.71 %
Cost of Funds (FTP)	4.66 %	4.45 %	0.21 %	4.21 %	4.05 %	3.88 %	0.78 %
Asset Product Spread—FTE	3.06 %	3.15 %	(0.09)%	3.14 %	3.05 %	3.13 %	(0.07)%
FUNDS PROVIDING PRODUCTS							
Credit for Funds (FTP)	5.06 %	4.93 %	0.13 %	4.69 %	4.55 %	4.40 %	0.66 %
Rate Paid on Total Deposits and Borrowings	3.05 %	2.85 %	0.20 %	2.64 %	2.45 %	2.25 %	0.80 %
Liability Product Spread	2.01 %	2.08 %	(0.07)%	2.05 %	2.10 %	2.15 %	(0.14)%
Maturity/Rate Mismatch	(0.40)%	(0.48)%	0.08 %	(0.48)%	(0.50)%	(0.52)%	0.12 %

overall institution. Exhibit 4 shows overall financial performance of our sample bank introduced in Exhibit 2.

Performance numbers at the beginning of the profitability reports show the sample bank's actual performance for each period. Upon reviewing these

Exhibit 6. Money Market Product Trend

	Q4	Q3	Change	Q2	Q1	Q4	Change
P & L:	**All percentages are % of average money market deposits**						
Credit for Funds	5.15 %	5.04 %	**0.11 %**	4.81 %	4.71 %	4.58 %	**0.57 %**
Interest Expense	3.41 %	2.90 %	**0.51 %**	2.26 %	1.92 %	1.57 %	**1.84 %**
Total Interest Spread	1.74 %	2.14 %	**(0.40)%**	2.55 %	2.79 %	3.02 %	**(1.28)%**
Noninterest Income	0.01 %	0.01 %	**0.00 %**	0.08 %	0.08 %	0.07 %	**(0.06)%**
Noninterest Expense	0.81 %	0.78 %	**0.03 %**	0.70 %	0.71 %	0.71 %	**0.10 %**
Pretax Profit (Loss)	1.07 %	1.47 %	**(0.40)%**	2.03 %	2.26 %	2.47 %	**(1.41)%**

numbers, the analyst may draw the conclusion that this bank is a high performer due to its return on assets (ROA) and return on equity (ROE). ROE may be deceptively low due to the level of equity to assets.

On the other hand, the bank's expense ratio (noninterest expense as a percentage of average assets) and efficiency ratio (noninterest expense divided by the result of net-interest income plus noninterest income) appears high, given the high level of net-interest spread and noninterest income. This may be appropriate if the bank has fee-based businesses that exhibit high efficiency and expense ratios, such as trust or insurance. Clearly, the onion needs to be peeled further.

Look Beyond Overall Performance

First, let us test the assumption made in the previous paragraph that net-interest spread is at a high level. Senior managers that only look at overall reporting would reasonably draw this conclusion, given the data and information from similarly situated banks using publicly available resources, such as FDIC UBPR, or call reports. Satisfied with the result at this level, no action is necessary.

Trend results can be revealing and lead to positive action to improve your bank's performance.

Peeling back one layer of the onion by introducing coterminous FTP to both the asset and liability side of the balance sheet identifies weaknesses in this thinking. Exhibit 5 shows the results for our sample bank.

The top three rows of Exhibit 5 are the sample bank's actual net-interest spread as a percentage of average earning assets and support the contention that the bank compares favorably to similarly situated banks. When we introduce FTP in the "Market Basis" section, however, we learn that the spread is primarily generated on the asset side of the balance sheet. Liability product spread is a less significant contributor and exhibits a negative trend.

This introduces the concept of trend. Because profitability reporting is part art, part science, single-period numbers can be challenged by those that disagree with the results. However, if assumptions are consistently applied, trend results can be revealing and lead to positive action to improve your bank's performance.

In this example, it appears as though spread is a strength on the asset side of the sample bank's balance sheet. But it is less so, possibly even a weakness, on the liability side, and spread is demonstrating a negative trend. At this level, we have only parsed the balance sheet by total assets and total liabilities.

One level deeper, we review the financial performance of sample bank's primary fund providers, the branches, highlighted back in Exhibit 2. Net liability spread exhibits a mildly negative trend and was less than TKG profitability peers. It appears as though actions are appropriate at the branch level to improve funding costs.

But where should the focus be? There were a few answers to this question. To get closer, this bank evaluated the profitability of deposit products. Exhibit 6 is the profit trend of the sum of sample bank's money market products.

Money market balances were the second highest growth deposit category behind CDs. CDs' growth as a percentage of total deposits was clearly one reason for the decline in net liability spread, but Exhibit 6 demonstrates another. The decline in money market spread and pretax profit was alarming. In addition, when compared to other branch-distributed products, the revenue generated from money market accounts fell to second last (ranked only above the lowly CD). TKG profitability peers showed far higher spreads in this product. Here, the pricing committee needed to rethink its strategy with these products, and branch personnel needed to redirect how they spent their time.

Profitability Reporting Leads to Action Steps

Recall that the top of the house review of sample bank's financial performance exhibited very favorable spread and profitability. By using profitability reporting, bank managers found actionable items at the branch and product level to improve spread and overall bank performance. Drilling down even further, to individual branches and numerous money market products, gets to the heart of organizational challenges and holds individual managers accountable.

Overall bank performance measures also revealed high expense and efficiency ratios. One reason for this was the level of fee income businesses relative to the rest of the bank. Bank managers were satisfied with this rationale.

However, referring back to Exhibit 2, the level of indirect and corporate overhead expenses allocated to branches seemed excessive. Branch indirect and corporate overhead expenses for TKG profitability peers represented slightly more than half of total branch expenses. For our sample bank, it represented two-thirds of total branch expenses. This bank had an inefficient back office that was disguised by its positive spread. The mask was uncovered due to the power of profitability reporting.

Profitability Reporting: Difficult, but Worth the Effort

Bank finance is becoming increasingly complex, and community bank finance departments are heavily taxed for time and resources. These constraints push banks to achieve minimum reporting requirements to satisfy the myriads of regulations thrust upon them.

Few great achievements would have been undertaken if the achievers knew the amount of toil and trouble that lay ahead. Most finance professionals know the difficulty in building a profitability model for their bank. A further challenge is the chance, a very good chance, that business-line and product managers will not use the information. For these reasons banks don't undertake the journey to develop profitability reporting. Why bother?

Recall that the number of FDIC-insured institutions declined by more than 21 percent in the past 10 years. Very few have failed, so the decline cannot be due to lack of regulatory compliance or safety and soundness. Allowing regulators to run your business makes you compliant, not necessarily good or relevant.

Bank finance managers must present profitability measurement information to the business-line managers at a relevant level of significance in order to measure the execution of strategies, maintain accountability and improve bank financial performance. Profitability reporting should result in information designed to enhance and improve financial performance.

Endnotes

[1] Jeffrey P. Marsico, *Tying Management Information to the Front Line*, BANK ACCOUNTING & FIN., Dec. 2006–Jan. 2007, at 11–16.