Performance Measurement | Strategic Management | Profit & Process Improvement | Board & Management Advisory Services | Financial Advisory

First Quarter 2017 Volume 9 Issue 1

TKG Perspective

Teaching & Speaking Engagements

Montana Bankers Association
Executive Development Program
Helena, MT **April 6**
Bank Profitability

Utah Bankers Association
Executive Development Program
Wasatch Retreat and Conference Center
Salt Lake City, UT **April 7**
Bank Profitability

Financial Managers Society NY/NJ Chapter
Half-Day Seminar
The Stony Hill Inn
Hackensack, NJ **April 21**
Performance Measurement

Northern New Jersey Community Bankers
April Meeting
The Stony Hill Inn
Hackensack, NJ **April 27**
Financial Industry Overview

Conferences, Conventions & Other Events

New York Bankers Association
Women in Banking Conference
Roosevelt Hotel
New York, NY **April 24**

AMIfs
Annual Conference
Sheraton Lake Buena Vista
Orlando, FL **April 26-28**

Northern New Jersey Community Bankers
April Meeting
The Stony Hill Inn
Hackensack, NJ **April 27**

Maryland Bankers Association Council of Professional Women in Banking and Finance
Annual Conference
Martins West
Baltimore, MD **May 4**

Pennsylvania Bankers Association
Annual Convention
JW Marriot Beach Club & Spa
Marco Island, FL **May 10-13**

Your Competitors Are Using Performance Measurement Data to Improve Their Performance. Are You?

By: Gregg J. Wagner, Managing Director

We have just completed producing the Performance Measurement reports for our clients for the 4th quarter of 2016 and thought this would be a good time to take a look back and review the profit performance of selected banking products and bank branches. We will also take a look at how the profitability has changed over the last 10 years and the impact the anticipated interest rate hikes will have on profitability in 2017.

Our Performance Measurement service is designed to provide institutions with profitability information for their organizational profit centers and for the products they offer. Our clients also use data from these profitability systems to feed customer level data into their MCIF and CRM systems. Over the years we have provided this service to hundreds of institutions so they can foster an accountability culture and improve their bottom line results. One of the most valuable components of our service is compiling PEER information our clients can use to measure against their performance.

The following are some of our observations from 2016.

Community Banks are in love with CRE lending and here is why:

As with most community financial institutions, our client base grew their loan portfolios primarily through the addition of commercial real estate (CRE) loans during the past 10 years. Our client CRE loans represented 54.7% of their total loans in the fourth quarter of 2016 (see table), compared to 53.1% a year ago and 32.6% in the 4th quarter of 2006! While the level of CRE loans continues to be the bane of regulators, our data confirms why banks are in love with them. CRE loans are the most profitable product for most institutions. Our clients had a pretax profit (as a % of loans) on their CRE portfolios of 2.34% in the 4th quarter of 2016, higher than both the 2.22% recorded last year and the 2.17% in the 4th quarter of 2006. The average pretax profit per loan increased from $17,000 to $19,000 from the 4th quarter of 2015 to the 4th quarter of 2016 (average loan size is approximately $900,000).

The pressure on the profitability of CRE loans in 2017 will depend greatly on the ability of banks to keep pace with the increase in funding associated with anticipated interest rate hikes. Will market pressures prohibit them from increasing rates, thus lowering their net interest spread earned on CRE loans? And will regulators allow the banks to maintain their growth in CRE lending or will they continue to pressure banks to lower their concentrations? These issues will tell the tale of CRE profitability in 2017.

	4Q 2016	4Q 2015	4Q 2006
Commercial Mortgage as a % of Loan Portfolio	54.7%	53.1%	32.6%
Pretax Profit w/o Provison (as a % of loan)	2.34%	2.22%	2.17%
Pretax Return on Equity	28.76%	24.90%	26.26%

While community financial institutions continue to remain competitive in commercial lending, the stiff competition from non-bank entities makes consumer lending a difficult task. One look at the pretax ROA's for the 4 major loan categories shows why banks have concentrated their efforts into building their commercial real estate portfolios. As noted below, commercial real estate loans have consistently been the most profitable loan category for community financial institutions. While commercial C&I loans have an advantage of net interest spread compared to commercial real estate loans, inherent higher costs weigh down overall profitability. The primary driver of the improvement in residential mortgage profitability has been the increase in net interest spread. Our PEER group interest spread on residential mortgages increased from 125 basis points in the 4th quarter of 2006 to 195 basis points in the 4th quarter of 2016. Consumer loans continue to struggle, but have shown a slight increase in profitability compared to 2006 primarily due to higher interest spreads related to lower funding costs, particularly in home equity lines of credit.

Will 2017 be the year we see profitability return to branches?

	Pretax ROA without Provision		
	4Q 2016	4Q 2015	4Q 2006
Commercial Mortgages	2.34%	2.22%	2.17%
Commercial C & I	1.45%	1.19%	1.27%
Residential Mortgages	1.25%	1.27%	0.59%
Consumer Loans	0.28%	0.17%	-0.03%

While banks have certainly "rationalized" their branch networks during the past 10 years, they cannot overcome the impact low interest rates have had on branch profitability. In the 4th quarter of 2006 before interest rates began their great decline, our clients earned $1.00 pre-tax income on every $100 of branch deposits (see table below). In the fourth quarter of 2016 our clients lost ($0.08) per $100 of branch deposits even though branch deposits increased 48% during this period.

The breakdown of the branch profitability is as follows:

- Banks earned $3.02 of net interest spread on every $100 of branch deposits in the 4th quarter of 2006. In the 4th quarter of 2016, it was half of that level falling to $1.71. (The net interest spread is primarily the credit for funds for deposits less interest expense and also the net interest income for consumer loans that are located in the branches.)
- A driver of the profitability of a deposit product is based on its credit for funds. We provide our clients with a credit for funds based on the average duration of their deposit products. The longer the duration of a deposit product, the longer we go out on the FHLB Fixed-Rate Advance curve to calculate its credit for funds. Since the credit for funds for non-term deposits is priced using duration pools that are developed by rolling averages, the credit for funds lags the actual change in rates. The shorter duration of a deposit, the quicker its credit for funds will increase in a rising rate environment.

	Branch Pretax Profit (per $100 of Deposits)		
	4Q 2016	4Q 2006	Difference
Average Deposits	$66,981,000	$45,246,000	$21,735,000
Net Interest Spread	$ 1.71	$ 3.02	$ (1.31)
Non-Interest Income	$ 0.40	$ 0.56	$ (0.16)
Total Income	$ 2.11	$ 3.58	$ (1.47)
Non-Interest Expense	$ 2.19	$ 2.58	$ (0.39)
Pretax Profit (Loss)	$ (0.08)	$ 1.00	$ (1.08)

- The impact of the current low interest rate environment on the profitability of a branch can be noted by the decrease in the net interest spread of a personal demand deposit product during the past 10 years. As an example, the credit for funds for a personal demand deposit account was 5.17% in the 4th quarter of 2006 and was only 1.89% in the 4th quarter of 2016.
- New regulations focused on overdraft fees also did not help the profitability of branches during this period. Non-interest income earned on $100 of branch deposits decreased from $0.56 in the 4th quarter of 2006 to $0.40 in the 4th quarter of 2016. Both the lower net interest spread and fee income levels resulted in Branch Total Income decreasing from $3.58 per $100 to $2.11 during this period.
- The fully absorbed cost to run a branch in the 4th quarter of 2006 was $2.58 per $100 of branch deposits. The cost was reduced to $2.19 in the 4th quarter of 2016 as banks continue to focus on driving down the costs to run a branch.

During 2017 we should see an incremental increase in branch profitability through a rise in the credit for funds on deposits, as long as the demand for deposits does not propel banks to aggressively raise interest rates. We should also continue to see an overall reduction in branch costs through the sustained trend of reducing the number of branches throughout our industry, and striving for efficiencies in support functions.

Are you interested in learning more about how your bank can utilize performance measurement information to make more informed decisions to enhance the profitability of your organization and products? If so, please contact me at gwagner@kafafiangroup.com or give me a call at 973.299.0300 ext. 114.