

Are Your Management Reports Just An Illusion?

By Gregg J. Wagner, Managing Director

Many financial institutions produce management reports using data only from their general ledger systems. An example is producing branch profitability reports limited to data from the branch's cost center. Limiting the information within your management reports to only general ledger data may be producing reports that are just an ILLUSION!

As noted by this famous painting by Salvador Dali, what you first see may just be an illusion. At first you may see an elderly couple gazing into each other's eyes. Take a closer look and you will see a man playing a guitar against a wall within the man's face and a woman holding a basket on her head within the woman's face. The same is true if you are only using general ledger data to produce management reports, you may not be seeing a true picture of your financial results. The addition of "Performance Measurement" data helps to transform your management reports into a true picture of performance!

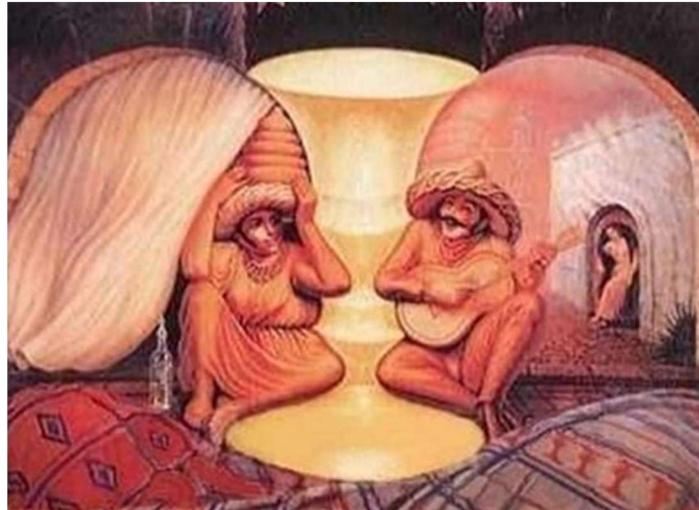
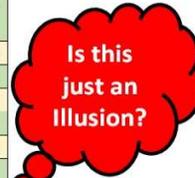


Chart A is an example of how a branch network's income statement is only an illusion "without" using Performance Measurement data.

The chart shows an income statement for a branch network using only information from the institution's total branch cost center, or on a direct cost basis. The results show that their branches lost \$92,000 during the 4th quarter of 2019. Calculating the profit on a direct cost basis does not tell the true profitability story of the branch network and basing decisions on this information may lead to unintended results.

Chart A

SAMPLE INSTITUTION RETAIL BRANCH PROFITABILITY REPORT Q4 2019	
"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	970
5 Interest Expense	694
6 Total Interest Spread	276
5 Provision for Credit Loss	24
6 Marginal Inc (Loss) After Prov.	252
7 Non-Interest Income	377
6 Total Income	629
7 Direct Expense	721
8 Pretax Profit (Loss)	(92)



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Senior Consultant

Performance Measurement



Strategic Management



Profit & Process Improvement



Management Advisory



Financial Advisory



Continued from previous page

Chart B

SAMPLE INSTITUTION RETAIL BRANCH PROFITABILITY REPORT Q4 2019	
Balance Sheet	
	Total Branches
1 Deposits	298,000
2 Loans	73,000
3 Net Funds Provided (Used)	225,000
Income Statement	
4 Interest Income	970
5 Cost of Funds	?
6 Net Asset Spread	970
7 Credit for Funds	?
8 Interest Expense	694
9 Net Liability Spread	(694)
10 Total Interest Spread	276
11 Provision for Credit Loss	24
12 Marginal Inc (Loss) After Prov.	252
13 Non-Interest Income	377
14 Total Income	629
15 Direct Expense	721
16 Indirect Support & Allocated Overhead	?
18 Total Non-Interest Expense	721
19 Pretax Profit (Loss)	(92)

To provide a true picture of the profitability of the branch network, the following items should be included:

Transfer Pricing

Without transfer pricing, deposits would only have interest expense and loans would only have interest income. Transfer pricing provides a “credit to deposited funds” and “cost of funds for loans.” Transfer pricing is typically tied to the “FHLB Fixed Rate Advance Curve,” which eliminates the influence of other decisions not under the control of the management team members responsible for each product.

Funds Transfer Pricing

Allocate Indirect and Overhead from support centers throughout the institution

- The “credit for funds” is based upon the average duration of branch deposits. The longer the duration of a deposit product, the longer the credit is extended on the FHLB Fixed-Rate Advance curve which calculates the credit for funds (a core deposit may have an average life of 4 to 7 years, a CD’s transfer pricing is based upon its maturity term).
- The “cost of funds” for a loan is based upon its actual maturity and interest rate characteristics. The cost of funds for a 30-year mortgage would be based upon the FHLB Fixed-Rate Advance curve for the term of its discounted cash flow (example: 7 years) and a floating loan rate cost of funds rate may be based upon a 90-day borrowing.

Charts C & D show a sample of the “credit for funds” and “cost of funds” for the sample branch network. As you will see, these two data points significantly change the profitability picture of the branch network.

Transfer Pricing Loan "Credit for Funds"
Chart C

SAMPLE INSTITUTION BRANCH DEPOSIT "CREDIT FOR FUNDS" CALCULATION Q4 2019			
Average Quarterly Balance	Total Branches	Credit for Funds	Credit for Funds \$
1 Checking (Non-Int)	\$ 48,000,000	2.57%	\$ 310,935
2 Interest Checking	28,000,000	2.58%	182,084
3 Money Market	66,000,000	2.43%	404,245
4 Savings	60,000,000	2.47%	373,545
5 Certificates of Deposit	96,000,000	2.38%	575,895
6 Total Branch Deposits	\$ 298,000,000		\$ 1,846,705

SAMPLE INSTITUTION RETAIL BRANCH PROFITABILITY REPORT Q4 2019	
Balance Sheet	
	Total Branches
1 Deposits	298,000
2 Loans	73,000
3 Net Funds Provided (Used)	225,000
Income Statement	
4 Interest Income	970
5 Cost of Funds	-
6 Net Asset Spread	970
7 Credit for Funds	1,847
8 Interest Expense	694
9 Net Liability Spread	1,153
10 Total Interest Spread	2,123
11 Provision for Credit Loss	24
12 Marginal Inc (Loss) After Prov.	2,099
13 Non-Interest Income	377
14 Total Income	2,476
15 Direct Expense	721
16 Indirect Support & Allocated Overhead	?
18 Total Non-Interest Expense	721
19 Pretax Profit (Loss)	1,755



Transfer Pricing Deposit "Cost of Funds"
Chart D

Sample Institution Branch Loan "Cost of Funds" Calculation Q4 2019				
	Average Quarterly Balance	Total Branches	Cost of Funds	Cost of Funds \$
1	Residential Mortgage	\$ 38,000,000	2.54%	\$ 243,283
2	Home Equity Loans	9,000,000	2.38%	53,990
3	Home Equity Lines of Credit	5,000,000	2.26%	28,482
4	Auto Loans	10,000,000	2.33%	58,729
5	Personal Loans	3,000,000	2.29%	17,316
6	Credit Card	7,000,000	2.44%	43,051
7	Commercial Loans	1,000,000	1.71%	4,310
8	Total Branch Loans	\$ 73,000,000		\$ 449,162

SAMPLE CREDIT UNION RETAIL BRANCH PROFITABILITY REPORT Q4 2019		
Balance Sheet		Total Branches
1	Deposits	298,000
2	Loans	73,000
3	Net Funds Provided (Used)	225,000
Income Statement		
4	Interest Income	970
5	Cost of Funds	449
6	Net Asset Spread	521
7	Credit for Funds	1,847
8	Interest Expense	694
9	Net Liability Spread	1,153
10	Total Interest Spread	1,674
11	Provision for Credit Loss	24
12	Marginal Inc (Loss) After Prov.	1,650
13	Non-Interest Income	377
14	Total Income	2,027
15	Direct Expense	721
16	Indirect Support & Allocated Overhead	?
17	Total Non-Interest Expense	721
18	Pretax Profit (Loss)	1,306

Indirect Support & Allocated Overhead Expense Allocations

The last piece of data we are missing is an allocation for the Indirect Support and the Allocated Overhead expenses associated with a branch. Indirect Support expenses include services provided to the branches from support cost centers (deposit ops, compliance, IT, etc.) and Allocated Overhead expenses are services provided by administrative cost centers (finance, executive management, etc.). Through PEER data from our TKG's outsourced Performance Measurement services, we have determined the median cost of indirect and overhead per branch is 1.01% of total branch deposits.

Chart E

The median cost of "Indirect" + "Overhead" costs per branch from our clients = 1.01% of Total Deposits

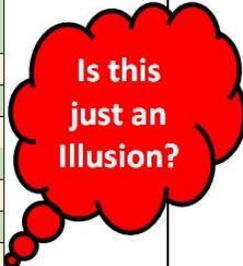
	Branch Deposits
Branch Deposits	\$ 298,000
The Kafafian Group "PEER" Median Total Indirect & Overhead Cost per Branch	1.01%
Indirect & Overhead Expense	\$ 759

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14	Total Income	2,027
15	Direct Expense	721
16	Indirect Support & Allocated Overhead	759
17	Total Non-Interest Expense	1,480
18	Pretax Profit (Loss)	547

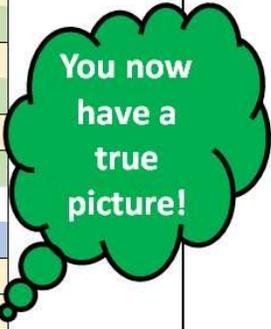
Adding transfer pricing and cost allocations, provides a true picture of the profitability of branches! The branch profitability after adding the performance measurement data shows a profit of \$547,000, compared to a loss of \$92,000 without it. **Which report do you want to use as the basis for your decision?**

Chart F

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SAMPLE INSTITUTION RETAIL BRANCH PROFITABILITY REPORT Q4 2019		
"With" Performance Measurement Data		
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18	Total Non-Interest Expense	1,480
19	Pretax Profit (Loss)	547



TKG's Performance Measurement service is designed to provide institutions with profitability information for organizational branches, lending, wealth management, etc. as well as for the products offered. 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 that our clients can use to measure against their own performance.

Are you interested in learning more about how institutions 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 call me at 973.299.0300 ext. 114. For institutions under \$500 million in assets, TKG recently introduced our "Performance Insight" service which is an affordable profitability measurement system designed specifically for smaller financial institutions.