The Kafafian Group

Bank Financial Principles

Maryland Bankers' Association School of Banking

August 2024

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FORWARD LOOKING STATEMENTS

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Source: The Kafafian Group, Inc

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WHOLE BANK PROFITABILITY MEASUREMENT

KEY PROFIT AND FINANCIAL PERFORMANCE METRICS

Return on Avg. Assets: $\frac{Net\ Income}{Average\ Total\ Assets}$

Return on Avg. Equity: $\frac{Net\ Income}{Average\ Total\ Equity}$

Net Interest Margin(NIM): $\frac{Net\ Interest\ Income}{Average\ Earning\ Assets}$

Yield on Earning Assets: $\frac{Interest\ \&\ Dividend\ Income}{Average\ Earning\ Assets}$

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WHOLE BANK PROFITABILITY MEASUREMENT

KEY PROFIT AND FINANCIAL PERFORMANCE METRICS

Cost of Funds: $$\frac{Interest\ Expense}{Average\ Int.\ Bearing\ Liabilities\ \&\ Non\ Int.\ Bearing\ Deposits}$$

Efficiency Ratio: $$\frac{Operating\ Expense}{Net\ Int.\ Income + Non\ Interest\ Income}$$

Expense Ratio: $$\frac{Operating\ Expense}{Average\ Assets}$$

Also referred to as: Non-interest expense to average assets.

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REVIEWING THE BASICS

Risk / Reward Profile

- Risk and Reward optimization
  - Are you willing to take on greater risk for greater return?

- Risk
  - Credit
  - Liquidity
  - Interest Rate Risk (more to follow)
  - Cyber
  - Operations

Example: Higher Loan-to-value (LTV) home equity loans
  - More credit risk should result in more yield

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REVIEWING THE BASICS

Balance Sheet

<u>Assets</u> = Liabilities + Equity

- Assets: Loans, investment securities, cash, buildings, intangibles, ALLL
    - Earning: Assets generating revenue
    - Nonearning: Assets not generating revenue
    - ALLL: a contra-asset (negative balance sheet item) “rainy day funds” to ensure part of the balance sheet is prepped for potential loan losses

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REVIEWING THE BASICS

Balance Sheet

Assets = <u>**Liabilities**</u> + Equity

- Liabilities are the debts or borrowings of the bank: Deposits, FHLB borrowings, other debt
  - Interest Bearing: Liabilities with interest-based payments tied to them; all deposits that bear interest, FHLB Borrowings
  - Noninterest Bearing: Liabilities without interest-based payments tied to them. DDA and other liabilities

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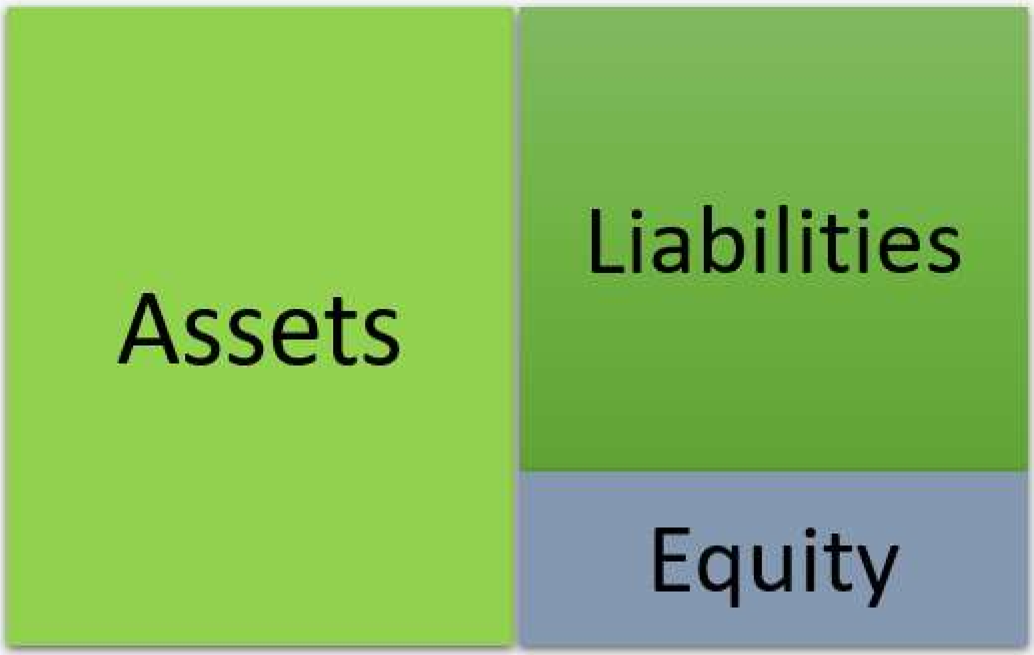
REVIEWING THE BASICS

Balance Sheet



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REVIEWING THE BASICS

Sample Bank Balance Sheet ($000)

Assets ($000)	CY-1	Current Year	Percent Change
Cash and Due from Banks	23,944	24,822	3.7%
Fed Funds Sold	0	0	
Deposits at Financial Institutions	10,621	130,989	1133.3%
Securities Purchased, to Resell	0	0	
Other Cash & Cash Equivalents	0	0	
Cash and Cash Equivalents	34,565	155,811	350.8%
Trading Account Securities	0	23	
Available for Sale Securities	272,839	350,035	28.3%
Held to Maturity Securities	0	0	
Other Securities	6,382	5,271	-17.4%
Total Cash & Securities	313,786	511,140	62.9%
Gross Loans Held for Investment	828,479	901,102	8.8%
Loan Loss Reserve	8,950	11,950	33.5%
Loans Held for Sale	1,061	2,107	98.6%
Total Net Loans	820,590	891,259	8.6%
Real Estate Owned	289	58	
Goodwill	0	0	
Other Intangibles	0	0	
Total Intangible Assets	0	0	
Loan Servicing Rights	356	324	
Credit Card Rights	0	0	
Other Loan Servicing Rights	0	0	
Total Servicing Rights	356	324	
Fixed Assets	20,618	20,879	
Interest Receivable	3,234	4,286	
Prepaid Expense	2,658	2,496	
Bank-owned Life Insurance	31,230	31,712	
Other Assets	10,780	3,525	
Total Other Assets	68,520	62,898	
Total Assets	1,203,541	1,465,679	21.8%

Liabilities ($000)	CY-1	Current Year	Percent Change
Total Deposits	1,001,709	1,287,448	28.5%
FHLB Borrowings	46,909	0	NM
Senior Debt	50,380	3,581	-92.9%
Trust Preferred	10,310	10,310	
Total Subordinated Debt	10,310	10,310	
Total Debt	60,690	13,891	-77.1%
Total Other Liabilities	7,535	8,480	
Total Liabilities	1,069,934	1,309,819	
Equity ($000)			
TARP Preferred Equity	0	0	
Other Preferred Equity	0	0	
Total Preferred Equity	0	0	
Common Equity	133,607	155,860	16.7%
Total Equity	133,607	155,860	
Total Liabilities + Total Equity	1,203,541	1,465,679	

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REVIEWING THE BASICS

What to Look for in a Balance Sheet

- Large period over period changes in balances
- Concentration risk
  - Securities
  - Loans
  - Deposits
- Asset quality (past-due loans)
- Capital adequacy

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REVIEWING THE BASICS

What to Look for in a Balance Sheet ($000)

Loan growth lagged deposit growth so cash and securities grew.

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Total Liabilities + Total Equity	1,203,541	1,465,679	

Significant deposit growth

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REVIEWING THE BASICS

What to Look for in a Balance Sheet

Deposit Composition (%)	CY-3	CY-2	CY-1	Current Year
Nonint-bear Dep/ Deposits	4.99	14.30	17.92	21.10
Transaction Accounts/ Deposits	9.38	8.89	11.11	56.54
MMDAs+Savings/ Deposits	71.34	64.64	69.52	28.41
Retail Time Dep/ Deposits	15.01	21.42	14.58	12.26
Jumbo Time Deposits/ Deposits	4.27	5.06	4.78	2.79

Significant non-interest-bearing deposit growth

Likely a reversal of reclassification of deposits.

Loan Composition (%)	CY-3	CY-2	CY-1	Current Year
Construction & Land Dev. Loans/ Loans	2.72	2.48	5.72	6.62
Tot 1-4 Fam Loans/ Loans	23.35	22.03	22.74	21.95
Multifamily Loans/ Loans	2.18	2.51	1.99	3.29
Farm Loans/ Loans	0.12	0.07	0.06	0.03
CommRE/ Loans	31.59	28.67	31.44	26.94
Total Real Estate Loans/ Loans	59.96	55.76	61.96	58.83
Total C&I Loans/ Loans	19.29	17.72	17.75	26.02
Total Consumer Lns/ Loans	15.10	19.25	14.96	9.70
Total Agricultural Prod/ Loans	0.00	0.00	0.00	0.00
Total Other Loans/ Loans	5.66	7.27	5.34	5.47
Total Leases/ Loans	0.00	0.00	0.00	0.00

Business loans are a larger proportion of portfolio.

Consumer lending a challenge.

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REVIEWING THE BASICS

What to Look for in a Balance Sheet

Capitalization (%)	CY-3	CY-2	CY-1	Current Year	Well Capitalized
Total Risk Based Capital Ratio (%)	12.49	12.17	14.78	15.80	10.00
Tier 1 Risk-based Ratio (%)	11.36	11.11	13.71	14.54	8.00
Common Equity Tier 1 RBC (CET1)	11.36	11.11	13.71	14.54	6.50
Leverage Ratio (%)	8.24	8.27	10.36	9.57	5.00

When total RBC trends up and leverage ratio trends down, what does that tell you?

- CET 1= $\frac{Total\ Capital - Preferred\ Stock \pm Miscellaneus\ Adjustsments}{Risk - Weighted\ Assets}$
- Tier 1 Capital Ratio= $\frac{Equity\ Capital + Disclosed\ Reserves}{Risk - Weighted\ Assets}$
- Total Capital Ratio= $\frac{Tier\ 1\ Capital + Tier\ 2\ Capital}{Risk - Weighted\ Assets}$

Asset Quality (%)	CY-3	CY-2	CY-1	Current Year
NPLs/ Loans	1.54	1.57	2.01	1.39
NPAs/ Assets	1.11	1.14	1.42	0.87
NPA Excluding Restructured Loans/ Assets	0.31	0.46	0.79	0.39
NPAs + 90 Days PD/ Assets	1.11	1.14	1.42	0.87
Loan Loss Reserves/ Gross Loans	1.17	1.13	1.08	1.32
Reserves/ NPAs	70.03	67.64	52.74	94.74
Net Chargeoffs/ Avg Loans	0.02	0.25	0.16	(0.12)
Loan Loss Prov/ NCOs	499.35	123.49	58.35	(183.29)

Asset quality is trending better in all metrics.

When Loan Loss Prov / NCO is negative, what does this indicate?

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REVIEWING THE BASICS

Income Statement

Net Income = Revenue – Expense – Taxes

- Revenue is the income generated by the bank
  - Interest income
  - Noninterest income
- Expenses represent costs of the bank operation
  - Interest expense
  - Noninterest expense

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Income Statement

Income Statement ($000)	CY-3	CY-2	CY-1	Current Year
Total Interest Income	37,847	45,082	45,979	46,262
Total Interest Expense	4,120	7,950	9,342	5,909
Net Interest Income	33,727	37,132	36,637	40,353
Provisions for Credit Losses	769	2,550	797	1,941
Total Noninterest Income	5,326	11,712	6,269	6,516
Unrealized Holding Gains on Equity Sec not HFT	NA	(27)	29	13
Realized Gain on Securities	1,597	(4)	1,227	1,528
Total Noninterest Expense	27,501	28,845	29,325	28,575
Net Income before Income Taxes	12,380	17,418	14,040	17,894
Income Taxes	11,288	3,071	2,326	3,219
Net Income	1,092	14,347	11,714	14,675

Strong net interest income growth was offset in-part by the need to increase the provision.

Expense discipline is helping profitability.

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REVIEWING THE BASICS

Ratio Analysis

- With data from the bank we can utilize thresholds or guidance.
  - Regulatory
  - Strategic (policy or SMART goals)
  - Peer groups
- Trend analysis is another key area of ratio analysis.

Performance Measures (%)	CY-3	CY-2	CY-1	Current Year
ROAA	0.10	1.17	0.98	1.10
ROAE	0.96	14.12	9.01	9.97
Noninterest Expense/ Avg Assets	2.42	2.35	2.44	2.13
Net Interest Margin	3.22	3.24	3.27	3.26
Efficiency Ratio	69.18	58.48	67.66	59.95
Yield on Earning Assets	3.62	3.93	4.11	3.74
Cost of Funds	0.39	0.63	0.75	0.48

Yield on Earning Assets declined 37 bps year over year, while cost of funds decreased 27 bps, causing slight decline in NIM.

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WHOLE BANK PROFITABILITY MEASUREMENT

EXERCISE

Let’s answer some questions together about the peer group distributed to you:

1. What appears to be the greatest financial strength of your bank and why?
2. What is this bank’s key challenge and why?

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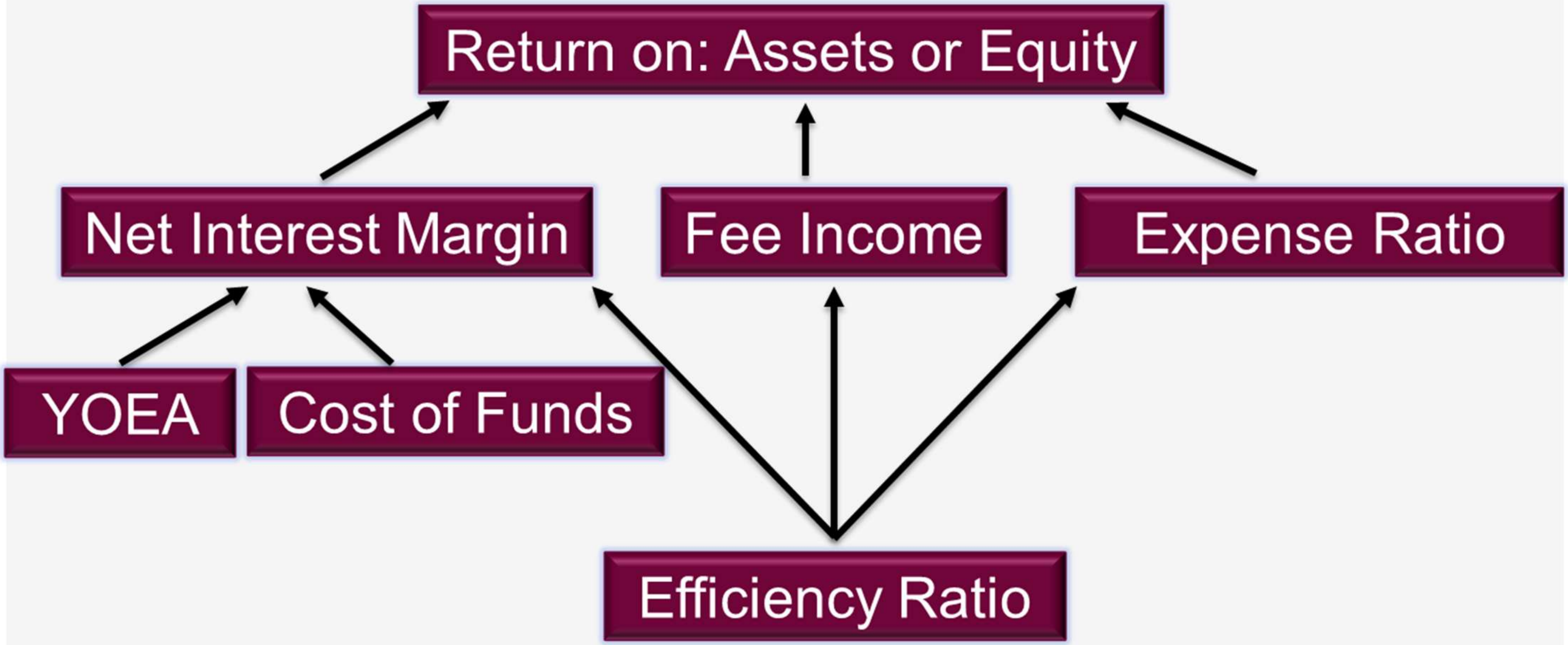
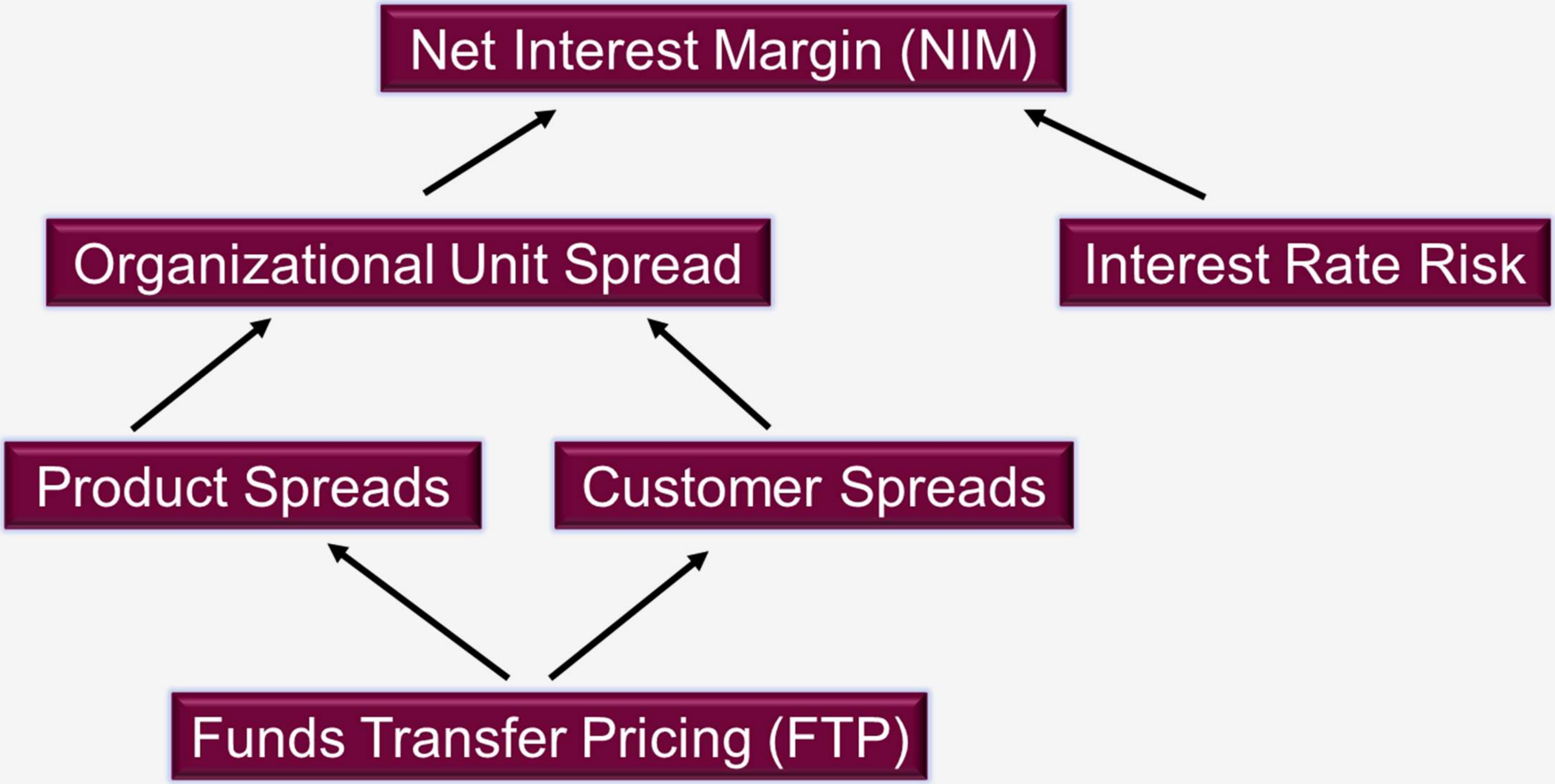
WHOLE BANK PROFITABILITY MEASUREMENT

PROFIT CONTINUUM: WHOLE BANK



WHOLE BANK PROFITABILITY MEASUREMENT

PROFITABILITY DRILL-DOWN



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PROFITABILITY AT GROUND LEVEL

LINE OF BUSINESS, PRODUCT, AND CUSTOMER

“Building a profitability model is like making sausage.
Nobody wants to know *how* it is done, just *that* it is done.”

- Todd Sassaman, VP of JPMorgan

PROFITABILITY AT GROUND LEVEL

BRANCH PROFITABILITY

(all dollars in thousands)	Branch Average Deposits	Pre-tax Profit (fully absorbed)	Pre-tax Profit (direct)
Breakeven - direct costs	$27,369	-3.53%	0.00%
Breakeven - fully absorbed costs	$58,196	0.00%	1.66%
Critical mass (>1.0% pre-tax ROA)	$85,518	1.00%	2.13%

Data:	
Branch direct Opex ($000)	$857
Branch direct Opex (%)	0.95%
Branch total revenue to deps.	3.13%
Branch indirect expense (%)	1.07%
Branch indirect expense ($000)	$965

Source: The Kafafian Group Inc. profitability peer database medians. 3Q23

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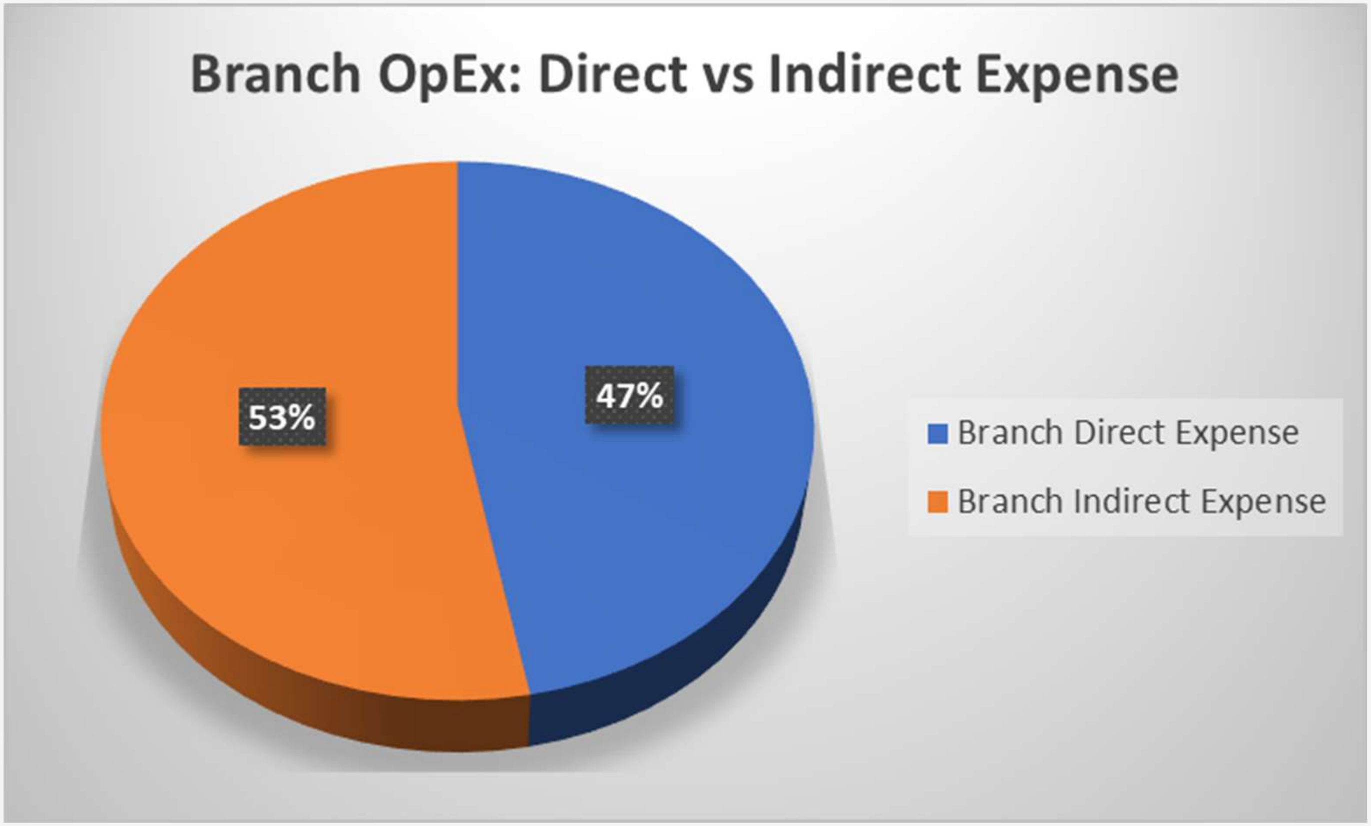
PROFITABILITY AT GROUND LEVEL
BRANCH PROFITABILITY



Source: The Kafafian Group Inc. profitability peer database medians. 3Q23

PROFITABILITY AT GROUND LEVEL
CASE STUDY- HOW TO USE IT: PERFORMANCE MEASUREMENT TOOL

(dollars in thousands)	**CP -3**	**CP -2**	**CP -1**	**Current Period**	**Growth**
Branch-originated Loans	$12,225	$13,874	$14,002	$15,145	$2,920
net asset spread	*3.01%*	*2.98%*	*2.95%*	*2.94%*	
Branch Deposits	$37,034	$39,892	$42,354	$45,089	$8,055
net liability spread	*2.10%*	*2.06%*	*2.02%*	*1.99%*	
Net Asset Spread	$368	$413	$413	$445	$77
Net Liability Spread	778	822	856	897	120
Total Spread	1,146	1,235	1,269	1,343	197
Branch Fee Income	$148	$160	$169	$180	$32
Total Branch Revenue	$1,294	$1,395	$1,438	$1,523	$229

Source: The Kafafian Group, Inc.

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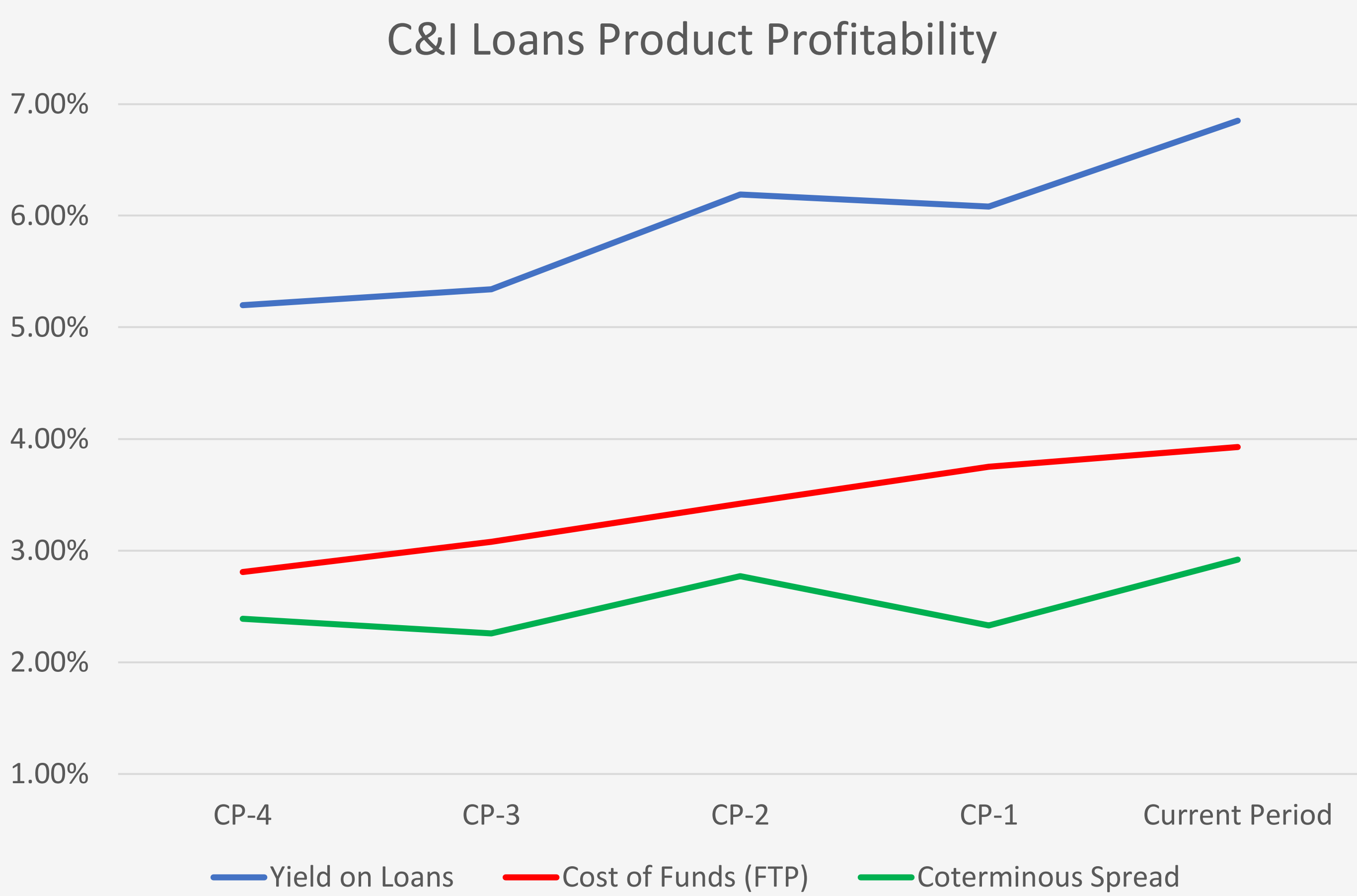
PROFITABILITY AT GROUND LEVEL

CASE STUDY- HOW TO USE IT: DIAGNOSTIC TOOL



Note: CP-2 Yield on Loans includes a significant reversal (addition) of interest income from a non-performing loan.

Source: The Kafafian Group, Inc.

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HOW IT'S MADE

PROFITABILITY SPEAK

1. **Funds Transfer Pricing (FTP)** – Determining the spread (Yield minus Cost) of an account, typically by matching the interest income (for an asset account) or interest expense (for a liability account) to a market instrument (such as an FHLB borrowing) of the same duration.

2. **Risk Adjusted Return on Capital (RAROC)** – Account pre-tax profit divided by assigned capital. Capital is assigned to account based on its balance and risk characteristics.

3. **Cost Assignment** – For organizational profitability, assigning support center costs to profit centers based on the work being done in the support center. For product and customer profitability, assigning organizational costs to products and/or customers based on the work being done, products supported, or customers served by organizational units.

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HOW IT'S MADE

FUNDS TRANSFER PRICING

	Balance	Annual Interest	Rate
Home Equity Loan (5 Year Fixed/Amortizing)	$43,278	$1,731	4.00%
FTP (4 Year FHLB Borrowing)	NA	$714	1.65%
Co-terminous Spread		$1,017	2.35%
Business Checking	$65,840	$0	0.00%
FTP (Blended Average)		$1,103	1.68%
Co-terminous Spread		$1,103	1.68%

Blended Average		Weight	Result
90 Day FHLB Borrowing	0.40%	10.00%	0.04%
1-Year FHLB Borrowing	0.90%	15.00%	0.14%
5-Year FHLB Borrowing	2.00%	75.00%	1.50%
			1.68%

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HOW IT'S MADE

CAPITAL ASSIGNMENT- RISK ADJUSTED RETURN ON CAPITAL (RAROC)

RAROC is considered to be a "best practice" tool for measuring risk vs. return in the financial services industry. It provides a framework for measuring risk-adjusted financial performance of organizational units, products, and customers.

FRB Risks

- Credit
- Market (Interest Rate)
- Liquidity
- Reputation
- Legal
- Operational

OCC Risks

- Credit
- Liquidity
- Interest Rate
- Price
- Reputation
- Strategic
- Transaction
- Foreign Exchange
- Compliance

CAMELS Ratings

- Capital
- Asset Quality
- Management
- Earnings
- Liquidity
- Sensitivity (Interest Rate)

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HOW IT'S MADE

RAROC- CUSTOMER SAMPLE

	Low		Medium		High	
Risk Rating Scale	1	2	3	4	5	
Capital Assignment	0%	4%	6%	8%	10%	

Risk Categories	Credit	Interest Rate	Liquidity	Composite	Assigned Capital	Capital ($000)
Risk Weights	55%	35%	10%	100%		

Loans:	**Balance**						
Loan on building(CRE)	250,000	2	4	4	2.90	5.80%	14,500
Home equity loan	50,000	3	3	3	3.00	6.00%	3,000
Deposits/funding:							
Business checking	30,000	1	2	2	1.45	2.90%	870
Funding gap	270,000	1	2	2	1.45	1.80%	4,860
Total Capital for Customer	23,230						
Capital Ratio	7.74%						
Pre-tax ROE Hurdle Rate	15.00%						
Pre-tax Profit Requirement	$3,485						

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HOW IT'S MADE
COST ASSIGNMENT

- Activity-based-costing
- Full absorption versus standard costing
- Variable/fixed-direct/indirect costs
- Isolating efficiencies/inefficiencies
- Capacity utilization

Allocations methodologies:

- Average balances
- Fixed percentages
- Statistical databases
- Weighted statistics
- Direct Dollar Assignment
- Rate X Volume (ABC)

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GIVEN HOW IT'S MADE…

WHAT DO YOU THINK?

(percents are % of portfolio balance)	**4Q19**					**4Q23**			
	Pre-tax Profit	**Rank**	**Net Revenue***	**Rank**		**Pre-tax Profit**	**Rank**	**Net Revenue***	**Rank**
Product Profitability									
Business non-interest checking									
Commercial real estate loans									
Interest bearing checking									
Savings accounts									
Money market accounts									
CD's									
Residential mortgage loans									
Retail non-interest checking									
Commercial/business loans									
Consumer loans									

*Net revenue = co-terminous spread plus fee income less provision, if applicable

Source: The Kafafian Group, Inc.

Polls: Of the products listed above, which one….

1. Has the greatest net revenue as a percent of its balance in 4Q23?
2. Has the greatest pre-tax profit as a percent of its balance in 4Q23?

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BRINGING IT ALL TOGETHER
CAMPAIGN PROFITABILITY: SIMPLE APPROACH

Number of Prospects	10,000
x conversion rate	2%
= number of new customers (accounts)	200
x average balance per account	$43,278
x spread per account	2.46%
= revenue per new account	$1,065
New Revenue from Campaign	$212,928
minus cost of campaign	$50,000
minus incremental cost to service new accounts	$36,000
=marginal profitablity of campaign	$126,928

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BRINGING IT ALL TOGETHER

ROI VS. ROE – MAKING CHOICES

	(dollars in thousands)	**Credit Card**	**HELOC**
1	New Balances	$10,000	$10,000
2	Interest Income	$1,000	$400
3	Cost of Funds (FTP)	150	150
4	Spread	850	250
5	Fee Income	200	50
6	Total Revenue	$1,050	$300
7	Estimated net charge-offs	400	25
8	Incremental Operating Expenses	200	15
9	Net Revenue	$450	$260
10	Campaign Cost	$50	$50
11	**Return on Investment (ROI)**	**900%**	**520%**

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BRINGING IT ALL TOGETHER

ROI VS. ROE – MAKING CHOICES

	(dollars in thousands)	Credit Card	HELOC
1	New Balances	$10,000	$10,000
2	Net Revenue	$450	$260
3	Campaign Cost	$50	$50
4	**Return on Investment (ROI)**	**900%**	**520%**
5	Capital Allocation	$1,000	$500
6	**Risk Adjusted Return on Capital (RAROC)**	**45%**	**52%**

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BRINGING IT ALL TOGETHER

ROI VS. ROE – LENDER P&L

(dollars in thousands)	**CP -3** $	**CP -3** %	**CP -2** $	**CP -2** %	**CP -1** $	**CP -1** %	**Current Period** $	**Current Period** %
Average Portfolio	27,890	100.00%	28,865	100.00%	30,001	100.00%	30,298	100.00%
Yield on Portfolio	1,392	4.99%	1,429	4.95%	1,485	4.95%	1,503	4.96%
Cost of Funds-FTP	753	2.70%	776	2.69%	801	2.67%	803	2.65%
Spread	639	2.29%	652	2.26%	684	2.28%	700	2.31%
Provision	95	0.34%	92	0.32%	132	0.44%	91	0.30%
Spread less Provision	544	1.95%	560	1.94%	552	1.84%	609	2.01%
Cost of Portfolio*	268	0.96%	271	0.94%	282	0.94%	282	0.93%
Pre-tax profit	276	0.99%	289	1.00%	270	0.90%	327	1.08%
Equity Allocation**	1,738	6.23%	1,798	6.23%	1,869	6.23%	1,888	6.23%
ROE		15.89%		16.05%		14.45%		17.34%

*Operating cost per account x number of accounts

**Equity allocation per loan type based on risk.

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CUSTOMER PROFITABILITY

		Business DDA		Commercial Mortgage	Home Eq. Loans
		Percent of Average Balances			
1	Credit for Funds	3.45%	Interest Income	6.27%	6.32%
2	Interest Expense	0.00%	Cost of Funds	3.95%	4.57%
3	Total Interest Spread	3.44%	Total Interest Spread	2.25%	1.72%
4	Funds Credit Allocated Equity	0.15%	Funds Credit Allocated Equity	0.39%	0.24%
5	Net Interest Spread	3.58%	Net Interest Spread	2.62%	1.93%
6	Non-Interest Income	0.72%	Provision for Credit Loss	0.69%	0.21%
7	Total Income	4.35%	Marginal Inc (Loss) After Prov.	2.07%	1.76%
8	Non-Interest Expense	3.76%	Non-Interest Income	0.10%	0.10%
9	Pretax Profit (Loss)	0.39%	Total Income	2.15%	1.83%
10			Non-Interest Expense	0.66%	1.29%
11	Number of Accounts	2,525	Pretax Profit (Loss)	1.16%	0.61%
12	Average Balance per Account	$18,432			
13	Non-Interest Income per Account	$36.88	Number of Accounts	405	1,185
14	Annualized Cost per Account	$719.87	Average Balance per Account	$505,002	$58,427
15	Annualized Net Income per Account	$76.28	Non-Interest Income per Account	$71.09	$9.82
16			Annualized Cost per Account	$3,535.46	$781.60
17			Annualized Net Income per Account	$6,762.85	$670.03

	Customer Balances from RAROC Sample:		**Profits**		
18	Commercial Mortgage	$250,000	$2,900	Capital Allocation to Customer	7.74%
19	Home Equity Loan	50,000	305		
20	Business DDA	30,000	117	Profit Hurdle for 15% ROE	$3,485
		Total Profit	$3,322	------------------------------------>>>>>>	$3,322
				Customer profit over (short) of hurdle	**($163)**

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WHERE TO GO FOR MORE INFORMATION

Externally

- For FDIC Summary of Deposit (deposit market share data), Institution Directory, Statistics on Banking, and other industry profitability and related data: www.fdic.gov/quicklinks/analysts.htm
- For Call Reports, Thrift Financial Reports (TFR), and Uniform Bank Performance Reports (peer reports), and other industry related data: www.ffiec.gov

Internally

- Internal profitability reports (Fiserv Vantage, Profitstars, Axiom/Syntellius.)
- CRM Systems
- Responsibility reports/general ledger system

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Jeff Marsico is the President, shareholder, and founding member of The Kafafian Group. His specialties include: facilitating the development of client strategies; mergers & acquisitions; profit/process improvement consulting engagements; profitability consulting; and regulatory order assistance.

As part of the strategic consulting team, he has analyzed and facilitated over one hundred strategy development engagements for community financial institutions resulting in documented strategic plans to guide client employees and improve performance. He has negotiated, analyzed, and advised Boards of Directors regarding bank mergers and acquisitions resulting in whole institution and branch sale transactions with values in excess of $1B, including the first reverse merger-conversion where the converting thrift acquired a commercial bank.

Jeff began his banking career in 1985 and his experience includes: IT and Trust operations with Northeastern Bank of Pennsylvania (now PNC Financial Services Group, Inc.); retail branch management and strategic planning with First Maryland Bancorp (now M&T Bank Corporation); and financial institution mergers & acquisitions, consulting, and capital formation with Tucker Anthony Sutro Capital Markets (now RBC Capital Markets). He interrupted his banking career and served seven years as a Military Intelligence Analyst in the United States Navy, earning three Navy Achievement Medals, the Kuwait Liberation Medal, the Southwest Asia Service Medal, the Combat Action Ribbon, Sea Service Ribbon, and other various commendations.

He is the author of *Squared Away-How Can Bankers Succeed as Economic First Responders* and serves on the faculty of various state banking associations' Executive Development Programs. He is frequently sought out by industry publications regarding the changes occurring in financial services and is a noted industry commentator via his blog.

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