

The Income Statement: A Closer Look at a Bank's Revenues and Expenses

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Source of Information

- October, 2001 BITS Article
 - Title: "Studying a Bank's Revenue and Expenses"
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The Business of Banks

- "A Spread Business"
 - Banks earn the difference between deposit costs and loan earnings
 - Fixed rate loans (fixed rate mortgages) are matched with fixed rate deposits (long-dated certificates of deposit (CD))
 - Floating rate loans (adjustable mortgages) are matched with floating rate deposits (short-term CDs) with interest rates that reset frequently

What are sales for a Bank?

NAIC Data files define Sales this way:

Interest Income
-
Interest Expense
-
Provision for Loan Losses
+
Non-Interest Income

HARLEYSVILLE NATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

| | Year Ended December 31, | | | Horizontal Analysis | |
|--|---|----------------|----------------|---------------------|------------|
| | 2005 | 2004 | 2003 | 2005 | 2004 |
| | (Dollars in thousands, except per share data) | | | | |
| Interest income | | | | | |
| Loans, including fees | 113,240 | 88,079 | 79,064 | 29% | 11% |
| Lease financing | 2,093 | 4,439 | 6,582 | -53% | -33% |
| Investment securities: | | | | | |
| Taxable | 23,923 | 23,891 | 18,697 | 0% | 28% |
| Exempt from federal taxes | 10,846 | 10,796 | 14,509 | 0% | -26% |
| Federal funds sold and securities purchased | 1,451 | 489 | 244 | 197% | 100% |
| Deposits in banks | 186 | 35 | 104 | 431% | -66% |
| Total interest income | <u>151,739</u> | <u>127,729</u> | <u>119,200</u> | <u>19%</u> | <u>7%</u> |
| Interest expense | | | | | |
| Savings and money market deposits | 22,319 | 9,871 | 7,777 | 126% | 27% |
| Time, under \$100,000 | 18,516 | 17,662 | 18,999 | 5% | -7% |
| Time, \$100,000 or greater | 5,814 | 3,240 | 4,304 | 79% | -25% |
| Short-term borrowings | 3,972 | 1,381 | 946 | 188% | 46% |
| Long-term borrowings | 13,997 | 10,484 | 8,053 | 34% | 30% |
| Total interest expense | <u>64,618</u> | <u>42,638</u> | <u>40,079</u> | <u>52%</u> | <u>6%</u> |
| Net interest income | <u>87,121</u> | <u>85,091</u> | <u>79,121</u> | <u>2%</u> | <u>8%</u> |
| Provision for loan losses | 3,401 | 2,555 | 3,200 | 33% | -20% |
| Net interest income after provision | <u>83,720</u> | <u>82,536</u> | <u>75,921</u> | <u>1%</u> | <u>9%</u> |
| Noninterest income | | | | | |
| Service charges | 8,202 | 7,807 | 7,855 | 5% | -1% |
| Gains on sales of investment securities, net | 4,794 | 3,689 | 6,613 | 30% | -44% |
| Gain on sale of branch | 690 | — | — | | |
| Trust, investment services and advisory | 6,651 | 6,586 | 3,837 | 1% | 72% |
| Bank-owned life insurance income | 2,234 | 2,406 | 2,615 | -7% | -8% |
| Income on life insurance | 177 | 586 | 1,119 | -70% | -48% |
| Other income | 7,242 | 7,084 | 5,599 | 2% | 27% |
| Total noninterest income | <u>29,990</u> | <u>28,158</u> | <u>27,638</u> | <u>7%</u> | <u>2%</u> |
| Net interest income after provision | <u>113,710</u> | <u>110,694</u> | <u>103,559</u> | <u>3%</u> | |
| Noninterest expense | | | | | |
| Salaries, wages and employee benefits | 37,441 | 37,080 | 31,173 | 1% | 19% |
| Occupancy | 5,176 | 4,557 | 3,770 | 14% | 21% |
| Furniture and equipment | 4,231 | 4,863 | 4,995 | -13% | -3% |
| Marketing | 2,506 | 2,262 | 1,191 | 11% | 90% |
| Prepayment fee | — | — | 2,594 | | |
| Other expense | 13,125 | 10,799 | 15,806 | 22% | -32% |
| Total noninterest expense | <u>62,479</u> | <u>59,561</u> | <u>59,529</u> | <u>5%</u> | |
| Income before income tax expense | <u>51,231</u> | <u>51,133</u> | <u>44,030</u> | <u>0%</u> | <u>16%</u> |
| Income tax expense | 12,403 | 12,566 | 8,697 | -1% | 44% |
| Net income | <u>38,828</u> | <u>38,567</u> | <u>35,333</u> | <u>1%</u> | <u>9%</u> |
| Net income per share information: | | | | | |
| Basic | <u>1.41</u> | <u>1.42</u> | <u>1.35</u> | | |
| Diluted | <u>1.38</u> | <u>1.37</u> | <u>1.3</u> | | |
| Cash dividends per share | <u>0.75</u> | <u>0.68</u> | <u>0.59</u> | | |
| Weighted average number of common shares: | | | | | |
| Basic | 27,515,630 | 27,147,992 | 26,244,807 | | |
| Diluted | 28,085,920 | 28,062,489 | 27,148,029 | | |

Income Statement Excerpt from HNBC's 2005 10-K

| | | |
|--|---------|-----------------------------------|
| Interest income | | |
| Loans, including fees | 111,510 | |
| Letter financing | 2,899 | |
| Investment securities | | |
| Treasury | 13,929 | |
| Foreign Government securities | 18,840 | |
| Federal funds sold and securities purchased | 1,451 | |
| Deposits on hand | 180 | |
| Total interest income | 151,739 | Interest Income (151,739) |
| Interest expense | | |
| Savings and money market deposits | 12,310 | |
| Time under \$100,000 | 18,514 | |
| Time \$100,000 or greater | 7,814 | |
| Short-term borrowings | 1,971 | |
| Long-term borrowings | 15,999 | |
| Total interest expense | 64,618 | Interest Expense (64,618) |
| Net interest income | 87,121 | |
| Provision for loan losses | 3,401 | Provision for Loan Losses (3,401) |
| Net interest income after provision | 83,720 | |
| Noninterest income | | |
| Service charges | 8,262 | |
| Gains on sales of investment securities, net | 4,794 | |
| Gains on sale of loans | 488 | |
| Trust, administrative services and advisory | 4,851 | |
| Bank-owned life insurance income | 2,234 | |
| Income on life insurance | 171 | |
| Other income | 7,342 | |
| Total noninterest income | 29,990 | Non-Interest Income (29,990) |
| Net income before income taxes | 113,710 | Sales (113,710) |

Interest Income

- Fees from loans
- Fees from investments
- Typically charged competitively based on what the market will allow

Interest Expense

- Fees paid to depositors as interest
- An expense to the bank for earning interest income
- Typically kept as low as market conditions will allow

Provision for Loan Loss

- An expense set aside as an allowance for bad loans
 - Bad loans are:
 - customer defaults
 - terms of loan that must be renegotiated
 - Etc.
- Not found in the expenses section of the income statement

Provision for Loan Loss (Cont'd)

HARLEYSVILLE NATIONAL CORPORATION AND SUBSIDIARIES
NONPERFORMING ASSETS

| | December 31, | | | | |
|--|--------------|------|--------|--------|--------|
| | 2005 | 2004 | 2003 | 2002 | 2001 |
| Allowance for loan losses to total loans | 1 % | 1 % | 1.19 % | 1.29 % | 1.18 % |

- Also used as a valuation measure
 - Should be less than 1% when compared to total investment loans
 - Pay attention to upward trends over time
 - Pay attention to growth rates above the industry or direct competitors

Provision for Loan Loss (Cont'd)

HARLEYSVILLE NATIONAL CORPORATION AND SUBSIDIARIES
NONPERFORMING ASSETS

| | December 31, | | | | |
|--|--------------|--------|--------|--------|--------|
| | 2005 | 2004 | 2003 | 2002 | 2001 |
| Nonperforming loans to total loans | 0.42 % | 0.31 % | 0.32 % | 0.47 % | 0.65 % |
| Allowance for loan losses to total loans | 1 % | 1 % | 1.19 % | 1.29 % | 1.18 % |

- It is also helpful to compare this valuation measure to the ratio Non-performing (late) loans to total investment loans
 - This comparison is an indication of a bank's ability to absorb any increase in loan problems
 - A provision for loan loss that is at least twice the ration of non-performing loans to total investment loans is considered good

Non-Interest Income

- Fees earned from fee-based banking services
- Trust Department Fees
- Mortgage Servicing Income
- Derivative Activities
- Gains from sales from assets like loans and securities

Non-Interest Income (Cont'd)

- Games that banks play
 - Including in Non-Interest Income items that are not part of the normal course of business
 - Gains on sales of securities
 - Gains on sales of mortgages
 - When income in this area appears exceptional, check for consistency with prior periods on such figures

Non-Interest Expenses

- Similar to expense section on a typical income statement
- Includes compensation, occupancy, outsourced services, telecommunications, amortization of goodwill, etc for day to day operations

Non-Interest Expenses (Cont'd)

- Pay particular attention to a host of expenses lumped together as "Other"
- Use SEC Form 10-Q to get a more detailed breakdown of these expenses

Assessing Growth

- Banks with moderate growth rates have ROE's in the mid-teens
- Rough estimate of long-term growth
 - = ROE x (1 - Payout Ratio)
 - This calculation provides a growth rate that a company might be expected to achieve if it can reinvest its retained earnings at the same return it received on previous equity capital

Calculating a Long-term Estimate of EPS Growth for HNBC

From page 2 of the SSG

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 5-YR Avg. Rate | TREND |
|----------------------|------|------|------|------|------|------|------|------|------|------|-------------------|-------|
| B % Return on Equity | 14.7 | 15.2 | 15.3 | 17.2 | 18.7 | 14.9 | 15.8 | 15.4 | 14.0 | 13.8 | 14.8% | DOWN |

| Year | A ROE | | C Payout Ratio | D Risk-Adjusted Rate | | E Dividend Yield | G % Retained Earnings | F % EPS Growth |
|---------|---------|---------|----------------|----------------------|-----------|------------------|-----------------------|----------------|
| | HIGH | LOW | | HIGH (A-D) | LOW (B-C) | | | |
| \$ 2000 | \$24.62 | \$17.79 | \$7.31 | 18.9 | 13.6 | \$0.72 | 55.0% | 6.2% |

$$\begin{aligned}
 &= \text{ROE} \times (1 - \text{Payout Ratio}) \\
 &= 13.8\% \times (1 - 55\%) \\
 &= 6.2\%
 \end{aligned}$$

Summary

- ❑ Banks are a “Spread Business”
 - ❑ The Provision for Loan Loss is a key valuation measure to monitor if you own, or when purchasing a bank stock
 - ❑ It is important to understand significant changes in Non-Interest Expense by using 10-Q and 10-K statements
 - ❑ Evaluating growth rates of ROE and using ROE to estimate earnings growth are helpful measures in assessing a bank’s future prospect for growth
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