Introduction to Bank Financial Statements

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Bank Financial Statements

- **Balance Sheet: Assets = Liabilities + Equity**
  - **Assets:** What we own
    - Around 90% of assets are financial claims (loans and securities)
  - **Liabilities:** What we have borrowed
    - Deposits and other borrowings
  - **Equity:** The shareholder's financial interest
    - Ownership position

- **Income Statement: Profit = Revenue – Expense**
  - Revenue (income)
    - Interest earned, fees, and "gains"
  - Expense (costs)
    - Int paid, non-int expense, "losses," loan loss provisions, and taxes
  - Profit (net income) – belongs to shareholders

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Bank's Primary Purpose

Financial Intermediation (facilitate transfer of funds)

→ take deposits

→ make loans

For most banks:

→ Loans are the biggest asset

→ Deposits are the biggest liability

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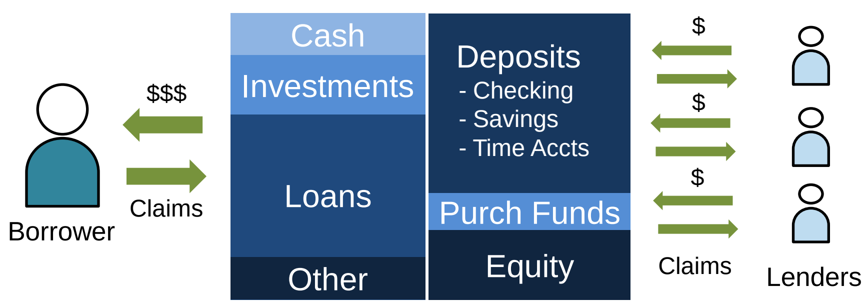
Basic Components of Balance Sheet



- Need cash
  - Transactions and reserves
- Offices and equipment
- "Excess" funds or "safe/liquid" assets?

- Many types of deposits
- Owner investment
  - Depositor confidence
- If deposits & equity are not sufficient to meet needs?

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Complication: Accounting for Credit Risk

- Loans on the balance sheet are generally net loans
  - **Net loans = Gross (total) loans – Loan loss reserve**
- Loan loss reserve is a balance sheet item
  - a.k.a., Allowance for Loan Losses (Loan Loss Allowance)
  - ***Amount based on expected future losses***
  - Contra Asset Account ("subtracted from assets")
- **Good news**: Belongs to the shareholders
- **Bad news:** Money we expect to lose (not collect)

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BankExec Balance Sheet

Assets	12/31/29
Cash Items	38.162
Fed Funds Sold	0.000
Securities	64.843
Loans (Net)	628.240
Business	217.663
Real Estate	312.068
Consumer	104.856
Other	0.000
Loan Loss Reserve	-6.346
Premises	15.462
Other Assets	34.386
Total Assets	781.093
Liabilities and Equity	
Total Deposits	671.270
Checking Accounts	158.938
Savings Accounts	241.252
Retail Time Accounts	233.944
Corporate CDs	37.137
Borrowed Funds	29.175
Repurchase Agreements	0.000
Fed Funds Purchased	29.175
FHLB Borrowing	0.000
Other Liabilities	29.026
Subordinated Debentures	4.000
Owners Equity	47.622
Total Liab & Equity	781.093

Net Loans	628.240
+LLR	6.346
Total Loans	634.586

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Balance Sheet ***Drives*** Income Statement

Balance Sheet	**Income Statement**
Earning Assets	Interest Income
	minus
Liabilities	Interest Expense
	Net Interest Income
Asset Quality	***Loan Loss Provision***
If sold:	***Capital Gains/Losses***
	Non-Int Inc and Non-Int Exp

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Loan Losses and the Income Statement

- Loan Loss Provision
  - a.k.a., Provision for Loan Losses
  - Amount subtracted from earnings each period to cover loan losses
  - Loan Loss Provisions can be required for several reasons
    - Provisions for new loans (growth)
    - Provisions for unexpected losses
    - Provisions due to changes in expectations about existing loans
- Loan Loss Provision (LLP) and Loan Loss Reserve (LLR)
  - Think of LLP as deposit into savings account
  - Think of LLR as the current balance of the savings account
  - Withdrawals are made from LLR to pay for actual loan losses

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Income Statement

Interest Income
- Interest Expense

Net Interest Income
- Loan Loss Provision

Net Interest Income after LLP
+ Noninterest Income
- Noninterest Expense
+ Capital Gains/Losses

Income Before Taxes
- Taxes

Net Income

Net Interest Income
- Loan Loss Provision
- Burden
+ Capital Gains/Losses
- Taxes

Net Income

Burden = Noninterest Expense – Noninterest Income

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BankExec Income Statement

	12/31/29
Interest Income	11.081
Loans	10.296
Business	3.468
Real Estate	4.945
Consumer	1.884
Other	0.000
Securities: Taxable Income	0.527
Securities: Tax-exempt Income	0.256
Federal Funds Sold	0.001
Interest Expense	5.681
Checking Accounts	0.104
Savings Accounts	1.924
Retail Time Accounts	3.152
Corporate CDs	0.333
Borrowed Funds	0.116
FHLB Borrowing	0.000
Subordinated Debentures	0.053
Net Interest on Swaps	-0.027
Net Interest Income	5.372
Service Charges & Other Income	2.808
Loan Loss Provision	1.209
Operating Expenses	6.379
Salaries and Benefits	4.540
Advertising - Promotion	0.100
Occupancy & Other Op.Expenses	1.740
Operating Earnings	0.593
Gains/Losses on Asset Sales	0.000
Income Taxes	0.134
Net Income	0.458

NonInt Income → Service Charges & Other Income

NonInt Expense → Operating Expenses

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Income Statement Notes

- For most banks:
  - Net interest income is the largest portion of income
    - Financial intermediation is where banks make most of their earnings
  - Loan loss provisions vary over time
    - Driven primarily by changes in economy
    - Possible changes in risk taking by bank
  - Non-interest expense exceeds non-interest income
    - Burden = NonInt Expense – NonInt Income
    - In most cases, burden must be covered by net interest income
  - Capital gains/losses are quite small on average
  - Dividends are not on the income statement
    - Dividends are paid out of net income (profit)
    - They are declared by the Board of Directors and management

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Some of the Many Banking Risks

- Credit (default) risk
  - Charge-off ratio
  - Non-performing loan ratio
- Concentration risk
  - Percentage of loans/assets in various areas
- Interest rate risk
  - Earnings risk
    - Gap ratios and earnings sensitivity
  - Price risk
    - Average duration (or maturity) of assets
- Liquidity risk
  - Funds available when needed (withdrawals, opportunity)
- Capital (insolvency) risk
  - Equity capital ratio
  - Risk-based capital ratio

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