

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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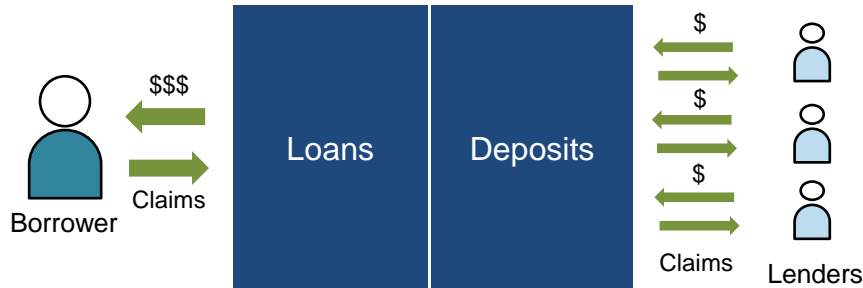
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Bank's Primary Purpose

Financial Intermediation (facilitate transfer of funds)

→ take deposits

→ make loans



For most banks:

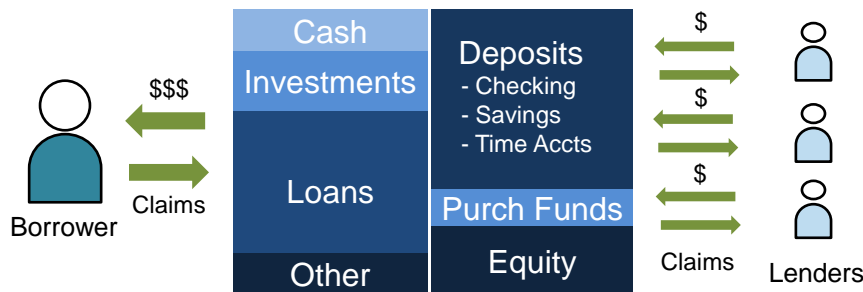
→ **Loans are the biggest asset**

→ **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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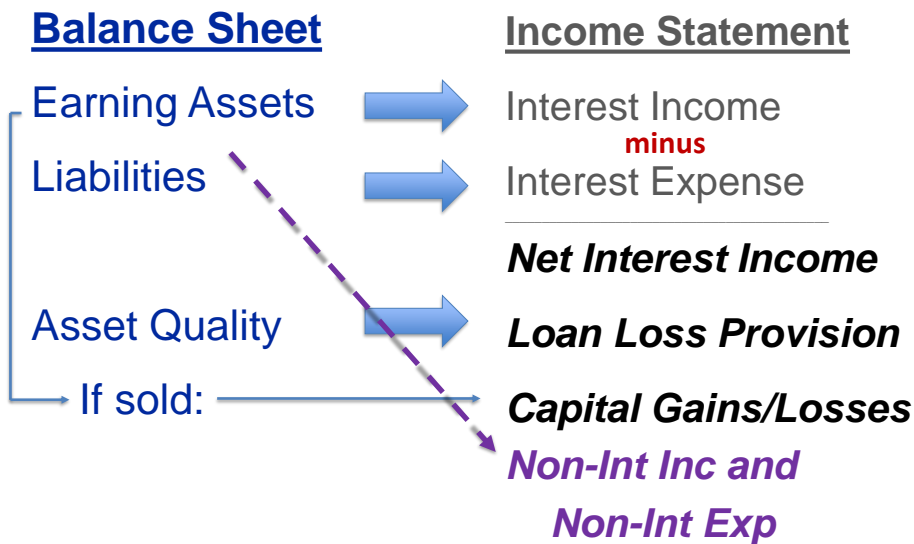
BankExec Balance Sheet

===== Assets =====		12/31/29		
Cash Items		38.162		
Fed Funds Sold		0.000		
Securities		64.843		
Loans (Net)		624.280	Net Loans	624.280
Business		217.663		
Real Estate		310.068		
Consumer		102.856		
Other		0.000		
Loan Loss Reserve		-6.306	+LLR	6.306
Premises		15.462		
Other Assets		34.386	Total Loans	630.586
Total Assets		777.133		
=== 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		29.221		
Repurchase Agreements		0.000		
Fed Funds Purchased		29.221		
FHLB Borrowing		0.000		
Other Liabilities		29.017		
Subordinated Debentures		0.000		
Owners Equity		47.625		
Total Liab & Equity		777.133		

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Balance Sheet *Drives* Income Statement



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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	Net Interest Income
- <u>Interest Expense</u>	- Loan Loss Provision
Net Interest Income	- Burden
- <u>Loan Loss Provision</u>	+ Capital Gains/Losses
Net Interest Income after LLP	- <u>Taxes</u>
+ Noninterest Income	<i>Net Income</i>
- Noninterest Expense	
+ <u>Capital Gains/Losses</u>	
Income Before Taxes	
- <u>Taxes</u>	
<i>Net Income</i>	

Burden =
Noninterest Expense
– Noninterest Income

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BankExec Income Statement

		12/31/29
	Interest Income	11.043
	Loans	10.260
	Business	3.468
	Real Estate	4.930
	Consumer	1.862
	Other	0.000
	Securities: Taxable Income	0.527
	Securities: Tax-exempt Income	0.256
	Federal Funds Sold	0.000
	-----	-----
	Interest Expense	5.645
	Checking Accounts	0.104
	Savings Accounts	1.924
	Retail Time Accounts	3.152
	Corporate CDs	0.333
	Borrowed Funds	0.133
	FHLB Borrowing	0.000
	Subordinated Debentures	0.000
	Net Interest on Swaps	-0.027
	Net Interest Income	5.371
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NonInt Income	→ Service Charges & Other Income	2.737
	Loan Loss Provision	1.169
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NonInt Expense	→ Operating Expenses	6.343
	Salaries and Benefits	4.505
	Advertising - Promotion	0.100
	Occupancy & Other Op. Expenses	1.738
	Operating Earnings	0.596
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	Gains/Losses on Asset Sales	0.000
	Income Taxes	0.135
	=====	=====
	Net Income	0.461

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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
 - $\text{Burden} = \text{NonInt Expense} - \text{NonInt Income}$
 - 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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