The Burden Ratio
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White Paper

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THE IMPORTANCE OF THE BURDEN RATIO

THE BURDEN RATIO: THE NEW IMPERATIVE FOR PERFORMANCE

Banking CFOs have embraced many norms with financial ratios over the years. Unfortunately, nearly all of them fail to explain what you really need to know.

Remember having the CFO running the bank by the Non-Interest Expense to Assets ratio? The CFO even typically had Marketing create a logo or slogan, ***Break 3***. Unfortunately, this was a short-sighted vision on how to improve financial performance by indexing non-interest expenses at 3.00% as an arbitrary measure of assets, without any connection to the contribution to earnings being generated by the areas being cut or eliminated to meet this goal. You have to love the simplicity of the Eighties.

Conversely, have you ever worked with a CFO who knelt at the Efficiency Ratio altar? Breaking the 60% (or 50%- 55%) Efficiency Ratio barrier was considered an organizational imperative. The problem that people often found though was that only the ratio numerator, (again) Non-Interest Expenses, was under scrutiny. Many have concluded that an expansive franchise strategy coupled with multiple non-banking business lines could not be cut to cover for a lower yielding portfolio and investment strategy. The Efficiency Ratio has two components that require equal scrutiny: expenses and revenue.

While these two ratios certainly continue to have contextual value, our experience in analyzing industry performance has led us to the Burden Ratio as another very important measure of predicting financial performance, especially given the long and projected continuing duration of lowered Net Interest Margin.

Why the burden ratio?

Within financial organizations, committees are focused upon the Net Interest Margin. How often have you heard anyone bring forth the Burden Ratio as a critical measure in one of these meetings? Our bet would be never. The Burden Ratio is the measure of the difference between Non-Interest Income and Non-Interest Expenses expressed as a ratio to Average Assets. Breaking it down, the Burden Ratio measures how the Net Asset Yield (Net Interest Income/Average Assets) will be burdened by the net expenses of the institution; how much of your Net Interest Margin must you give up to run the business?

The ratio is typically shown as the difference between Non-Interest Expenses less Non-Interest Income over Average Assets. We favor the less traditional method of reversing the order of subtraction as Non-Interest Income less Non-Interest Expense over Average Assets. In this way, the ratio almost always is a negative number, and it is easier to visualize that it is the net reduction (or burden) to Net Interest Income that combines towards overall earnings.

Consider the following example to illustrate the ratio:

Period Average Assets:	**$1,500,000,000**	**As % Assets**
Interest Income	$59,700,000	
Interest Expense	$5,100,000	
Net Interest Income	$54,600,000	3.64%
Non-Interest Income	$29,550,000	
Non-Interest Expense	$48,600,000	
Burden Ratio ($29.55M-$48.6M)	**-$19,050,000**	**-1.27 %**
Net Income (Before Provision, Securities Gains and Taxes)	$35,550,000	2.37 %

Why the Burden Ratio? It is the one measure focused outside of the Net Interest Margin that evaluates the coverage of the expense to operate the franchise and its subsidiaries with the fees being generated by the banking franchise *and its subsidiaries*. With the Prime Rate remaining at 3.25% for the past six plus years and funding costs under 1.00%, it is the varied and sustainable sources of fee revenues that have buoyed many organizations. The Burden Ratio gives a single measure as to the fee generation effectiveness compared against the expense base to generate this income.

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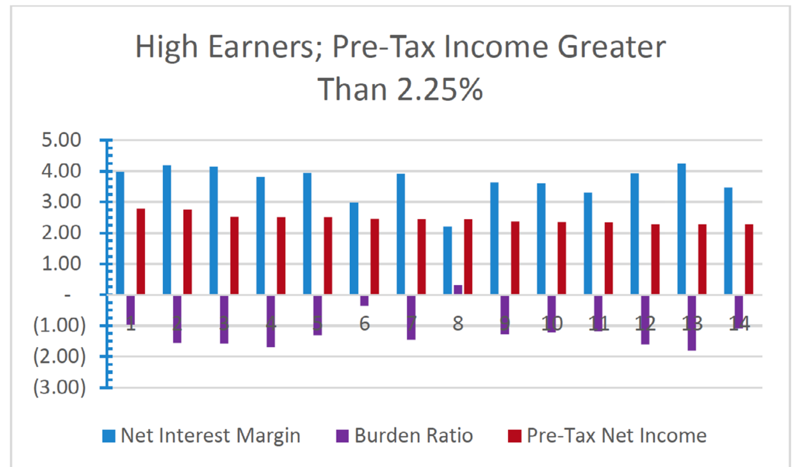
How do I know what is good?

Consider the following comparison based upon the most recent December 31, 2014 FDIC call reporting. Two populations were selected from institutions greater than $1.00 billion dollars in assets to $20.0 billion in assets to illustrate the importance of the Burden Ratio. The first population reported pre-tax earnings of greater than 2.25% of average assets. We did screen to focus upon traditional full service financial institutions. The second population was selected because their pre-tax earnings were less than 1.00%.

Twenty-eight institutions were placed into the two populations and are identified as either High Earners, or Low Earners.

This graph illustrates the relationship of Net Interest Margin and the Burden Ratio to reported Pre-tax Net Income.



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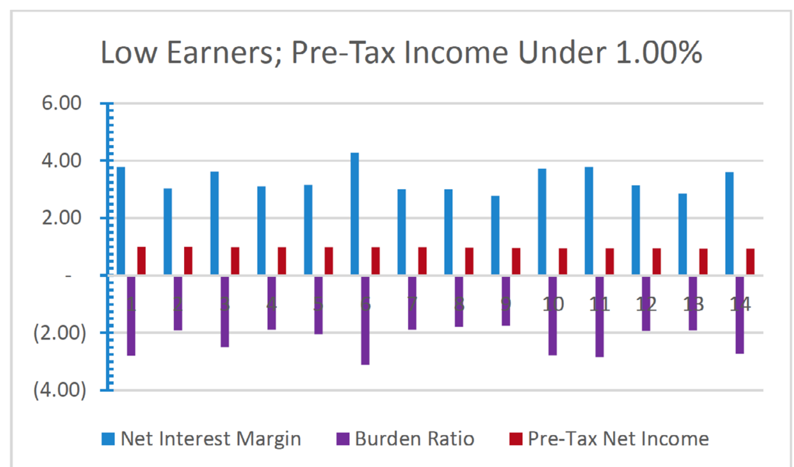

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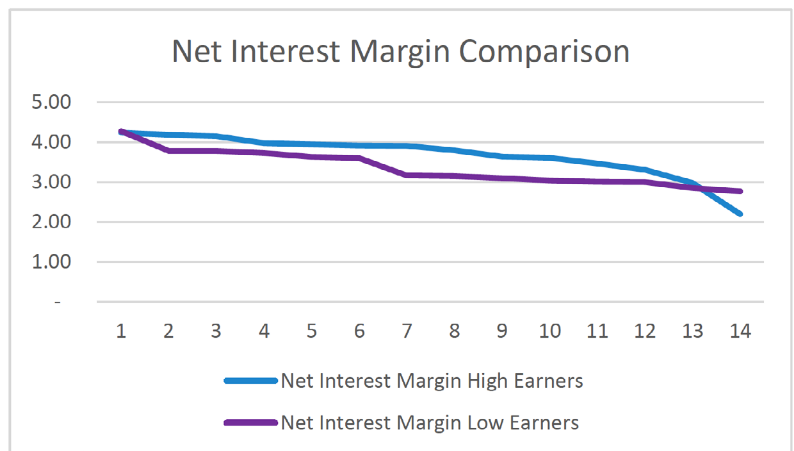
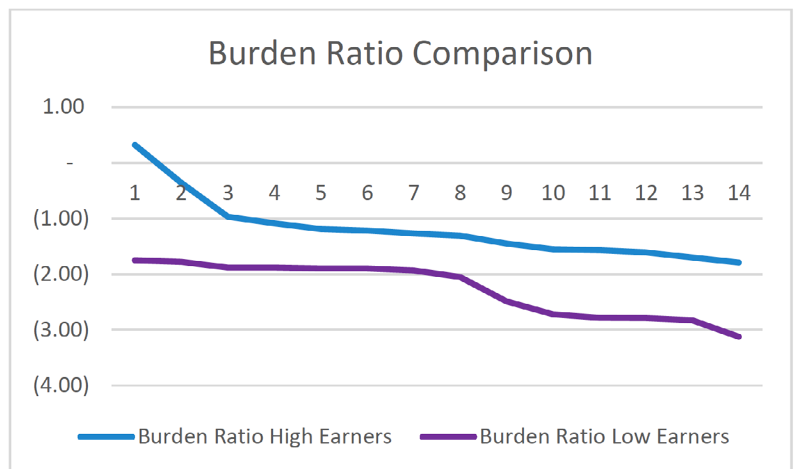
Note the relative proximity in Net Interest Margin between the two populations, yet the relative disparity between the Burden Ratio. This is more easily seen by ranking each of these ratios across each population and charting them comparatively as follows:

This graph illustrates the minimal differentiation in Net Interest Margin between the two populations.



This graph illustrates the substantive differentiation in Burden Ratio between the two populations.



CONCLUSION

Through these illustrations, we can see that the difference between these two groups of high versus low earning institutions is best defined by the difference in the Burden Ratio. Keep in mind that these organizations are separated by a minimum of 1.25% in Pre-Tax Net Income expressed as a percentage to average assets. This difference in the two populations of Pre-Tax Net Income is itself, greater than the Lower Earner total reported results. While the Net Interest Margin and the inherent risk associated with loan and securities portfolios are not being discounted, we are asserting that the Burden Ratio components and relationship are equally indicative of overall financial success. Based upon our experience with analyzing the Burden Ratio, we would identify -1.75% as the target threshold ratio for performing institutions.

While many organizations have the benefit of constrained infrastructure and costs, most will not be able to “cut their way to greatness” to improve this ratio. The options to lever impact upon the Burden Ratio most often will lead to the need for expanded Non-Interest Income. And therein lies the problem. In the current and evolving regulatory environment, fee income sources from deposit and loan accounts have become restrained, whether it be from the CFPB, Dodd-Frank or the Credit Card Act, and they will seemingly continue to decline as consumerist policies of abdicated personal financial responsibility expand.

The answer to improving the Burden Ratio lies in the need to expand fee income sources on existing and new products and services and ensure that the fee income you are due is not being manually waived, systemically reversed or not captured.

ABOUT MITRATECH

Mitratech is a proven global technology partner for corporate legal, risk & compliance, and HR professionals seeking to maximize productivity, control expense, and mitigate risk by deepening operational alignment, increasing visibility and spurring collaboration across their organization.

With Mitratech's proven portfolio of end-to-end solutions, organizations worldwide are able to implement best practices and standardize processes across all lines of business to manage risk and ensure business continuity.

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