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## Calculating the Net Margin

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### What is Net Margin?

The net margin tool should be an important component of an asset-liability management program. The net margin tool provides a picture of how well the financial institution is covering its cost of funds and operating expenses with its earnings on assets.

The definition of *net margin* is all sources of revenue less the cost of funds and operating expenses. Net margin provides a broader picture than *net interest margin*, which measures all interest earned and collected from loans and investments less the cost of funds. The principal difference between the two concepts is that other sources of income and operating expenses are included in the net margin calculation so that a net spread between all assets and liabilities is computed.

The net margin (percentage or amount) should always be positive. A positive net margin signals that the financial institution is generating sufficient income from its assets to cover the cost of funds paid on savings products and on other sources of funds, as well as its operating expenses. A negative net margin means the opposite, that the institution is not generating enough income to cover costs. The measurement of yield on assets and cost of funds on liabilities can also provide managers with a tool to measure the efficiency of their own financial institution compared to competitors in the same market.

Managers should run the calculation of net margin regularly to monitor whether or not the institution is covering its costs, since a change in either assets or sources of funds will change the outcome. The following table presents a simple mechanism to calculate the net margin.

## Using the Tool

1. The amounts for Net Loans, Cash, Investments, Other Assets, Fixed Assets, Current Liabilities, Dividends Payable, Demand and Fixed-term Deposits, Programmed Savings, Capital, and Net Income are taken directly from the institution's balance sheet and entered into the first column.
2. In the second column, the asset mix is calculated by dividing each asset by the total assets. The Mix column shows managers what percentage each asset makes up of total assets. In this example, Net Loans make up 75 percent of assets, Cash is 0.40 percent of assets, Investments are 22.47 percent of assets, Other Assets are 0.52 percent, and Fixed Assets are 1.60 percent of assets.

The cost of funds Mix is calculated by dividing each source of funds by the total funds. Current liabilities make up 0.63 percent of funds, Dividends payable (in credit unions) 0.34 percent, Demand and Fixed-term Deposits 91.34 percent, Programmed Savings 0.25 percent, Capital 7.24 percent, and Net Income 0.19 percent.

3. The example assumes data as of April; therefore, the annualized rates are calculated by multiplying the income/asset by 3. The annualized interest rate on loans is 8.23 (\$1,283,448) and the annualized return on investments is 2.47 percent (\$115,209). In the third column the total income earned on assets is calculated to be \$1,398,697.

The annualized rates on liabilities are calculated by multiplying the cost/liability by 3. The annualized rate paid out on demand savings deposits and fixed-term deposits is 3.60 percent. The annualized rate paid out on Programmed Savings is 4.35 percent. The total cost of funds is \$684,997.

4. The Gross Spread is calculated by subtracting the total paid out on Demand and Fixed-term Savings (\$682,752) and Programmed Savings (\$2,245) from the income earned on Total Assets (\$1,398,697). The Gross Spread in this example is \$713,700.
5. The Net Margin is calculated by subtracting Operating Expenses (\$594,351—taken directly from the Statement of Income) from Gross Spread. In this example, the Net Margin is \$119,349, or 0.57 percent.

With a positive Net Margin, the financial institution in this example is covering its costs.

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**INSTITUTION**  
**Yield on Assets**  
**As of DATE**

ASSETS		MIX	INCOME	ANNUALIZED RATE
Net Loans	46,771,027	75.00%	1,283,488	8.23%
Cash	250,200	0.40%		
Investments	14,011,266	22.47%	115,209	2.47%
Other Assets	326,141	0.52%		
Fixed Assets (Net)	999,129	1.60%		
<b>Total Assets</b>	<b>62,357,763</b>	<b>100.00%</b>	<b>1,398,697</b>	<b>6.73%</b>

COST OF FUNDS			COST	
Current Liabilities	394,017	0.63%		
Dividends Payable	210,183	0.34%		
Demand and Fixed-term Deposits	56,960,274	91.34%	682,752	3.60%
Programmed Savings	154,794	0.25%	2,245	4.35%
Capital	4,516,901	7.24%		
Net Income	121,595	0.19%		
<b>Total Cost of Funds</b>	<b>62,357,763</b>	<b>100.00%</b>	<b>684,997</b>	<b>3.30%</b>
<b>GROSS SPREAD</b>			<b>713,700</b>	<b>3.43%</b>
Less Operating Expenses			594,351	2.86%
<b>NET MARGIN</b>			<b>119,349</b>	<b>0.57%</b>

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