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HOW BANKS CAN THINK DIFFERENTLY ABOUT MARGIN PLANNING

EIGHT TECHNOLOGY CAPABILITIES BANKS NEED TO CONNECT THE DOTS BETWEEN FORECASTS, PROFITABILITY AND RISK

By Kyle Duckers

Bank planning has devolved from a crucial decision-making exercise to a rote administrative process. Because of the need for forecasts to support stress tests, new current expected credit loss (CECL) accounting standards and other regulatory submissions, financial institutions have an opportunity to transform planning into a mechanism that not only bolsters the accuracy of earnings projections, but also serves as a conduit to improved performance.

Banks are the purest manifestation of a fundamental business concept: the interplay between risk and return. No process reflects this more than banks' approach to forecasting.

How often have we seen stocks fall on a missed earnings projection? Consistently hitting earnings targets not only is valuable on its own, but reduces the perceived risk to shareholders and customers as well. Unfortunately, as banks rely on average portfolio forecasts and other simplified assumptions, the ability to pinpoint an accurate forecast is lost.

Over time, the mechanisms used to track risk, including asset liability management (ALM) and stress testing, have diverged from the planning and budgeting tools used to plan future performance. Forecasts and plans are developed with profitability in mind, often with a desire to assign ownership and accountability for achieving these goals across the organization. ALM and stress tests focus exclusively on risk measurement and management and typically take a total company perspective. In many instances, the two perspectives struggle to mesh.

For financial services institutions, the role of budgeting and forecasting has expanded beyond earnings projections. The data involved in these processes have far-reaching applications, from supporting new accounting standards and stress testing to regulatory submissions, such as Comprehensive Capital Analysis and Review (CCAR), Basel Committee on Banking Supervision (BCBS) frameworks and CECL. Banks' budgeting and forecasting groups must partner with treasury and risk teams to not only improve projected earnings, but help other parts of the organization strengthen their performance.

To stay competitive in a volatile economic and regulatory environment, banks need a framework for connecting each future decision, forecast or outcome to its impact on profitability and risk.

Technology, though far from a panacea, is a crucial element in developing plans that link risk and return. Finding the right tool for the job, however, takes careful vetting.

To transform your bank's planning methods and develop more accurate earnings forecasts, look for a solution that lets your team:

1. Forecast the Entire Balance Sheet

In most industries, the first step in planning is to start with the income statement. In turn, this informs changes to the balance sheet composition going forward. Banks flip this paradigm on its head.

An overwhelming share of a bank's earnings (specifically, its net interest margin and a significant share of its noninterest expense and income) comes from its loan and deposit product lines — its assets and liabilities, respectively. Rather than earnings driving the balance sheet, earnings are driven by the balance sheet. Because margin planning is essentially a bank's sales forecasting, any tool you use should be able to establish driver-based relationships between the growth goals of products reflected on the balance sheet and the sales (or other activities) required to meet them.

A balance sheet needs to do exactly that: balance. A valuable margin planning solution must accommodate each business line's forecasting requirements while also consolidating disparate information into a cohesive set of financial statements.

The balance sheet has to include not only loan and deposit products, but also line items such as cash, furniture, fixtures and equipment (FF&E), reserves, the loss allowance (especially under the new CECL standards) and required capital. Those logical relationships are essential to accurate balance sheet projections and to maintaining the tie between risk and return.

2. Integrate Known Cash Flows

Banks already have an enormous amount of information about future events. They simply need to consider the contractual requirements of loan and deposit instruments (along with knowledge of the investment portfolio and borrowings) to project what will happen during a forecasted period.

However, due to a historical inability to collect and organize this information in a consumable way, plans are often built upon average outstanding or back-of-the-envelope assumptions about customers. The ability to build up your current book of business from individual instruments, simply by using the information you already possess, is key to developing accurate margin forecasts.

3. Reflect Customer Behavior

Coupled with contractual payment, maturity and repricing information, assumptions about customer behavior — such as prepayments, loans that do not perform and characteristics of product usage — complete the forwardlooking picture. Where possible, tie that behavior to economic drivers to facilitate what-if analysis and stress testing. Examples of customer behavior to analyze include prepayment assumptions, early redemptions, differing behavior of nonterm products, seasonality of credit line utilization rates and changes in loan quality under various economic scenarios.

4. Incorporate Funds Transfer Pricing

To break out the specific returns achieved for each risk assumed, funds transfer pricing (FTP) is critical for managing both actual and future performance. An effective FTP mechanism transfers the inherent interest rate and liquidity risks your bank has accepted in making loans and taking deposits to the treasury department, where they can be centrally managed. This immunizes line units from market interest rate risks and fluctuations, letting them focus exclusively on what they can control: the pricing spread above or below a benchmark cost of/credit for funds. This simplifies planning efforts and strengthens buy-in to the plan or forecast.

A focus on what the planner can control is a hallmark of best-practice planning. Transfer charges and credits should be established for every balance sheet line item to isolate the amount of interest rate risk exposure embedded in forward-looking balance sheets.

5. Apply Key Drivers in the Forecasting Process

Expense budgets are often assembled based on a combination of negotiation skills and simplified growth projections (e.g., “we expect IT expenses to increase by 3% next year”), upping the chance of inaccuracies in bank forecasts. Your bank needs a way to connect expenses to portfolio and new business volume projections in order to develop a precise understanding of cost drivers and more closely align budgets with planned activity.

6. Adapt to Market Interest Rates and Other Macroeconomic Variables

Perhaps no business is more affected by local and macroeconomic variables than a bank. Future interest rate levels, economic activity and inflation each have significant influence over loan and deposit growth, portfolio repricing and bank expenses.

The more these variables can drive balance sheet projections, the easier it is to complete stress tests under different economic circumstances. When vetting potential planning tools, look for solutions that centralize, standardize and automatically apply assumptions about economic factors throughout the entire forecast.

7. Differentiate Business as Usual From Strategic Initiatives

Most of the time, board-driven approvals of future bank initiatives (not a review of minutiae) push plans over the finish line. When these strategic projects cannot be disentangled from the complete plan, forecasters often create isolated spreadsheets to finalize plans with and without these investments. Rather than perpetuate shadow planning and version control problems, find a planning solution that lets your team differentiate individual strategies from business as usual plans.

8. Manage in a Controlled and Auditable Process

Budgets, plans and forecasts have historically been internally focused processes designed to better manage the organization. Though these practices have been less structured than traditional accounting procedures, the tide is turning. In today’s regulatory climate, planning and forecasting must be held to the same control, transparency and auditability standards as financial processes that look at and report on actual results.

The updated CECL accounting rule for maintaining loss allowances, announced in 2016, is a direct reflection of this new reality. For the first time, an accounting standard requires a projection of future events instead of relying solely on measurable historical facts. Combined with stress testing and other regulatory scrutiny, forecasting tools are no longer internal-only, managerial tools. This shift means the tools used to support forecasts must pass the same muster as traditional accounting and other back-office systems.

Ensuring returns are commensurate with risks assumed is a hallmark of sound bank operations. Improved risk-adjusted returns are the culmination of effective risk and return management. By breaking forecasts, profitability and risk modeling out of their respective silos, bank leaders can guide their institutions toward improved, predictable performance.

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19-2225