Improving the Value of Margin Planning

8 CAPABILITIES BANKS NEED TO CONNECT THE DOTS BETWEEN BUDGETING AND FORECASTING, PROFITABILITY AND RISK.

By Kyle Duckers

The active management of risk and return for financial institutions has never been more critical. Looking ahead is no longer a once-a-year analytics exercise, with regulation and accounting standards such as current expected credit losses (CECL) and stress testing now required for institutional compliance. When done correctly, these requirements can serve as an opportunity to transform planning into a mechanism that improves the accuracy of earnings projections and strengthens performance.

How often do 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. This reduction of perceived risk, on its own, can have a positive effect on shareholder value. Forecasts that rely on average portfolio predictions and other simplified assumptions cannot accurately forecast earnings.

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. Yet over time, the mechanisms used to track risk, including asset and liability management (ALM), CECL, and stress testing, have diverged from the planning and budgeting tools used to plan future performance. Banks develop forecasts and plans with profitability in mind, often wanting to assign ownership and accountability for achieving those 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 views struggle to mesh. To stay competitive in a volatile economic and regulatory environment, banks need a framework for connecting each future decision, forecast or outcome to its potential impact on profitability and risk.

To transform your bank's planning methods and develop more accurate earnings forecasts, take an approach that adopts the following concepts:

1. Forecast the Entire Balance Sheet

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

An overwhelming percentage of a bank's earnings (specifically, its net interest margin and a significant share of its noninterest expense) comes from loans and deposits. If you are a banker, it is second nature to know your "products" sit on your balance sheet and that the balance sheet drives earnings. To put it another way: Balance sheet planning is forecasting based on the balance sheet results, factoring both assets and liabilities that impact the overall risk position of the bank.

A balance sheet needs to balance. A valuable margin planning solution must accommodate each business line's forecasting requirements while consolidating disparate information into a cohesive set of financial statements. The balance sheet should include loan and deposit products and line items such as cash and reserves, receivables and payables, the treasury portfolio, the allowance for loan and lease losses (ALLL) and required (economic) capital. These relationships are essential for accurate balance sheet projections that reflect the full effects of loan and deposit growth.

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 forecast period.

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

3. Reflect Customer Behavior

Assumptions about customer behavior (such as prepayments, loans that don't perform, and product usage characteristics) complete the forward-looking picture when coupled with contractual payment, maturity and re-pricing information. Whenever possible, that behavior should be tied to economic drivers to facilitate what-if analyses and stress testing. Examples of customer behavior to analyze include:

- Prepayment assumptions.
- Early redemptions.
- The differing behavior of nonterm products.
- The seasonality of credit line utilization rates.
- 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 a must for managing actual and future performance. An effective FTP mechanism transfers the inherent interest rate and liquidity risks that your bank has accepted in making loans and taking deposits to the treasury department, where they can be centrally managed. This transfer 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 cost-of-credit-for-funds benchmark. This simplifies planning efforts and strengthens buy-in to the plan or forecast. Additionally, financial organizations should establish transfer charges and credits for every balance sheet line item to isolate the amount of interest rate risk exposure embedded in forward-looking balance sheets.

5. Apply KeyDrivers 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. Banks need to connect expenses to portfolio and new business volume projections to develop a precise understanding of cost drivers and more closely align budgets with planned activity. Build a future expense budget based upon what will be needed to drive performance, not on who is the best negotiator or by just adding a few dollars to last year's plan.

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 re-pricing 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 can't 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, develop an approach that can differentiate individual strategies from business as usual.

8. Manage in a Controlled and Auditable Process

Historically, budgets, plans and forecasts have been internally focused processes designed to manage an organization better. 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 directly reflects this new reality. For the first time, an accounting standard requires a projection of future events instead of relying solely on measurable historical facts. 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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Key Takeaways

In order to improve the value of margin planning, banking leaders should:

Think differently.

Forecast your entire balance sheet and integrate known cash flows to project what will happen during a forecast period.

Plan differently.

Connect expenses to portfolio and new business volume projections to develop a stronger understanding of cost drivers and better align budgets with planned activity.

Act differently.

Combine forecasts, profitability and risk modeling to better predict and manage performance.

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