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How Can Depositories Improve Their Budgeting Process for 2020?

Many financial institutions are now focusing on their 2020 planning by identifying likely challenges, defining strategic direction, and forecasting the balance sheet and financial performance through the budgeting process. One of the top questions we field this time of year, whether lighthearted or not, is what rates are going to do over the coming year. Will the Fed cut rates, and if so, how many times and when? Will the 10-year Treasury yield face continued downward pressure stimulating a late 2012, early 2013 wave of refinance activity? We may not have a crystal ball, but we do have a few suggestions on how to keep speculation from dominating your strategic conversations and how to budget more effectively.

While no strategic plan is bulletproof, the planning and budgeting process should incorporate the key tenets of ongoing successful balance sheet management – namely funds management and capital planning. By prioritizing both components within the planning and budgeting framework, institutions should find that preparing for the upcoming year and determining the most appropriate strategic course of action should be no more challenging than the daily balance sheet management process.

Before You Plan: Establish Your Risk Appetite and Strategic Goals

Policies are the starting point for any strategic conversation, detailing the general goals of the institution and the risk parameters to operate within to get there. If your institution's risk policies are well structured, comprehensive, and include statements defining the general strategic goals and risk appetite of the Board, then this step is likely already complete. However, if you can't easily identify goals and risk preferences, pump the breaks on detailed planning and have this conversation first.

Defining what success looks like – growth, member/customer value, financial performance, etc. – is a critical aspect of the planning process. Once goals are established, risk expectations and parameters must be clearly and succinctly outlined. Having reasonable expectations of risk exposure given institutional goals is like filling your gas tank with the appropriate fuel for your engine. Without the right level of risk allocation, performance will suffer. Financial performance is the life blood of any depository institution, allowing it to better serve its members/customers, employees, and community in the most impactful ways.

Step 1: Evaluate Current Risk Allocation and Performance

Once goals are established and risk tolerance is clearly defined, the next step is to pinpoint the institution's starting position. To do this, financial institutions should construct a dashboard incorporating performance and risk metrics to better understand how each risk factor is being utilized and how effectively it generates financial performance. Determining which measurements

to monitor comes down to identifying the drivers of performance – those factors which either enhance or diminish returns and help reveal the current business practices which might be dragging performance down. Interest rate risk, liquidity risk, credit risk, capital leverage, and operational efficiency are principal factors to financial performance. Without adequate measurement of how each is being used to generate current performance, it is nearly impossible to develop forward-looking strategy.

Step 2: Align Strategy with Risk Needs and Return Targets

With adequate performance insights, an institution can then target the changes necessary to modify the current business plan to better align with long-term goals. For instance, if performance analysis indicates high capitalization and mediocre returns on equity, management can easily determine the need to leverage capital to boost economic returns and bottom-line earnings. If an institution is facing lackluster loan growth and collapsing net interest margins, adequate performance indicators will highlight the need for asset acquisitions or credit risk surrogates in the investment portfolio. Strategic needs are illuminated when the appropriate gauges of performance are consistently monitored, allowing management to spend their time evaluating how to best execute those strategies.

Step 3: Assess Relative Value and Tune Strategy

Tuning the approach relies on the funds management process to compare various opportunities for strategy execution. The process requires analytical rigor and a comprehensive risk-adjusted evaluation framework to properly assess economic compensation across multiple opportunities and isolate the choices with the best fitting risk-return profiles. Evaluating alternatives in an economic return framework helps keep all internal departments on the same page, aware of how each choice either contributes towards or takes away from financial performance and eliminates the influence of conflicting incentives. Without this type of quantitative framework, institutions may critically underestimate risk, make unsound economic decisions using gut feel rather than defendable analytics and stray from performance goals.

Step 4: Forecast Performance and Risk Exposure

In addition to the standard pro forma budgetary projections, institutions should evaluate the comprehensive, honed balance sheet strategy through analysis of risk from all angles. The forecasted balance sheet should be run through a stochastic ALM model and evaluated to confirm that the projected risk exposure is commensurate with the intended results. Liquidity risk should also be evaluated by assessing adequacy of comprehensive liquidity under normal business conditions and variations to the business environment. Scenarios to consider include varying degrees of funding stresses or systemic stressors such as economic downturns or more localized and institution-specific concerns. After working through these simulations and reviewing all risk exposures, the budget should be sufficiently vetted and ready for final Board approval and implementation.

Step 5: Rinse & Repeat

Risks aren't stationary – markets move, the balance sheet evolves, and new pressures and challenges will arise. Institutions that work through this process throughout the year are better equipped to identify the factors driving unanticipated variance in performance and risk exposure, allowing successful modification of the strategic plan to meet long-term goals. Meaningful analysis should be kept front and center at the ALCO and Board level, emphasizing forward-thinking strategy rather than excessive rear-view reporting. A rinse and repeat approach to this process

prevents the institution from getting off-target and having to make sweeping, and likely costly, changes to get back on track.

Recipe for Success

Budgeting doesn't need to be a burdensome and daunting process. With the consistent application of a risk-adjusted, quantitative decision-making framework, speculation is removed from the decision-making process and effective strategies can be employed quickly and confidently in any market environment. The funds management process is a critical aspect of long-run success, requiring diligence to keep management well-informed of current progress and aware of all viable strategic opportunities. Ultimately, focused ongoing strategic planning, supplemented by annual strategy summits leads to a more cohesive balance sheet management effort, consistently solid performance, and better value for all stakeholders.

Remember, ALM First is here to assist you by providing unbiased advice. Contact your advisor today or info@almfirst.com to learn more about how we can support your institution during budgeting season and throughout the year.