June 22, 2015

Weekly Post: Funding a Growth Plan

Dear Clients:

Challenge:

We need to consider funding strategies in today's rate environment to manage our balance sheet growth/changes, meeting regulatory guidelines.

- *Liquidity Coverage Ratio*: when incoming cash flows are used for funding new volume, will that adversely affect the liquidity risk exposure?
- *Earnings-at-Risk*: how will the earnings and NII be affected under multiple regulatory rate shocks?
- *Liquidity buffer and wholesale funding requirements*: diversity of funding sources is important for these liquidity requirements.
- *EVE % change under multiple shocks* over at least next 12 months: will your funding strategy continue to increase the balance sheet duration?

In short: how to manage interest rate and liquidity risk in our growth/strategic planning?

Solution:

One solution is to use a ladder funding strategy: using borrowings to match the projected cash flows of the loans, as discussed in May 19 Post. This strategy can be implemented to manage your interest rate risk and liquidity risk.

Since a budgeting plan is not implementable if it does not meet the above policy guidelines, we need to verify that your ladder strategy meets the above regulatory requirements. A summary report below illustrates how you can compare alternative planning strategies taking risks into consideration.

- THC Financial Simulation can provide you the risk reports enabling you to evaluate alternative funding strategies

Numerical Example

The example below assumes we project a monthly gross loan production to put on the balance sheet over the coming 24 months. We consider two alternative funding strategies: a 5 year term funding and a short term funding of 6mo borrowing each projected month. For clarity of exposition, we consider the 5 year funding as the ladder strategy, approximating a new loan projected cash flows by a 5 year borrowing.

The report compares the change of duration, EVE change under +400% and the earnings under alternative funding strategies. Since the loan production does not occur instantaneously, the current balance sheet is not affected. Hence the current duration and +400 bpt EVE% change are not affected. But they are both affected in a one year horizon.

	Current analytics / projection				pro-forma (horizon = 1 year)		
	eff.dur	+400bp EVE% chg	1yr NI	2y NI	eff.dur	1yr NI	+400bp EVE% chg
Current cycle report	2.47	-26.3%	-451	-979	4.80	-529	-33.9%
5yr borrowing	2.47	-26.3%	-29	-51	6.49	-22	-39.7%
6mo borrowing	2.47	-26.3%	10	19	8.63	10	-47.2%

The results indicate that the short term funding strategy would typically result in the balance sheet exceeding the EVE % change policy limit under 400 bpt shock (-47.2%) in 12 month time even though the strategy has the higher earnings impact.

Conclusions

We need to validate our budget/strategic planning by simulating the risk reports over your planning horizon. By using a ladder funding strategy, pro-forma risk measures can be managed.

To receive your copy of this pro-forma risk report based off your institution's data, please contact us.

Regards,

Tom Ho