March 2, 2016

Weekly Post: Three Performance Levers

Dear Clients-

Regulatory policy limits only ensure safety and soundness. Performance metrics such as earnings, margins, and loan production only set the business goals. But none of these measures provide you ways to enhance performance. This Post suggests using using three management tool (levers) to enhance performance.

Banking is rapidly changing. In just three years, balance sheet risks have become more transparent and manageable. Using performance levers, now you can balance your risk and earnings that would lead to the optimal size of the balance sheet, product mix, integrating risk analysis to operational management processes (to the regulators' delight).

Challenges

- EVE, EaR, Contingency funding plans, liquidity measures are reports to ensure safety, but, how should you manage the institution?
- Lacking loan demand and low asset yields, how can you unlock values from the balance sheet?

Solution

Today, banking is dynamic, not static. You no longer have to decide to put a 30-year fixed-rate mortgage on the book and hope for the best. You can now evaluate your entire balance sheet risks on a continual basis. By knowing your risk exposure, you can use your capital more efficiently (e.g., lower capital ratio) and exploit market opportunities more prudently (e.g., lengthen duration). Managing risk can indeed enhance performance.

Management cannot be effective by controlling too many performance levers. I suggest three: (1) Duration, (2) Liquidity Coverage Ratio (3) Current Loan-to-Value ratio.

Duration for Interest Rate Risk

I have often discussed the importance of duration. Duration is widely used in capital markets because risks are transparent as it measures the sensitivity of an asset price to movements in yields. Banks, thrifts and credit unions traditionally did not monitor duration because the balance sheets were believed to be static,and only held-to-maturity. The past three years of risk management has changed that notion.

The Office of Thrifts Supervision (OTS) had provided duration measure and TB13a for over ten years prior to 2012. No thrift had gone insolvent because of interest rate risk. The simple risk measure shows the effectiveness of monitoring a risk target. An institution that does not dynamically adjust its risk exposure would need to hold excessive capital, thus impacting earnings, or suffer excessive losses. Duration enables you to adjust continually the risk exposure of the balance sheet to exploit business opportunities.

Liquidity Coverage Ratio (LCR) for Liquidity Risk

LCR is the ratio of the monthly uses of funds to the sources of funds, the dollar inflow to each dollar outflow. Unlike liquidity gap ratio that assumes the balance sheet to run-off, a scenario that bears no resemblance to reality for an operating entity, LCR is based on your growth plan and strategies. The ratio measures the inflow and outflow of money, a tangible asset. LCR makes liquidity transparent.

Furthermore, LCR allows management to gain insights into their business. For example, the inflow of prepayments of loans and closing of deposit accounts are important components of LCR. Senior management often focuses on the net growth of loans and does not have access to the gross growth of loans that is required for planning. LCR enables management to easily gain insights into the fund flows in the institution and liquidity adequacy.

Current Loan-to-Value Ratio (CLTV) for Credit Risk

Last week, I discussed the significant impact of the recovery ratio of credit risk. CLTV enables you to measure the credit risk exposure of your loans. Because the economy has recovered in part of the country, CLTV can be low, and in some cases, the recovery ratio can exceed 100%.

Today, access to CLTV is inexpensive. For example, some websites offer free estimates of home values. By monitoring CLTVs of the loans on the book, you can adjust your product mix and underwriting standards for new loans.

Furthermore, research has shown that property value depends significantly on income and the economic well-being of the region. And thus, the trends of CLTV provide you insight into local economic activities, particularly your lending region, to manage your credit exposure.

Numerical Example

Many of our clients are using the THC Directors' Dashboard report for their Board meetings. As you review the Dashboard results, you can evaluate duration, liquidity coverage ratio and current LTV. You should also evaluate these performance levers the context of your business and the market environment. The numbers are too high or too low only when evaluated based on your perspective.

Uses and Sources of Funds($000)	1mo	2mo	3mo	4mo	5mo	6mo
Cash	37,085	37,127	37,154	37,174	37,187	37,203
Investments	3,919	2,737	2,343	1,187	847	1,491
Loans	951	1,703	1,741	1,775	7,876	2,228
Cash Income	42	27	20	13	16	11
Total Sources of Funds	71,887	46,404	46,170	46,998	52,782	49,053
Borrowings	-	-	-	-	-	-

Deposits	29,890	4,810	4,912	6,848	6,855	8,119
Total Uses of Funds	34,760	9,250	8,996	9,811	15,579	11,838
LCR(Liquidity Coverage Ratio,%)	2.07	5.02	5.13	4.79	3.39	4.14

Consider the Directors Dashboard's Uses and Sources of Funds results and the liquidity coverage ratio (LCR) of a hypothetical bank above. Typically, LCR should target a $2 inflow to cover $1 outflow, thus LCR equaling 2. Furthermore, you can evaluate your business strategies via LCR. Can you reduce the cash position by increasing the loans and investments matching the monthly outflows of funds? If you raise the deposit rates affecting the funding cash flows, how should that affect your loan and investment portfolio mix and how are they best adjusted. Should you be originating more loans or keeping them on your balance sheet instead of selling to the agencies to provide the fee income?

Conclusions

Managing duration, liquidity coverage ratio and current LTV can provide an opportunity to steer the balance sheet to optimize performance. This Post proposes a practical and effective management process.

Of course, other performance and risk measures are important and should not be discarded. But managing an institution with many goals and targets is complex and can be impractical. By exploiting the changing banking environment with more risk transparency and risk management tools, these three balance sheet performance levers can unlock values in your institution.

I have been meeting clients everyday the past five weeks sharing ideas. I thank you for your time and support. Please do not hesitate to contact me if you have any questions. I would be happy to schedule a review of your balance sheet.

Regards,
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