June 22 2016

Weekly Post:Use Variance Analysis to Enhance Performance

Dear Clients-

Variance Analysis refers to the monthly comparison between your budgeted numbers and your actual GL numbers. I often hear in Board meetings “YTD we are on target with our earnings,” “This quarter, we exceeded our target,” or “I recommend revising our 12 month financial projection because of the unanticipated significant rise in loan demand in recent months.”

In my opinion, this is a backward looking approach in using Variance Analysis and is problematic. Such reporting does not lend itself to any actionable decisions that can enhance your performance. This Post re-examines the use of Variance Analysis as a tool to improve balance sheet performance.

Challenges

- Are my “Board-approved strategies executed appropriately” to meet my budgeted targets, without taking on additional risks?
- Did my budget anticipate the significant calling of agency bonds and loan refinancing, and how will my revised budget take future prepayments and deposit withdrawals into consideration?
- What actions does the Variance Analysis suggest I take?

Solution

Post financial crisis, you may want to re-examine the use of Variance Analysis. Often budgeting is based on a set of assumptions extrapolated from previous experience. Also, the GL numbers used are void of risk measures. This type of budgeting has proven its flaws in preparing for the financial crisis. For these reasons, you may consider using risk-based budgeting and relate Variance Analysis to EVE, EaR and other risk reports.

Risk-based budgeting refers to your budgeting based on risk models. Interest rate, liquidity and credit risk regulations require you to simulate your financial projections based on models that take prepayments, withdrawals, and other risk issues into consideration. These models take your experience and market research into account to ensure that the models are “realistic” and “objective.” For this reason, your budgeting should leverage these ALM models.

Market Wisdom - Art Hilliard*

Not everything is fixable - continued

Recall the Scratch and Dent pool discussed last week. The bad news is all of my investors were no bids. The good news for the seller is the pool did trade.

Aside from the S&D issues, the quality of the pool was middle of the road:

- WAFICO 731
- WADTI 36.56
- WALTV 82.44

On the positive side:

- 83% of the pool were purchase loans
- All were first mortgages
- All were full doc
- The 4.129 WAC was respectable.

The pool traded to multiple bidders at a price in the low 80s. The compliance issues were a bitter pill to swallow. It is surprising that there was not a bigger hit in price. The price was probably propped up by the competitive bidding process. Note that S&D loans usually trade from the high 80s to the high 90s.

The market will ALWAYS take a discount on uncertainty.

Art Hilliard has been in the mortgage industry for 29 years. He has originated, managed secondary marketing, securitizations and settlements, provided mortgage financial advisory and performed multiple mortgage portfolio sales and acquisitions.He was past president of the Illinois Mortgage Bankers Association.

Pool details attached *THC* site *Conf Room*
https://www.thcdecisions.com/tro

Relate Variance Analysis to Risk Reports Earnings-at-Risk (EaR) presents the projected earnings and interest income along with the costs of your balance sheet items based on your ALM models. EaR report should not be just considered a regulatory model. The projected results should be compared with your budget projections and your Variance Analysis. Since the EaR report is consistent with all your other ALM reports, the EaR report provides the crucial link between your GL based financial reporting and your ALM risk reporting. You can then interpret these ALM results to make actionable decisions, a process I have discussed extensively in these Posts.

Numerical Example

Provided below a is sample approach of how you can leverage Risk Officer to generate a Risk-Based Budget Solution.

Risk-based Budgeting

Since all the financial models and data are maintained in Risk Officer, generating a Risk-Based Budget is simple. Download the Excel FinSim (VBA tool embedded), in the Financial Simulation module. Then you input your growth plan, operating expenses and non-interest incomes, and reinvestment rates assumptions easily. For the growth plan, one way is to project your "target" financials, as shown below. The THC model will seek the appropriate strategy that will fit your targets while maintaining consistenty with the your ALM models, such as your model deposit account assumptions of beta and decay, loan prepayments and investment callability.

Sub-group	P002	P003		Balance	2016Q2	2016Q3	2016Q4
			$	65,325,000.00	$ 65,325,000	$ 68,591,250	$ 72,020,813
s and currency and coin			$	2,312,000.00	$ 2,312,000	$ 2,427,600	$ 2,548,980
Construction, land	1-4 family residential construction l		$	4,481,000.00	$ 4,481,000	$ 4,705,050	$ 4,940,302
Construction, land	Other construction loans and all lar		$	2,624,000.00	$ 2,624,000	$ 2,755,200	$ 2,892,960

You input your projected operating expenses on the Non-Interest Income/Expense sheet, as illustrated below.

Group	Apr-16	May-16	Jun-16
VISION	15,000	15,000	15,000
Income from fiduciary activities	1,000	1,000	1,000
Service charges on deposit accou	1,000	1,000	1,000
Trading revenue	1,000	1,000	1,000
Fees and commissions from secu	1,000	1,000	1,000
Investment banking, advisory, and	1,000	1,000	1,000
Fees and commissions from annu	1,000	1,000	1,000
Underwriting income from insuranc	1,000	1,000	1,000
Income from other insurance activi	1,000	1,000	1,000
Venture capital revenue	1,000	1,000	1,000

The Variance Analysis report can simply be generated by identifying your GL number to the chart of account used in your risk report, as illustrated below. The first column is your GL account number and the following columns are the chart of account as specified in your PATH file (the Risk Officer data input file)

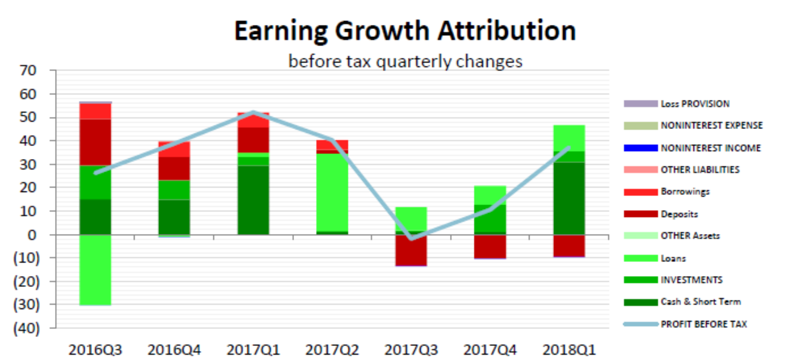
ACCOUNT	B040	B041	P001
1415	ASSETS	INVESTMENTS	Govt
1050	ASSETS	INVESTMENTS	Muni
1051	ASSETS	INVESTMENTS	Muni
1040	ASSETS	INVESTMENTS	MBS 15yr
1040	ASSETS	INVESTMENTS	MBS ARM
1040	ASSETS	INVESTMENTS	MBS Other
1045	ASSETS	INVESTMENTS	Prvt CMO Other
1424	ASSETS	INVESTMENTS	Mutual funds

Then the Variance Analysis can be generated and the FinSim excel book can be uploaded to Risk Officer to generate other reports incorporating your growth plan and other assumptions.

	Mar-16	Apr-16	Actual Variance(%)
Interest Rate Base Case			
Balance Sheet($000)			
ASSETS			
Total Cash & Short Term	67,637	67,780	
Total Securities	19,889	19,889	
Total Loans and lease financing rece	264,409	264,409	
Total Other assets	23,574	23,574	
Total ASSETS	375,509	375,652	
LIABILITIES			
Total Deposits	327,100	327,100	
Total Borrowings	4,000	4,000	
Total Other liabilities	5,489	5,489	
Total LIABILITIES	336,589	336,589	
Capital	38,920	39,063	
Chg in Capital		143	
Tier 1 Capital	37,101	37,244	
Total Assets for Leverage Capital Purp	371,881	373,852	

Relate Variance Analysis to ALM Report via the EaR report

The Earnings-at-Risk report provides the attributes of your projected earnings, and not just the Net Interest Income shocks over 12 and 24 months per regulatory requirements. The results are also presented in a bar chart in the EaR report showing the components contributing to the projected earnings monthly changes. These results should be related to your budgets.



Conclusions

Today, you need to re-examine the use of Variance Analysis. Instead of taking a backward looking approach, you can incorporate the risk models and ALM analysis into your Variance Analysis as an integrated asset-liability management process to enhance your performance.

If you have any questions on the THC Variance Analysis model, please do not hesitate to contact THC.

Regards,

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