Top Ten Budgeting Tips

1. Focus More on Projected Interest Income and Expenses

Too often, the emphasis is placed on the budgeting of operating income and expenses because some of these items are very close to the institution, and often seem like the easiest items to measure and control. The fact is that interest income and expense generally make up more than 80% of the income statement and deserve more attention. Income simulation models like PROFITstar® provide the ability to project yields and cost of funds very accurately, allowing you to test your plans and create more accurate budgets.

2. Focus on Risk as Well as Earnings

It's easy to focus only on the bottom line of the final budget, but what happens if interest rates move adversely? Prudent analysis of the interest rate risk components of the budget will help you stay within your organization's asset/liability management policy guidelines. For example, budgeting growth of 20% on a fixed rate mortgage portfolio will definitely have an impact on the interest rate sensitivity of the organization, not to mention credit risk. Measuring and controlling the interest rate risk components of your final budget is not only wise, it's necessary in today's competitive climate.

3. Give Yourself Enough Time to Complete the Budget After Analyzing Several Scenarios

Starting the budget in December gives you little time to test other alternatives. Many financial managers wait until December since they want the actual results from November to help them with their plan for next year. This gives them just enough rope to hang themselves because of the time pressure it creates.

One time-saving strategy to help you is to start the budget early when you don't have multiple projects due (such as in July or August). Run simulations each month through the end of the current fiscal year and for each month next year — fine tuning each projection the closer you get to the end of the current fiscal year. This reduces the amount of surprises in your plan itself, and reduces the stress you will feel. You'll also have a better plan in December since many alternatives will have already been analyzed during the prior months of modeling.

4. Coordinate Your Budget With the Long-Range Objectives of Your Organization

This can be hard, especially if you don't have a long-range strategic plan! We've heard many excuses for not having a long-range plan, but the most frequent ones are: "Long-range planning is meaningless," "It's too far out there," "Too many things can happen during the next few years," or "It's hard enough just to project earnings for one year, let alone five."

Consider long-range planning as a way of setting the goals of the organization and analyzing the chances of achieving them given all the uncertainties you could experience over the next few years. One strategy is to choose a time horizon between two and five years, depending on what you feel is possible. Set specific goals like growing ROA 1.0% or maintaining Risk Based Capital at 8% for the next three years. Make sure the goals are easy to measure, understand, and have a specific deadline. Similar to the budgeting process, model your financial statements over the long-range time horizon, and test the risks associated with your plan.

It's a given that many things can happen over a two-to-five year period, but without a sense of direction that a long-range plan provides, you could be steering your organization toward a cliff without an early warning system in place. Long-range planning provides the early warning system to allow you to change directions while there is still time.

5. Check Your Budget Variances for the Previous 12 Months to See Where You Need to Focus for a Better Budget Projection

It will help to see which areas were previously budgeted accurately, and which ones were not, in order to fine tune the process for the coming fiscal year.

It will also help to calculate the rate, volume, and mix components of the variances you see between your budgeted income statement and the actual income statement for last year — don't just look at the variance in dollars. By breaking the variance analysis down this way, you will be able to measure the reasons your actual results were off from your budget. (Did rates move differently than forecast, was growth off, or was the mix of assets and liabilities the culprit?) Once that is known, use the information to make a better budget this year.

6. Budget the Balance Sheet First, Then the Income Statement

This just makes sense, yet many organizations focus entirely on the budgeted income statement — even without a budgeted balance sheet. This can lead to poor planning, inaccurate plans, and missed opportunities.

Prudence suggests a well-planned forecast be made on the current "products" you offer your customers or members, as well as any new products you are considering adding to your list of services (i.e., loans, CDs, IRAs, etc.). Keep in mind that as you grow in any one area, you will need to measure both the risk and return of your projection. Obviously, integrating current maturity and repricing characteristics of both your current and projected business will make your budgeted income and expense more accurate. We have found the easiest way to do this is to import a list of all your current loans, deposits, and investments into your PROFITstar model. PROFITstar then calculates the balances and weighted average rates you have retiring over the next several months and years. This way, you'll have the necessary information showing how your projected yields and costs (and therefore income and expenses) will change under different growth and rate environments.

7. Test Your Goals Under Several Interest Rate Projections (Best, Worst, and Most-Probable)

Do this especially if your budgeting process is integrated with your asset/liability management, as we suggest. Many institutions still try to guess how their yields and costs of funds may change over the projected fiscal year. But once you have your current maturities and repricing characteristics loaded into your model (integrating budgeting with ALM), rate forecasts become easier to calculate without the guesswork.

We suggest you start with a flat rate scenario when creating your budget. As an example, if your current 12-month CD rate is at 1.25%, project that rate for the next year, and let your model calculate how the over-all "cost" of that CD portfolio changes as your current CDs come due. In other words, projecting flat rates does not mean projecting flat costs and flat yields. Also, be sure to test rising interest rate scenarios up to 500bps and with varying yield curves. Don't wait until it's too late — you can have contingency plans in place before interest rates shift again.

8. Make Sure Budgeting is a "Process," Not a Once-a-Year Exercise in Crystal Ball Management

Make budget/actual variance reporting part of your standard asset/liability management committee (ALCO) report packet. With everyone involved, budgeting becomes a useful monthly "process," helping you stay on course with your institution's goals.

For instance, let's say you design a great budget that is integrated with your current maturity and repricing schedules, with some very simple assumptions, (i.e., 5% growth in every category, flat rates, and one new loan product being planned to be introduced in July). If you find large variances over the first few months of the next year, you will want to discuss with your ALCO why the variances are taking place. Did you project growth at too high a pace? Have you taken on more interest rate risk than anticipated? Do you still need to offer the new loan product given your current budget variances and gap position? If yes, that's great, you're still moving in the right direction. And if you decide not to implement the new product due to too much interest rate risk exposure right now, your planning process is doing its job.

9. Get All of the Key Players in Your Organization Involved Early

A budget is basically a financial road map that supports the strategic direction of your organization. Therefore, you will need to communicate extremely well. Otherwise, even the best-laid plans may be pointless. The department heads of lending, deposits, and investments, as well as the president of your organization, will need to be involved early. Make sure you allow enough time to get their ideas for next year incorporated into your budget. By helping them understand how interest rate risk comes into play with their assumptions, you will be doing your organization a favor. Ask them to focus on the areas they manage and those sections of the balance sheet they control. Decentralizing the budgeting process with a product like PROFITstar Budget Manager works best to incorporate their ideas into the entire institution's budget. With this approach, every manager's assumptions are documented. Be sure to ask for their forecasts if rates go up 100-500 basis points, or if the yield curve flattens or steepens. How will loan demand be helped or hindered? Why do they think this will be true? Do you agree with them?

10. Don't Stop the Planning Process in January

Routinely create Rolling Budgets that continue to test "What-Ifs." The most successful organizations we have seen don't stop planning when their budget is finished. As conditions change due to increased mergers, interest rate changes, and new product offerings from the competition, a sound planning process puts you in the driver's seat.

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