

Performance Based Planning for Financial Institutions

An Oracle White Paper
August 2000

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OVERVIEW

The Value of Performance Based Planning

The need to develop plans based on an outlook of future performance is quite simple: No decision has ever been made which impacted historical economic results. Unless we witness astonishing advancements in the field of time travel, that simple fact is not likely to change.

We may use historical measures of performance as a guide to indicate areas where decisions are required, but to truly measure the impact of a proposed decision, anticipated future results (the results of our decisions) need to be measured in exactly the same manner as historical ones.

The value of a plan is often negligible as there is generally focus in the budgeting process exclusively on cost control...while important, the larger issue is future profitability, not just the containment of costs. Since managers are measured on performance not just cost control there is a disconnect between the planning process and how they are measured.

What is performance based planning

The concept of performance based planning is quite simple. Measure anticipated results in the same manner as historical ones. Measuring all performance throughout an organization consistently is the cornerstone of Value Based Management(VBM).

Planning is often thought of as one activity, when it fact encompasses a multitude of activities: budgeting, forecasting, strategic planning, human resource planning, asset/liability management to name a few. Making sure there is one consistent, reconciled view of the future throughout these multiple activities is a monumental, if not impossible task. A performance based planning approach, must not only make sure that historical and future measures are consistent but it must make sure all perspectives of the future are consistent and reconciled as well.

Encourage participation of all in the planning process

Lets face it, most line unit managers consider putting together a plan or budget, as something they are required to do before they can do their real job. As a result, the attention paid to and credibility of those plans are minimized and the plan once established is only beneficial to centralized control and analytical functions. With a performance based view of the planning process, the plan becomes something that is part of doing their job, as they are able to measure the economic performance of their decisions under consideration knowing the same methods will be used to measure their actual performance.

Why do traditional approaches to budgeting fail

Contrast this approach with the traditional approach of developing an annual budget. During the traditional budget process, the entire focus is placed upon cost control. While cost control is an admirable and required goal, without the perspective of what those costs will be used for, i.e. how will they provide a return for the bank, knowing only anticipated costs is meaningless.

Without incorporating anticipated return into the budgeting process, three things typically occur. First, a more is better attitude prevails for business units during the planning process. Certainly having more resources, staff, technology, space, capital, etc. makes the job of a line

manager much easier. It is often said that most golf bets are won on the first tee. Those players who can negotiate the best terms for the bet before starting the round are usually likely to win money. Likewise, a favorable budget means goals are easily accomplished without reflecting true performance

The second issue that makes the budgeting process difficult is politics. As unseemly as it may be to mention, and as much as it would like to get swept under the rug, it exists.. This means budgets, goals, and objectives are developed in a subjective, non economic manner. A Value Based Management framework where all plans, and results are measured on the same consistent, universal criteria helps reduce the influence of office politics on goal setting and decision making. No metric for measuring performance and making decisions is perfect, but at least it provides a consistent objective framework.

Finally, a budget established purely on the basis of cost control creates a tendency to “use up” any non spent, but budgeted for money. Afraid, if they don’t show they needed the amount budgeted, they will not receive the same levels next year, managers have been known to consume the amounts simply so the same amount(plus upward adjustment of course) is budgeted again next year.

THE COMPONENTS OF PERFORMANCE BASED PLANNING

Transfer Pricing

The mechanism of transfer pricing is the most important driver of measuring both historical and future profitability. Transfer pricing establishes a charge for funds for each asset and a credit for providing funds for each liability based upon objective, marketplace observable rates. The most accurate method of establishing transfer rates is to assign transfer rates based upon term to maturity of each asset and liability. This method known as matched maturity funds transfer pricing not only establishes an objective cost or credit for funds, it isolates the interest rate risk assumed by an institution where it can be centrally managed.

To develop a performance based plan, it is imperative to use the techniques of matched maturity transfer pricing. Transfer pricing permits the revenue side of performance to be forecast, and permits line unit managers the ability to forecast the components of a rate they can control. Namely, the spread above or below an established

transfer rate. This approach for the most part immunizes line units from the uncertainties of interest rate levels(except under extreme rate levels). They forecast what they control:the spread.

And once a plan has been developed with a transfer pricing foundation, the anticipated income(or loss) as a result of interest rate exposure has been quantified. This information can then be used by both the asset/liability management group as a foundation for interest rate simulations, and by the treasury for establishing hedging strategies if the amount of revenue contingent upon interest rate levels is too large.

Allocations of costs

As with a typical budgeting process, a budget of direct costs is required. Of equal importance is the ability to accurately model the impact of allocated costs. This completes the picture of forecast profitability. Revenue is forecast through the transfer pricing process, direct costs are planned for in a typical manner, and allocated costs are calculated. From this information a bottom line contribution can be derived.

A couple of distinctions exist between the way historical costs are allocated, and the cost allocation process in the planning process. First historical allocations can be performed as part of a formal, structured, sequenced process. Multiple step allocations can be ordered and calculated in the right sequence, and debit and credit integrity can be maintained through a two sided allocation process.

In the planning process, the luxury of this ordered sequence is not available as multiple individuals are planning simultaneously and the order of events of an allocation process cannot be as easily controlled. Therefore, it is common that models(representations) of allocations are used during the planning process to provide bottom line contribution numbers to be viewed by the planners. At the end of the process, the structured, formal allocations can be performed on budgeted information to ensure integrity of the planned amounts.

Volume Related/Activity Related Allocations

Volume or activity related costs are costs associated with a cost object(in the case of planning typically a product or a business unit) based upon activities associated with an account. For example, the

cost associated with check processing will be driven by the number of checks processed for a given product or organizational unit.

On a historical basis costs allocated to products or business units are built from the ground up. Given, known transaction volumes and a cost per transaction, costs can be easily computed as $\text{volume} \times \text{rate} = \text{total costs}$. While the calculations themselves are simple, there are often thousands or even tens of thousands such relationships.

We can easily apply the same approach for a forecast. The only problem is it requires the same amount of detail (thousands of rate times volume relationships) to be forecast. Instead, planning for these volumes generally reverses the approach outlined above. This way, planners can continue to plan items they normally plan and the costs that will be attributable based upon those plans is developed. Forecast for the cost objects are established, in turn they are turned into anticipated volumes, the unit cost applied to them and the total cost to be allocated is established. To use the example above, a forecast for checking account balances is created. In turn, based upon historical relationships a reasonable assumption about the quantity of checks to be processed can be established, and from there a total cost for check processing for that product is derived.

Capacity plans, sequence of planning

Using volume related metrics to allocate costs also improves the usefulness of the plan for those business units providing services to other, usually customer facing business units. Based upon the established forecast of anticipated required volumes, these service providers can better determine the requirements they need to satisfy the activities that will be required of them in the upcoming year and to ensure they have sufficient capacity and not capacity that will remain unused.

Projects/Strategies

The Economic profit returned by a proposed project or strategy should be the fundamental decision making criteria. Not only does it determine if a project will increase value to the shareholders, but it enables diverse projects to be analyzed in a consistent manner. It allows for a more sound process of allocating capital.

Obviously the measurement of the anticipated profitability of planned strategies is not a new concept. What is new is the idea that the same

approach for measuring historical multi-dimensional profitability can be used for measuring forecast profitability of an individual initiative. Again the goal of a value based management approach is realized through a consistent framework.

CONCLUSION

A performance based planning approach realizes several advantages. First, plans can now be developed for their chief purpose: namely, decision making. Second, the counterproductive incentives that arise from a traditional cost control approach are mitigated. Finally, a Value Based Management approach to planning is established as all individuals in the organization are planning based upon a common framework and are viewing future results in the same manner they are being measured (and often paid) historically, enhancing the usefulness of the process, not only at the top of the house, but throughout the company.

White Paper Title

October 1995

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