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Seven Practical Reminders for Financial Institutions in a Volatile 2020

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When interest rates make sudden, unexpected movements, it is imperative that financial institutions remain diligent and make sensible, yet timely decisions. Extreme volatility may provide rare opportunities to capitalize on disjointed markets. Here are 7 tips to keep in mind as we navigate the stormy waters of 2020.

1. **Stay calm**
2. **Keep pricing models tuned and timely**
3. **Look for opportunities to add wider spread (cheaper) assets**
4. **Don't chase credit to make up for narrowing net interest margins**
5. **Manage interest rate risk with derivatives and other funding/hedging strategies**
6. **Give added attention to non-interest items**
7. **Communicate with staff, borrowers and depositors**

1. Stay calm. Be reactive, but not overly reactive. Financial institutions should move quickly to lower deposit rates in keeping pace with decreased funding costs in the broader market. They should also keep a cool head on the asset side of the balance sheet. Hold on to those higher credit-quality assets. Liquidity on the balance sheet is likely to surge in the coming months.

2. Keep pricing models tuned and timely. Volatile markets can make loan and prepayment models stale in a matter of hours (not days or weeks). Allow extra cushion in loan rates. Unless your model uses real-time interest rate updates, it could be behind the curve in terms of market proxy. The same goes for liability pricing. Consumer rate-sensitivity typically drops substantially as "flight to quality" mentality ensues. Dropping interest/dividend rates on deposits will probably not drive away deposits as much as expected. Investors will likely pull funds out of riskier assets, and reduce spending, resulting in increased deposit balances.

3. Look for opportunities to add wider spreading assets. Sticker shock on higher priced bonds may cause bond investors to balk at comparatively lower yields. Staying focused on risk-adjusted spreads helps to identify the better investment opportunities. Increased volatility tends to cause a widening of spreads. This presents an opportunity to capture high credit quality assets before calmer markets return, and spreads compress back to normal levels. When spreads are wider, hedged return expectations are also higher. Return on Equity (ROE) and profitability levels are heightened. Investors are well compensated for increased market volatility and increased cash flow uncertainty when spreads expand.

4. Be wary of chasing credit risk to combat pressures on net interest margins. Investors may not be adequately compensated for the likely higher credit exposure in the current environment. Focus on high credit quality assets.

5. Manage your interest rate risk with derivative and other funding/hedging strategies. Long funded mortgages look attractive and it is extremely cheap to hedge interest rate risk with derivatives right now. Institutions who weren't prepared to take advantage of this in today's market should start planning for the next opening. It takes time to get derivatives policies and procedures in place. Those who start preparing now will be ready to act when the market presents the right opportunity again. In the meantime, there is the option to lock in low cost, longer term borrowings from the Federal Home Loan Bank (FHLB) and similar funding sources.

6. Give added attention to non-interest items. It is expensive to maintain depository institutions. When margins compress, look to other sources of income to maintain operations. Borrowers and depositors alike will pay a premium for services when seeking out safe havens.

7. Communicate with staff, borrowers and depositors. During times of uncertainty, constant communication is important. There may be questions as to why deposit rates are falling so much, or why mortgage rates are lagging. Chaotic markets have short lifespans. Confidence during turbulent times will help alleviate anxiety until stability returns.

With increased volatility comes greater opportunities. Don't look at today's markets like the sky is falling. Instead, seek out quality prospects. All spreads are widening. Reset expectations for future returns. With more uncertainty, comes a higher return requirement. Expect the biggest changes in areas where the cash flows are most uncertain.

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