ALM FIRST

How Can My Institution Make a Difference While Managing the Balance Sheet?

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The world is grappling with an issue of enormous scale and I find myself cherishing my family, work family, friends, and amazing clients. Our hearts go out to all those affected by the virus. No crisis is an isolated, neatly contained incident and the COVD-19 outbreak is exceptional by all standards. ALM First has modeled numerous scenarios, but this one comes with extreme uncertainty. What we do know, is that this event will have a lasting impact on the world. There will be numerous stories that will be told of heroes, as well as villains.

My daughter left York University in Toronto in a panic with only a Canadian credit card. After crossing the border into Michigan, she walked into a Starbucks only to find that the Canadian card was denied. The attendant took the seven American dollars that she happened to have and gave her $20 of food. In a normal environment, would a large company really do that?

On the hero front, our clients are doing amazing things by implementing extended skip-a-pay offers, suspending foreclosures, suspending fees, offering temporary unemployment loans at low rates, increasing credit card limits, and providing other support. Foreclosures and car repos are being stopped. What great moves not only for the consumers, but to jump start the economy. As a financial institution leader, you have the power, similar to CEOs of big companies, to give back and make a real difference in members' or customers' lives. But as we all know, great moves for the consumers can hurt the institution's financial performance to some degree. But will it and will it only be temporary?

Here are a few actions finance professionals can take to ensure that their institution makes a difference today and remains financially solid over the long-term.

Update Your Board Members and Regulators Regularly

Stay calm and alert your board and regulators that budget numbers may not be met. Bank stocks have dropped approximately 50% due to perceived losses and liquidity. Community

bank merger valuations have dropped by 40% with perceived margin compressions, and increased defaults. If there is any time that board members and regulators should be understanding of low ROA results, it is now.

Discuss & Reset Expectations

The credit union and community banking industries are extremely well capitalized and, as we learned from the 2008 crisis, many local institutions are resilient. If your capital is greater than 8%, then you are well capitalized. Why do you have a high amount of capital? The answer is economic times like this. If the board and examiners were fine with a target ROA of zero, would your strategy change? Would the stress of searching for yield change? I distinctly remember having discussions with examiners in 2008 about relaxing ROA standards for this very reason.

Now is also the time to alert board members and examiners regarding your modeling results. Spreads are widening. Spreads widen due to credit risk, the higher the uncertainty of cash flows, or liquidity concerns and all three are happening. This widening will result in asset price devaluations. On the liability side, since rates are down and deposit rates have dropped, liability prices have also dropped. The drop in both asset and liability pricing will put pressure on the base NEV. In addition to lower ROA, alert your board and examiners to expect higher capital volatility in your ALM reports.

Utilize COVID 19 Strategies and Modeling

How do you ensure safety and conduct a COVID-19 strategy? Of course, the first priority is to take care of your staff. This includes producing clear policies and identifying any potential points of failure.

The second priority is to ignore all the spreadsheets and listen, talk to members and colleagues, and comprehend. I am on the phone and emailing clients as much as possible to understand exactly what they are witnessing and how depositor behavior is changing.

As far as modeling, encourage your staff to go deep into the models to ensure that market values in this illiquid market are correct. Don’t waste time on superficial checks of numbers that have no bearing on risk results. The base capital impairment phenomenon that occurred in 2008 returned to normal once liquidity increased in the markets. Institutions that were not forced to sell assets did fine. If effective duration volatility is forefront in your institution's strategy, then the amount of interest rate risk may be minimal for your institution; however, if interest rate risk needs to be mitigated, derivatives should be considered. We have seen a huge surge of client interest in derivatives for these reasons, as well as partially hedging away interest rate risk from longer term mortgages with very wide spreads to safely enhance yields.

Avoid Confusion

Although modeling spread widening and the effect on your NEV analysis is fairly straight forward, we are concerned that modeling unknown economic events from the COVID-19 phenomenon can cause confusion. Uncertainty lies in how long the shutdown will last, how many depositors will require cash, how many loans will be made and what the government plans to do. Estimating the effect of the virus on your balance sheet is very difficult but can be done in a capital plan focusing more on increased default rates, lower and lagging recovery rates, and depositor behavior rather than negative rates or other Fed actions. The latter types of stress tests are tricky and will most likely produce misleading results. In the remote event that this happens, clients are informing us that systems cannot handle negative rates anyway.

Manage Liquidity Carefully

Liquidity is critical but be smart about it. Be careful with leveraging in this environment. There are great leverage opportunities that we are taking advantage of and, if you have adequate capital, they should be utilized in a safe manner without duration mismatches and reaching for illiquid assets while deploying the funds. Liquidity does not mean hording cash. Liquidity generally comes from the investment portfolio. Bullet securities and mortgage backed securities are liquid, meaning that they have a readily available market. With the Fed buying agency mortgage backed securities we are seeing dollar roll trades again that produce enhanced yields, similar to what we saw during quantitative easing.

Now is the time to truly understand the various types of risk and their potential impacts. Broad brushing risk is a dangerous thing. Don't lose sight of other risks beyond interest rate risk. The many other risks are not diminished by the virus, such as Cybersecurity or fraud. Now is not the time to reach for credit risk, especially in your investment portfolio. Credit risk will already be increased with member lending.

We will all get through this together and I cannot wait until we get back to some form of normalcy. On a final note, I went to Starbucks last week in Dallas and ordered my normal grande Caramel Macchiato. I paid $25.14 for the drink and thanked them for their kindness to my daughter. Consider the positive impact of your institution's actions on your members, their families and the broader communities you serve. Each opportunity you take to support members today will make a real difference in their lives and generate enormous feelings of gratitude that will ripple into the future.