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What Best Practices Could Enhance Profitability in 2021?

Many depositories have already tightened where they are willing to lend as changes in delinquency reporting requirements, payment assistance programs and forbearance are making risk forecasting more complex and causing institutions to think twice about adding risk to the balance sheet. While uncertainty continues and financial institutions grapple with credit performance and what to expect in terms of potential losses down the road, finding new opportunities to enhance bottom-line performance while remaining flexible is vital.

Little Room for Error

Spreads have been tightening on high quality liquid assets while excess liquidity has remained, making it more difficult for depositories to manage margin. A traditional investment portfolio with tighter spreads and the absence of significant opportunities to streamline expenses or reduce operational costs leaves little room for error. However, there are other levers that financial institutions can push to generate profitability.

One of the strategies depositories have deployed relates to their resources. While shifting resources to a more active and profitable business line like mortgage lending may be easier said than done, it is an example of being nimble and opportunistic as an organization.

Partnerships are another avenue to generate profitability. Tapping into lending partnerships, through participations or even partnering with traditional competitors, such as Fintechs, can bring in a steady stream of higher-yielding assets. However, evaluating the pricing and risk-adjusted returns that come along with different programs is integral to profitability.

Best Practices for a Better Bottom-Line

Financial institutions must look beyond a flashy yield to evaluate costs, risks, and determine whether an opportunity is best for the institution given pricing, resources and alternatives. It's easy to focus on top-line yield, which is why it's critical to use a quantitative model that addresses all necessary risk and cost components. This doesn't merely include the credit component, it takes a host of other factors like the cost of acquisition (including internal lending team bonuses and indirect dealer incentives) or prepayment risks, into consideration to dissect the true, risk-adjusted value. This is one thing I see that causes tension between the lending and finance teams – missing pieces can cause parties to disagree over profitability and prevent them from making timely decisions. In the current environment especially, you have to look at more than top-line yield, credit cost and the treasury rate before you can say yes. A very robust modeling framework is required and so is education to ensure all departments are on the same page.

When everyone understands what the institution is working towards and is on the same page regarding how each decision will impact the bottom-line, generating additional profitability becomes simpler. Often, lending teams have volume-based incentives while finance teams have bottom-line driven incentives. This creates tension. Education, incentive models, structure and alignment are all important aspects to consider when trying to drive performance.

Using a risk dashboard is another key part of the puzzle. It's not about the burden of seeing where we have too much risk; it's about seeing where we have room left in our risk budgets so we can pull the appropriate levers. When used effectively, a risk dashboard enables our ability to narrow our focus to ideas that are the best fit for the institution and helps us to potentially push basis points to the bottom line.

Having the right team in place to implement the new ideas we uncover through risk dashboarding and analysis is huge. We can have great models and the appropriate analysis, but if we don't have a team that can clearly discuss those themes and execute them, we cannot realize the profitability.

Avoid Potential Pitfalls

Remaining in a very traditional mindset of what a depository is and how you provide value can limit your opportunities, especially when it comes to reducing your cost of funds. If your goal is to always provide the top deposit rates and lowest loan rates, there is simply not enough room in an environment like this to profitably manage your funding and your assets. When you evaluate your funding as a spread to swaps, it allows us to see where we may be missing the mark or missing opportunities to generate profitability and eating into our profits. Don't miss an opportunity on interest expense to capture basis points as you plan for 2021. Depositors today likely care less about rate and more about the safety and soundness of their funds and ability to access them when needed.

Control What You Can, Stress Test the Rest

The fluidity of the current economic environment should be matched with agility in your business plan. Most of the depositories we work with are looking to expand their toolbox to generate stronger, sustainable performance. Using derivatives is a great example. If you don't have ability to hedge your core balance sheet, there is likely an opportunity there as institutions are continuing to see mortgage loan growth. However, they may be hesitant to add long-term risk exposure. Hedging that risk could allow your depository to be more flexible, agile, and opportunistic. Rather than avoiding risk, try to manage or hedge that risk and add that profitability to the bottom-line.

We're advising our clients to control what they can, specifically by ensuring they have access to all of the tools or levers available to them, and stress test the rest. For example, another round of strong fiscal stimulus could push deposit growth rates even higher next year, or we could see the exact opposite if additional stimulus is smaller or non-existent. Working through the outcomes of each scenario and asset strategies associated with each helps to improve both preparedness and performance.

It's a challenging time for the industry, but it's also very exciting as we're pushed to evolve more quickly. Financial institutions should be more forward-thinking to stay relevant and continue to provide value. While there is a likelihood for increased consolidation in the future, institutions that remain open to new ideas and new opportunities are more likely to pull through.

Be Flexible Enough to Change Course

The expedited evolution of the depository landscape is a trend that I think will ultimately be positive for both the institutions and the consumers. While no one has a crystal ball, we do have a few closing pieces of advice for 2021: Stay open to new ideas, build the team that can help you implement them, and be flexible enough to change course.

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