Embracing Challenges and Opportunities in the Current Market

hedging credit economy

Summary: The economic market presents both challenges and opportunities for CFIs. From interest rate increases and talent shortages to loan demand and digital transformation investment, we dive further into both.

The most famous opening line that Charles Dickens wrote came from his novel “A Tale of Two Cities,” and it begins something like this: *“It was the best of times, it was the worst of times…”* Dickens meant to remind the reader that extreme opposites can occur simultaneously.

In any given year, we can experience great opportunities and steep challenges, often at the same time. Now that we’ve wrapped up Q1, we can already see plenty of opposing forces impacting the financial world. So, what are the biggest challenges and best opportunities for community financial institutions (CFIs) right now? **Let’s first discuss the challenges:**

Rising interest rates. While you might be able to increase rates on loans, more rate increases by the Federal Reserve could likely dampen economic activity. There’s also the risk that prices on an institution’s deposits and other liabilities would reprice faster than rates on loans, investments, and other assets, thereby impacting margins.

Given that repricing risk is a major concern, CFIs should always be mindful of their mix of fixed-rate and floating-rate assets and what liabilities they have on their balance sheets, taking note of when — and for how much — each reprices.

One way for institutions to mitigate repricing risk is to alter their balance sheets, with the goal of reducing mismatches in the maturities and repricing schedules of assets and liabilities. Another option is to hedge such risk with derivatives such as interest rate swaps.

For example, a Minnesota CFI mitigates this risk by making more variable-rate loans, while a CFI in Colorado “aggressively” attracts low-cost deposits that don’t reprice as much. That way, they are able to build a defensive balance sheet, while maintaining a low-to-moderate risk profile.

Slowing economy. Even if the economy doesn’t dip into a recession, slowing activity could continue to decrease loan demand and increase the threat of credit quality deterioration. According to the Senior Loan Officer Opinion Survey on Bank Lending Practices, more financial institutions are reporting lower demand for both Commercial Real Estate (CRE) and C&I loans. They are also tightening underwriting standards on both types in anticipation of credit quality deterioration.

A New York City-based CFI, for example, is bracing for possible credit deterioration by being more selective about the CRE loans it makes. They are also sticking to the properties that have a good track record of consistently generating income — even if they aren’t able to raise rent prices over the next year.

The Great Resignation. According to a 2022 Fortune/Deloitte CEO Survey, 71% of CEOs expect talent shortages to continue in general, and nearly all CEOs expect to see talent shortages for certain roles. They are combating this by:

- Allowing more flexibility and predictability in hours and location.
- Recognizing or rewarding workers who take on more responsibility.
- Providing more reskilling and upskilling opportunities.

Nearly all plan to enhance the overall "employee experience" within their workplaces. This includes workplace culture and other perks that will draw top talent to teams.

Now let's talk about the opportunities in the current market:

Pockets of loan demand. Not all CFIs are experiencing lower loan demand — at least not for all loan types. One CFI in North Carolina is scaling up its SBA 7(a) line of business, and a CFI in Florida is rolling out a 30Y fixed-rate mortgage product that can then be sold to either Fannie Mae or Freddie Mac.

For existing commercial customers, some are borrowing now to lock in interest rates before they rise further, while others are borrowing to expand, according to the CEO of a California CFI. Its customers, whether in retail, wholesale, or professional services, all tell the CFI they see opportunities within their sector.

A CFI in South Carolina is taking advantage of the population and business exodus from more expensive states to the Palmetto State. Business activity is up across the board, from restaurants to manufacturing, to travel and tourism. Says its CEO, *"Businesses are growing, businesses are looking for credit, they're looking for funding to finance inventory, they're looking for funding to buy real estate."*

Even a recession, if that is indeed where the market is headed, can sometimes be a good time to gain new customers who appreciate the help through turbulent waters. One Minnesota-based CFI has gained new customers by touting the benefits of working with a smaller, independent financial institution as more institutions in its market consolidate.

Further digital transformation. While most financial institutions will *"batten down the hatches and keep costs down"* in the face of a possible recession, the smart ones will continue to make surgical-level strategic investments to position them more competitively for the subsequent economic upturn, Forrester predicts. But institutions should not just improve their customer-facing digital experiences — they should also transform their core systems toward *"digital engagement solutions,"* or risk losing out to competitors that already have.

While this unpredictable economic market presents risks, there are also rewards for those who have their sights set on the long game. By being prepared for this year's challenges and ready to take advantage of the strategies fellow CFIs are already employing, you can embrace the current economic environment and maximize your efforts this year.

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ECONOMY & RATES

Rates As Of: 04/12/2023 05:32AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg

3M	5.04	0.19	0.62
6M	4.99	0.05	0.23
1Y	4.70	0.10	0.00
2Y	4.06	0.03	-0.37
5Y	3.55	-0.02	-0.45
10Y	3.44	-0.03	-0.44
30Y	3.63	-0.02	-0.33

FF Market	**FF Disc**	**IORB**
4.83	5.00	4.90
SOFR	**Prime**	**OBFR**
4.80	8.00	4.82