Five Themes for 2021

Executive Summary

Endurance Advisory Partners believes 5 key themes will resonate for financial institutions in 2021. In many ways, 2020 felt like a lost decade – it dragged on with catastrophic results for some people, some companies and some social institutions. That said, the unique environment of 2020 holds the potential of dramatic upsize, but requires careful management. Here are our thoughts on business priorities for financial institutions in 2021.

COVID-19 forced financial services to go online/mobile wherever possible. This accelerated adoption of digital banking tools ensures that traditional branch banking will never be the same. By the same token, disruption of traditional business practices threatens the credit performance of both consumer and commercial loans. Financial institutions that manage through credit risk are likely to face the problem of low loan-to-deposits or inadequate asset diversification. Whether due to digital, credit events, or the need for loan growth, all financial institutions will face cost and regulatory pressures. When we emerge from the COVID-19 lock-down, these five themes will be of paramount importance:

Digital Banking for Retail & Commercial Clients

- Implementing digital banking solutions to capture new clients
- Managing customer service requests through online channels
- Picking the right vendor(s) for your digital banking offerings
- Optimizing technology for scale, growth, and cost efficiency

Managing Risk in the Loan Portfolio

- Managing exits of PPP loans and forbearance agreements
- Best practices in monitoring, managing and reporting credit risk
- Assessing credit risk in your portfolio and developing strategies and action plans
- Establishing a special assets strategy that allows your personnel to focus on new opportunities. It's a new year, production remains important
- Considering new avenues for loan growth with acceptable risk parameters, adding geographic and industry diversity
- Managing interest rate risk within the loan portfolio versus balancing using the investment portfolio (see our commentary on current liquidity strategies)

Diversifying Loan Portfolios

- Growing and diversifying loan portfolios: what works and what doesn't
  - Understand your strengths and weakness. Consumer, Commercial, CRE and Specialty Lending
  - Set achievable goals that meet your bank's risk parameters, market and return targets
- Consider a focus syndicated loan market approach that aligns with your bank's risk appetite and need for diversification
- Aligning banking teams to achieve profitable

Operational Improvement/Cost Control

- Redesigning operational processes that are costing time, money, and customers
- Enhance FP&A functions to improve ability to forecast and analyze performance
- Improving cost efficiency or even radically reducing costs
- Improving the front-to-back lending process to reduce risk and improve client service

Regulatory Risk

- Avoiding pitfalls during M&A discussions/ transactions
- Revisit Enterprise Risk
- Assessing your Business Continuity Plan ahead of the next crisis (or wave of COVID-19)
- Navigating risk and regulatory complexity in financial services
- Ensuring KYC compliance in the age of online/mobile banking
- Adapting and enhancing BSA/AML/OFAC sanction programs
- Maintaining an active dialogue with your regulator and writing a strategic plan that meets their requirements
- Building effective compliance with PPP, forbearance and other government mandates

Digital Banking for Retail & Commercial Clients

If the pandemic taught us anything, it is how to work remotely. Across industries, both commercial and retail clients now have expectations that their financial institutions will be able to serve their needs without face-to-face contact. This puts a premium on digital product offerings.

Most banks need to optimize their technology to support their existing business and provide a platform that is scalable to support growth. Even though most banks offer online banking and mobile banking, most digital banking products offer limited functionality and are poor replacements for in person banking. Since banking has gone digital, it is critical for financial services firms to upgrade their technology to meet customer expectations. The prevalence of fraud during the pandemic and continuing cybersecurity threats makes this a high priority.

Digital banking transforms your ability to optimize liquidity, pricing and balance sheet management. With online account opening, any bank has the opportunity to grow deposits by posting a competitive rate. These depositors will often stick with a bank even if rates drop at rollover. Digital platforms are highly effective onramp to your digital platform, and effective at capturing money in motion during a market event. Online account opening is a highly effective way to build a deposit franchise and support growth without use of brokered deposits.

Endurance Advisory Partners gets banks online using state of the art products and independent vendors that fit best with each client's existing technology platform. The key decision is often choosing the right vendor partners. With our breadth and depth of experience with financial services vendors, we can guide your institution through the needs assessment and contracting process.

Managing Risk in the Loan Portfolio

As always, credit risk mitigation is key. Historically, unexpected credit losses have been the most important risk facing banks. The pandemic has transformed business models of borrowers across all industries. In 2021 even if we exit the pandemic, 2020 financial performance will provide limited insight into projections for 2021. It is impossible to know the full extent of the economic damage. As a result, banks will need to manage several new initiatives:

- **Best practices for Managing Credit Risk**. Many community banks are moving to dual assessment frameworks such as (i) probability of default and (ii) loss given default to better predict credit exposure.
- **Credit Risk Management/Monitoring**. To make it through any credit cycle, it is imperative that banks maintain accurate reports about the status of watch list and troubled borrowers. Ideally, the bank will understand and have visibility into the client's embedded risks, cost structure, and sources of revenue.
- **Work Out Plans**. Even banks with historically clean portfolios and good credit risk management practices will face challenging client situations. To best assist clients, the community and the bank, it is imperative to develop a game plan for each credit – one that is customized for that particular client that is practical and compliant. Endurance Advisory Partners can advise on individual client situations and help prioritize the bank's approach.
- **Special Asset Management**. Endurance Advisory Partners helps banks work through troubled credits either by organizing an in-house special asset/work-out function or by providing an outsourced solution.
- **Interest Rate Risk Management**. In the current environment, many banks are unable to raise deposits that match the interest rate exposure in the loan portfolio. Meanwhile, securities investments offer asymmetrical risk (rates up, price way down vs limited price appreciation potential). Endurance works with banks to quantify this risk and evaluate alternative strategies.
- **Liquidity Risk**. Considering the lack of attractive securities investments, banks should consider using syndicated loans to meet some of their liquidity needs.

Asset Diversification

Loan growth is the most important factor to protect net interest margin in 2021. With near zero interest rates on short term investments and few prudent long-term investments yielding more than 2%, loan growth is the only thing that has a chance of keeping NIM in the normal 2-3% range. Client acquisition and retention through your PPP and Main Street Lending programs may help, but the current economic environment clearly presents challenges and competitive pressures that we have not seen in decades. Banks must be able to differentiate themselves from the competition.

Investing in syndicated term loans is an underutilized mechanism to increase loans outstanding. Endurance Advisory Partners helps identify syndicated term loans that are available in either the primary or secondary markets to meet client risk / reward parameters. In many cases, syndicated loan borrowers have more financing alternatives, which result in lower risk on secured bank debt than exists elsewhere with many community bank loans.

Aligning and/or building banking teams by industry sector is another way of telegraphing an institutions commitment to a particular sector. This alignment is also a great way to build internal expertise that is critical to successfully penetrating sectors where such expertise is required. This alignment can be effective even when it is a few bankers.

Shifting portfolio limits to manage asset diversification within the bank's risk appetite is also necessary. In Endurance Advisory Partners experience, it is necessary to revise the segmentation categories specific to the bank's portfolio by adjusting some limits up or down to achieve the right risk balance. Since the goal of asset diversification is to reduce risk, it is important to get the limits right during periods of increased credit volatility.

Operational Improvement/Cost Control

Redesigning operational processes to reflect change in the way that business is done is especially important during periods of significant change – like now. Poorly designed processes, or well-designed processes that are no longer optimal, cost time and money. When old processes designed for a different economic environment now result in a poor customer experience, it also costs the bank customers. Endurance Advisory Partners works with its clients to achieve operational improvements.

Improving efficiency can radically reduce costs. The pandemic forever changed the way that customers interact with their bank. Retail lobby services and associated personnel costs have been replaced by remote/mobile deposit capture, mobile payments, and even mobile account opening. On the commercial side of the business, in person meetings moved to more efficient Zoom calls. With the right technology, these changes provide opportunities to improve efficiency and reduce costs while improving the customer experience.

Operational improvement can reduce risk in addition to cost. In many cases, banks gather the right information at the wrong time, or vice versa. For example, in commercial lending client selection is, arguably, as important than deal structuring. Hence, it is critical to manage the information flow from banker to credit approval, loan operations and portfolio management so that the bank makes the right decision and onboards the right loans. Improving the front-to-back lending process to reduce risk and improve client service.

Regulatory Risk

Special lending programs like PPP create operational risk that can trip up even well managed banks. With PPP& Main Street Lending, it is likely that loans made under these programs could be on the books for quite some time. Some PPP loans may not qualify for forgiveness. It is important for participating banks to have the right capabilities to ensure compliance with Federal Reserve or other regulatory rules. This applies just as much to residential loans that were granted forbearance.

COVID-19 is a real-life test of business continuity planning. For the most part, disaster recovery and business continuity plans worked. During the pandemic, many banks migrated a substantial portion of staff to remote work. Regulators will expect banks to adjust their BCPs to fix anything that did not go smoothly during the first wave of COVID-19. Of course, that needs to be done to make it through the entire COVID cycle as well as other potential events. In addition, a BCP must now address changes to operational processes coming out of the pandemic.

Managing KYC compliance in online/mobile activity is challenging. Know Your Customer (KYC) rules were developed for a world of in-person banking. For example, while compliance is a must, the path and tools for compliance and fraud monitoring change in a digital environment. Procedures are very different and policies may need to be revised as well. These changes should be addressed proactively. For example, waiting until you near full implementation of a digital platform will mean the project could risk delay or derailment. Banks also need to rethink other compliance rules in a world when customers are managing their bank relationship online. Navigating risk and managing regulatory complexity going forward will challenge many institutions. Our Risk and Compliance team can help.

Summary

Endurance Advisory Partners provides support enabling your bank to endure. We help clients sustain performance through informed strategic decision-making, continuous innovation, and effective governance. Endurance Advisory Partners follows strategy development with implementation–robust and efficient tactical practices to ensure firms can meet and exceed expectations coming out of the COVID-19 pandemic. Now more than ever, it is necessary to adapt quickly and reflexively in order to thrive during change. This also requires disciplined risk management programs that are integrated into the culture and decision-making process to address regulatory or shareholder concerns.

The Endurance Advisory Partners team is passionate about advising clients with complex challenges and providing solutions that work. We achieve results by pairing extensive industry relationships with deep understanding of banking, regulatory, technology, and financial markets to help clients develop and execute strategies.

Endurance Advisory Partners is personally committed to your success.

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