The BakerGroup

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Is Your Balance Sheet Recession Ready?

I recently joked that I have read an article every week for the past year that says a recession is starting the next month. But where is that recession? Everyone—or maybe some of us—remember the common rule of thumb that two consecutive quarters of negative gross domestic product (GDP) growth equals a recession. However, determining a recession is not quite that simple. The official recession determination is made by the National Bureau of Economic Research (NBER), which is a committee made up of eight economists who use many factors in making that determination. The NBER states their traditional definition of a recession is "a significant decline in economic activity that is spread across the economy and that lasts more than a few months." As of September 2023, the NBER hasn't declared an official recession since the COVID-induced recession of April 2020.

A recession typically has plenty of negative consequences, including a rise in the unemployment rate as well as stagnate or declining incomes. As a result, consumer spending declines, which further impacts businesses and their bottom lines. The early phases of an economic downturn often coincide with increases in interest rates as the Federal Reserve uses monetary policy to pump the brakes on an overheating economy to help control inflation. The Federal Reserve's monetary actions have a major impact on institutions' balance sheets, specifically with loan and deposit pricing. As the Fed raises rates, the cost of credit increases and deposit rates increase (usually at a slow pace), therefore incentivizing less borrowing and more saving. These macroeconomic and interest rate dynamics play a major factor in overall performance and balance sheet management.

No one has the crystal ball on when the next recession will begin, how long it will last, and how severe it will be. However, given the recent decline in inflation levels due to the Fed's aggressive tightening cycle, it does feel as if we are getting closer to the peak in interest rates and closer to the end of the current economic cycle. Whether this current Fed tightening cycle ends in a recession or a soft landing, the Fed's latest Dot Plot points to a path for lower interest rates in the future. Balance sheet managers and ALCOs should never try to time the peak of interest rates. Rather, they should best prepare the balance sheet for the next recession and/or falling interest rates.

Here are some considerations for preparing the balance sheet for the next recession.

- **Interest Rate Risk –** Whether the current tightening cycle ends in a recession or a soft landing, there is a high likelihood for some level of lower rates in the future. Utilizing your Interest Rate Risk Model to identify any exposures to falling interest rates is critical. Managing your asset sensitivity and asset duration through effective investment selection and strategy is key. Being reactive is not a strategy.
- **Credit Risk –** Asset quality problems of some magnitude accompany recessions. Ensure current loan pricing and structure is appropriate given the deal and current environment. Avoid chasing loan demand late in the cycle by tightening credit underwriting standards.
- **Liquidity –** Historically, during recessions and falling rate scenarios, deposit levels increase, and liquidity levels grow. Ensure your assets are fully deployed to optimize your earning asset mix while keeping a cushion of unencumbered liquid assets. Lastly, every institution should have ample contingent liquidity sources for those unforeseen liquidity events and needs.
- **Stress Testing –** Stress testing should be done on a regular basis. It important to consider higher impact, lower probability scenarios when creating stress scenarios. Stress testing can be conducted to various aspects of the institution including the following: capital, liquidity, and interest rate risk.

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"How can we better prepare for a possible recession?" I encourage you to put this question as an agenda item for your next ALCO meeting. Every institution's balance sheet and risk profile are unique. There is no one-size-fits-all strategy but being proactive and having a plan (as well as contingency plans) is essential.

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