White Paper

If Recession, Then What? Why You Need a Plan for Any Downturn

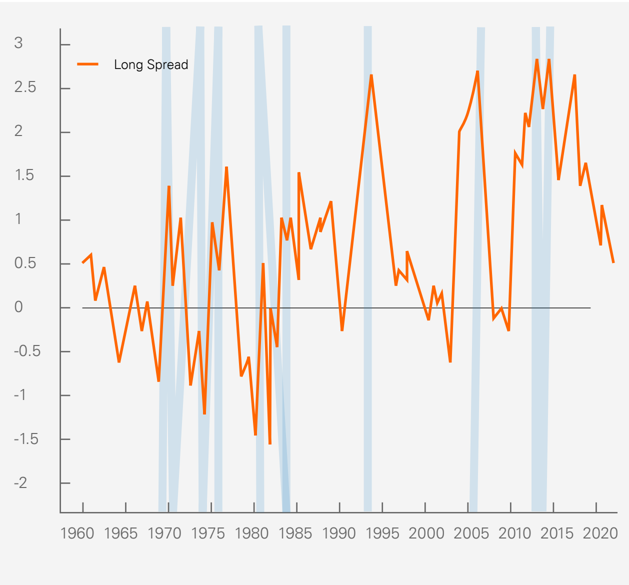
Conversations have been buzzing about the possibility or likelihood of a recession. Although the economy might not seem to be on the brink of slowing down, recessions are often preceded by economic strength. Now is the time for bank CEOs and senior planning leaders to dust off their contingency plans.

Part of the current talk of recession or correction is predicated on the age of the current recovery (which is much longer than normal by historical standards) and part of it is provoked by various market indicators that may portend a downturn. Examples of the latter are such things as the slowing rate of new and existing home sales, lower automobile sales and related industry layoffs and restructurings, the expected slowdown of growth in the Chinese economy, and a U.S. economy that seems to be at or near full employment (which effectively caps additional growth due to resource constraints).

In addition, there has been a great deal of attention on the shape of the yield curve, since historically an inverted (downward sloping) yield curve has been a reliable leading indicator of impending recession. In fact, a Federal Reserve of Chicago white paper published in September 2018 asked the question "Why does the yield curve slope predict recessions?" What followed in that 17-page white paper is a well-reasoned and very academic discussion of the relationship between slope and recession, but a compelling argument is made in a single graph (below) that shows a time series of the slope of the yield curve (the difference between the two-year and 10-year treasury rates) and the subsequent recessions.

The graph on the next page shows that every single recession since 1960 has been preceded by a period in which the two-year treasury yield exceeded the yield on the 10-year treasury (sometimes by a little, and sometimes by a lot). In some cases, those events happened very close to each other in time. In other cases, it took longer. In a few cases the yield curve slope turned negative, reverted to positive for a while, and then went negative again – but every negative slope was followed by a recession.

Ten-to-two-year yield-curve spread



Federal Reserve of Chicago, 2018

The shape of the yield curve does not cause the recession, but it is instead an indicator of investors' collective expectations about the future course of the economy. Not coincidentally, their expectation of a downturn and the actions taken as a result of that expectation generally lead to the subsequent recession. In that sense, the slope of the curve can be thought of as an indicator of investor confidence, and when investors lose confidence, there are inevitable consequences.

So is a recession imminent? The jury is still very much out on that matter and thus far there is no real consensus, but we have just seen (December 2018) the two-year to five-year section of the yield curve invert for the first time in about 10 years. So while we are not ready to label it imminent, the circumstances seem very appropriate to have a plan in place.

When Should You Be Concerned?

According to the U.S. Bureau of Economic Analysis, a recession is a marked slippage in economic activity. While GDP is the broadest measure of economic activity, the often-cited identification of a recession with two consecutive quarters of negative GDP growth is not an official designation. The designation of a recession is the province of a committee of experts at the National Bureau of Economic Research (NBER), a private nonprofit research organization that focuses on understanding the U.S. economy. The NBER recession is a monthly concept that takes into account a number of monthly indicators – such as employment, personal income and industrial production – as well as quarterly GDP growth. Financial institutions shouldn't panic if they see negative GDP growth. That is not the time to bring out your contingency plan. Instead, keep tabs on the NBER, which has a broader understanding of the U.S. economy.

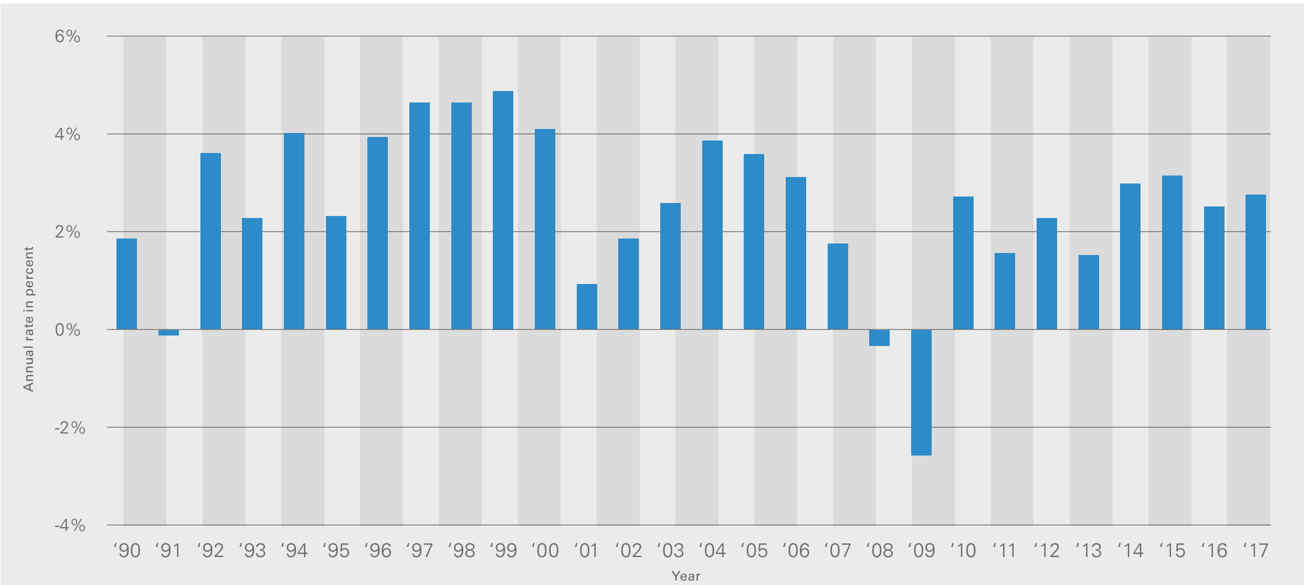
How Long Will It Last?

You've brought out your contingency plan and now you're waiting for signs of improvement. One thing to keep a watchful eye on is the employment rate, because the speed of recovery can be the best indicator of the depth and duration of a recession.

When economic growth slows and then actually contracts, employment tends to drop. How far employment drops and how long it takes to recover tend to be pretty good measures of the depth and duration of a recession.

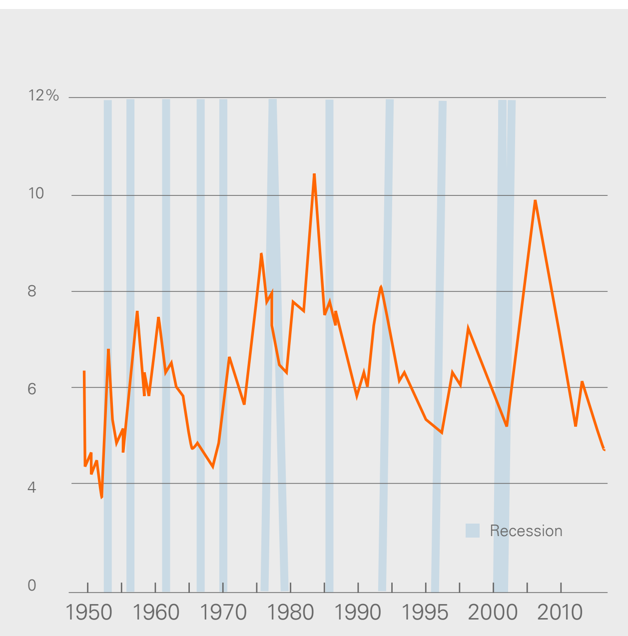
As shown in the charts below, the depth of the most recent recession took less than two years to reach bottom (a rise of 6 percent in unemployment), and it took almost five years to get employment back to its prerecession levels.

Real GDP Growth of the United States, 1990–2017



Source: Statista

Unemployment Rate

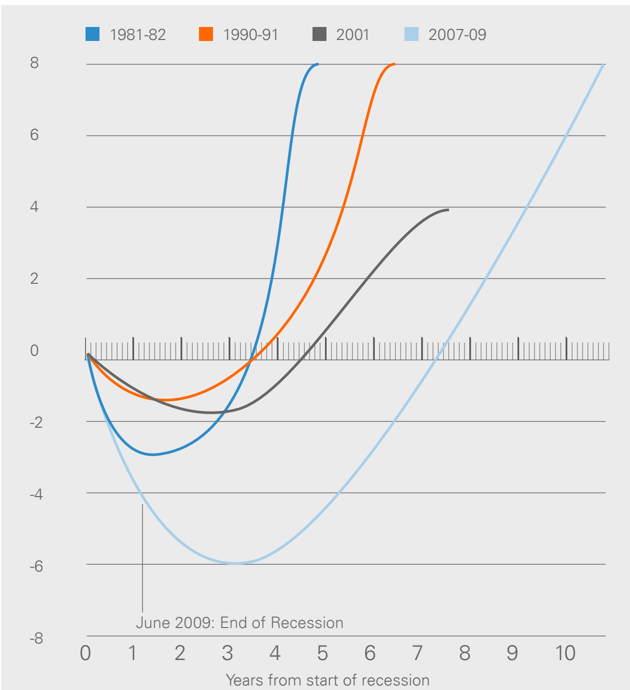


Source: Bureau of Labor Statistics and National Bureau of Econimce Reasesachr

Planning for the Downturn

The irony is that if enough people take the same actions at the same time to prepare for a downturn, that may serve to accelerate the timing of, and amplify the depth of, a downturn. Community bankers need to weigh what they can do to help their community weather the downturn without taking risks that would jeopardize the safety and soundness of their community financial institution. As a result, managers may wish to consider which actions they should implement sooner and which might be considered contingency plans. One example of this would be staffing. If demand is expected to soften, should financial institutions forestall hiring and use contract/temporary employees, allow attrition to occur naturally or resort to layoffs? Early decisions allow more flexibility than do later ones.

Percent Change in Nonfarm Payroll Employment Since Start of Recession



Source: CBPP calculations from Bureau of Labor Statics data

Here are some prerecession to-dos:

- Forecast deposit and loan growth levels given the best available information, and determine what those expected demand levels dictate in terms of human and other resources. It may be prudent to perform a sensitivity analysis in case the actual turns out to be more than 10 percent above or below the forecast
- Identify current capacity, given existing resources, to compare with the demand forecast. Is there excess capacity? Are there opportunities to streamline and improve processes? Are there opportunities to outsource some functions or use consultants to augment staff in re-engineering?
- Identify underperforming segments, branches and staff, and consider means by which you might lighten the load. It is entirely possible that a branch or branches that are underperforming might still be perceived favorably by others and might earn a premium on sale now versus a discount later
- Look at credit standards and deposit pricing and make sure you are not stretching too far. Make sure incremental growth is profitable and well grounded. How would each new credit look if the borrower suffered a 10 or 20 percent reduction in sales? Is the market overbuilt? Are customer receivables slowing and delinquencies rising? Should collateral and equity requirements be raised and debt service requirements tightened? On the deposit side, are deposits growing faster than can be put to work, and are we possibly paying a premium for the privilege? Does that encourage extra risk to cover the cost of those deposits? Can we afford to allow 5 or 10 percent of deposits to run off, and what needs to be done to accommodate that sort of shrinkage?
- Is the balance sheet clean, or are there other real estate owned (OREO) and nonperforming loans to resolve? Such assets seldom appreciate in a downturn, and it may be that the last offer was the best offer
- Is an interest rate sensitivity restructuring of the balance sheet in order? Perhaps now is an appropriate time to consider extending maturities in the bond portfolio, perhaps even using floating rate borrowings to fund fixed rate assets

- Review contingency funding plans to make sure they are current and viable. In a downturn, sources of funding may dry up entirely or be much more difficult to access. Sometimes, borrowing in advance of the actual need may be appropriate to ensure that the funding is locked in, in which case the question is: Can we reinvest and cover the cost through temporary investments?
- Compare your institution's performance carefully and critically versus comparable peers. Quantify the dollar value of any material differences and rank them in order of cost benefit, then draw up any implementation plans that are needed. Are there opportunities for automation?

By understanding the need to plan for an economic downturn, and prepare alternatives in advance, your organization stands a better chance of mitigating adverse effects. Fiserv has the resources, solutions and expertise to help you plan for any circumstance. Engage your client partner or a senior strategist today to learn more.

About the Authors

Grey Winstead, Senior Strategist
Grey brings over 30 years of experience in the executive management of six successful community banks in the metro Atlanta and north Georgia markets. He is a certified public accountant and a Chartered Global Management Accountant. His experience includes organizing de novo banks, converting charters, and going public and going private capital transactions. His merger and acquisition experience includes the sale and purchase of community banks, including due diligence, valuations, negotiations, closing and merger integration. He has been responsible for strategic planning and execution management, incentive alignment, investor relations, regulatory relations, and financial, operations and IT management. His perspective brings balance to the competing needs of shareholder returns, customer value propositions, and regulatory safety and soundness.

Anne High, Director, Advisory, Bank Intelligence Solutions
Anne brings over 20 years of financial service experience to her role as director. In addition to serving as a senior strategist for Bank Intelligence Solutions from Fiserv, she has held leadership roles in both finance and marketing along with serving in retail and operational areas of banks and a captive finance company. In finance, Anne participated in the implementation of a profitability measurement initiative and held positions in the asset-liability committee, financial planning and accounting. In marketing, she developed a market optimization strategy for a regional bank with $18 billion in assets, led marketing research analytics teams and managed the sales performance measurement initiatives. As a former user of BankAnalyst® from Fiserv in the bank environment, Anne brings expertise in the practical application of the tools for strategic planning, peer analysis and market planning.

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