COVID-19 Risk Analysis

stress testing risk management pandemic

Summary: With the current environment, you will need to view credit risk in a much different way than ever before. We give you three important steps to take.

Did you know that goldfish can tell the music of one composer from another? Maybe not. But, all bankers know that the coronavirus is creating a symphony of risk these days.

In considering the impact of COVID-19 on virtually all aspects of life, we find ourselves using words like "unprecedented." With this new reality, we also feel compelled to view credit risk in a much different way than ever before. With such a critical task, in such an unknown (and developing) environment, it is valuable to have the right approach and not rely solely on what we have done in the past. So how do financial institutions (FIs) do this?

1. Amidst all this uncertainty, let's begin with something we do know - **historical performance** - to help provide a starting point to discuss the future. We have found that looking at the correlation of GDP, unemployment and loan loss rates over a period of time can provide a sense of how the first two factors impact the third, loan loss rates. While this type of analysis certainly can be done using a number of methodologies, we have found that multiple-regression is a highly effective tool to provide a starting point. Additionally, focusing on state-level loss rates may offer a better starting point, as a more representative picture of your loan loss history.

   For example, on a national basis, (using a set of projections for GDP and unemployment), the Q2 2020 projected quarterly loan loss rate would be 1.59% for all loan categories; but for IL, the quarterly loan loss rate would only be 0.50% (over the same time period with the same forecast). National data, after all, includes areas like Nevada that were hard hit during the last recession.

2. Next, once you have a starting point based on historic data and regularly updated projections, you can start to overlay those results with the **trends and economic indicators** you are seeing in this current environment for your various loan groups. Be vigilant for new characteristics that may point to emerging risks that perhaps had not been a consideration in the past.

   It might be beneficial to run a report on all your COVID-19 loan payment deferrals, and then further divide those out by industry or property type. Another option is to parse them out by "likely to regain steady business after shelter-in-place is lifted" vs. "likely will struggle to recover even after shelter-in-place is lifted."

3. Finally, the goal is to pair the historic and economic data with your own experience in the local markets. Certain industries are doing better than others within your community. Also, certain borrowers are more able to weather through this crisis than others. Your institution's actual history, underwriting and credit structures, and the timing of past losses will provide additional guidance as to what multiplier to use when reviewing state or national results as will the timing.

If you feel confident with your risk assessment approach, then you are a step ahead of many other FIs. It is a necessary task to assess the risk of COVID-19, but it doesn't need to be a painful one.

If you need any further guidance, listen to our on-demand webinar, Incorporating the Impact: COVID-19 and Your Loan Portfolio or contact us today.

COVID-19 IMPACTING YOUR RESERVE

COVID-19 uncertainty makes calculating your reserve more challenging. So, we created a complimentary analysis of the historical relationship of loss rates, GDP and unemployment to use for your calculations. To learn more, download COVID-19 Reserve Insights today.