Assessing Capital Using Economic Data

stress testing risk management pandemic

Summary: Many financial institutions are evaluating their loan portfolios for COVID-19 effects on capital. We explain how to use economic data effectively when doing this.

The top 3 most stressful events in life are: 1) death of a loved one; 2) divorce and 3) moving. Of course, many of us would add stress testing your loan portfolios during COVID-19 to that list.

Last Friday, the Fed announced the results of its annual stress test. While testing the big banks, the Fed came to the conclusion that they are strong enough to weather the continuing coronavirus crisis. Yet, loan losses could add up to $700B for them, so they clearly need to watch their capital levels. Although losses would not be that high for community financial institutions (CFIs), they too need to watch their capital levels.

In today's still evolving crisis, the best way to do this is to closely evaluate loan portfolios for their potential effects on capital. The unemployment rate and GDP trends are excellent data for forecasting possible losses in your portfolio. CFIs may also want to consider other economic data for analysis of their portfolio too, such as housing data and consumer confidence.

Housing Data. After a 9.4% YoY increase in pending home sales in February 2020, contracts to buy previously owned homes declined 16.3% in March 2020 vs. last year. On a regional basis in March, pending home sales saw the steepest decline in the West at 21.5%, followed by the South at 17.8%, the Midwest at 12.4%, and the Northeast at 11.0%. When evaluating this data for your financial institution, it is of course important to look past national and regional data to evaluate state and local data. For instance, although the Northeast saw the smallest decline of the regions above, the state of New York alone saw pending home sales drop 21.1% March over March.

Consumer Confidence. Alternatively, your financial institution may want to evaluate trends in consumer confidence as a result of the crisis. Per the University of Michigan's study, national consumer sentiment reached 101 in February of this year, then fell to 89.1 in March and 71.8 in April. The index did rebound slightly in May to 73.7.

When evaluating the effects that consumer confidence may have on your portfolio, you may also want to use both national and state data. It is interesting to note that recent studies have shown that COVID-19-related consumer confidence in most states shows a higher correlation with the number of confirmed cases in the country as opposed to the number of cases in the state.

Given the acute volatility in economic conditions today, several of our clients have asked that we extend our COVID-19 Reserve Insights to be expanded for stress testing. We've done that.

If you find you need some assistance reviewing the effects of COVID-19 on your loan portfolio and capital levels, let us know. We all want to be well-prepared as this crisis continues to unfold.

SAVE TIME AND MONEY WITH OUR STRESS TESTING SERVICE

Now more than ever, it is important to stress test loans of all types from multiple perspectives and on a portfolio basis. Get expert help to save you time and money. Learn more about stress testing today.