Inflation Is Up – Now Is The Time For Stress Testing

stress testing CECL liquidity

Summary: The personal consumption expenditures price index rose more than 3.6% YoY, according to the US Commerce Department. With inflation here for now, community financial institutions should update their loan and liquidity stress tests to ensure they are ready for anything. Here are three steps to prepare your institution for the coming effects.

Shaquille O'Neal divulged that he once spent $1MM in one day when he was young and newly rich — by buying three expensive cars and lots of jewelry for himself, family, and friends. However, he forgot to take into account his agent's salary, taxes, and other outflows, which put him in debt by $60K.

Many consumers went on a bit of a spending spree with pent-up demand after last year. The US Commerce Department recently reported that the personal consumption expenditures price index (PCE) increased by more than 3.6% YoY, which is the quickest surge in three decades. With this rise in inflation, now is the time for community financial institutions (CFIs) to update their loan and liquidity stress tests.

Stimulus programs kept losses low — and calmed markets. But now, the amount of stimulus causes one to think more deeply about inflation. Some experts say that inflation is artificially high and will come down once supply issues resolve and labor supply stabilizes. However, when and how that happens is still uncertain. In the meantime, interest rate risk is increasing and CFIs need to prepare.

Small increases in inflation will slowly drive up rates which would likely help margins. Yet, as rates continue to rise, default rates will increase. Customers that can't accommodate their cash flow with the rising cost of their loan will be in jeopardy. It is only through stress testing that CFIs will know how resilient they are to these new economic shifts and which customers are at greatest risk.

As Wharton School of Business Finance Professor points out, "*When inflation goes up and rates go up, the value of long-term positions decreases faster and in a more pronounced way than the value of short-term positions. [Consequently], banks will see a decrease in the value of their assets, [which will be] more than that in the value of their liabilities.*"

So, how ready is your institution? Here are **three steps to ensure that it is properly prepared**.

1. Stress test your loan portfolios rigorously. With economic support stopping on a few fronts for businesses, it is vital to test your loan portfolios with multiple scenarios. Even the slightest changes could affect certain loan portfolios profoundly, especially if they are concentrated in one sector. One should include scenarios such as continuing inflation, while another should include economic ramp-up, based on new OSHA COVID guidance, among others.

Fine-tuning the parameters will be important too. How much more will inflation rise or drop? Using those metrics with varying increases in interest rates, what is the effect on your loans? Loans in industries that are more sensitive to inflation and economic fluctuations, such as construction, and business capital goods, will likely be more heavily impacted. Other sectors such as health care will likely fare better.

2. Mitigate liquidity risk. Right now, most CFIs have plenty of liquidity. But, that won't last forever. When do you expect it will decrease? How consistently or inconsistently will that happen? As your liquidity is depleted, will you have other sources? Are there sources that may be better today than when you last laid your liquidity plans? Are you too reliant on brokered or other wholesale deposits? Make sure you review your liquidity plan carefully and adjust accordingly.

3. Sync up with CECL. We have found that many bankers still haven't started their CECL preparations, but now is the time. Not only will you need to collect more data, but you will also need to have CECL's forecasted assumptions tied together with other analyses. So, while you stress test your loan portfolio and liquidity, you need to connect those activities with your CECL implementation. How does your CECL implementation timeline affect your stress testing activities? Make sure that they are in sync, not only for the sake of your institution, but also for the sake of the regulatory agencies that will be checking them.

While it may seem that there is a lot to do these days, if you start with these three steps, you will be ahead of the game. These days, that is where we all strive to be.

STRESS TESTING: TOP-DOWN OR BOTTOM-UP

In this market, it is important to stress test your loan portfolio. We offer multiple approaches that will fit your needs and your regulatory compliance requirements. Quickly stress test your loan portfolio and get pre-exam assistance. Learn more about stress testing today.

ECONOMY & RATES

Rates As Of: 10/04/2021 06:26AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	0.04	0.00	-0.05
6M	0.05	0.00	-0.04
1Y	0.09	0.00	-0.02
2Y	0.28	0.00	0.16
5Y	0.96	-0.01	0.59
10Y	1.50	0.00	0.57
30Y	2.06	0.02	0.42

FF Market	FF Disc	IORB
0.08	0.25	0.15
SOFR	**Prime**	**OBFR**
0.05	3.25	0.07