How Big Banks' 2024 Stress Testing Scenarios Can Help You

stress testing risk management

Summary: The Federal Reserve has released its 2024 stress testing scenarios: its primary tool to assess the largest banks' fiscal health resiliency by estimating losses, net revenue, and capital levels under hypothetical recession scenarios. This year's severely adverse scenario includes unemployment reaching 10%, a widening spread on corporate bonds, and dramatic declines in asset prices. We summarize the scenarios and determine how they can help CFIs devise their own tests to improve their capital planning and risk management.

In 1940, only four months after opening, the Tacoma Narrows Bridge in Washington state twisted and collapsed into Puget Sound during a windstorm. The third-longest suspension bridge in the world, it undulated even in moderate winds, earning it the nickname "Galloping Gertie" after the engineer. Nowadays, engineering simulation plays a crucial part in testing bridge designs to help prevent failures like this one. The replacement bridge, opened in 1950, underwent years of rigorous aerodynamic testing to ensure it would be a safe design. This version of the bridge still carries westbound traffic across the Puget Sound.

Speaking of testing stability, financial institutions go to similar lengths to ensure they can withstand any severely adverse conditions. Last month, the Federal Reserve (Fed) released its stress test standards for banks with assets over $100B. The stress test is part of an annual health check that ensures financial institutions can withstand adverse market conditions and have adequate capital to cope with a potential market shock. Last year's headline-grabbing bank failures and the more recent concerns about certain subsectors of the commercial real estate (CRE) market — affected by higher interest rates and lower occupancy due to continued remote working — underscore the importance of these tests.

Although community financial institutions (CFIs) are not required to conduct the Fed's stress tests, there are important insights for them to gain from the standards. CFIs, of course, still need to understand how global or national downturns can impact their operations, risk profile, and ability to serve their local markets. Analyzing the Fed's scenarios can help CFIs design their own stress tests to reflect their specific circumstances.

Understanding the Fed's Scenarios

The Fed's stress test scenarios, which outline hypothetical economic conditions, revolve around 28 variables, including the following:

- Six measures of economic activity and prices — nominal and real GDP, nominal and real disposable income, consumer price index, and unemployment rate
- Four aggregate measures of asset prices — such as residential and commercial real estate (CRE) prices, equity prices, and stock market volatility
- Six measures of short and long-term interest rates
- Twelve variables describing international economic conditions

The Fed's baseline and severely adverse scenarios for 2024 are as follows:

1. The baseline scenario. This scenario mirrors the average projections gathered from a survey of economic forecasters and features moderate economic growth and minor changes to current metrics. Notable variables are:

- A 26% increase in real GDP
- A 4.1% unemployment rate
- A 21% drop in inflation
- Annual increases of 1.5% in home prices and CRE prices
- A 41.5% fall in the 3-month Treasury yield
- A 25% fall in the 10Y Treasury yield

2. The severely adverse scenario. The severely adverse scenario outlines an extreme hypothetical situation designed to evaluate the robustness of financial institutions in challenging economic conditions. This year, most variables are in line with 2023 scenarios, including a high unemployment rate and sharp falls in real estate prices. In particular, this scenario notes the following conditions:

- An 8.5% drop in real GDP
- A 10% unemployment rate
- A 40% decline in CRE prices
- A 36% drop in house prices
- A 55% fall in equity prices
- A 4.1% increase in BBB-rated corporate bond spreads
- A peak value of 70 in the volatility index

Lessons for CFIs

So, what are the key takeaways for CFIs? We outline some scenarios that CFIs may wish to incorporate into their own stress testing.

1. **Local economic downturn.** Global and national events can impact local economies, leading to a decline in local industries, spikes in unemployment, and/or a fall in real estate values.
2. **Deterioration of credit quality.** A CFI's scenarios should involve adverse credit events, such as increases in loan defaults and a fall in collateral value. Although CRE is the prime concern, the testing should reflect the CFI's specific lending concentrations and their historic experience in other significant downturns, such as in 2007 and 2001.
3. **Interest rate changes.** Sudden changes in interest rates could impact net interest margins, loan demand, and deposit levels. Building these into their stress testing can help CFIs evaluate their interest-rate risk exposure and develop strategies to mitigate potential losses.
4. **Liquidity challenges.** CFIs may face liquidity challenges, such as a sudden withdrawal of deposits or difficulty accessing funding sources. Using these scenarios might assist in evaluating the institution's ability to maintain adequate liquidity and develop contingency funding plans.

Stress testing is a key component of solid risk management and critical to capital planning. Taking a deep dive into the Fed's scenarios can help CFIs develop a system that works for them and reflects their unique business operations, portfolios, and concentrations. Some smaller institutions may only need a simple CRE stress test, while others may require a more sophisticated approach. Correspondent banks, such as PCBB, can offer both top-down and bottom-up credit stress testing and provide helpful insights to CFIs. For large institutions, the Fed plans to publish the findings of this year's stress test in June. We'll keep you updated once the results are released.

TOP 6 STRESS TESTING TIPS FOR TODAY'S MARKET

With recent market downturns, interest rate fluctuations, and even liquidity issues, where do you start with stress testing your portfolio? Download this white paper for tips.

ECONOMY & RATES

Rates As Of: 03/28/2024 05:14AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.45	0.00	0.05
6M	5.36	0.06	0.10
1Y	5.00	0.01	0.24
2Y	4.62	0.00	0.37
5Y	4.23	-0.02	0.38
10Y	4.22	-0.03	0.34
30Y	4.37	-0.01	0.34

FF Market	FF Disc	IORB
5.33	5.50	5.40
SOFR	**Prime**	**OBFR**
5.33	8.50	5.32