How To Test For Volatility In A Post-Pandemic Normal

stress testing risk management credit risk pandemic

Summary: Trying to figure out how today's balance sheet will respond to future events is more difficult than ever before. But, as the pandemic unevenly ends, this becomes critical. Test for volatility to anticipate structural weaknesses by examining the business model, back-testing for validity, and challenging assumptions.

Auguste Rodin's bronze statue, *The Thinker*, was originally commissioned in 1880 for a doorway area called, The Gates of Hell. While this area was based on Dante's "The Divine Comedy", some would say that with the pandemic and economic disruptions, we have passed through similar gates. Further, just like Rodin's statue, bankers have been prompted to think deeper about the interplay of risks for their institution.

For instance, expected loan losses are particularly difficult to calculate during the pandemic, with many businesses struggling, some thriving, and government assistance programs keeping many afloat. The economy is rapidly showing signs of strength. However, the recovery is uneven. Many questions are being asked by bankers these days.

Ongoing questions. With the additional stimulus, have we overstimulated the economy and created future asset bubbles? Short rates are rising quickly too. Are we seeing speculation in single-family assets? Regarding commercial real estate (CRE), no one knows how much CRE we're going to need. Is my CRE portfolio in the right place, but the wrong sector? How do I manage through this? Should I grow and take advantage of the distortions in the market or should I hunker down and protect capital? What scenarios will I model to test these decisions? Will the near future be like the rebound from the 1919 Spanish Flu into the Roaring 20s or are we headed into another asset bubble correction like the Great Recession? The bottom line with all these unknowns is to integrate ALM & stress testing to be reflective of the entire organization.

Test for Volatility. Scenario testing is useful but with so many unknowns, testing for volatility is equally important. This means looking at the balance sheet and examining it for concentrations not only in loans, but in liquidity and by extension, its underlying business strategies. Once you have examined the business model, back-test validity and challenge your assumptions. Those three steps will show you where your institution lands on volatility.

1. **Examine the business model.** To do this, start with what the strategic weaknesses of the business model are. For instance, take two community financial institutions (CFIs), one in an urban market and one in a more suburban market. They both share a similar size, similar use of technology, and a similar financial condition in 2019. Yet, the urban CFI developed from a niche-driven strategy, focusing on one or two segments, groups, or industries. In contrast, the suburban CFI was forced to be more diversified, perhaps driven from a geographically-driven strategy, or needing to serve a more diverse set of consumers and businesses that resulted in multiple lines of business. Which one will be stronger in 2021? To answer that question, you would need to know the weaknesses and capital cushion for each institution relative to their business model.

2. **Back-test for Validity.** Next, look at how historically the balance sheet has responded in previous recessions. Does the needed data exist in the asset-liability management solutions and existing top-down stress models? Are the assumptions and results from the asset-liability models consistent with the post-pandemic world? As the results of stress tests are discussed, are the assumptions made between departments consistent with the institution's overall assumptions? As historical data is reviewed, what levels of capital did others need to weather those disruptions?
3. **Challenge assumptions.** To ensure that the assumptions made won't create additional weakness, they need to be tested. To test these, use different stress scenarios, including those that turn both downwards and upwards. Consider assessing how concentrated the balance sheet is by industry by NAICS. Your results will also need to consider if you are a niche lender with high underlying concentrations or a diversified lender with strong correlations to certain industries.

We know that CFIs have a better understanding of their business customers than many other financial institutions. Yet, between the challenges of the pandemic and the new guidelines, it may be helpful to have a third party's perspective. We can help you get it right the first time around. Contact us for more information.

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Regulators have raised the bar on interest rate risk and liquidity analysis, yet there is more to do than there are hours in a day. To see how easy it can be & get expert help, contact us today.