How CFIs Can Maintain Adequate Capital in a Downturn

stress testing risk management capital capital management

Summary: The Federal Reserve just concluded its annual capital adequacy annual stress test with 33 participating banks. While regulators don't require CFIs to run stress tests to assess their capital adequacy, the federal banking supervisory agencies indicate that they should have the capacity to analyze the potential impact of adverse outcomes, and particularly encourage this for CFIs with CRE portfolios. We provide four steps to help form the foundation of an effective capital planning process.

According to the National Earthquake Information Center, of the average 20K earthquakes that occur across the globe annually, more than a dozen result in extreme devastation. Collapsing buildings cause $2.1B in damage and lead to the loss of 10K lives each year. In 2021, to help mitigate the impact, University of California San Diego upgraded its Large High Performance Outdoor Shake Table — the first and largest shake table in the world. It enables seismic testing on large structural systems by reproducing multi-dimensional ground motions with unprecedented accuracy. This testing method has led to the development of safer structures that can withstand strong earthquakes.

The results of a different kind of stress testing were released on June 23 by the Federal Reserve. The 33 participating banks passed the annual test with flying colors, proving they have "*strong capital levels, allowing them to continue lending to households and businesses during a severe recession .*" This year's hypothetical scenario included a severe global recession, stress in commercial real estate and corporate debt markets, rising unemployment, and declining GDP. Despite projected total losses of $612B, large banks maintained an aggregate common equity capital ratio of 9.7%, double the required figure.

This data effectively gives banking giants the go-ahead to distribute billions of dollars in excess capital via dividends and share buybacks, as most of them have already announced. Bucking the trend, JPMorgan Chase and Citigroup are keeping the payouts unchanged. "*We will continue to use our capital to invest in and grow our market-leading businesses, pay a sustainable dividend, and we will retain capital to fully satisfy our future regulatory requirements,*" said JPMorgan Chase CEO Jamie Dimon.

Why CFIs should conduct stress tests

Although regulators don't require community financial institutions (CFIs) to run stress tests to assess their capital adequacy, the federal banking supervisory agencies "*emphasize that all banking organizations, regardless of size, should have the capacity to analyze the potential impact of adverse outcomes on their financial condition.*" This is particularly encouraged for institutions with commercial real estate portfolios.

CFIs can benefit from stress testing — whether at the transaction, portfolio, or enterprise level — in many ways, including enabling better strategic decision-making, improving risk management and capital planning, and enhancing the value of the institution.

For example, consider a CFI with relatively strong capital, asset quality, and earnings performance. Stress testing could provide management with evidence of more than adequate capital levels, allowing for the distribution of excess capital through increased dividends, shareholder buyback plans, or a strategic acquisition. Conversely, a CFI in more distressed circumstances might benefit from the insights provided by stress testing to develop a plan to help fill the potential shortfall.

How CFIs can ensure capital adequacy

As the demands for capital adequacy increases, it's recommended that all CFIs establish and maintain a comprehensive capital plan. An essential element of a sound risk framework, a capital plan can enable an institution to better manage its capital reserves and reduce its dependency on raising extra capital from other sources.

These **four steps** form the foundation of an effective capital planning process:

1. **Review your strategic plan** to outline the goals set by the board of directors and provide an initial view of the financial position of the institution over the next five years. This should include forecasts for asset quality, asset-liability mix, and equity multipliers, as well as capital targets, sources and uses.
2. **Assess the material risks**, including primary banking risks, such as credit, interest rate, liquidity, price, reputational and strategic risk, and other risks the institution may be exposed to, such as third-party relationships or off-balance sheet exposures.
3. **Conduct various stress tests**, such as a sensitivity analysis and scenario analysis. A portfolio sensitivity analysis examines the effect of variations in certain inputs (such as recovery or loss rates) on asset quality, earnings, and capital. For scenario analyses — to test and stress for changes in interest rate and credit risk — the Fed's 2022 scenarios provide a good starting point for CFIs to develop their own scenarios, customized to their individual risk profiles.
4. **Develop a contingency plan** to maintain capital adequacy. Effective capital plans typically establish triggers that allow the institution to act in advance of adverse scenarios. Options may include retaining more earnings, issuing stock, tax planning strategies (such as municipal bond portfolio strategies), and altering the balance sheet size and mix.

All financial institutions are expected to maintain adequate capital relative to their risk profile. A comprehensive capital plan that includes appropriate stress testing will go a long way to ensure long-term growth and resilience to adverse events.

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ECONOMY & RATES

Rates As Of: 08/17/2022 09:07AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	2.70	0.29	2.64
6M	3.12	0.21	2.93
1Y	3.31	0.38	2.92
2Y	3.35	0.46	2.61
5Y	3.08	0.40	1.81
10Y	2.91	0.26	1.40
30Y	3.16	0.15	1.26

FF Market	FF Disc	IORB
2.33	2.50	2.40
SOFR	**Prime**	**OBFR**
2.29	5.50	2.32