Gaining confidence through stress-testing and planning

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Stress testing your institution's capital and liquidity is no longer an academic exercise. COVID-19 shocked the financial system, and the fallout continues to spread through Wall Street and Main Street. The pandemic has put significant pressure on financial markets, businesses and individuals, causing market distortions, cash flow interruptions, and loss of employment. Capital and liquidity have quickly moved to the top of concerns for most financial institutions, as COVID-19 has created unique challenges and stress factors. Given the unprecedented uncertainty in the economy today, we must identify and be prepared for the capital and liquidity stresses of tomorrow.

Capital Assessment

Capital serves as the cornerstone for all balance sheets, supporting growth, absorbing losses, and providing resources for seizing opportunities. Most importantly, capital serves as a last line of defense, protecting against risk of the known and the unknown. As we navigate this period of uncertainty over the next 12 to 24 months, capital will be tested. Rapid changes occurring within the economy are not entirely cyclical in nature; rather, structural changes will develop as consumer behavior evolves and business operations adjust to a 'new normal.' The following are key considerations for assessing the current and future adequacy of your capital base:

- **Credit Quality Deterioration—**The depth and severity of cash flow interruption could lead to an expansion in non-performing assets, ultimately increasing provision expense. Given the volume of deferrals and modifications in the immediate wake of the pandemic, realization of problem assets may not materialize until late 2020 or early 2021.
- **Margin Compression—**With the yield curve down 200 basis points, asset-sensitive banks could likely see margin compression at a time when Net Interest Income/earnings are most needed to offset increased loss reserves.
- **Asset Growth—**Increased loan funding, customer draws on credit lines, and slower loan amortization may lead to larger balance sheets.

Knowing the 'breaking points' for your capital base in terms of growth, credit deterioration, and a combination of these factors will serve your institution well for the board and regulators. If your capital stress testing results project risks to your 'well capitalized' status, it is critical to understand the ramifications this can have on your liquidity and access to various funding sources.

Liquidity Assessment

At Taylor Advisors, we have a saying, "Asset quality deterioration leads to capital erosion which leads to liquidity evaporation." Beyond the potential for heightened credit risk, the COVID-19 pandemic has also created additional stressors for your institution's assessment of liquidity:

- **Cash Flow Interruption—**Borrower deferral and modification requests will reduce expected cash inflows to your institution.
- **Accelerated Loan Funding—**Some financial institutions are seeing significant draws on unfunded lines of credit as businesses and consumers look to hoard any additional liquidity to 'weather the storm.'
- **Reduced Borrowing Capacity—**Borrower cash flow interruption and potential for intermediate-term asset quality deterioration could lead to lower borrowing capacity with your correspondent bank, Federal Home Loan Bank and Federal Reserve Bank.

MORE ABOUT TAYLOR ADVISORS

Taylor Advisors provides consulting and advisory services in the areas of ALCO, capital, liquidity, interest rate risk and investments to community-based financial institutions throughout the country. To learn more, visit *www.tayloradvisor.com* or contact Todd Taylor at *todd@tayloradvisor.com* and Omar Hinojosa at *omar@tayloradvisor.com*.

- **Deposit Outflows—**As cash flow interruption persists and credit availability tightens, customers' next source of liquidity will come from their liquid assets, i.e. stocks, bonds, and deposits. Institutions could very well see deposit balances decline as customers begin to live off their savings.

Looking Beyond 2020

Regulatory agencies have updated guidance providing regulatory relief in several key areas, such as treatment of loans impacted by the coronavirus, lowering Community Bank Leverage Ratio requirements, funding and favorable capital treatment for SBA PPP loans, among other measures. These policies will eventually phase out, which is why it is critical that we stress test and prepare for the possibility of a prolonged credit cycle. Consider the impact on your clients of a few potential structural changes:

- Business realize new efficiencies as they can accomplish more with less during the stay-at-home orders; temporary furloughs may become permanent.
- The success of teleworking and the impact on office space demand going forward.
- Additional pressure on demand for retail real estate as the dominance of on-line shopping is further solidified.
- Reduced appetite for business and consumer travel given the success of virtual meetings and reduced discretionary income for consumers.

With liquidity and capital taking center stage in most community bank ALCO discussions, moving away from regulatory appeasement and towards pro-active planning and decision making will be of paramount importance. This can start with upgrading your tools and policies, improving your ability to interpret and communicate the results, and helping implement actionable strategies.