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What is the Right Amount of Capital for Your Depository?

Capital is the core of an institution's ability to grow and succeed yet answering the question of "How Much Capital Does Our Institution Really Need?" remains a common challenge for industry leaders. Performing a Strategic Net Worth Analysis enables institutions to develop a strategic road map that identifies capital adequacy and potential risks.

Whether the risk is increased defaults due to COVID-19, cybersecurity failures, or natural disasters, the potential financial impact can be modeled to help your institution prepare. A Strategic Net Worth Analysis can complement your existing Enterprise Risk Management plan and assist your institution in determining how much capital would be needed to survive severely adverse scenarios such as a severe recession.

What's Holding Your Institution Back?

Time management experts often advise breaking up a long to-do list into categories such as tasks that must be done, and tasks that might be nice to do if time allows. Where does your institution place capital stress testing or an initial strategic net worth analysis? Many may weigh the time and effort involved and wonder whether the value received would place the task in the "could be done" rather than the "must be done" category.

Financial regulators require capital stress testing for institutions with more than $10 billion in assets, but we've found it to be an important exercise for financial institutions of all sizes. Annual stress tests aim to ensure financial depositories have enough capital to withstand a severe economic downturn, including the ability to quickly adjust their balance sheets.

The Benefits

Regular stress testing and analysis offers key insights about the institution's financial position that exceed regulatory requirements, making them a good idea for *all* sized depositories. A comprehensive examination of the balance sheet and various potential risks forces the institution to more critically evaluate its current position and its potential to change with various scenarios.

Below are some of the benefits derived from a detailed stress testing analysis:

- Confidence that the institution has adequate capital to survive a market downturn
- Assurance of adequacy of allowance for loan and lease losses
- Identification of possible future problems, such as an over-concentration in a specific asset type
- Improved decision-making as management and the board see the need to set risk-tolerance levels
- Enhanced capital and asset planning by verifying risk-reward assumptions

Implementing Capital Stress Testing

Although establishing and executing a capital stress testing process takes time to implement, institutions can potentially benefit by developing an organized approach that helps keep the program moving smoothly. Here are some steps to consider:

1. Gather and organize data – Creating and developing a process to collect and organize data is essential to evaluate an institution's profitability, value, and overall balance-sheet trends. Before the advent of capital stress testing requirements, many depositories did not keep the necessary critical data on their loan originations – often the biggest challenge to adequate testing. Knowing that the input data are accurate allows management and the board to be confident in the results of analyses, permitting them to plan strategies more effectively for future success.

2. Develop test scenarios – Scenario simulations are a beneficial exercise for all institutions. As part of stress testing, the Fed issues scenarios that incorporate a baseline status, as well as those that assume adverse and severely adverse economic environments. The resulting analyses determine how well the depository will perform in the face of a deteriorating market. Reviewing the portfolio under different scenarios allows financial managers to more accurately price and invest in risk, ensuring the institution is fairly compensated.

   Testing scenarios should include local economic actions, such as increases in competition or a decrease in skilled workforce. Other scenarios should test for global

economic events, including changes in market rates, as well as other random risks, such as security breaches.

3. Determine assumptions about loss and recovery – A cornerstone of capital stress testing is determining the assumption of principal losses and severities. After the Fed issues economic changes that form the basis of testing scenarios, the depository should make assumptions about the loan portfolio's default tendencies. To ensure assumptions are appropriately designed for the balance sheet, delinquency and charge-off information should be captured across all collateral types. By understanding the depository's performance in a typical environment, it can be easier to predict results under adverse market conditions.

4. Execute analyses – Conducting regression analyses on performance and changes in macroeconomic variables may help an institution understand its sensitivity to economic factors. To be most helpful, these analyses should incorporate unique scenarios unrelated to market performance, as they wouldn't be included in the model projections. Random probability simulators can project the probability of a natural disaster, or other negative local events, and how it would potentially affect operations.

   Whether your institution chooses an initial Strategic Net Worth Analysis or make Annual Capital Planning & Stress Testing part of its standard processes, choosing a trusted partner with advanced analytical capabilities and expertise can ensure a smooth experience and deliver valuable insights.

5. Prepare reports – One of the greatest values of capital stress testing comes from the information it provides to management and the board. To aid in strategic planning and auditing, testing and capital planning methods should be transparent and well-documented for easy auditing. This should include highlighting key variables, assumptions, and the institution's sensitivity to particular changes. For maximum effectiveness, credit-monitoring reports should be available during planning sessions, liquidity discussions and profitability analyses.

We believe stress testing can be beneficial for institutions of all sizes, not just those required to perform this task. If properly planned and implemented, the results can potentially provide critical information in aiding strategic planning for future success, making it a "must do" task.

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