



Strategic Planning During Uncertain Times

Testing Your Balance Sheet's Capacity to Weather the Pandemic and to Embrace New Opportunities

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As we adjust to the new reality and navigate through the immediate operational challenges, long-term planning comes back into the focus. What is the bank's balance sheet capacity to weather the economic downturn, absorb the potential losses, and leverage the existing resources to support households and businesses affected by the pandemic?

Community banks, with their relationship-based business models, are uniquely positioned to support their markets by using their in-depth knowledge of the local economies and the borrowers' unique situations to provide timely and individualized assistance for impacted customers. This is an opportunity to facilitate a return to economic stability and be the source of information and communication, but also to enhance customer relationships and trust over the long term.

Unlike during the 2008 financial crisis, most banks have stronger risk infrastructure, larger capital buffers, and higher liquidity reserves. How long the existing safeguards will last depends on the length and severity of the downturn. As we continue to work surrounded by an array of unknowns, there are planning steps that can be taken now to get in front of problems and position the bank to leverage its strengths to support the local communities and its shareholders.

Capital Plan Review – How much capital can be deployed into new credits? How much stress can we absorb?

Considering the abrupt economic changes, the bank's risk-specific minimum capital level requirements should be revised to reflect the likely changes in the levels and direction of credit risk, interest rate risk, liquidity risk, and others. The recently issued regulatory statement relaxing capital requirements includes modifications related to the amount of retained income available for distribution, allowing banking organizations to dip into their capital buffers and to continue lending without facing abrupt regulatory restrictions. Institution-specific capital adequacy calculations can also provide a basis for the decision whether or not to opt in to using the community bank leverage ratio, which has been temporarily reduced from 9 percent to an 8 percent minimum threshold.

Stress testing the capital against credit losses, adverse interest rate environment, and other earnings challenges can help identify potential vulnerabilities and allow management to proactively prepare and protect the bank from losing its well-capitalized status should the simulated stress scenarios unfold. The sooner the problems are identified, the more flexibility you have in developing a solution. Every bank should have an up-to-date capital contingency plan to be implemented if the capital levels approach the minimums needed for a well-capitalized bank designation.

The review of the minimum capital requirements and the stress tests can provide valuable insights regarding not only the bank's ability to survive a recession, but also to estimate the amount of "excess" capital that can be used to support additional lending. Many banks can justify lower capital

requirements once they customize the capital adequacy calculations to their specific risk profiles. If additional asset growth can be supported from the capital perspective, the plan should be further evaluated from the liquidity standpoint.

Liquidity Plan Review – Are the existing liquidity reserves sufficient to support additional loan growth and the potential funding pressures?

Liquidity plan review needs to go hand in hand with capital planning. While most community banks have strong liquidity positions, the scale and speed of the coronavirus shock have raised concerns that credit drawdowns, sudden declines in revenues, and a higher potential for credit issues will strain bank balance sheets. Funding pressures may be building because of uncertainty about the amount of damage that the coronavirus might cause. Banks may be experiencing deposit drains from customers experiencing financial hardship or seeing withdrawals driven by fear. On the other hand, the volatility of the stock market and the uncertainty may drive the “flight to safety” and increases in bank deposits.

Changes in the business strategies and the results of the capital stress tests should be incorporated in the liquidity plan and the projected cash flows should be stress tested. Banks need to plan for ways to meet their funding needs under stressed conditions. The simulations should cover both short-term and prolonged stress events using a combination of stress constraints that are severe enough to highlight potential vulnerabilities of the bank from the liquidity perspective. The analysis should show the impact on both the on-balance sheet liquidity and the contingent liquidity, while taking into consideration changes in the available collateral, collateral requirements, limitations on access to unsecured funds or brokered deposits, policy limits on the use of wholesale funding, and other relevant stress factors.

Credit Risk Assessments – What is the loan loss potential?

Credit risk has the highest weight among the risk factors affecting capital and it is the biggest unknown in today’s environment. The assessments will need to shift to be more forward looking rather than solely relying on past performance. The stress tests will be most useful when customized to reflect the characteristics particular to the institution and its market area. Banks need to understand which segments of their portfolio will be the most affected and perform targeted assessments of the potential fallout, along with the review of other segments that may have had weaker risk profiles before the pandemic, higher concentrations of credit, or those segments that are significant to the overall business strategy. The estimates might be a moving target in the foreseeable future; however, once the framework is set up, the analyses can be regularly repeated to determine the current impact. The results of these credit risk assessments will provide a valuable input for fine-tuning the capital plan and assessing adequacy of liquidity reserves, as well as for formulating strategies for working with the affected borrowers and extending new credit.

Measuring Impact of Plans

As we face abrupt changes in the strategic focus, taking the time to diagnose strengths and weaknesses, to understand the range of possible outcomes of the new business strategies, and to line-up contingency plans ready to be invoked as the picture get clearer is a worthwhile exercise. Young & Associates, Inc. remains committed to assist you in every step of the planning process. Our modeling and stress testing tools will allow you to generate valuable support information for your decision making, ensure regulatory compliance, and be proactive in addressing potential problems and positioning for new opportunities. For more information, contact Martina Dowidchuk at mdowidchuk@younginc.com or 330.422.3449.

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