The Capital Conundrum

How COVID has changed the conversation about managing capital

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Like many other sectors of the economy in early 2020, financial institutions were rightly concerned about what the future had in store as the pandemic took hold. However, a very plausible specter of widespread credit losses never ended up materializing, as massive government intervention in the form of low interest rates and stimulus programs helped prop up the economy and fuel a surprisingly speedy recovery.

Yet even as the worst initial fears were short-circuited, many longer-term effects of this economic rollercoaster ride remain unknown. The ebb and flow of new fiscal and monetary policies – not to mention those that are still unseen – have resulted in a new set of capital challenges for banks and credit unions, with tremendous growth in balance sheets, rising pressure on earnings, lower capital ratios, increased credit uncertainty, and heightened concentration risk.

Some institutions may look at their capital ratios today and question why they would use valuable resources worrying about them now. But the question they should really ask is *whether current trends are sustainable or if the pandemic-fueled surge in deposits is just a temporary blip that is likely to turn*. Those banks and credit unions that do take a hard look at their capital situations with this question in mind will undoubtedly be better positioned to make informed strategic decisions going forward. There could be a considerable opportunity cost of not fully understanding your institution's appropriate level of capital and/or concentrations.

Understanding potential downside risks

What is not in question is that, on average, institutions across all asset sizes saw substantial asset growth over the past year, with most falling in the range of 10% to 25%. But the unique circumstances of the pandemic make it difficult to accurately predict whether this growth will continue. Institutions looking to get a better handle on where things might be headed should consider "what if?" analysis to determine their potential downside risks. Their questions may include:

- What is the impact on our leverage/net worth ratio if this kind of growth continues? Where does our capital buffer need to be?
- While deposits have outpaced loan demand over the past several quarters, what happens if that trend begins to reverse itself? How will shifts in asset mix impact our risk-based capital ratios?
- Leverage and net worth ratios have declined despite earnings tailwinds thus far, but what if earnings are lower in 2022?
- Can we support our current loan concentration levels, or do we have an opportunity to maintain higher concentrations?
- Looking ahead, how do we determine a plausible range of potential credit losses for our capital forecasting models?

The central theme running through these is that while credit is strong today, nobody can say for sure what comes next. Given today's uncertainties, modeling the extreme scenarios can be a powerful exercise. Good strategic planning and responsible loan concentration decisions are only as powerful as the assumptions upon which they're built, and a variety of credit concerns are playing into those assumptions at present, including:

Inflation – After the highest CPI number in almost 40 years, what comes next?

Fed uncertainty – What does the timeline for tapering and rate hikes look like?

Real estate – What impact will debt levels sustain?

COVID variants – How does the ongoing uncertainty play into future economic movements?

Stimulus status – Will debt levels increase as temporary programs wind down?

Geopolitical unrest – What comes next in an area that is always a wild card?

There is no crystal ball to predict how each of these concerns will play out – and how they will ultimately impact capital decisions going forward. That's why, even during a period of elevated capital, banks and credit unions need to make stress-testing a priority. In fact, this is precisely the right time to do so – *before* conditions begin to shift or deteriorate and it becomes too late to make the meaningful adjustments necessary to maintain a solid capital footing.

Stress-testing to minimize risk and increase earnings amid uncertainty

Only by analyzing a variety of "what if?" scenarios can an institution truly determine where its capital risks lie – and develop an action plan to help remediate those areas of concern. Is it time to consider selling assets, deleveraging, or reducing/eliminating dividends to try and bolster capital? Or is the problem an excess of capacity – and the attendant opportunity cost that comes with that kind of surplus – which could lead to potentially increasing dividends, buying back stock, increasing concentrations, or looking to acquire another institution to enhance capital utilization?

> **"Visualizing what 'could' happen helps institutions develop successful strategy to minimize risk and increase earnings potential."**
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> **– John Demeritt**

In either case, be it a dearth or excess of capital, the value of stress-testing in this post-pandemic environment is clear: helping to support decision-making on key issues including potential growth plans, lending directives, dividend distributions, stock buybacks, and capital-raising initiatives, as well as internal policies such as capital ratios and maximum concentrations. Stress-testing also helps fuel deeper insight into the balance sheet, allowing the institution to operate with a best-in-class approach to capital decisions that is sure to be appreciated by every important stakeholder, from auditors and regulators to management and the Board.

No one knows exactly what the future holds. Now more than ever, capital planning has evolved into one of the most critical risk management practices for banks and credit unions. Make sure to prepare your institution for whatever comes next.

For More Information

To learn more about how capital forecasting and stress testing can help your financial institution better understand capital risks and develop remediation strategies for potential downside impacts, contact **John Demeritt, Managing Director, Darling Consulting Group.**

For more insights from John about building a successful strategy to minimize risk and increase earnings potential, click to hear the replay of his recent webinar, **"The Capital Conundrum."**

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John is a Managing Director at Darling Consulting Group, working directly with financial institution executives to improve the effectiveness of their asset liability management (ALM) process. In this capacity, he provides insight and education in managing interest rate risk, liquidity risk, credit risk and capital. John also advises on regulatory compliance, stress testing, and contingency planning.

John began his career with DCG in 2006 as a financial analyst and currently manages DCG's Risk Analyzer Plus product and Loan Credit Loss Model solution. John is a graduate of the University of Massachusetts with a degree in finance and marketing