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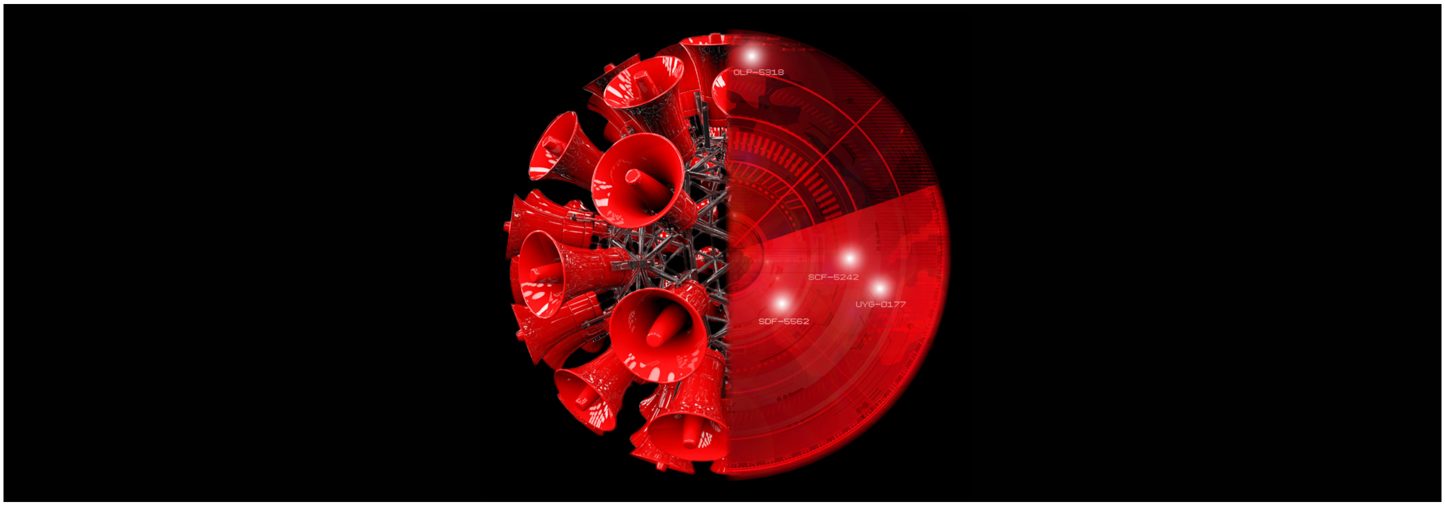

Addressing capital and stress testing impact during COVID-19

Due to the pandemic and associated effects on the global economic environment, there is significant stress on the capital positions of financial institutions of all sizes. In this unprecedented economic environment, financial institutions are grappling with challenges in addressing and managing impacts to their business strategies, risk profiles, portfolios, and risk and capital management end-to-end processes.

As financial institutions attempt to understand where they are and what future impacts may be, economic and market-driven impacts on business lines, risk profiles, capital, and liquidity positions, as well as government interventions, must be effectively incorporated into identification, measurement, reporting, and monitoring processes that forecast and/or depend on stressed capital measures.

The impact the crisis is having on the global economy is likely to increase both financial and nonfinancial risks faced by financial institutions:

- *Credit risk* – As individuals potentially become delinquent on payments, capital levels associated with retail portfolios, such as mortgage and credit cards, should continue to experience upward pressure. On the corporate side, many banks are seeing client stress increase, additional demand for credit extensions, and generally deteriorating financial outlooks, leading to additional capital requirements.
- *Market risk* – Volatile markets can materially affect the exposure positions of trading counterparties and clients who are being provided clearing services. Where institutions have material trading book positions, increased market risk capital requirements will need to be met across equities, commodities, rates, etc.
- *Nonfinancial risk* – Capital measures may be affected by multiple areas, including heightened third-party risks; virtual workforce challenges; and increased levels of data, security, fraud, and cyber risks.

Financial institutions will also have to determine how to most effectively incorporate the impact of supervisory and governmental activities into their risk assessment and capital planning:

- Extensive government fiscal and monetary policy response aimed at providing liquidity to individuals, businesses, and municipalities will affect general default, prepayment, and recovery behavior.
- Evolving regulatory capital requirements and implementation timelines affecting areas such as capital buffers and incorporation of CECL into available capital.
- Short- and medium-term regulatory expectations around integration of crisis impact into existing stress testing framework and processes and establishing an effective regulatory communication strategy.

Current challenges and questions to ask

As banks revisit their capital estimates and planning, it will be critical to appropriately incorporate the potential impact of the crisis and establish reasonable assumptions about the path of the economic downturn and eventual recovery. There are several risk- and capital-related questions that should be considered when addressing current challenges, including:

How do I incorporate current crisis and associated economic repercussions into capital planning and forecasts?
When considering capital forecasts, some risk drivers, such as unemployment rate, are moving to historically extreme levels, and current assumptions and modeling will need to be adjusted based on business judgment with appropriate oversight from bank management. In addition, banks should assess each component of their stress testing process—for instance, the sensitivity of models to black swan events and the impact of market events and related government interventions as captured through adjusted stress scenarios. Above and beyond core stress testing processes, underlying inputs should be considered as well, which may include adjustments to risk rating and exposure frameworks to incorporate structural changes in key markets and industries such as hospitality, energy, and airlines.

How do I best address the impact of current client demands on portfolio risk profiles?
As banks continue to work through day-to-day engagement with clients and manage current portfolio issues, they should evaluate optionality and capital impact related to the intersection of product design and market stress. This could include analysis of the risks and benefits of complex client relationships and products, as well as the rebalancing of portfolios in line with the firm’s adjusted strategy and risk appetite given the crisis. In addition, prioritization of active capital management for high-impact sectors and clients will be important, as capital requirements and expected losses are expected to rise for clients in sectors that have been most affected by the pandemic. Some impacts may be short-term, while others could be enduring and may potentially affect strategic planning over a longer horizon.

How do I ensure capital strategy and implications are contemplated as ongoing business decisions are made?
Given the likelihood of ongoing challenges across the various markets and client segments that banks operate in, capital frameworks should be revised to align with changes to business strategy and risk appetite. This should be in addition to reviewing and adjusting the existing product portfolios based on revised return-on-capital assessments, which will be critical given the changing environment. While trying to connect stressed capital and forecasts to business decisions, attempts should be made to strike a balance between short- and medium-term structural changes based on an uncertain economic recovery.

Key considerations

For an organization to effectively manage these types of questions and challenges, they should drive significant enhancement and realignment of their capital approaches and stress-testing infrastructure. Taking a broad approach to these efforts can provide efficiencies and reduce risk as it analyzes, designs, and implements solutions that are necessary to effectively respond and manage the current environment.

Driving these changes requires coordination and careful consideration across foundational components of the stress-testing infrastructure, such as:

Governance and oversight – This area is critical given ongoing uncertainty in the current environment and heightened regulatory expectations in relation to institutions appropriately managing how processes are being enhanced and executed. A key focus should be determining whether end-to-end controls are in place for newly instituted operational processes (for example, new lending program operations, increased staff augmentation usage, and remote workforce). In addition, consider enhancing oversight processes such as review and challenge to adapt to the current needs, such as accelerated modeling and validation timelines.

Scenarios and models – Internal and external stakeholders should make sure that models include applicable environmental dynamics. This should include design and implementation of appropriate stress scenarios and corresponding model impacts, recognizing that adjustments and overlays may be necessary in the short term while model recalibrations and foundational redevelopment may be required longer-term.

Data and technology – Data requirements will need to be supplemented and updated to account for changes implemented throughout the process, including the incorporation of revised scenarios, model enhancements and overlays, and incremental regulatory reporting requirements. As part of this effort, banks should establish a coordinated and centralized effort to perform end-to-end data diagnostics and process review. This can enable alignment with updated stress testing requirements and regulatory expectations across the enterprise. Moreover, as you move forward, greater use of process management tools and emerging technology can enable more effective management of workflows and traceability and support changes in headcounts and operating models.

Management review and credible challenge – A rigorous review of process enhancements and execution will be critical to make sure calculations and stress testing are appropriate and timely for effective decision-making. This should include items such as enforcing a robust management review process for model adjustments and overlays to achieve heightened risk sensitivity in an evolving and challenging economic environment. Balance and loss forecasts may require additional expert scrutiny before submissions, with a transparent challenge process that clearly documents and tests all underlying assumptions.

Strategic planning and enterprise connectivity – With the significant amount of change occurring both within and outside the institution, it is important that adjustments made to capital frameworks and processes are aligned with the broader enterprise. This will include making sure capital planning remains connected to the strategic vision of the enterprise and considers risk appetite, business planning adjustments, and interactions with recovery planning. In the medium term, banks should also capitalize on opportunities to strengthen the overall value of the stress-testing process and outcomes by driving greater integration with existing business decisioning frameworks.

Regulatory alignment and communication – Regulators will be keenly focused on upcoming capital report submissions and are expected to use exams and ad hoc interactions as a mechanism for gauging readiness and the robustness of crisis responses. It will be key to demonstrate a clear understanding of end-to-end impact of the macroeconomic environment and alignment with the institution's capital requirements and planning. Financial institutions should also be prepared for increased regulatory scrutiny on forward-looking capital adequacy assessments and indications of crisis-related lessons learned and planned enhancements.

Moving forward

As you work through driving or addressing change in your approaches to capital management and stress testing, it will be important to take an enterprise-wide approach that enables you to effectively manage short-term challenges, as well as identify opportunities for strategic change. As this and other crises have demonstrated, capital continues to be a core area that should be managed, not just from an enterprise perspective, but also integrated with business-specific drivers and decisions.

When planning immediate capital activities, banks should focus on:

- Getting mobilized and defining cross-functional roles and responsibilities with clear accountabilities for managing change across end-to-end stress testing processes
- Gathering incremental data from across the enterprise to enable redesign and enhancements, based on responses to the current crisis in addition to evolving client and portfolio conditions
- Analyzing quantitative and qualitative data, including appropriately adjusted external data, as applicable, to enable insights and planning
- Prioritizing areas of focus based on existing reporting requirements and regulatory requests, as well as "low-hanging fruit" around areas of greatest business impact or ongoing regulatory focus
- Reviewing key capital management areas, such as escalation triggers and protocols, to determine appropriateness and alignment to ongoing enhancements
- Developing a detailed plan for moving forward, with meaningful connectivity into broader strategic initiatives, as well as transition to BAU, which contemplates new workforce operating models and potential future crises

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