WHITE PAPER

“No Regrets” Moves: How Midsize Banks Can Enhance Their Risk Capabilities

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It's been said that "history doesn't repeat itself, but it often rhymes." The adage certainly applies to banking crises in the US: every crisis, however unique the cause, has typically been followed by a new wave of regulations. This trend is likely to continue in the wake of the current crisis. In fact, reporting from the Wall Street Journal and other sources indicates that the Federal Reserve and other banking regulators are already in discussions about changes to the US regulatory regime, especially for midsize banks.

As has been well covered by now, the current crisis has been driven by an elevated level of interest rate and liquidity risks on the balance sheets of some banks. This was exacerbated by concentration risk in these banks' portfolios that may not have been fully understood. While we do not wish to speculate as to what specific changes regulators and lawmakers are likely to enact—or over what timeline—the current regulatory framework provides some clues as to what may be coming. (See Exhibit 1.)

As banks consider their response to the crisis, we believe they can glean valuable insights from regulation that has been enacted since the Global Financial Crisis of 2007–2008. While the most stringent rules and expectations were targeted at the largest banks, it is

Exhibit 1 - Summary of Select Regulatory Requirements Across Tiers of Banks

Nonexhaustive

	Topic	Category I US global systemically important banks (GSIBs)	Category II ≥$700B total assets or ≥$75B in cross-jurisdictional activity	Category III ≥$250B total assets or ≥$75B in NBA, wSTWF, or OBS exposure	Category IV Other firms with $100B to $250B total assets
Capital	Annual capital plan submission	✓	✓	✓	✓
	Annual supervisory stress tests	✓	✓	✓	☑
	Countercyclical buffer	✓	✓	✓	
	Supplementary leverage ratios	✓	✓	✓	
	Annual company-run stress tests	✓	✓	☑	☑
	No opt-out of AOCI capital impact	✓	✓	☑	
	Advanced approaches	✓	✓	☑	
Liquidity	Monthly liquidity stress tests (internal)	✓	✓	✓	☑
	Full daily LCR (100%) for all institutions	✓	✓	☑	
	Daily FR 2052a reporting for all institutions	✓	✓		
	Annual supervisory stress tests	✓			
	Resolution plan filing at least every two years	✓	☑	☑	☑

✓ In scope for current regulatory requirements ☑ Requirements prior to 2018 changes

Source: Federal Reserve.

Notes: NBA = Nonbank assets; wSTWF = weighted short-term wholesale funding; OBS = off balance sheet; AOCI = accumulated other comprehensive income; LCR = liquidity coverage ratio.

likely that a combination of the following regulatory elements[1] may be revisited for smaller banking institutions:

- No longer allowing an AOCI opt-out from capital calculations
- More frequent LCR calculations and reporting
- Expanded CCAR-style capital stress testing
- Expanded CLAR-style liquidity stress testing
- Expanded resolution planning requirements

While the exact timing and nature of future regulatory changes cannot be known, we do believe there are some no-regrets moves that banks can make now, not only to prepare for the coming regulations but also to build a culture of more informed and risk-aware decision making.

Four No-Regrets Moves

The actions below represent, in our view, a set of sound risk-management practices that will help banks steer through what is likely to be a more volatile medium-term environment; these moves can also provide comfort to boards and investors regarding their banks' safety and soundness.

1. **Establish and/or strengthen your reporting of interest-rate risk on the balance sheet**

- Report on AOCI and unrealized losses in the available-for-sale book
- Report on unrealized losses in the held-to-maturity book
- Report on the economic value of equity and overall interest-rate sensitivity of the full balance sheet

While many banks already calculate and share this information as part of their ALCO governance processes, the recent crisis has shown us that this is not necessarily universal practice across all banks. Understanding interest-rate risk on the full balance sheet, including the extent of unrealized losses as well as sensitivity to future rate changes, will allow robust discussions of risk taking and of the costs and benefits of various hedging strategies; it also will provide transparency to the board and investors into the risk profile of the bank.

2. **Establish and/or strengthen your current liquidity-measurement and stress-testing programs**

- Calculate the LCR and report internally daily
- Further build out net-cash-outflow assumptions beyond the regulatory-driven, lookup-table-based requirements to reflect the bank's own internal analysis (see Exhibit 2)
- Run daily liquidity-sensitivity analysis
- Run a more comprehensive liquidity stress-test analysis on a periodic basis—including, at minimum, an annual full-management tabletop exercise (for details, see our previous white paper, *"Is Your Bank Ready for a Digital Speed Bank Run?"*)

1. AOCI = accumulated other comprehensive income; LCR = liquidity coverage ratio; CCAR = Comprehensive Capital Analysis and Review; CLAR = Comprehensive Liquidity Analysis and Review.

As with interest-rate risk, having a clear view on your bank's liquidity position—and how the position may evolve under stress—is critical. The LCR provides a ready-made framework for quantifying liquidity risk, and it provides an opportunity to understand how your bank fares against peers that report their LCRs.

Exhibit 2 - Sample of Prescribed Outflow Rates, by Type

Retail funding outflows	Rate
Stable retail deposits held at board-regulated institutions	**3%**
Other retail deposits held at board-regulated institutions	**10%**
Deposits placed at board-regulated institutions by a third party on behalf of a retail customer/counterparty that aren't brokered deposits, where the retail customer/counterparty owns the account and:	
(i) The entire amount is covered by deposit insurance	**20%**
(ii) Less than the entire amount is covered by deposit insurance	**40%**
Funding from a retail customer/counterparty that is not (i) a retail deposit, (ii) a brokered deposit provided by a retail customer/counterparty; or (iii) a debt instrument issued by board-regulated institutions that is owned by a retail customer or counterparty	**40%**

Unsecured wholesale funding outflows	Rate
For unsecured wholesale funding that is not an operational deposit and is not provided by a financial sector entity or consolidated subsidiary of a financial sector entity, where:	
(i) The entire amount is covered by deposit insurance and the funding is not a brokered deposit	**20%**
(ii) Less than the entire amount is covered by deposit insurance or the funding is a brokered deposit	**40%**
All unsecured wholesale funding that is not an operational deposit and is not included in the items above, including (i) funding provided by a company that is a consolidated subsidiary of the same top-tier company of which board-regulated institutions are a consolidated subsidiary; and (ii) debt instruments issued by board-regulated institutions, including instruments owned by retail customers/counterparties	**100%**
All operational deposits, other than operational deposits that are held in escrow accounts, where the entire deposit amount is covered by deposit insurance	**5%**
All operational deposits not included in the item above	**25%**
All unsecured wholesale funding that is not otherwise described in all items above	**100%**

Source: Code of Federal Regulations

However, the LCR requirements as prescriptively defined are not sufficient to capture the true liquidity risk in a portfolio—as we have observed in the current crisis. It is valuable for banks to invest the time and effort to develop their own view of how their deposit portfolios may run off under stress. This should be complemented by running bespoke stress-test scenarios to explore a bank's sensitivity to various run-off assumptions.

Through thoughtful scenario design (including considering "reverse stress-test" scenarios that describe what it would take to cause the bank to fail), management can better understand the underlying drivers of risk that may be lurking in the balance sheet, including those that may not be visible during calmer circumstances or siloed risk scenarios.

Finally, as noted in our previous paper, management should be prepared to act quickly in the event of a liquidity crisis, having plans and playbooks ready for these emergency circumstances.

3. **Establish and/or strengthen your capital stress-testing capabilities**

- Build back CCAR capabilities, including credit-loss modeling, pre-provision net revenue (PPNR) modeling, and risk-weighted assets (RWA) and balance-sheet forecasting

- Expect to handle scenarios that combine both capital and liquidity stress events

We observe that supervisory changes are much more likely in the near term than regulatory and legislative changes, given the long lead times required for the latter to be approved and implemented.

Banks subject to CCAR requirements today can likely expect that combined capital and liquidity stresses will become a core element of the supervisory scenarios for upcoming capital-plan submissions. Supervisory expectations on bank-specific scenario design will also likely increase with a focus on interest rate, liquidity, and other market risks.

For banks that are not currently subject to CCAR requirements, building (or rebuilding) stress-testing capabilities will help them understand their ability to withstand future crisis scenarios. It will also prepare them for what is likely to be heightened supervisory pressure and scrutiny in the months and years ahead.

4. **Start building up your risk, treasury, data, and technology teams now**

- Reassess your operating model for core risk, treasury, and finance functions, including size, shape, and enabling capabilities

- Develop a plan to ensure that critical functions build and maintain top talent

Talent, already at a premium, will continue to be a core need as new rules and requirements emerge. Risk management, treasury, finance, and data talent are at a premium and may be a constraint as banks try to build out the capabilities outlined above. Technology budgets, as well as technology resources, remain a constraint to delivering change in line with expectations.

We would encourage banks to act now to develop plans to grow their talent base, and to begin to budget for increased risk, treasury, and technology spending in the months and quarters ahead. Given an already hot talent market, and the likelihood that many banks will be competing for the same limited pool of talent, there are material first-mover advantages to be had for building up your teams and capabilities early.

Change Is Coming

As we noted, it is impossible to predict the exact shape of the regulatory reform agenda that will come from this recent crisis. However, we believe all banks will benefit from investing in some of the no-regrets moves we outline above—both to allow for more informed and risk-aware decision making on the part of management and to facilitate more transparent and confident conversations with boards, investors, and clients going forward.

And if these moves make it easier to comply with future regulatory expectations, so much the better.

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