Evolution of Capital Planning

April 18, 2011

Tool 1 of the ABA Liquidity Toolbox focuses on capital planning. As a companion to Tool 1, we developed a capital planning model. It takes your capital goal as an input.

So how do you come up with the number to drop into the capital goal cell of the our capital worksheet. Most of us start out with the core capital minimum for well capitalized status. Let's say we expect that to be 8% when our regulators come forth with the revised BASEL III Capital requirements.

Then we add a cushion so that if 'bad things' happen, we won't fall below that figure. How do we calculate that cushion? Most of us SWAG it. We get our board and management team together in a planning retreat. We mutter joint incantations, allow each participant to express his or her opinion, then settle on a number. Let's assume for a second that number is 10%. If we can't agree on the number we may set a range like 9 to 11%.

Not very scientific, is it? The flaw of the SWAG approach was exposed in the last 2-3 years when a significant number of financial institutions underestimated the extent to which 'bad things would happen'. As a result we lost a significant number of institutions. Even more are currently on watch lists, and dealing with memorandums of understanding, or 'cease to exist' orders. Yes, I know, the actual term is 'cease and desist' orders.

When the dust settles, you can bet regulatory 'quants' are going to be asking you for a more mathematical method for determining the minimum size of your capital buffer. It is already happening in the international arena. You've read stories about big international banks who are concerned about failing capital stress tests under the BASEL III Capital regulations.

It would be easy to dismiss this as big bank stuff. "They wouldn't require capital stress tests for US community banks and credit unions!" Really? On March 15, 2011, Thomas Barnes, Deputy Director of OTS sent CEO Letter #380 to his flock of examinee CEOs. Click here to read the OTS letter. It calls for setting capital goals appropriate to a thrift's risk profile and business plans. The tool of choice for setting these goals is the impact of stress tests on the capital level in the business plan considering concentration risk, credit risk, interest rate risk, mortgage pipeline risk, operational risk, liquidity risk and other risks.

Up to this point in small to medium sized institution land, risk stress tests have been silos. We do interest rate risk stress tests as part of interest rate risk analysis. We do the same thing for liquidity risk. And we're beginning to do the same for credit risk. Let's take a test involving a rise in interest rates for example. We test the effect on income and economic value (NEV, EVE, NPV). But how many of us concurrently consider the effect of the rise in rates on credit risk –

you know, the borrowers that can no longer afford to make their payments. And do we also concurrently test the effect of the rise in rates on liquidity risk? Cash flows coming off loan portfolios decline in rising rate environments as prepayments slow. How many of us drill the stress tests we run all the way down to the effect on capital, then use the results of the stress tests to set capital goals that incorporate the minimum capital buffers needed to survive stress tests while remaining above well capitalized minimums?

You might say this is an OTS missive. It won't apply to me. Let me make a prediction. When the new capital regulations come down, they will not merely set regulatory capital minimums. They will also specify the process you are expected to use in setting your capital goals. The letter from the OTS Deputy director to OTS supervised CEOS is a 'heads up' relating to examiner expectations. After all, he is head of Examinations and Supervision. But I think it is also an advance warning to the rest of us as to where we are headed.

Want to know more? Certainly you are welcome to follow the link to the CEO letter earlier in this article or you can view the XSpeak Webinar Evolution of Capital Planning.

Click here to view the XSpeak Recording Now