



Why and How Financial Institutions Must Prepare for a Trade War Recession

Agenda

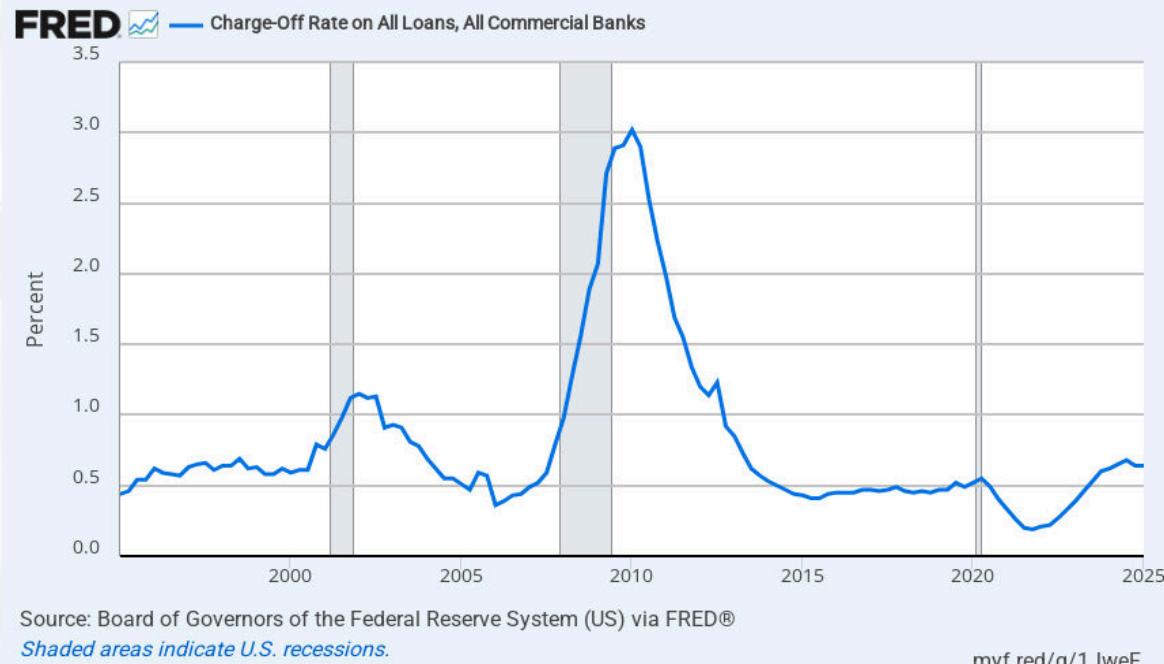
1. Planning vs Predicting: How to Think About the Risk of a Recession
2. What could a TailRisk Outcome look like?
3. Sizing up the Threat to Financial Institutions
4. Trade War Stress Testing
5. How to Adapt Your Capital Plan



Planning vs Predicting

How to Think About the Risk of A Trade War Recession

- Except for the Pandemic, it's the biggest threat to the financial institutions since the 2008 GFC
- The probability of a recession is in the eye of the beholder...
- But has clearly crossed a threshold of “better be ready for one”
- Sure, this means you should have a contingency plan just in case...
- But it should also immediately how you evaluate all significant strategic decisions



Let's not forget that loan losses predominantly occur in "bad times"

What Could a Tail Risk Outcome Look Like?

Stark differences vs the 2008 GFC & CCAR

1. Industries (and regions) dependent on importing and exporting are in the crosshairs
2. Fed is boxed in from aggressively cutting rates or restarting QE because of inflation
3. Long-term rates remain elevated because of excess supply of Treasuries & selling from foreign investors

Sizing up the Threat to Financial Institutions

Possible convergence of credit, interest rate, and liquidity risks

- Credit Risks

- Systemic / common recession risk- i.e. (beta risk)
- Amplified risk on importers and exporters
- Amplified risk on 2021-22 vintage loans scheduled to reprice

- Interest Rate Risks

- Lower betas and longer lags on cost of funds (assuming slower and shallower decrease in rates than 2008 GFC)
- Exacerbated AOCI problems
- Lost interest income from increasing NPLs

- Liquidity Risks

- Lighter regulation -> More banks allowed to fail-> Increased sensitivity of depositors and investors
- Continued QT + Wells Fargo effect + large bank SLR relief = Hand to hand combat for core deposits
- Competition with the US Treasury / crowding out of private sector capital



Problems with the Existing Toolkits

- Most ALM models can barely spell “credit”
- CCAR / DFAST stress testing is like using a flat screwdriver to turn a Phillips head screw
- Loan-level CRE sensitivity testing is already useless
- Top-down stress testing is strictly a superficial exercise
- Maintaining capital at an arbitrary level (i.e. 9% Leverage) is either dangerous or risks encumbering unnecessary capital



Trade War Stress Testing

The Right Tool for the Job

- Specifically designed to reflect today's risks, not 2008!
- Brings the “Big 3” risks (credit, interest rate, liquidity) together under one roof
- Enables proactive risk management
- Properly evaluates critical strategic decisions under consideration
- Creates customized capital requirements

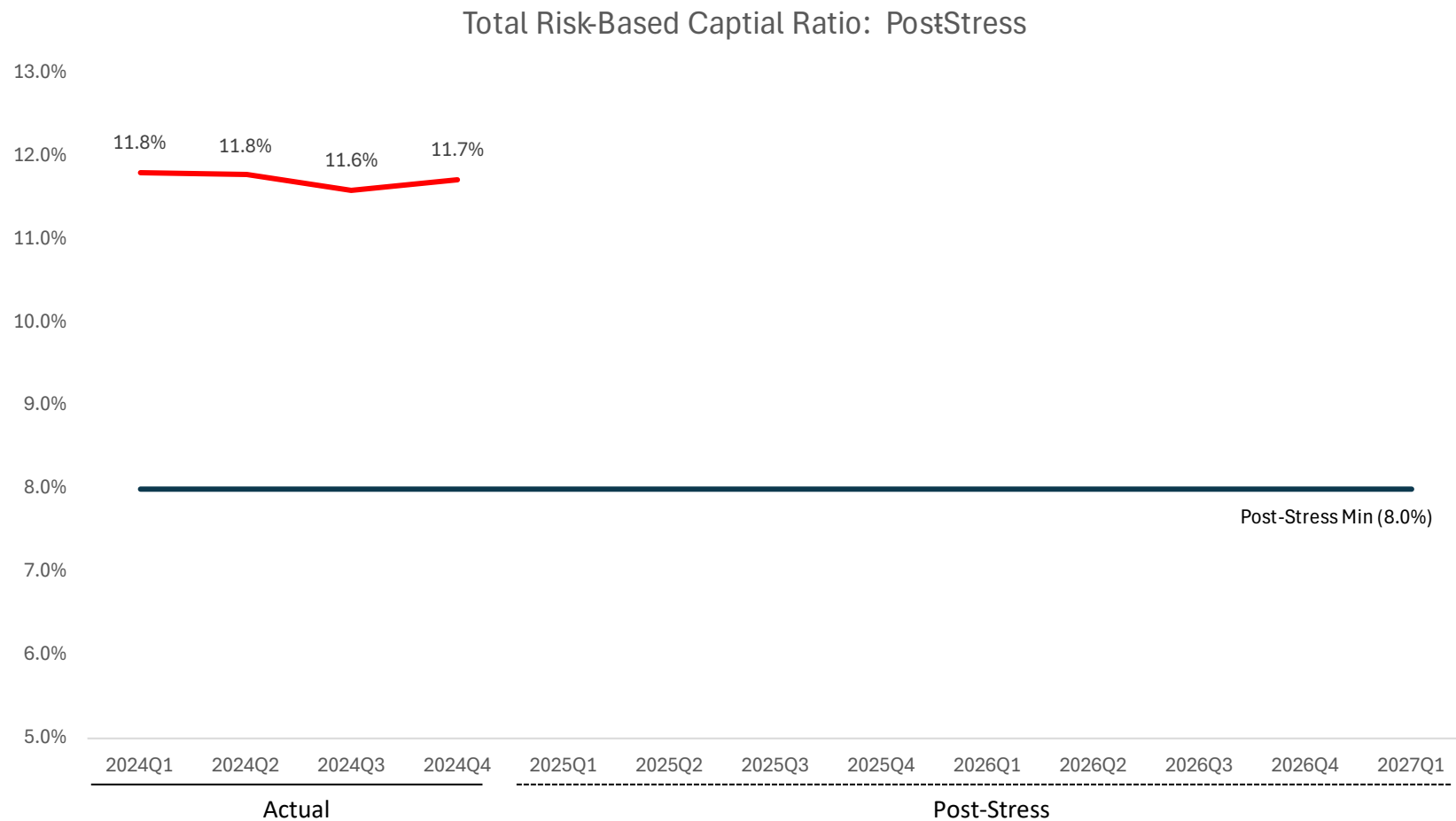
Table I: Invictus Tarrif and Trade War Recession Scenario: Domestic variables, Q1:2025-Q1:2027

Quarter	Real GDP Growth	Nominal GDP Growth	Unemployment Rate	CPI Inflation Rate	3-Month Treasury Yield	10-Year Treasury Yield	Mortgage Rate	Prime Rate	Cumulative Pct Change in the Dow Jones Total Stock Market Index from 2024Q4	Cumulative Pct Change in Housing Prices from 2024Q4	Cumulative Pct Change in CRE Prices from 2024Q4
2025Q1	-2.8	0.0	4.1	2.8	4.3	4.2	6.6	7.5	-5.2	0.5	0.5
2025Q2	-3.4	0.1	4.8	3.5	4.3	3.8	6.1	7.5	-24.5	-7.3	-1.7
2025Q3	-4.0	0.0	5.4	4.0	3.8	3.6	5.6	7.0	-28.4	-10.4	-3.4
2025Q4	-3.0	0.8	6.1	3.8	3.6	3.3	5.1	6.8	-29.5	-12.8	-5.6
2026Q1	-0.9	2.7	6.7	3.6	3.3	3.6	5.1	6.5	-30.0	-14.5	-9.0
2026Q2	0.3	3.6	7.4	3.3	3.1	3.6	5.3	6.3	-28.9	-15.5	-12.8
2026Q3	0.5	3.4	8.0	2.9	2.8	3.8	5.8	6.0	-27.3	-16.2	-16.2
2026Q4	3.2	5.9	7.8	2.6	2.6	4.1	6.3	5.8	-25.1	-16.7	-19.6
2027Q1	3.0	5.3	7.7	2.3	2.3	4.1	6.6	5.5	-22.4	-15.8	-22.5



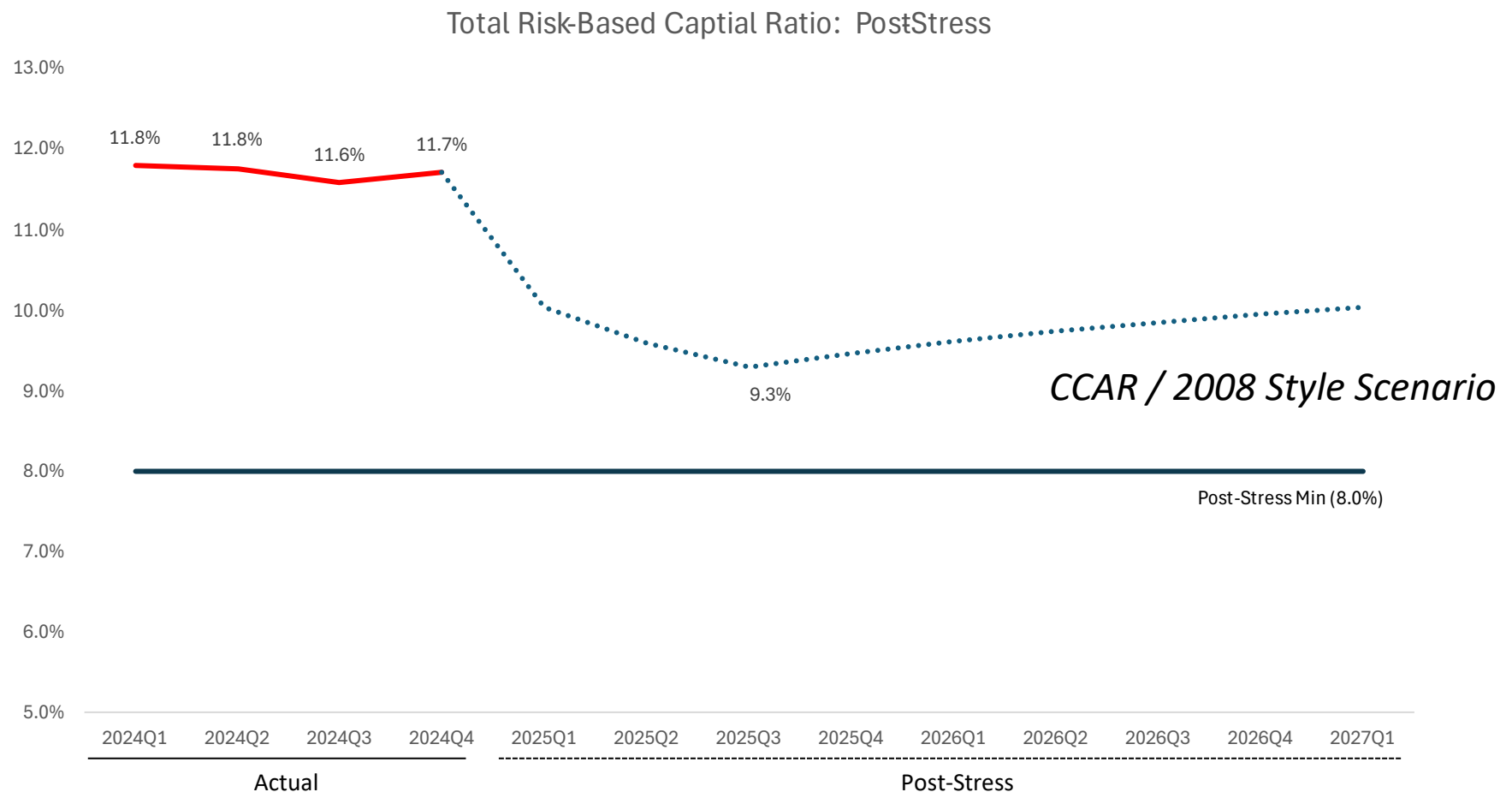
Example Trade War Stress Test

Evaluating Key Strategic Decisions



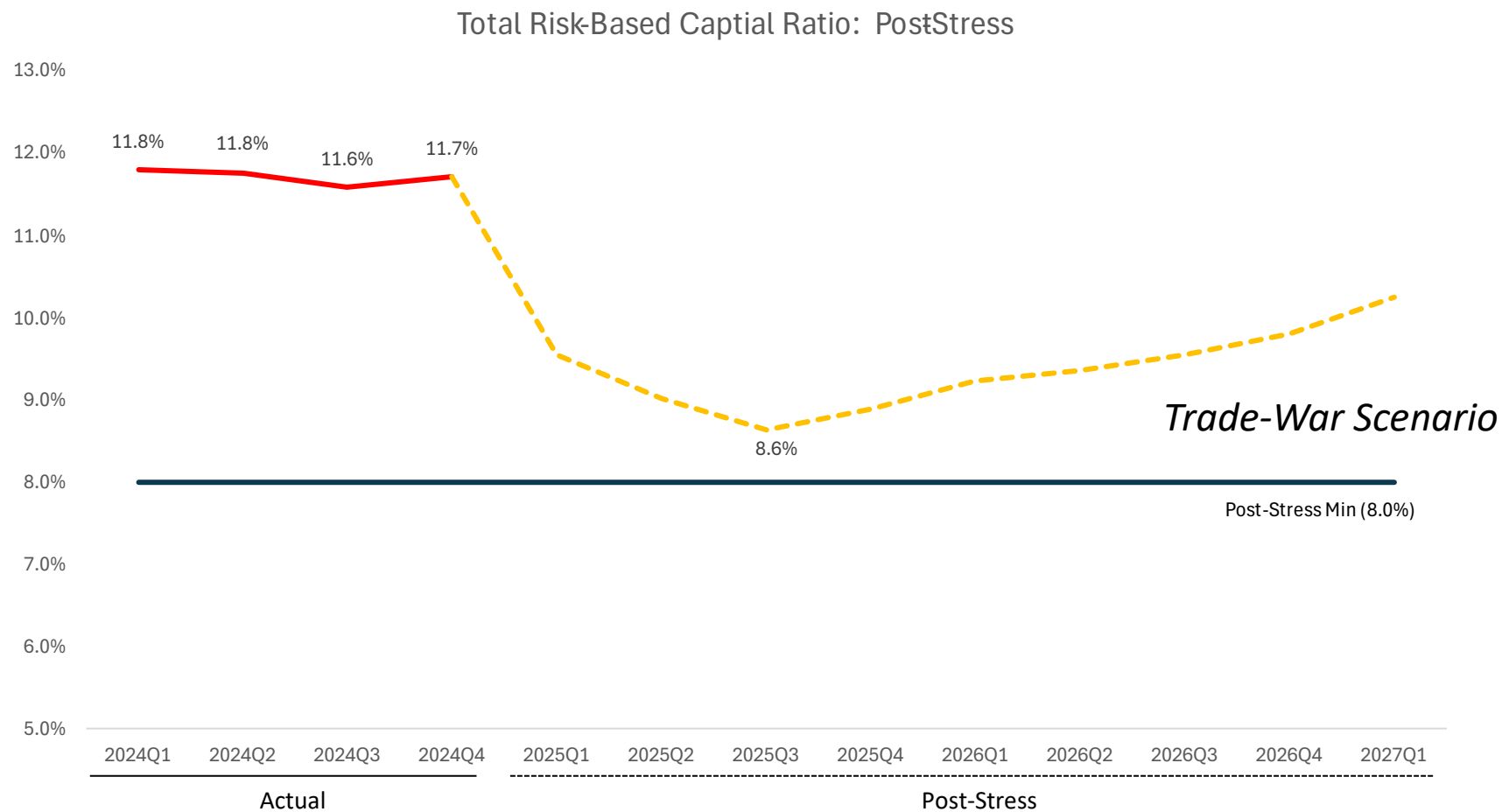
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Evaluating Key Strategic Decisions



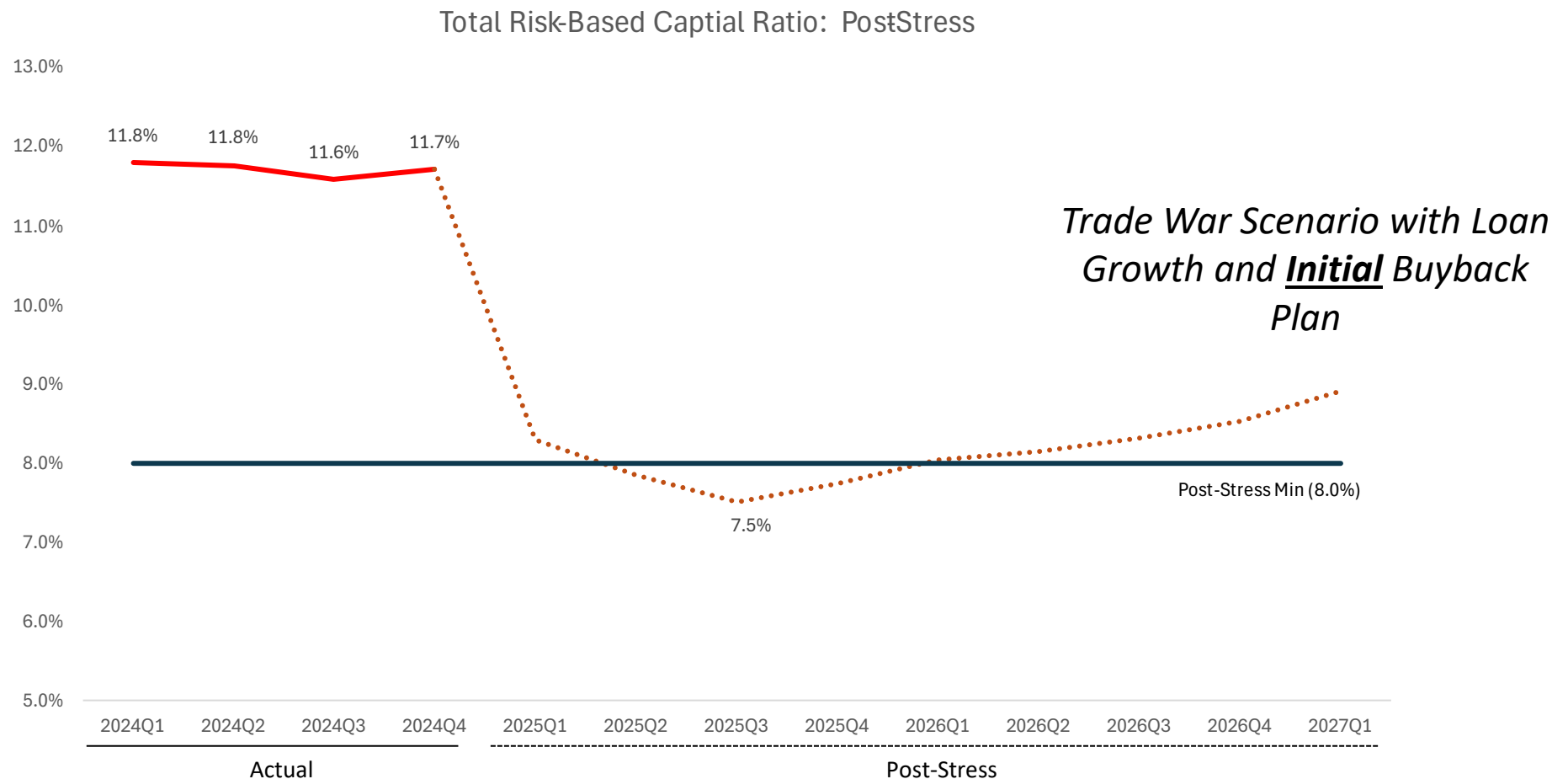
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Evaluating Key Strategic Decisions



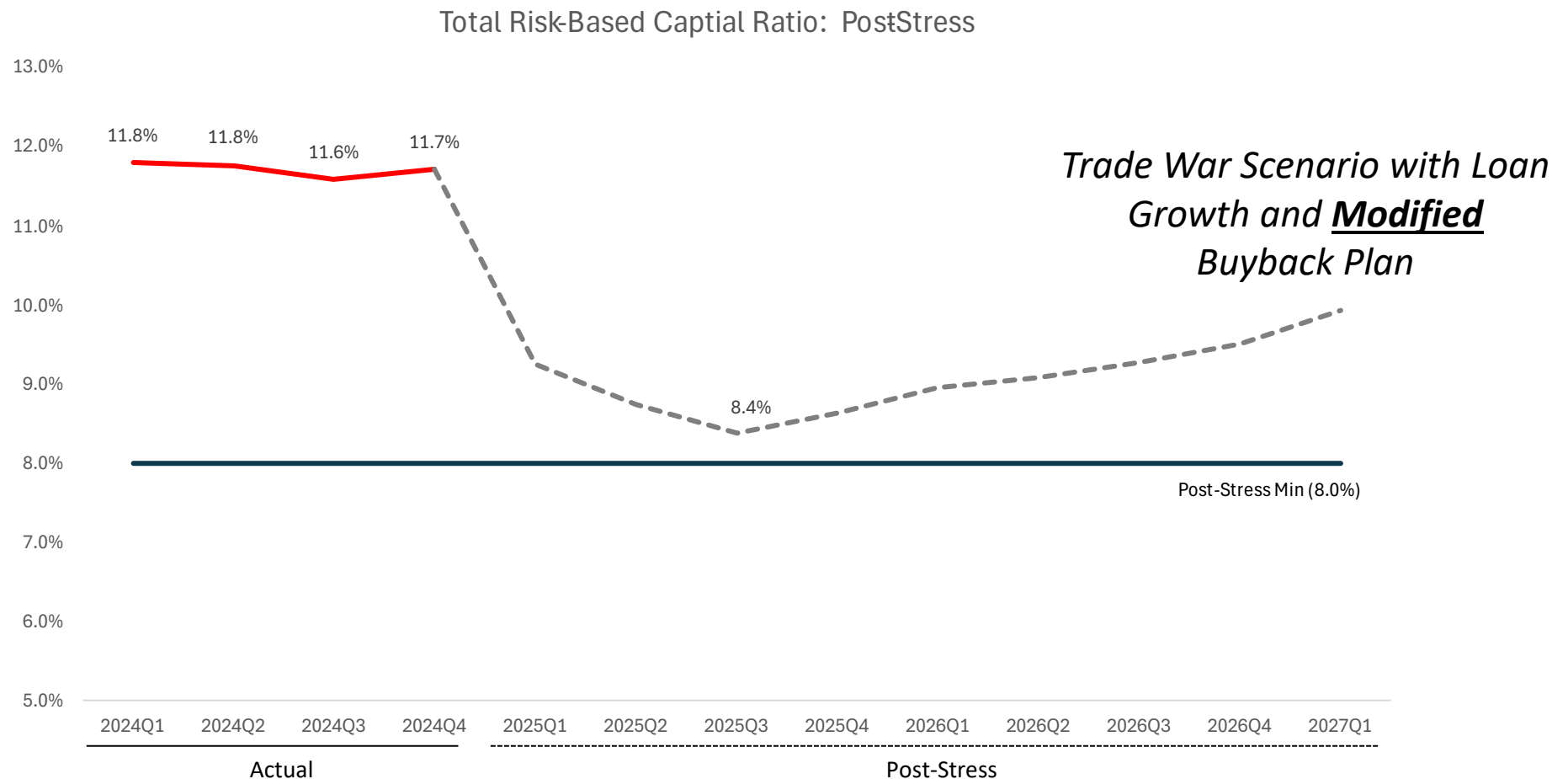
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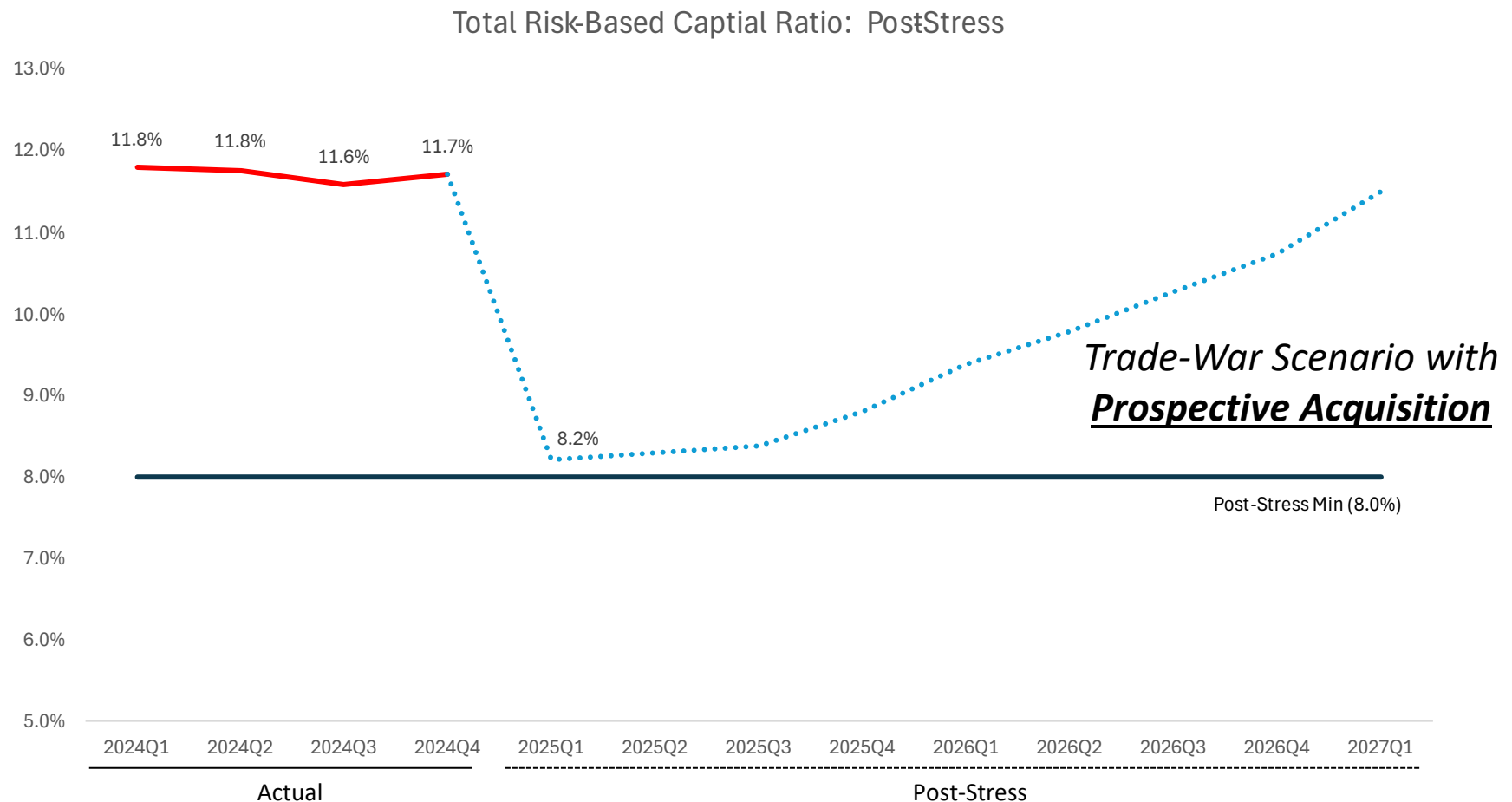
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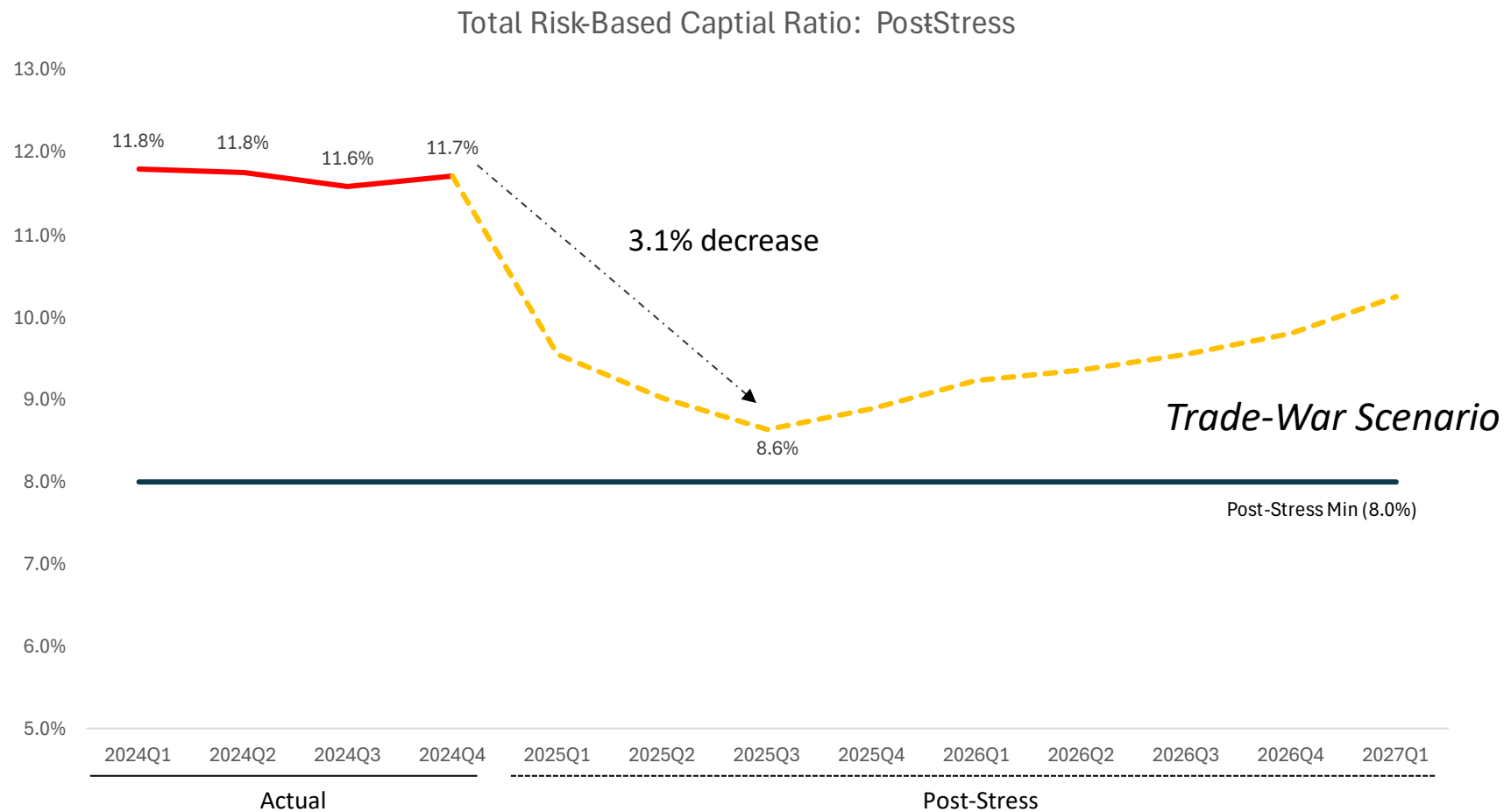
Risk Management

Triage List: Pass-rated Loans sorted by Capital at Risk under a Trade War Stress Test

Rank	Account Number	Current Balance	Loan Category	Origination Date	Maturity Date	Current LTV	DSCR	Subcategory (Property Type / NAICS)	Risk Rating	Repricing Risk	Estimated PD	Estimated LGD	Capital at Risk	CAR/Current Balance	CAR/Total Exposure
1	874654321	\$18.1	CRE-NOO	7/28/21	7/31/26	70.7%	1.60	Retail CRE	5	400-450 bps	16.9%	42.2%	\$1.3	7.2%	7.2%
2	7654321	\$23.1	CRE-OO	8/9/21	7/31/26	92.3%	1.67	Manufacturing	4	350-400 bps	9.3%	50.0%	\$1.1	4.7%	4.7%
3	654321	\$16.4	C&I	12/23/24	12/31/26	82.9%	1.31	Retail	4	0-50 bps	16.8%	24.2%	\$0.7	4.1%	4.1%
4	54321	\$14.8	Construction	11/30/24	11/30/26	62.3%	n/a	Multifamily	5	0-50 bps	17.8%	25.2%	\$0.7	4.5%	4.5%
5	4321	\$6.9	CRE-OO	3/12/22	3/31/27	57.0%	1.13	Transportation	5	350-400 bps	30.4%	23.5%	\$0.5	7.2%	7.2%
6	1234	\$1.8	C&I	6/19/24	6/19/27	84.0%	2.39	Accommodation and Food Services	4	0-50 bps	9.3%	50.0%	\$0.3	15.7%	4.6%
7	12345	\$2.2	CRE-NOO	11/3/21	10/31/26	65.0%	1.39	Office	5	300-350 bps	17.8%	50.0%	\$0.3	12.1%	8.9%
8	123456	\$4.4	CRE-NOO	6/30/22	6/30/26	73.3%	1.40	Retail	5	300-350 bps	16.7%	32.1%	\$0.2	5.4%	5.4%
9	1234567	\$17.4	CRE-OO	9/14/21	10/1/31	39.8%	1.20	Energy	5	n/a	18.2%	7.2%	\$0.2	1.3%	1.3%
10	12345678	\$8.7	C&I	7/29/23	7/31/25	76.7%	2.29	Manufacturing	4	100-150 bps	10.0%	25.0%	\$0.2	2.5%	2.5%

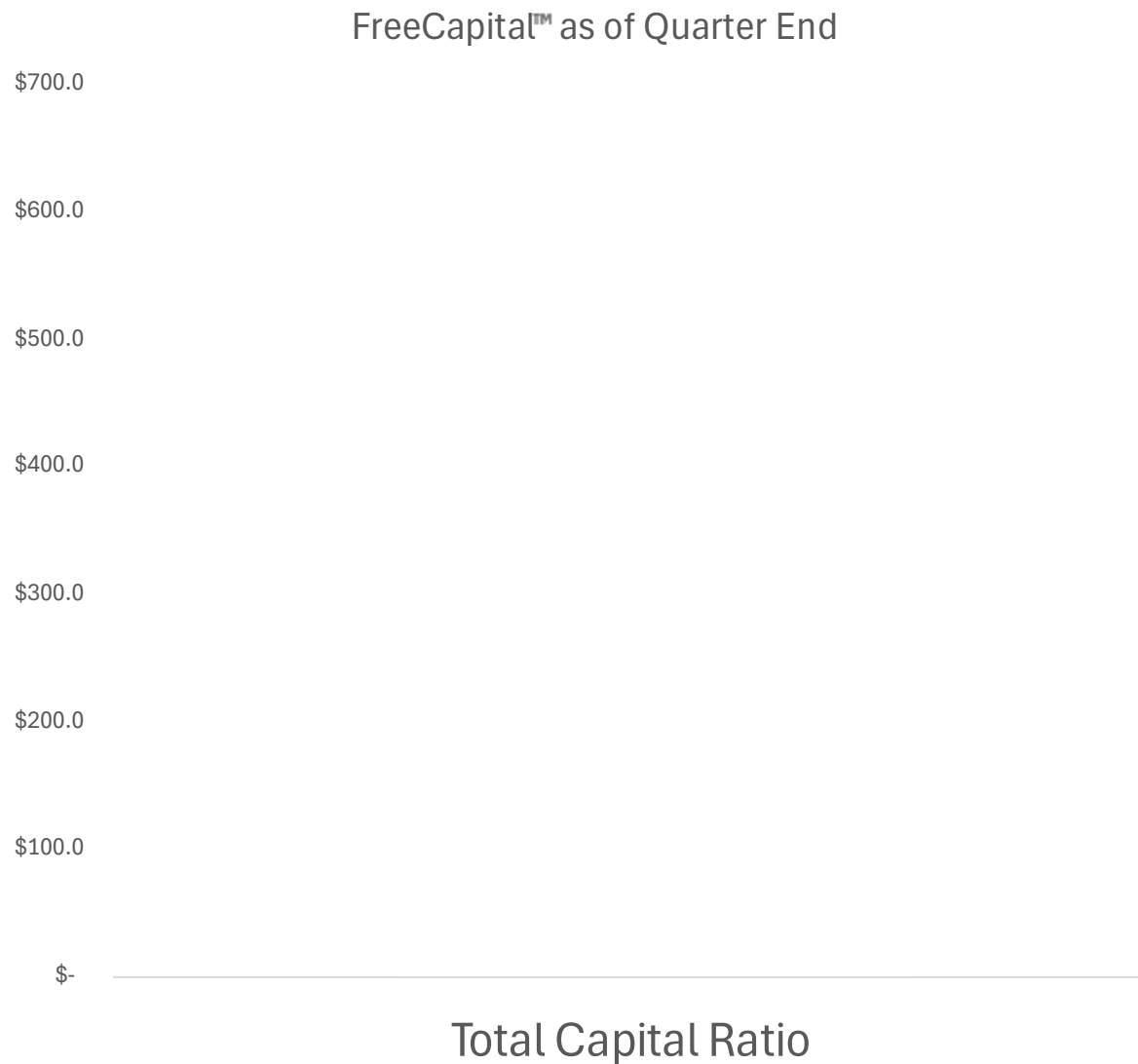
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Evaluating Key Strategic Decisions



Example Trade War Stress Test

Customizing Capital Limits



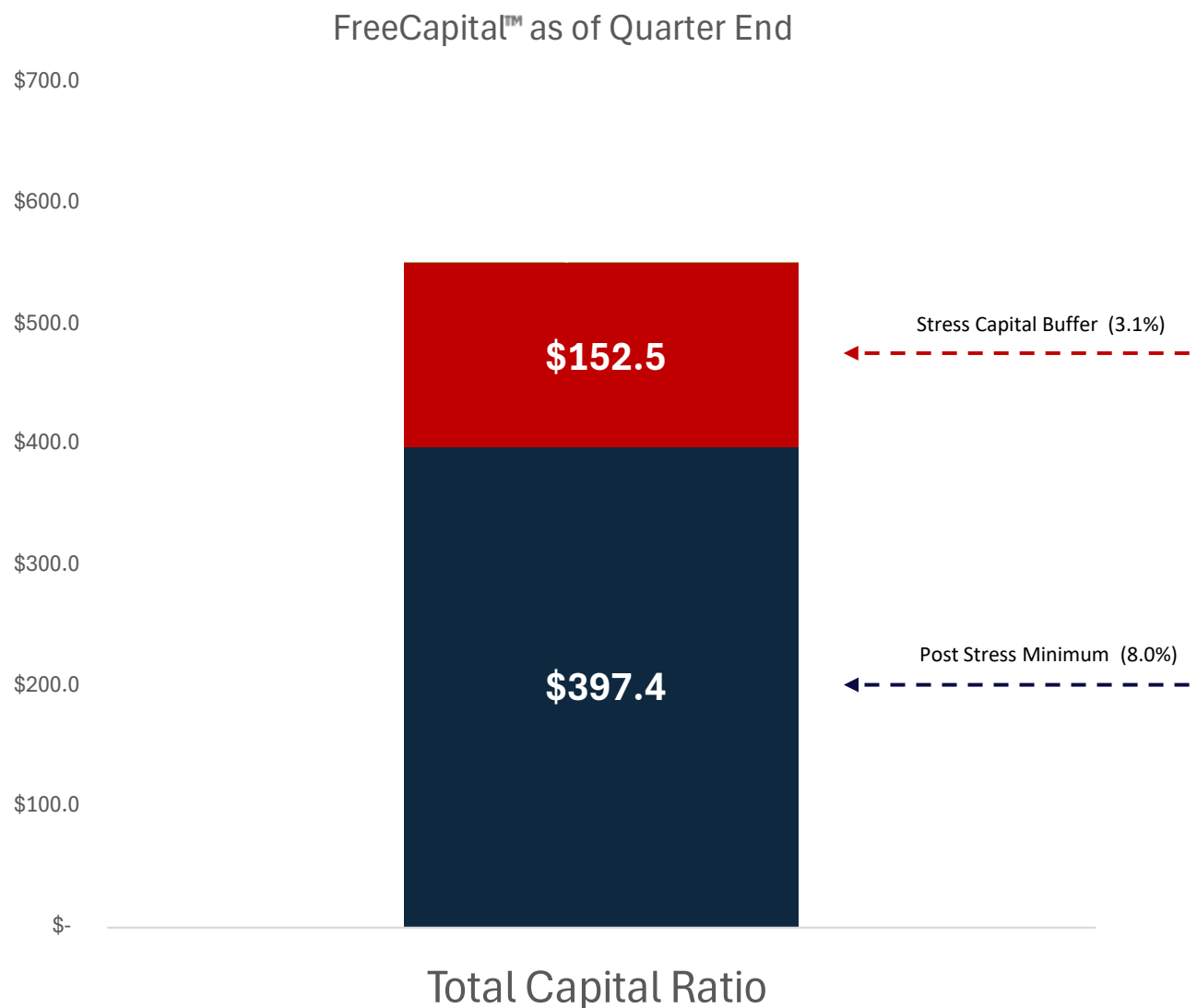
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Customizing Capital Limits



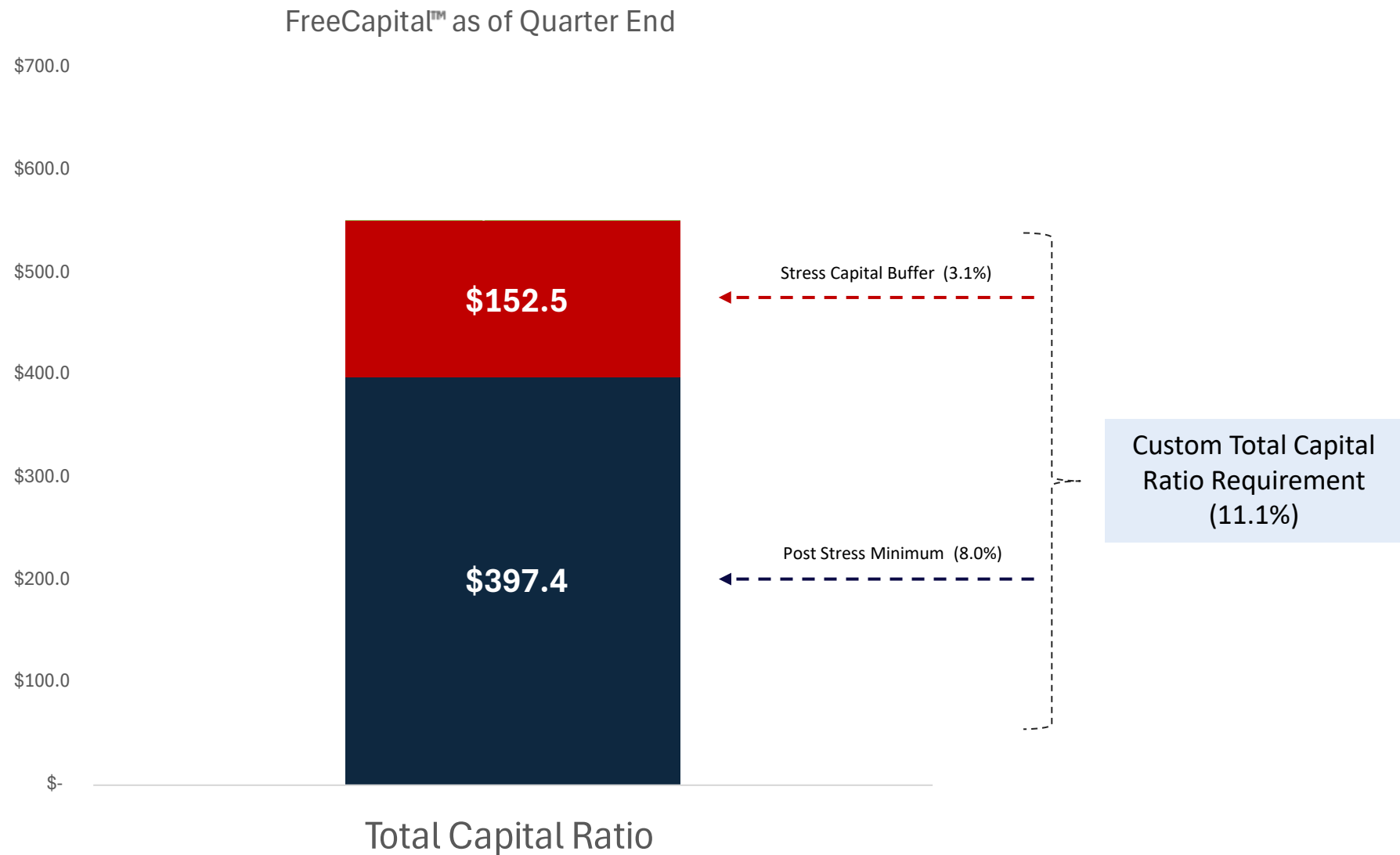
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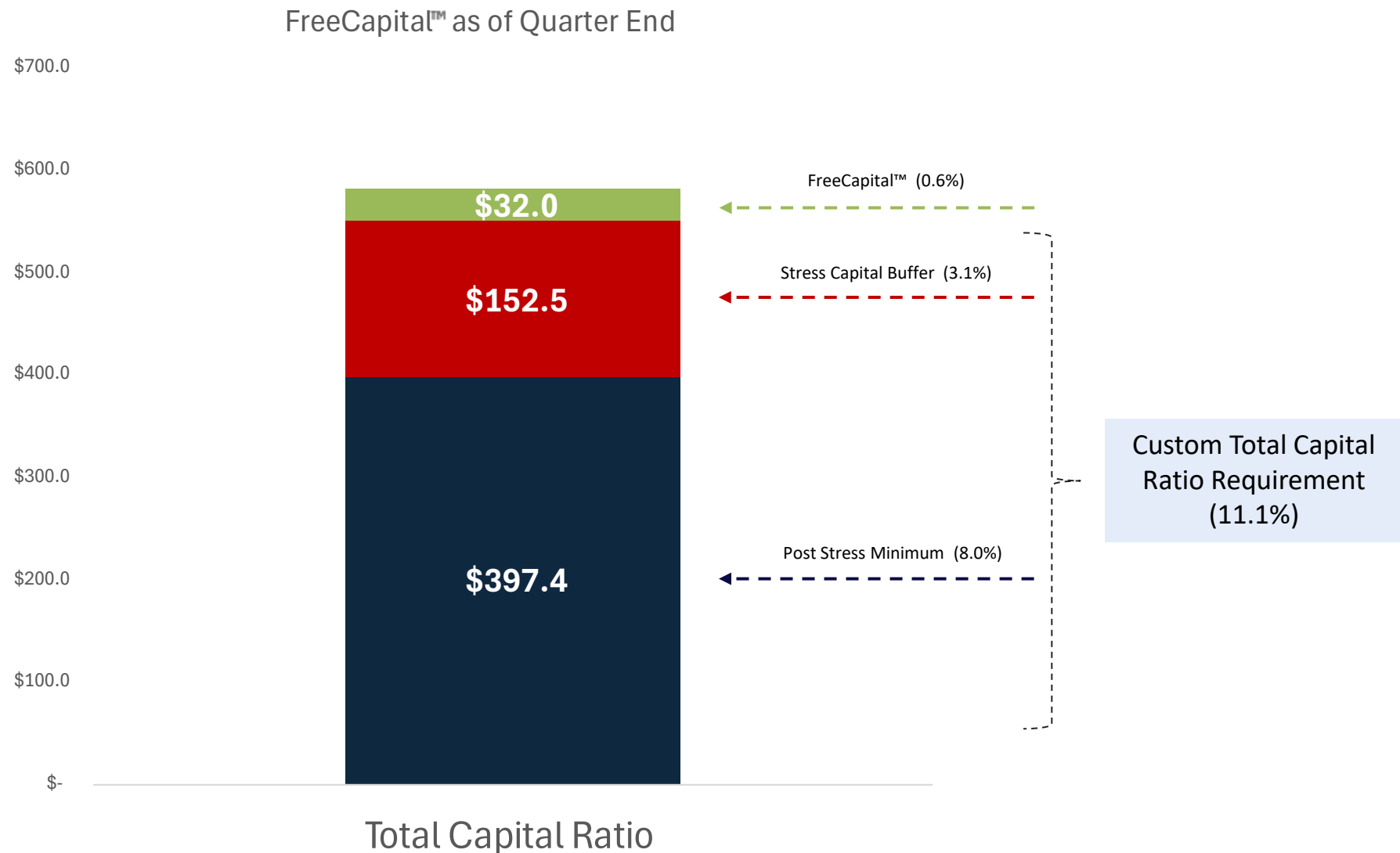
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Customizing Capital Limits



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Customizing Capital Limits



Recap

- Financial Institutions should be prepared for a trade war recession, irrespective of its probability
- A trade war recession will look very different than other recessions such as the 2008 GFC
- Trade war stress testing can help financial institutions evaluate critical strategic decisions and properly divide their capital



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ANALYTICS



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