Stress Testing

Why It Won't (and Shouldn't) Go Away

DAVE KOCH

abrigo™

make big things happen.

SUMMARY

Recent discussions suggest easing of legislative requirements related to stress testing, but prudent stress testing as an important risk management tool for financial institutions is unlikely to go away -- nor should it. Stress testing, as part of overall best practices for mitigating financial institution risk, can provide the board and management with key decision-making information on capital allocation and other decisions driving the achievement of long-term goals.

INTRODUCTION

Recent discussions surrounding the implementation of last year's Economic Growth, Regulatory Relief and Consumer Protection Act have community banking leaders envisioning a full repeal of many of the Dodd-Frank Act's requirements around capital standards and stress testing.

A recent notice of proposed rulemaking put forth a framework whereby banks with strong core capital positions that are under $10 billion in assets would be exempt from the new capital standards adopted under Basel III. The comment period has closed, and now we all await word on how the proposed changes might truly be implemented. The proposed changes to the capital standards are welcomed for many community financial institutions, as the community banking market remains strong and profitable. In the meantime, however, community banks and credit unions need to be proactive in managing their financial results, improving profitability, and ensuring future volatility of results will be well managed and controlled.

It is my view that Congress will focus on softening key aspects of the financial-reform law, rather than make wholesale changes. Areas mentioned for revision are consumer protections, restrictions on derivatives trading, and how regulatory requirements such as capital stress testing change depending on asset size. If Congress does tinker with the capital stress test requirements, it is possible they may actually modify the process used, and at the same time increase the size thresholds for the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) and maybe even for the Dodd-Frank Act stress tests (DFAST).

On the surface, this seems to say that banks under $10 billion would get a pass on the need for regulatory capital stress testing. Under the proposal, this may even extend to banks between $10 billion and $50 billion. Financial institutions may see this as providing relief.

But wait, how can we offer relief to those that were never subject to the initial rule? Removing the specific requirement of CCAR and DFAST testing from banks < $10 billion is fool's gold. These banks were never required to run such tests under the original act. We were told that stress testing is a prudent activity for ALL sizes, but the specific requirement of defined regulatory tests was not mandated for banks of all sizes.

STRESS TESTING ALL ALONG

In fact, while stress testing has taken center stage due to its inclusion in Dodd-Frank, regulators have a long history of requiring various stress tests on individual risk areas. For example, in 2006, the FDIC outlined guidance for institutions to conduct stress tests that evaluated the impact of economic changes for institutions that have 100 percent of total capital in loans tied to construction, development, and other land deals, or that have total commercial real estate loans of 300 percent or more of risk-based capital. Coming out of the last crisis, institutions had to develop contingency funding plans that tested the impact of unanticipated events on overall liquidity. And going back to the 1990s, regulators have been requiring interest rate risk stress testing that remains a staple of asset/liability management efforts today. To manage the credit risk exposures, regulators have repeatedly indicated that some form of stress testing or sensitivity analysis of loan portfolios on at least an annual basis is considered a key part of sound risk management for community banks.

Over the past 10 years we have come to know CCAR and DFAST as the most prescriptive regime, but other regulations and guidance prescribe stress testing within a bank's business. For instance, there are specific stress testing requirements that focus on:

- Positions that lead to interest-rate risk
- Loans in the pipeline and at the point of underwriting
- Credit losses on individual positions and portfolios
- Liquidity positions
- Operational vulnerabilities
- Key metrics that support risk appetite statements

Prudent stress testing as a broader risk management tool is unlikely to go away. Community FIs will still be required to demonstrate stress-testing capabilities across the enterprise, even for a community financial institution with less than $10 billion in assets that is not a big risk taker. It is true that some firms may see relief from requirements for implementing a DFAST regulatory-reporting framework and public-disclosure process, but most community FIs will see business as usual in the risk identification, management, and mitigation process.

And in fact, they should, because risk identification, risk management, and risk mitigation are what drive long-term viability and enable growth opportunities for these critical institutions.

BENEFICIAL TO SURVIVAL AND GROWTH

Community banking represents a key difference in the access to capital in the U.S. versus all other countries. Even though the number of community banks has been falling steadily in recent years, the need for local capital allocation and decision making has never been more in need.

Having a local institution that understands the local community and offers the needed capital to their local economy by taking measured risks is why community banking is different. One in every five counties in the U.S. would be without a physical bank branch if it weren't for a community bank located there. In addition, community banks strengthen the communities they operate in when they are strong businesses themselves and are able to employ people, support local charities, and purchase local goods and services to run their financial institutions.

> "One in every five counties in the U.S. would be without a physical bank branch if it weren't for a community bank located there."
>
> FDIC
>
> COMMUNITY BANKING STUDY

Community financial institutions should expect to continue measuring and managing exposure to interest rate changes, portfolio-specific risks, credit condition, or liquidity risks. These risks, as well as market exposures, information security risks, etc., are all still a part of doing business in the banking space, and as such, demand prudent controls that provide protection and control to smaller banks in line with their risk-taking appetite. Deposit pricing strategies, asset/liability strategies, cybersecurity protection plans, and even portfolio stress testing are all examples of how community financial institutions measure and manage these key risks as part of their larger risk mitigation strategies. It is crucial for community banking as a movement to recognize the enduring importance of stress testing and to see concerted efforts to continue enhancing their overall stress-testing capabilities as beneficial to long-term survival and growth, and not just as a response to meeting regulatory requirements.

Financial institutions looking to meet their long-term performance goals must be able to look critically at how they can deploy capital to meet needs by taking prudent and necessary risks. Banks and credit unions that stress the portfolio, concentrations, and borrower relationships to identify risk as a sensible contingency-planning activity will help accomplish this.

A BROADER STRESS TESTING PROGRAM

Establishing a stress-testing framework that extends beyond regulatory requirements offers banks the opportunity to include meaningful elements and metrics that improve risk management and risk-based decision-making and help develop detailed risk appetites.

In today's competitive environment, having the right tools and information to make key decisions on issues such as acquisitions, funding and credit concentrations, term structures, and growth opportunities requires management to have strong analytical tools based on reliable and consistent data. Where possible, leveraging a single source of data for the various metrics and analysis helps ensure consistency. Strong analytics for base case

risk/return analysis must be matched with well-designed and executed stress testing to provide the board and management with key decision-making information on capital allocation and other decisions driving the achievement of long-term goals.

Moving the view of stress testing from a regulatory requirement to an important component of the institution's overall risk management process, and investing in the right tools, talent, and advice opens the door to driving long-term value and growth.

Advances in technology in recent years have "leveled the playing field" so that community financial institutions of all sizes can gain access to the tools and talents to implement a stronger stress-testing process. Consider how the evolution of technology has changed our daily personal lives, with the first cell phones compared to today's smart-phone "communicators," or the first desktop or laptop computers vs. today's tablets. Utilizing the same stress-testing system of a decade ago is limiting in the same way using a Blackberry to access the Internet today would be.

Lending and portfolio stress testing systems that provide the risk identification, risk management, and risk mitigation that will drive financial institutions' long-term viability and open the door to growth opportunities incorporate the following features:

- They are adaptable to the size and complexity of the institution.
- They allow institutions to stress the entire loan portfolio, concentrations, and specific borrower relationships to identify risk.
- They allow institutions to create custom concentrations and apply multi-variable stress scenarios using key factors such as interest rate, cash flow, and collateral value.
- They provide a structured, manageable process for data aggregation and governance.
- They automate reporting and documentation for examiner review of stress-testing decisions.
- They integrate easily with loan origination, loan grading, loan pricing, and ALLL modules to reduce the efforts required for performing stress testing and reserve calculations while improving overall risk management capabilities.
- They provide "what if" analysis to show effects on capital and earnings.

Of course, community financial institution executives know they cannot wave a wand or simply sign a check for new technology and expect a functioning stress-testing process to be implemented.

Keys points for making the change include:

- A key group of people charged with and committed to changing. Stress testing assumptions normally will cross functional areas. Having a team that spans those areas helps ensure buy-in and reasonable assumptions.

- A review of what capabilities are present within the FI to run the analysis and stress tests. Sometimes this might involve an outside review or a peer network to challenge the status quo.

- A review of data for accuracy, timeliness, and completeness. Front-line data management drives accuracy. Without control of the data integrity, effective stress testing may be harder to implement.

- Robust risk identification of current and future plans. Having a defined process for assessing the current plan risks, and evaluating potential changes in plans is the "normal" being sought.

- Access to best in class models, platforms, and assistance. Matching the right tools for the job helps drive better, faster success.

- Well-documented procedures. Active management of risk identification is a process that takes time to implement. Tools don't do the work by themselves.

CONCLUSION

It is clear that the regulators' efforts to install a more disciplined approach to risk identification, measurement, and management will not be tossed aside. As the primary insurer of depositor funds, it is their duty to ensure strong and effective practices are in place. What should change is how financial institutions look to enhance their own efforts to ensure long-term viability through more effective risk taking. After the 2009 crisis, many FIs pulled back from risk and are now either engaged in, or poised to return to risk taking for their markets. What must remain is a measurement approach and stress-testing framework that focuses on how financial institutions are defining their actions in relation to their long-term goals. Technology will be instrumental in helping financial institutions achieve this due to its ease and accessibility for influencing analytical risk-driven decision-making.

ABOUT ABRIGO

Abrigo provides technology that community financial institutions use to manage risk and drive growth. Our solutions automate key processes – from anti-money laundering to fraud detection to lending solutions – empowering our customers by addressing their Enterprise Risk Management needs.

Make Big Things Happen.
Visit abrigo.com to learn more.

ABOUT THE AUTHOR

Dave Koch
MANAGING DIRECTOR - ADVISORY SERVICES
Abrigo

Since 1989, Mr. Koch has delivered educational programs on Asset/Liability Management and pricing topics to Federal Regulatory Agencies, national and state industry trade groups, Federal Home Loan Banks, and Corporate Credit Unions nationwide. Dave currently serves on the faculty of the Graduate School of Banking at the University of Wisconsin – Madison as well as numerous other industry schools.

In addition to his speaking roles, Dave is actively involved with Abrigo clients consulting with them on capital planning, loan & deposit pricing, and other ALM concerns in an effort to make the ALCO processes more effective. Abrigo and Dave are committed to helping the community financial industry develop workable strategies and risk management processes to improve financial performance, regulatory compliance and overall solutions to their business challenges.

Additional Resources

Stress Testing: The Who, What, When and Why

Best Practices for Stress Testing the Commercial Real Estate Portfolio

Leveraging Digital Channels & Capabilities for Revenue Growth

Real Price of Risk, Loan Pricing and Risk Rating

CECL for Community Banks: The Practical Path

How Community Banks Can Regain the Small Business Lending Market

CECL'S Impact on Your ALM Modeling

abrigo™