

# Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

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## Stress Testing for Real? Prove It, Examiners Say

Examiners won't expect your bank's stress testing program to follow a regulatory blueprint – because there isn't one (see lead story, at right). What they will expect, however, is that you can show that you take your stress testing seriously. What does that mean? Regulators don't want to see Potemkin programs. They'll check to see that you have a policy, that you're implementing procedures, that you put serious thought into the assumptions behind the tests and that they are actually being used as a strategic tool rather than a pro forma exercise, says Rona Pocker, a consultant with Turn-around Risk Management, Inc., New York, NY, and a former SVP at the Federal Reserve.

When it comes to your stress testing program, here is what examiners will expect.

1. Demonstrated completeness. Regulatory expectations for stress testing are evolving, says Pocker. One way that they're changing: Regulators will want your program to take in a full spectrum of risk. Yes, regulatory calls for stress testing were originally included in interagency guidance on CRE and managing

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## No Regulatory Minimum for Stress Testing Standards, Experts Say

If you happen to be one of the largest 19 banks in the country, regulatory expectations for stress testing are exceedingly clear. After all, you've been through the Supervisory Capital Assessment Program (SCAP) once and will go through it again. And thanks to the very public way in which the Federal Reserve put you through that program, everyone who cares to know can find out what scenarios the regulators used and how severely you were stressed.

What about everyone else? Regulators already expect a certain number of community banks – i.e., those that meet certain CRE concentration thresholds – to run stress tests. Regulatory demands for stress testing will likely trickle down to everyone else eventually. So, what are the regulatory standards for a basic, no-frills community bank stress testing program?

The answer is: There are none. Regulators have resisted being prescriptive when it comes to stress testing standards. Banks can't

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## Scale Your Stress Testing Program to Complexity, Not Size

A lot of banks assume that their stress testing program should be scaled to their asset size. Not true, says Orlando Hanselman, the education programs director for Fiserv Risk & Compliance in Johnstown, Pa. Hanselman instead advises banks to scale their programs to their level of complexity. Smaller banks with more complexity in their model may need a bigger, more sophisticated stress testing program than a bigger, simpler bank.

"Banks are underestimating the robustness of the stress testing they need," Hanselman says. "Regulators always say: 'Your risk systems should be commensurate with your balance sheet complexity.' A lot of times, banks erroneously construe that to mean: 'The bigger you are, the more you need.' That's not the case."

What factors can make meaningful gauges for complexity? Here's one example: optionality. "A key component of your risk tolerance and your current risk position is optionality," he says. "You need to know how much of your balance sheet is non-contractual or contractual but subject to unilateral changes by the customer. These days, even small

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## Scale Testing

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community banks have a great deal of optionality embedded in the balance sheet."

In the absence of detailed regulatory guidance, the banking industry is testing a wide range of stress testing best practices. Here, according to various experts, are a few that might stick.

### 1. Between portfolio-level and loan-level testing, choose both

Ideally you should do both, says Bill Nayda, principal with Second Pillar Consulting, Glen Allen, Va. "Loan level can help you identify which loans are the riskiest," he says. "It allows relationship managers to go out and check on those loans more frequently – to make sure the capital is there, to come up with alternate plans to help those borrowers out, to report back to the board. Portfolio-level testing can help you find the blind spots."

Just don't stop at credit testing, Nayda adds. He recommends that banks not only test for credit, but also for interest rate risk, operational risk and liquidity.

"Once you do, you'll have a pretty good picture of the risk inherent to that institution," he adds.

### 2. Draft off of SCAP

A lot of banks have built their stress testing program as modified, scaled-down versions of the SCAP model. As the one regulator-approved model out there, it does make sense to do so, says Nayda.

"There are some models out there by vendors that do take a more robust look at losses," he says. "We've seen folks compare their portfolio to SCAP banks and say: 'I'm better or worse than

those banks, based on, for example, delinquencies and charge-offs and I'll stress my portfolio accordingly.'"

It makes sense because it's a relatively easy way to get a program going and it's regulator-approved. "The regulators have proscribed this stress test for the biggest banks, and if I want to stay in regulatory favor, why not use what they put out there?" Nayda says.

### 3. Get creative

Stress testing isn't a pro forma, push-button process, says Hanselman. Banks that put some effort and imagination into the planning process – i.e., banks that come up with new assumptions and new scenarios to build around them – may be much better off when it comes to anticipating risk and planning for the future.

"It wasn't so long ago that interest rate risk stressing was viewed as parallel shifts up and down the yield curve," Hanselman says. "The regulators mandated the 300 basis point up-and-down shocks and now bankers have become accustomed to this. But now bankers need to be more creative. They need to look at a variety of scenarios and they need more imagination in developing the assumptions behind key scenarios."

### 4. Qualitative data can work

For smaller banks, getting the quantitative information for a stress testing program can be a real challenge, says Shahram Elghanayan, Managing Director at SunGard Ambit. "After the credit crisis, regional banks now have, for better or worse, the data to go build the tools that will help them build a stress testing program," he says. "But smaller institutions, even those that were hit dramati-

cally, won't have that data."

Banks in that situation can outsource a stress test model or use a "more judgemental approach" to building a program.

"If you get the qualitative component right, you can get a lot of value out of it," he adds. "Data will usually enhance the approach, but it's not a deal breaker if you don't have it."

Here's how Elghanayan recommends getting started with a qualitative approach.

1. Ask yourself: To what is my portfolio most susceptible? Come up with severe-but-plausible scenarios that could have a meaningful impact on your bank's performance.

2. Look at the scenarios and start planning for them. "Developing the strategy around those scenarios is a very useful exercise," he says.

### 5. Testing catches overcapitalization, too

Another potential benefit to using stress testing as a tool: Spotting overcapitalization. Not all banks are undercapitalized and bankers shouldn't assume that stress testing will show as much, argues Hanselman. In fact, stress testing not only helps bank

executives and board members sleep well at night, it can also help overcapitalized banks understand just how overcapitalized they are. And banks that know just how overcapitalized they are can deploy that capital with confidence, Hanselman argues.

"Don't presume that stress testing will reveal that all banks are undercapitalized," he says. "Many of my clients are overcapitalized. Those banks need to identify that overcapitalization in a safe and secure manner. They need to do so with quality analytics."

Today's skittish bankers tend not to believe in this until they've run their own stress tests, Hanselman adds. "Until you know whether you're under- or overcapitalized, there's skepticism. A great many banks are overcapitalized right now and the only way to know it is by engaging in robust stress testing. Without it, you're flying blind. Once banks prudently determine their capital position, hopefully, they can discover that they are overcapitalized and have more earnings opportunities."

### 6. Go beyond the macroeconomic

SCAP ran the biggest 19 banks through tests based on national macroeconomic indicators: actual and projected growth rates in

GDP and unemployment data. Smaller banks shouldn't rely on macroeconomic inputs alone, argue Paul Melville and Nichole Jordan, Principal and Audit Partner, respectively, in the Chicago office of Grant Thornton.

In their recent whitepaper, "Continual Stress Tests: Peace of Mind for Banks and Regulators," the two suggest that, in relying on macroeconomic factors too heavily, smaller banks could easily miss the regional or local factors that could have a big impact on bank operations. "[Macroeconomic] tests are useful because they can be applied widely, [but] they are also limited because they do not fully take into consideration the differences between regional marketplaces or other significant variables.

### 7. Just do it

"While institutions with less than \$10 billion in assets are not yet required to conduct stress tests, managers and the board would be well advised to incorporate sensitivity scenarios into routine examinations of their operations and also into their corporate governance practices," Melville and Jordan write. "Most forward-thinking institutions, unlike their weaker competitors, will be able to capitalize on opportunities to expand."

## Regulatory Minimum

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expect to find models for examiner-friendly programs in agency guidance. In absence of such guidance, banks are much better off by designing a useful program, experts say.

"There just isn't a lot of information out there about how banks

should stress," says Bill Nayda, principal with Second Pillar Consulting, Glen Allen, Va.

"The regulatory requirements are definitely vague," agrees Shahram Elghanayan, managing director at SunGard Ambient. "Some banks are just now trying to get their arms around what it means."

Nayda points to Interagency Guidance on Concentrations in

Commercial Real Estate SR 07-1 – guidance that calls for stress testing at banks that meet certain CRE concentration thresholds. Those banks should know that examiners expect them to run stress tests, but the guidance won't tell them how. "It's been almost five years since that came out and we still don't have anything proscriptive about how a portfolio

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## Regulatory Minimum

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should be stressed," he adds.

The regulators did offer a model of sorts for smaller banks when the federal reserve designed SCAP for the nation's largest 19 banks, but it's unclear just how regulator might want SCAP standards to be tailored to a community bank profile, Nayda says.

What's worse, the SCAP program injected another element of confusion into an already murky subject. Banks were used to following a small set of regulatory ratios. For SCAP, the regulators added one more: Tangible Common Equity.

"The regulators put all 19 SCAP banks through that exercise and made them hold additional levels of capital based on the result," Nayda says. "The bottom line was that, after testing, those banks needed to hold at least 4% in Tangible Common Equity. They couldn't fall below 4% under the stress. This added a completely new measure to what banks were used to seeing."

Smaller banks that look to SCAP as a potential (and potentially examiner-friendly) model have to decide if they're going to include that fourth ratio and how. Regardless, regulators haven't issued any guidance one way or another.

"There's no official regulation out there [on Tangible Common Equity]," Nayda says. "This adds some confusion. Should banks look at old measures: Tier 1 Capital, Risk Weighted-Capital or Leveraged Capital? Or should they use the new ratio? It isn't clear what banks are supposed to look at."

Since no one really knows what the regulators want, banks are using a wide range of practices. "We're seeing a hodgepodge of different methods," Nayda says. "We see some folks doing loan-level stress testing. Others are doing credit stress testing, based on [factors like] changes in the LTV of a loan or changing vacancy rates."

For a lot of banks, stress testing is still a relatively new concept and all this buzzing variation in practice may seem confusing and frustrating. It's also a great opportunity for banks to set their own stress testing standards, argues Orlando Hanselman, education programs director for Fiserv Risk & Compliance in Johnstown, Pa.

Regulators are hoping that all this experimentation leads to an emergent best practice, he says. It's in the industry's best interest to do so, because if the regulator doesn't see a suitable best practice emerge, it will get proscriptive awfully fast.

"We're in a phase right now where regulators are waiting for bankers to step up," he says. "If they don't step up voluntarily, regulatory guidance will get much more pronounced. They'll issue specific mandates that banks will be less comfortable with."

This is how regulators typically work, he adds. "Regulators always outline broad principles and hope bankers adjust. If after several years they haven't adjusted, then they'll come with a much heavier hand. Look at Dodd-Frank and Basel III. Those regulations are now very rigid and specific. It all started out in Basel I as general guidelines."

What the regulators have offered to the industry is enough to go on, he argues. Banks should, for

their own good, take the opportunity to craft their own program. "It's a sad commentary when bankers wait for regulators to come out and provide best practices," Hanselman says. "Regulators have presented an excellent framework for expectations. It's not presented with the Nth degree of specificity, but the regulations are clear. It should be the board and not regulators leading the charge to craft best practices. It's time for bank leadership to take charge."

If banks start using stress testing as a serious tool it would be a "watershed moment," Hanselman adds. "Bankers need to stop viewing this as a regulatory requirement and a burden. It's really an opportunity for revenue enhancement."

In the meantime, there will still be exams. Banks can't know how an examiner will evaluate a nascent stress testing program, but in most cases, the bank is far better off having a program in place before the examiner arrives, says Ron Widner, the chief risk analyst with Trinovus, Birmingham, Ala.

Stress test standards will vary "depending on the regulator you talk to," Widner says. "There is no set standard and you won't know what the regulator will expect before he walks in the door. It's been that way for a while with the large banks and its starting to become that way with smaller banks."

That regulatory reluctance to set best practices extends to examiners, Widner adds. "They want to come in, look at your program and say: yes or no," he says. "They want to shoot holes in it. They don't want to have to say: 'Here's the game plan.' That's why we're telling clients to have something already on the table. That's what examiners want." ■

## An Outline for Building a Basic Stress Testing Program in Five Steps

**1. Identify the risk drivers in your portfolio.** What drives risk in your portfolio? There is no one-size approach for bank stress testing. Different banks have different risk profiles and a bank's stress testing program should reflect that. A bank with a big CRE portfolio may be sensitive to rental rates of different property types going up or going down, whereas an agricultural bank will be more susceptible to fluctuations in commodity prices. Start by identifying the factors that drive risk in your portfolio, says Shahram Elghanayan, managing director at SunGard Ambit.

"You want to understand what's driving the dynamics in your portfolio," Elghanayan says. "What is your bank most sensi-

tive to? This is your hypothesis."

**2. Link those drivers to performance.** At this point, the bank's executives should think through how those risk drivers could impact the performance of the bank. Look for a simple link, Elghanayan says. "For a bank with a CRE-heavy portfolio, what is the likely loss rate on the portfolio if office or retail rental rates move down by 10%? How many customers will default?"

**3. Build stress testing scenarios around those links.** Once you've identified those risk drivers and described how they impact your bank's performance, define those scenarios and design your stress tests. The trick is in the calibration, Elghanayan says. Tests need to be extreme,

but if they're unrealistic they won't be useful.

"This step is a challenging one for banks right now," he says. "For an agricultural bank, having wheat prices come down by 50% will clearly stress the portfolio, but the question is: What is the likelihood of this happening? You should be able to quantify the likelihood of those scenarios."

**4. Track the impact.** Once you've run the tests, survey the damage. How did the scenario impact loss rates, capital, allowances or liquidity buffers? "You need to understand the impact on all these items," Elghanayan says. "Articulate the great information, identify the weak spots, and put it all into a report."

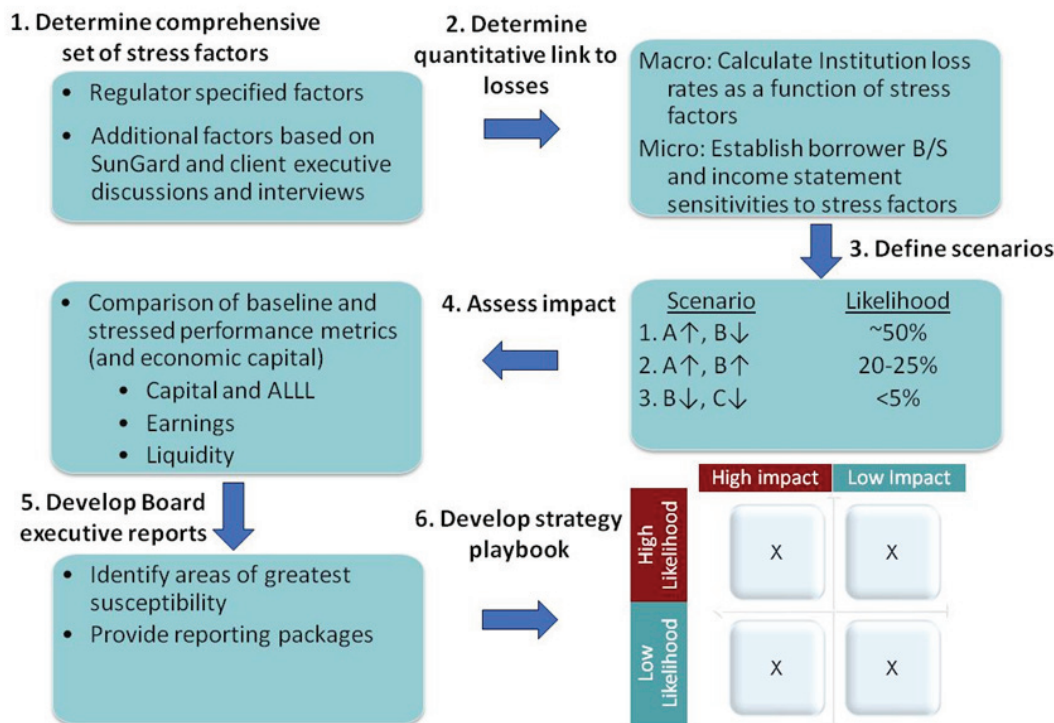
**5. Use your results.** Stress testing can play a central role in strategic planning, Elghanayan says. "You can spend time on stress testing and treat it as a regulatory check box or you can leverage it. Organizations that really take stress testing seriously can use it to their advantage."

Banks leverage stress testing when they give it a central role in strategic planning Elghanayan argues.

"Look at stress testing scenarios that could have a mean-

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### Stress Test Generation: A Simple How-To



(Source: SunGard Ambit.)

## Examiners

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interest rate risk, but your program needs to go well beyond that. "It should include the complete range of assets and off-balance sheet exposures," she says. "CRE as well as investments, trading assets, many types and varieties of loans – it all needs to be incorporated into your various stress testing scenarios. They'll want to know if you've identified all the risk in your balance sheet and that you've found a way to measure it, using metrics or qualitative measures."

Regulators don't expect smaller banks to use the same complex, expensive resources the biggest banks use for their programs, but smaller banks do need to account for their total risk profile in testing.

"The level of detail expected by regulators will depend on the magnitude and materiality of the identified risks, but there are ways to getting an answer without the extensive tools of a large, complex institution," she says. What's important is finding a way "to determine completeness and articulate and support your process both internally and when examiners come calling."

2. Demonstrated utility. You may or may not think of stress testing as a box to check, but examiners will want you to prove that your methodology is reasonably comprehensive and that you use the results to change bank strategy, Pocker says.

According to Pocker, the way an examiner will expect you to communicate all this is with a

document all banks should have on-hand: a stress testing policy.

3. A stress testing policy. Your policy should be your rulebook, she says. It should show the examiner what you're doing with the test and what you did with the results.

"Examiners will look for your stress testing policy first," adds Orlando Hanselman, the education programs director for Fiserv Risk & Compliance in Johnstown, Pa. They'll want to know when the board discussed it, when it approved it and why.

"It should be a board approved policy, which gives examiners the first tangible sign that the institution has the sense of urgency that the subject matter requires," he adds.

Banks with a policy on hand earn instant credibility from examiners, Hanselman says. "If you don't have one, the level of scrutiny will go up a lot. If you have one, you've passed the first test."

Here, according to Hanselman, are the key elements all stress testing policies should have:

1. A statement of purpose
2. A clear account of who should do what and when
3. Details about the frequency of stress testing and how those results are reported to the board
4. Some samples of recent stress test board reporting
5. A description of the stress test process
6. A clear outline of quantitative and/or qualitative aspects of the program
7. A discussion of the technology

and resources committed to the program

8. An account of the board's role in reviewing the program

9. A description of how the board set stress testing objectives

10. A discussion on the creative process the bank uses to creating new scenarios

Not all institutions are drafting these policies, but they are becoming more prevalent, Hanselman says. It should be a concise statement – no more than two or three pages long – and it is fast becoming a basic requirement for banks of all sizes. ■

## Outline

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ingful impact," he says. "What will I do [in these scenarios]? How quickly will the bank rein things in?"

If this process looks a lot like a proto-ERM sort of program, it should, says Elghanayan. Banks that pinpoint and tailor stress tests to enterprise-wide risk can segue into an ERM-like program. But putting together this kind of stress testing infrastructure might be too large a first step for banks just getting started with stress testing. Banks don't necessarily need to go that far to create a useful tool that will likely satisfy examiners, he adds.

"A siloed but comprehensive approach for community banks is a good start," he says. Once that's in place, "the next natural step would be to look at the impact a scenario has on all of the risk types at once, including diversification effects." ■

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