Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

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Reverse Stress Testing: A Short How-to

In the recently released big-bank stress testing guidance, regulators push for regular stress testing, including reverse stress testing, as a way to gain insight into institutional risk. Small banks can expect to hear about regular stress testing and about reverse stress testing, too, experts say.

Several commenters on the initial draft of the regulation took issue with the usefulness of regulators' reverse stress testing requirements. Regulators defended the requirements inclusion.

"Commenters expressed doubts regarding the effectiveness of reverse stress testing, as the approach could produce results of questionable value and captures unlikely, 'extreme scenarios,' the regulators note. "The agencies reiterate the value of reverse stress testing, as it helps a banking organization evaluate the combined effect of several types of extreme events and circumstances that might threaten the survival of the banking organization, even if in isolation each of the effects might be manageable."

The point of a regular stress

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Regulators Exempt Community Banks from Capital Stress Testing

Ever since Dodd-Frank mandated new rules for big bank stress testing, smaller banks began to worry that those rules would, sooner or later, come to apply to them as well. Last week, the three banking regulators – the OCC, Federal Reserve and FDIC – not only released final rules for big bank stress testing, but they also directly addressed community bank stress test concerns. Community banks won't be "required or expected" to conduct the kinds of tests they detail in the finalized big-bank stress testing rules, they note.

Does that mean examiners won't expect community banks to stress test? Nope. As the regulators are careful to note, community bank stress testing exemptions apply only and exclusively to a specific form of stress testing: the bank-wide capital stress tests, such as CCAR and SCAP, designed for the biggest banks. Regulators aren't saying that community banks get a pass on stress testing. They may not have to run bank-wide capital tests, but there are still plenty of expectations for small bank stress testing out there, even if you won't find them in Dodd-Frank, experts say.

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3 Small Bank Lessons from the New Big-Bank Stress Testing Regulation

Federal regulators released the final version of the long-promised big-bank stress testing rules last week. And, as the regulators have gone out of their way to say, they won't expect community banks to run the kind of bank-wide capital stress testing they address in the new rules. However, that doesn't mean there's nothing of note for community banks in the new regulation. Regulators do address some general stress testing principles in the new guidance, principles that signal how examiners will be thinking about community bank stress testing now and how regulators might address small bank stress testing in the future, experts say.

1. Don't underestimate examiner interest in stress testing governance. In drafting the final version of the big-bank stress testing rules,

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Publisher:

Aaron Steinberg
800-929-4824 ext 2471
asteinberg@banksoundness.com

Group Publisher:

Hugh Kennedy
800-929-4824 ext 2213
hkennedy@banksoundness.com

SUBSCRIPTIONS:

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ADDRESS:

Bank Safety & Soundness Advisor
Two Washingtonian Center
9737 Washingtonian Blvd., Ste. 200
Gaithersburg, MD 20878-7364

Regulators Exempt

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As the joint statement makes clear, none of the three banking regulators expects community banks – those with $10 billion in assets and below – to follow the new stress testing regulation.

"Community banks are not required or expected to conduct the types of stress testing specifically articulated in the initiatives, which are directed at larger organizations," the statement reads. "In particular, community banks are not required or expected to conduct the enterprise-wide stress tests required of larger organizations under the capital plan rule, the proposed rules implementing Dodd-Frank Act stress testing requirements, or as described in the stress testing guidance for organizations with more than $10 billion in total consolidated assets."

"The regulators are feeling some significant discomfort from the press, public and legislature and at this point they have to be careful – particularly with community bank regulations – to not be seen as 'killing community banks with endless compliance edicts,'" says Peter Cherpack, director of credit risk technology with Ardmore Banking Advisors, Inc., Ardmore, Pa.

At the same time, the joint statement makes clear that regulators are still very much interested in enforcing existing, non-Dodd-Frank stress testing-related guidance, including guidance on CRE concentrations, liquidity and interest rate risk management.

"The agencies note that such existing guidance, including that covering interest rate risk management, commercial real estate concentrations, and funding and liquidity management (among others), continues to apply," the statement adds.

"In other words, they are sticking to their guns that stress testing is valuable and important – but at the same time saying that smaller institutions will not be asked to follow the larger bank frameworks," Cherpack says.

> **"In this release, they're not talking about exempting community banks from the additional requirements for IRR stress-testing ..."**

The banking industry and the public may be focused intently on Dodd-Frank, but for community banks, the rising regulatory burden isn't really coming from Dodd-Frank, adds Brad Olson, president of Olson Research Associates, Columbia, Md.

"In this release, they're not talking about exempting community banks from the additional requirements for IRR stress-testing, or liquidity stress-testing, or credit stress-testing," Olson says. "Everyone thinks that all the 'new' requirements are bundled into Dodd-Frank Act, but they're not. And now the regulators can say, 'See, we're not burdening commu-

nity banks with any of this Dodd-Frank stuff,' but they can continue to enforce all the additional requirements in [guidance like] the 2010 IRR Advisory."

In the meantime, stress testing expectations are as hazy as ever, Cherpack says.

"For the couple of banks I have talked to since this was released, this makes them more uneasy, as it says 'you really should be doing this - but we will not give you anything other than principles to follow,' he says. "This makes the community banker uneasy. An earlier promised stress testing guidance for banks under $10B with some more specifics would be much more helpful."

A best practice?

Community banks want to forget about capital stress testing, but that might not be such a great idea. Regulators now expect higher standards from bank risk management – at banks of all sizes – and the new big-bank stress test requirements do contain plenty of useful information for banks aiming to anticipate those new standards, argues Jonathan Hightower, an attorney in the Atlanta office of Bryan Cave, LLP.

"Whether we want to call it stress testing or something else, the fact is that risk management expectations have been raised," Hightower says. "This is coming from regulators, but also directors and shareholders. Given all the events of the financial crisis, directors want to know that management is on top of the risk. Shareholders want to know that the board is on top of management."

"It's good that the regulators clarified that this dense and thorough guidance doesn't apply to banks under $10 billion, but the principles expressed here are very good," he adds. "All banks should be paying attention to this and implement these principles in a way that makes sense."

The new stress testing regulation does fit with the trend in regulatory thinking – that banks should try to look ahead and anticipate risk, adds Tariq Mirza, managing director in Grant Thornton's National Bank Regulatory practice and a former senior advisor at the FDIC.

Community banks may not want to forget about capital stress testing, despite their regulatory exemption.

"The sentiment among regulators is that, before the crisis, banks were looking at risk in the rear view mirror and that regualtors themselves, to a certain degree, were looking at bank risk as a static thing," he says. But the new stress testing regulations for bigger banks "do follow new, basic core principles – that risk management should be forward-looking."

And for any bank looking to meet examiner expectations for forward-looking risk management, the new big-bank rules are best practices, adds Paul Melville, principal in Grant Thornton's advisory service, Chicago.

Bank-wide capital stress testing "has not been regulated for community banks, but look at what they're asking for [in the regulation]," he says. "Interest rate risk management, CRE management, liquidity management. A sensible bank should be looking at this every day of the week. To the extent that it's not developed into a regulation for small banks called stress testing is almost irrelevant."

A defacto standard?

In fact, community banks may find that bank-wide capital stress testing – whether technically required or not – may not be avoidable if they want good exam outcomes. Regulators may be exempting community banks from bank-wide capital stress tests, but they're also sending an important message: bank-wide capital stress testing is the new regulatory standard for adequate capital, says Kamal Mustafa, CEO of Invictus Consulting Group, New York, N.Y.

"The reality is that stress testing for defined levels of capital is how the regulators define capital – it's how they determine adequate capital cushions," he says.

This means that capital stress testing, like it or not, is the new defacto standard, he adds. And proactive capital planning – supported by capital stress testing – may be the only way banks can successfully defeat examiner arguments for conservative capital levels.

"Will regulators give community banks a pass [on capital stress testing]? No," he says. "They will

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Regulators Exempt

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expect them to stress test themselves and defend their position or they'll arbitrarily impose requirements on them, based on statistics and averages. Technically, no community banks need to run these kinds of stress tests, but if community banks can run the stress tests, they should run them. If they don't do a capital stress test and defend their position, they'll inevitably get stuck with higher Tier 1 capital ratio requirements that reflect more conservative regulatory opinions."

Community banks do have a clear advantage over their larger institutional brethren when it comes to capital stress tests, however. For big, complex banks, capital stress testing is a massive, complicated project. For smaller, relatively simple community banks, capital stress testing doesn't need to be difficult, Mustafa adds.

"For community banks, capital stress testing is a much simpler process," he says. "They have much greater knowledge about their loan portfolio and their borrowers. They know their own geographic footprint better. They have all the information. In a sense, they're much better equipped to run these tests. That means it's also easier for them to push back when regulators demand more capital."

"The better you can demonstrate that your bank is on sound footing – that it can withstand fluctuations in the marketplace, the better position you'll be in with your examiner," adds Melville. "If you have a good story to tell, then tell it." ■

Small Bank Lessons

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regulators added a fifth and final key principle for bank stress testing frameworks devoted explicitly to governance.

"The agencies have incorporated a fifth principle specifying that an organization's stress testing framework should include strong governance and effective internal controls," regulators note. "The agencies reorganized this discussion into a fifth principle in order to underscore the importance of governance and controls as a key element in a banking organization's stress testing framework."

Governance isn't just a big-bank stress testing concern.

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"This has been stated repeatedly - that the stress testing exercise was not created to be run by credit analysts and put on a shelf," says Peter Cherpack, director of credit risk technology with Ardmore Banking Advisors, Inc., Ardmore, Pa. "This was meant to create useful credit information that should be shared with management and the board, but somehow, bankers seem to have lost the importance of sharing the results of the tests with management and the board."

Examiners have noticed that at some banks, the stress testing function has been, by design or not, firewalled off from the rest of the bank and they want to make sure that stress testing actually plays a role in strategic planning, says Brad Olson, President of Olson Research Associates, Inc., Columbia, Md.

Some community bankers may be disinclined to use risk management tools like stress testing when making plans, but following market demand blindly can lead to bad outcomes, he says.

"I've talked to plenty of community banks whose perspective on risk management is to say, 'We can't really manage this risk; We take risks and we're happy to measure them but the market really dictates what we can and can't do,'" Olson says. "Banks can be cavalier about this, but examiners have a point. This is a risky environment."

And the market can push banks into risky strategies, he adds.

As the guidance makes clear, regulators want to see stress testing programs engage with the broader discussion of bank risk and strategy within the bank.

"A banking organization's stress testing framework will be effective only if it is subject to strong governance and controls to ensure that the framework functions as intended," the regulation states. "Strong governance and controls also help ensure that the framework contains core elements, from clearly defined stress testing objectives to recommended actions. … A banking organization should ensure that the stress testing framework is not isolated within a banking organization's risk management function, but is firmly integrated into business lines, capital and asset-liability committees, and other

decision-making bodies."

In fact, when it comes to big bank board involvement in stress testing, the regulators stop short of requiring board input into the technical work behind test design, but will expect plenty of board involvement when it comes to stress test development and use.

According to regulatory expectations, "senior management, not the board of directors, should have the primary responsibility for stress testing implementation and technical design," the regulation states. "However, the agencies emphasize that a banking organization's board of directors should be provided with information from senior management on stress testing developments (including the process to design tests and develop scenarios) and on stress testing results (including from individual tests, where material). As a general matter, the board of directors is also responsible for monitoring effectiveness of the overall framework, and using the results to inform their decision-making process."

Regulators consider stress testing to be a key piece of strategic planning, which means that they want board involvement in areas of the stress testing process that management tends to consider its purview alone. And they're expecting this level of board engagement at the community banking level, too, says Orlando Hanselman, the education programs director for Fiserv Risk & Compliance.

"There's a tug of war going on between management, boards and regulators," he says. "Management wants boards to remain somewhat distant and keep a narrow focus – a focus they describe as 'strategic.' What the regulators are now saying is that they agree with management when it comes to tactical planning, but that much of the work in stress testing – in creating scenarios and calibrating stresses – is a key element of strategic planning and is therefore a board responsibility. Some of the lines separating board and management responsibilities are getting a little blurred, but this regulatory opinion isn't going away. They think boards should be involved in stress testing design as well as monitoring."

"Each banking organization should design a specific stress testing framework to capture risks relevant to the organization, ..."

Another way banks can make sure bank boards are engaged with stress testing: make the results understandable.

"One common fault is that the results of the testing are too 'quant' and not really meaningful," says Cherpack. "The results can appear to be more of a math exercise. The real meaning of the process, assumptions and inputs should be understandable to the average board member."

Regulators will also look for proof that banks are sharing stress test results with the board, he adds, which means they'll want to see test results "noted in the board minutes," and that "periodic results of the testing are shared with the board regularly."

2. Regulators won't tell you how to build a stress testing program because they want you to build it yourself.

Several commenters on the big-bank stress test guidance asked for more uniformity or standardization in the tests, i.e., common coefficients, models or benchmarks, which would help banks better implement tests and help examiners better compare organizations. The regulators declined, noting instead that they favored a principles-based approach. Flexibility, they say, is a "key aspect to the guidance."

"Each banking organization should design a specific stress testing framework to capture risks relevant to the organization," the regulation notes. "The agencies believe that prescribing standardized stress tests in this guidance would have its own inherent limitations and may not appropriately cover a banking organization's material risks and activities."

In other words, regulators want tailored programs and they want banks to tailor those programs.

"A banking organization should choose the approaches that appropriately consider the unique characteristics of that particular organization and the relevant risks it faces," the regulation notes. "The agencies expect that stress testing methodologies will evolve over time as banking organizations develop approaches that best capture their individual risk profiles."

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3. Regulators want regular stress testing. One commenter expressed concern that too-frequent stress testing could "desensitize" senior management and the board to stress test results. That's not an excuse not to test regularly, the agencies said.

"The agencies believe that regular review of stress test results is useful – both during periods of economic downturn and benign periods – and have clarified that such review can help a banking organization track over time the impact of ongoing business activities, changes in exposures, varying economic conditions, and market movements on its financial condition," the regulation notes.

Community banks should stress regularly, too, but don't get carried away with it, warns Olson. Bank management and boards can and do become desensitized to stress testing reports.

"Think about the board meeting," he says. "It can range anywhere from three hours to a whole day. And bank board members have a lot to talk about. The agenda can be pages long. Now inject stress testing into that agenda. If you start to talk about it too often, people will tune it out."

How often should community banks stress test? For interest rate risk testing – which is Olson's specialty – once a quarter is sufficient. ■

Reverse Stress

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testing program – one that includes reverse stress testing, too – is not to manage directly to extreme scenarios, but rather to gain insight into how the bank might fare in such scenarios, regulators say.

"A given stress test result will not necessarily lead to immediate action by a firm, and in some cases stress test results – including those from reverse stress tests – are most useful for the additional information they provide," the regulation states.

"So far, the agencies say they see this as a valuable forward looking risk management practice, not a way to establish a 'failure number.'"

"In terms of supervisory responses to an organization's stress testing activities, the agencies expect to consider a banking organization's stress test results and the appropriateness of its overall stress testing framework, along with all other relevant information, in assessing a banking organization's risk management practices, as well as its capital and liquidity adequacy."

Reverse stress testing isn't as scary as it seems, says Peter Cherpack, director of credit risk technology with Ardmore Banking Advisors, Inc., Ardmore, Pa.

"All this means is that you stress until you hit a meaningful break point," he says. "This is common sense."

For example, he says, a bank can increase stress amounts (lowering NOI, raising cap rates/interest rates, reducing collateral value) until it hits an average weighted loan-to-value of 100 or DSCR of 1.05x for the segment it is stressing.

"Now you know your theoretical buffer," he says.

Bankers worry that if they engage in this kind of testing, they'll generate a "magic number," which could trigger a myriad of bad regulatory outcomes if they hit it, Cherpack adds.

"The real issue here is, will examiners commit to their bankers that they will not use these directional 'what if' scenario results as potential punitive measures of bank health?" he says. "So far, the agencies say they see this as a valuable forward looking risk management practice, not a way to establish a 'failure number.' In my view, if a bank does actually realize a break point number from their stress testing process, they will have many far worse issues to deal with than hitting the number." ■

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