

Stress Tests are a Start, but Will They Be Enough?



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U.S. federal bank and thrift supervisors are currently using stress tests to assess whether the country's largest banking organizations have a sufficient capital buffer to withstand the impact of an even more challenging economic environment than we are currently experiencing. There has been a lot of discussion and talk about the tests of the largest banks under the capital assessment program (CAP).

The New York Times distilled the test guidelines by [saying](#), "According to the new Treasury Department guidelines, the banks would have to assume that the economy contracts by 3.3 percent this year and remains almost flat in 2010. They would also have to assume that housing prices fall another 22 percent this year and that unemployment would shoot to 8.9 percent this year and hit 10.3 percent in 2010."

Will it work? Maybe. What is unknown is how the regulators plan to project exactly how these guidelines will affect all of a bank's assets and holdings enterprise-wide. How will increasing unemployment rates affect mortgage loans, fixed assets, commercial loans or depository products? Stress testing is certainly a good way to test assets and capital needs against a realistic worst-case scenario. However, some of the criticism of the

CAP is that the worst-case scenarios presented in the stress tests [may not actually be the worst case](#). In some cases, such as the unemployment rate, the "worst-case" scenario seems likely to occur, suggesting that the assessment program assumptions are not extreme enough.

There is also talk that regional and community banks may also be subjected to CAP, but nothing is final. However, banks that want to get a handle on their true capital needs can do their own stress testing. If you don't have the resources to do an enterprise-wide test, focus on the areas with the most risk. For most community banks, this is their CRE loan portfolio.

For banks that are highly leveraged with CRE loans, the most important thing you can probably do right now is to conduct a thorough stress test of your CRE loan portfolio. Test how the entire portfolio will respond to changes in projected gross income, vacancy rates and interest rates, among other variables. Results of your stress testing should enable you to identify vulnerable segments and therefore determine the best way to reduce your risk. The key here is to be honest and test for the realistic worst.

A robust loan portfolio should be able withstand a realistic worst-case scenario; otherwise the bank may want to reconsider its loan reserves or diversify its portfolio. Banks should also use stress testing to ensure that they are not setting aside too much of a reserve, since restricting too much capital provides fewer funds for generating

additional income. Stress testing can be done manually, or there are software programs that can analyze the portfolio data.

Recommended links:

[FDIC FAQ on CAP](#)

[FDIC CRE Guidance](#)

[Guide to the CRE Guidance on CRE Lending](#)



About Doug Keipper

Doug Keipper is a Certified Anti-Money Laundering Specialist (CAMS) and former BSA officer for a \$500M commercial bank in Atlanta. He has spent over 15 years in retail banking, wholesale mortgages and financial services. Doug lives in Duluth with his wife and two daughters, Rebecca (13) and Rachel (11).



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