ACTIONABLE ITEMS FROM YOUR STRESS TEST

FOR COMMUNITY BANKS

Providing simple solutions to complex problems with another helpful white paper from Banker's Toolbox
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WHAT WILL WE COVER?

A Table of Contents

INTRODUCTION

Stress testing has been a part of the large bank world for five years now. Since the beginning, both regulators and banks have learned more about the intricacies of the exercise and gained enough experience to refine the features. Most importantly they have learned the value of the exercise and are putting the knowledge gleaned from the results to better manage numerous areas of their institutions.

For the most part, the community bank world has remained on the sidelines. There are several pieces of regulatory guidance targeting smaller banks, including the 2012 FDIC Supervisory Insights and the OCC's Bulletin 2012-33. Additionally, the 2006 CRE Interagency Guidance requiring portfolio level stress testing for banks with high concentrations (100%/300%) is still outstanding but regulatory enforcement has been inconsistent.

Most community bankers have probably been thankful for that. Compliance costs for any regulation disproportionately impacts the smaller bank because costs are spread over a smaller asset base.

> "MOST IMPORTANTLY THEY HAVE LEARNED THE VALUE OF THE EXERCISE AND ARE PUTTING THE KNOWLEDGE GLEANED FROM THE RESULTS TO BETTER MANAGE NUMEROUS AREAS OF THEIR INSTITUTIONS."

INTRODUCTION

> **"CONCENTRATIONS OF CREDIT, PARTICULARLY IN COMMERCIAL REAL ESTATE (CRE) LOANS FOR ACQUISITION, CONSTRUCTION, AND LAND DEVELOPMENT PURPOSES, HAVE BEEN A COMMON FACTOR IN BANK FAILURES DURING STRESSFUL PERIODS, ESPECIALLY FOR COMMUNITY BANKS."**

Although community banks do not present a systemic risk to the economy, their services are very much relied upon by local communities. In a May 8, 2014 speech, Federal Reserve Governor Daniel K. Tarullo stated that:

"Smaller community banks-those with less than $1billion in assets-account for nearly a quarter of commercial and industrial lending, and nearly 40 percent of commercial real estate lending, to small-and medium-sized businesses, despite their having less than 10 percent of total commercial banking assets."

Clearly, community bankers are managing huge amounts of commercial assets. These loan types continue to be the "bread and butter" for smaller institutions. However, as the OCC's 2012 Supervisory Guidance points out:

"Concentrations of credit, particularly in commercial real estate (CRE) loans for acquisition, construction, and land development purposes, have been a common factor in bank failures during stressful periods, especially for community banks."

A very true statement! Community banks failed at alarming levels both during the past crisis as well as the previous crisis in the early 90s. A community bank can go through the FDIC resolution process fairly easily. Not so with large banks.

Even though your regulator may not be demanding portfolio level stress testing, now is the time for community institutions to take a stab at adding this exercise to their proactive risk management processes.

To get started there is an abundance of documentation that can help with formulating a portfolio level stress test but there is far less information on what to do with the results and how to best use the information to an institution's advantage.

So let's explore how to **incorporate the conclusions into strategic decision making** by outlining some "actionable items" bank management can take.

RISK MANAGEMENT

The results of a portfolio level stress test should clearly inform the analyst what segments present greater risk to the institution. Loan portfolio segments should include, but not be limited to, property type and geographic location (city, MSA, county, zip code).

> **"THE RESULTS OF A PORTFOLIO LEVEL STRESS TEST SHOULD CLEARLY INFORM THE ANALYST WHAT SEGMENTS PRESENT GREATER RISK TO THE INSTITUTION."**

- If, for example, the test revealed that the majority of loans secured by retail shopping centers failed the stress test, bank management and the board of directors can revise the Loan Policy to reduce overall exposure to this segment.
- Underwriting requirements can also be revised by requiring a greater down payment and higher debt service coverage ratios.
- If the results of the stress test reveal this segment to be at an alarming rate of risk to the institution, bank management and the board of directors can completely cease new originations of this type.
- Loans on the books can also be sold or participated out to reduce exposure.
- If the results of the stress test reveal that loans originated (or secured with collateral) in a certain geographic location present high risk, bank management can take action similar to the strategies listed above. If this is the case, be sure to convey this finding to examiners and explain with documentation that the step was taken in order to protect the bank's capital base and maintain the safety and soundness of the examination. When banks avoid lending in certain areas, Consumer Compliance bank examiners will take notice so avoiding any Fair Lending issues is in your best interest.
- In order to continue loan growth, the bank's Marketing Plan can be revised by targeting marketing material to alternate types of real estate such as Industrial and Apartment.

Loan Information		Mild Stress Factor						Severe Stress Factor					
Note #	Loan Balance	Interest Rate	Total Collateral Value	DSCR	LTV	Net Collateral Shortfall	Pass / Fail	Interest Rate	Total Collateral Value	DSCR	LTV	Net Collateral Shortfall	Pass / Fail
9914610	$561,571	6.9000%	$829,658	1.73	0.6769	$0	Pass	6.9000%	$742,326	1.5479	0.7565	$0	Pass
10003120	$1,318,307	5.7555%	$1,742,562	0.9994	1.2156	$233,841	Fail	5.7555%	$1,559,135	0.8942	1.3586	$347,996	Fail

INDIVIDUAL LENDING DECISIONS

The results of the portfolio level stress test should clearly identify the loans that failed the test. With this information, bank management should immediately create an “action plan”.

> “THE RESULTS OF THE PORTFOLIO LEVEL STRESS TEST SHOULD CLEARLY IDENTIFY THE LOANS THAT FAILED THE TEST. WITH THIS INFORMATION, BANK MANAGEMENT SHOULD IMMEDIATELY CREATE AN ‘ACTION PLAN.’”

- If the loan is secured by an income generating property, the Loan Officer should strive to obtain updated rent-rolls. If units are vacant, question the borrower or Property Management firm about their plans to fill the space and at what rates do they expect for a new lease? This information will help to analyze the current cash flow and provide the ability to project cash flow coverage under stressed scenarios.
- If the loan is owner occupied, the Loan Officer can try to obtain updated financial statements.
- Loan officers can perform a site visit to ensure the collateral is being maintained. The bank can also order an updated evaluation or an appraisal to be sure of current collateral value.
- Is it possible that the bank can strengthen a problem credit by obtaining additional collateral or an additional guarantee(s)?
- Loans that fail the stress test can also be placed on the Watch List.

STRATEGIC & CAPITAL PLANNING

Strategic & Capital Planning

	Results	Earnings	
Stress	(A) Total Loans with DSCR< 1.0000 Estimated Increase in Criticized/Classified Loans*	(B) Weighted Average Interest Rate	(C) Potential Interest Income Lost*
Fail - Mild Loans	$1,791,241	6.74%	$120,730
Fail - Severe Loans	$2,107,432	7.00%	$147,520

During stressful time periods loan demand usually declines as well, so forecasting additional interest income on newly originated loans may not be prudent.

Forecasted earnings analysis during stressful time periods should also consider increasing overhead expenses as more time and attention will have to be devoted to the work-out of troubled loans and ORE, as well as increased audit expenses.

Forecasts for the ALLL are paramount. Delinquent and nonaccrual loans will require greater allocations in provision expense. Sales of troubled loans may also result in losses that will have to be absorbed. Troubled economic times will also have to be accounted for in the Q Factors which will also require increased provision expenses.

Estimated Impact on Earnings Two Years Actual		Estimated Impact on Earnings Pro Forma Stress Period	
Pre-Provision Net Income	$4,500	Pre-Provision Net Income	$3,500
Less provision to cover two-year losses	$500	Less provision to cover two-year losses	$14,687
Less provision to maintain adequate ALLL	$0	Less provision to maintain adequate ALLL	$250
Income Tax expense (Benefit)	$235	Income Tax expense (Benefit)	$100
Net Income	$3,765	Net Income	-$11,337
Estimated Impact on Capital		**Estimated Impact on Capital**	
Tier 1 Capital $	$28,120	**Tier 1 Capital $**	$28,120
Net change in Tier 1 Capital	N/A	Net change in Tier 1 Capital	-$11,337
Adjusted Tier 1 Capital $	$28,120	**Adjusted Tier 1 Capital $**	$16,783
Quarterly Average Assets $	$301,500	Quarterly Average Assets $	$286,500
Tier 1 Leverage Ratio %	9.33%	**Tier 1 Leverage Ratio %**	5.86%

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CONCLUSION

Hopefully this discussion has outlined "Actionable Items" that community bankers can take using the results of a thorough and accurate portfolio level stress test.

Once you have thought through these items and added to the list on your own, a Stress Test Policy should be created for your institution. If you would like to start with a template, please contact us and we'd be happy to share ours with you.

Armed with this knowledge, and of course documentation, community bankers will have a forward and specific plan to proactively manage the risk in their institution under stressful time periods.

When the bank undergoes a safety and soundness examination, all should be revealed, demonstrated, and discussed with regulators. Remember that most community bankers are not performing this type of analysis, so having taken this step will go a long way to improving your relationship with them. It will also put them at greater ease knowing that you have a thorough and specific plan in place to protect the bank's capital base in times of trouble.

"ONCE YOU HAVE THOUGHT THROUGH THESE ITEMS AND ADDED TO THE LIST ON YOUR OWN, A STRESS TEST POLICY SHOULD BE CREATED FOR YOUR INSTITUTION"

ABOUT BANKER'S TOOLBOX

Austin-based Banker's Toolbox was incorporated in 2000 as a privately-held 100 percent employee owned company and remains so today.

Daniel Cho is the founding CEO. As a former community bank operations and technology officer for nearly two decades, Daniel understood from his own experiences the need for powerful yet practical software solutions among community bankers.

In 2007, the banking crisis underscored the need for better loan risk management solutions for community and mid-size banks. Crest™ was developed in 2008 and released in 2009 in response to that need. Based on lessons learned from earlier products, Crest was developed with the specific vision of providing turnkey, state-of-the-art loan risk management technology to banks nationwide.

Crest™ is an affordable CRE portfolio solution that provides comprehensive stress testing capabilities for community banks. As a hosted solution the software does not require expensive servers. The software also offers CRE indices that will help bankers to estimate current collateral values on collateral properties that have outdated appraisals. This feature creates uniformity during the stress testing process as bankers can focus on stress test factors for possible future stressful economic times.

Comprehensive capabilities for "what-if" scenarios are available at several levels and output in spreadsheet and PDF formats for pictorial presentations is provided.

ABA ENDORSEMENT

A careful and thorough analysis of the Banker's Toolbox Crest™ solution and its ability to help financial institutions meet regulatory requirements, while also being an effective, efficient, cutting edge software solution, led ABA through its subsidiary the Corporation for American Banking, to endorse Crest™ as the solution for CRE loan stress testing.

Corporation for American Banking, L.L.C.