

ABA BANKING JOURNAL

ADD HIGH-PERFORMANCE SECURITY TO YOUR PORTFOLIO



ADD HIGH-PERFORMANCE SECURITY TO YOUR PORTFOLIO

- HOME
- ABOUT
- COMMUNITY BANKING
- COMPLIANCE
- CYBERSECURITY
- ECONOMY
- PAYMENTS
- MORTGAGE
- POLICY
- RETAIL/MARKETING
- MORE ▾

Stress Testing: Feeling the Pressure?

October 26, 2015

By Evan Sparks

In 1928, a pair of heart researchers conducted an experiment. They took several patients with a history of clogged arteries, wired them to an electrocardiograph and asked them to do sit-ups until it hurt. In some cases, the researchers even pushed down on the patients' chests to make them work harder.

The result: for the first time the ECG showed a clear pattern of reduced blood flow from the heart as the patients worked harder. The ECG allowed the researchers to identify with greater precision just how clogged a patient's arteries were—and how it would affect his life. It was the first deliberate "stress test," and it became a fundamental diagnostic tool of cardiology.

Nine decades later, it's bankers who are wired up and sweating through crunches. According to a recent survey from SageWorks, nearly six in 10 depository institutions are stress testing themselves in some way. An additional 18 percent had been asked by their examiners to start stress testing; just a quarter of institutions reported no pressure to stress test.

Large financial institutions have been stress testing themselves for more than a quarter century, and certain community banks have been stress testing in some form since 2006, when regulators issued guidance on managing concentrations in commercial real estate that included stress tests. But while few institutions face the mandatory and complex stress testing processes for the largest banks, many bankers note that regulators are increasingly encouraging smaller banks to use stress test methods.

To cope with these increased pressures, bankers are trying to find the best way forward, identifying test methods that work for their institution, finding partners to smooth the process and making the best of it by integrating their test results into business planning.

When regulators 'recommend'

Conversations with bankers confirm the survey results. Examiners from the Federal Reserve recommended stress testing as a "best practice for a bank with our kind of profile," says Will Chase, president and CEO of the \$520 million Triumph Bank in Memphis, Tenn, "which we had never done before or even contemplated for our size of institution."

At Eaton Federal Savings Bank in Charlotte, Mich., president and CEO Timothy Jewell says his examiner first raised the issue a year and a half ago—and repeated the request a year later, "in a way that did not feel like a recommendation but rather a directive that, if not followed, would be grounds for criticism at our next exam."

Eaton Federal is a \$295 million mutual bank with a longstanding focus on home loans. "This just isn't going to be meaningful for us," Jewell recalls thinking. "Our capital ratio is more than double adequately capitalized, and our allowance for loan loss has a large excess. It wasn't going to be a good expenditure of our time." But given the pressure, Jewell personally conducted a basic top-down portfolio stress test as indicated in 2006 interagency guidance. "It yielded nothing meaningful, as we knew would be the case—we are just too well capitalized and reserved for it to matter," he says.

But other bankers see regulatory expectations coming and are trying to get out ahead of them. Gerald Coia, chief credit officer at the \$1.3 billion Savings Institute Bank and Trust in Willimantic, Ct., designed a top-down stress test model for three different dimensions. His model projects the overall

Ready to Test?

- Decide on what type of stress testing is appropriate. (Examples include transactional sensitivity

TRUST INNOVATION COLLABORATION

- 400+ financial institution partners
- 100% U.S.-based customer service
- 20+ years in business
- \$54 BILLION+ annual processing volume

Take a Look at TransFirst® — Visit our Booth at the ABA Annual Convention!

[LEARN MORE](#)

TRANSFIRST®
First In Secure Electronic Payments

NEWSBYTES

ISM: Non-Manufacturing Sector Continues Expansion

January 6, 2016

Manufactured Goods Orders Down 0.2 Percent in November

January 6, 2016

U.S. Foreign Trade Deficit Narrowed in November

January 6, 2016

ADP: 257,000 Jobs Added in December

January 6, 2016

ABA Urges Changes to FDIC DIF Assessment Approach

January 6, 2016



This way to a debit card program made just for you.

[LEARN MORE >](#)

This way to a debit card program made just for you.

[LEARN MORE >](#)

delinquency rate in the portfolio based on historical results, the degree to which loans would migrate in grade (“a leading indicator of a deteriorating portfolio,” he explains), and loan-to-value deterioration in the portfolio. “Each one of those indicated the bank would be fine after extremely stressing the portfolio under these various scenarios.”

While both state and federal supervisors approved of the process and the results, Coia was not principally looking to satisfy the regulators. “Sometime down the road, the regulators are going to ask us to do it, but we should do it for our own management purposes first,” he says. “We did it because it’s the right thing to do from the managerial point of view. We as a bank need to understand what happens if, and if we get that if, how the capital will continue to support the bank’s operations and growth. We should be doing this testing on an ongoing basis just for the success of the bank.”

Nuts and bolts

Once bankers decide to stress test, they have to decide how. Top-down stress testing involves applying historical loss rates to a set of macroeconomic scenarios, whereas bottom-up testing brings borrower-level data into the equation, generating more granular results that better inform how a bank sets its risk appetite. Banks must also choose whether and in what ways to work with vendors.

Regulators do not specify any particular approach; “rather, the extent and depth of an institution’s credit-related stress testing should be commensurate with its unique business activities, portfolio size, and concentrations,” FDIC officials wrote in 2012. “Stress tests can be performed effectively by bank staff or, at the institution’s discretion, a competent third party, using methods ranging from simple spreadsheet computations to more complex software applications. For example, some smaller community banks have successfully implemented relatively simple, yet effective, CRE loan stress-testing processes.”

Triumph Bank decided on a bottom-up, transaction-based approach. Getting ready for stress testing meant a “laborious process of scrubbing more than 1,600 lines in credit files and collateral files and updating that information on the core,” says SVP and loan review officer Rick Smith. It took six to eight months, he says. Triumph selected a stress testing solution that combined financial data with loan characteristics in the core to give you “a really deep look at every loan in the portfolio.”

Choosing to use a vendor, as Triumph did, is another key decision for stress testing banks. Jewell and Coia used Microsoft Excel and found it satisfactory, while Smith says Triumph’s needs were more complex. For most banks, the level of complexity, regulatory recommendations and plans for growth will dictate whether they use a vendor and in what ways.

For example, Capital Bank of New Jersey, a \$361 million bank based in Vineland, currently does stress testing on its own. “Before we get to the point where our CRE exposure exceeds the guidance issued by the regulators, I expect that we will purchase outside software to help us do portfolio level stress testing,” says Joseph Rehm, EVP and chief lending officer. He is already investigating software and expects to reach that point in the next year or two.

Michelle Lucci, a risk management consultant for Bankers’ Toolbox, recommends not using Excel, noting that inaccuracies in one part of a spreadsheet can then be carried forward. Lucci manages Crest, a software solution for CRE stress testing developed in response to the regulators’ 2006 guidance. (Crest is endorsed by ABA for portfolio stress testing.) “If you agree that time is money, the cost to put a stress testing exercise together in Excel would exceed the cost of our solution,” she says.

There are other roles vendors may play. Annette Russell, the president and CEO of Security Federal Bank, a \$215 million mutual thrift in Logansport, Ind., reports that her bank recently outsourced its stress testing and revisited its own risk assumptions. The Office of the Comptroller of the Currency recommended that Security Federal obtain independent validation of the assumptions in its interest rate risk model.

Regardless of the choice to outsource, no stress testing program is fully outsourced, says Carmine Servidio, VP and portfolio manager at Crest client Flagship Community Bank, a \$94 million institution in Oldsmar, Fla. While Crest has “definitely enhanced our credit risk management processes,” he explains, “simply contracting with a service will not satisfy the requirement to comply with the joint guidance.”

Regulators who recommend stress testing will look for a robust overall program to support the stress tests, including internal sponsors who are “adept at managing cultural change,” as well as a process for ensuring the data used in the stress test is in good order, that stress scenarios are appropriate and that the bank’s parameters are properly set.

Making the most of it

Is stress testing a useful tool for management beyond its important role in satisfying examiners’ expectations? Opinions are mixed, but most agree that it has value. “We’re not simply producing reports to mollify the regulator,” says Servidio. “This is part of a broader credit risk management program. Crest is really a tool that has help us change the way we manage our risk.”

analysis, stressed portfolio loss rates, scenario analysis and grade migration analysis, conducted from either a top-down or bottom-up direction.)

- Decide whether to engage vendors and for what functions.
- Determine appropriate adverse economic scenarios in line with your bank’s business model and market area.
- Define risk measures that will be used to assess the health of the portfolio. (Examples include debt service coverage, LTV ratios, variable rates, occupancy status and contractual terms.)
- Scrub loan files before exporting data.
- Run the analysis.
- Review the results with senior management and the board and determine whether changes should be made to risk appetite, capital planning and other policies.

TRUST INNOVATION COLLABORATION



400+
financial
institution
partners



100%
U.S.-based
customer
service



20+
years in
business



\$54
BILLION+
annual
processing
volume

Take a Look at
TransFirst® —
Visit our Booth at
the ABA Annual
Convention!

LEARN MORE

 **TRANSFIRST®**
First In Secure Electronic Payments

TOPICS

- regulatory burden
- cybersecurity
- Agenda for America's Hometown Banks
- data breaches
- risk management
- TILA-RESPA integrated disclosures
- payments system
- credit cards
- GSEs
- ABA news
- anti-money laundering
- regulatory capital
- Ability-to-Repay/Qualified Mortgage
- Weekly Infobyte
- fair lending

For example, Crest works by accessing the bank's regulatory loan file, allowing banks to conduct sophisticated analyses of the entire portfolio that go well beyond the minimum requirements for CRE stress tests. Not only will Crest tell a bank what will happen in a stressed scenario, it can "also tell them whether or not they're making enough money on those loans to compensate for the risk," says Lucci. "The software will tell them what the weighted-average interest rate is for that group of loans. I've had many customers say, 'Gosh, it's only 4 percent. My cost of funds is 2 7/8ths—I'm not making enough of a spread on this.'"

Will Chase agrees. Say you have a commercial property and you want to know how it would be underwritten or priced differently if you have a different vacancy rate. "It could give you a really good indication to say maybe we need to underwrite this a little differently to account for a change in the underlying economics of the collateral," he points out.

Rick Smith underscores the point, noting that Triumph Bank found that stress testing's "real use is as a management tool," helping the bank identify hot spots and formulate policies, set its risk appetite and better plan for capital needs. Servidio adds the staff at Bankers' Toolbox has helped him and his colleagues become "subject-matter experts," which he says has strengthened Flagship's overall risk management process.

Stress testing is expensive, Chase admits, but he sees it as a valuable step in preparing for growth. "If I want to continue to grow and gain market share, I need to manage the company to figure out what a billion-dollar bank going to be doing," he says.

But it may prove just as valuable in protecting the bank, too. "You know, we're supposedly several years out of the recession—but it doesn't really feel that way," Chase reflects. "If something happens, it would be nice to have some knowledge that could direct your actions two years from now. It might be the cheapest money we ever spent, quite frankly."

For more on how mid-sized banks over the \$10 billion asset threshold are handling the Dodd-Frank Act-mandated stress tests, [click here](#).

 Email This Post

 Tweet  Like  34  G+1  0  Share  64

Tagged with: [RISK MANAGEMENT](#) [STRESS TESTS](#) [COMMERCIAL REAL ESTATE](#)

ABOUT EVAN SPARKS



Evan Sparks is editorial director at ABA, where he edits ABA Daily Newsbytes.



RELATED STORIES

Fed Seeks Comment on Countercyclical Capital Buffer Proposal

 December 21, 2015

Fed Issues Guidance on Capital Planning Expectations

 December 21, 2015

Agencies Warn about Rising Risks in CRE Lending

 December 18, 2015