FUNDAMENTALS OF STRESS TESTING FOR BOARD MEMBERS

Why directors and trustees should care, and how they should play their part

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Much is being written these days on ABA Banking Journal’s website and other industry publications about stress testing and the “forward-looking supervision” concept. Examiners and bankers are trying to learn from what went wrong in this banking crisis so that history won’t repeat itself.

The focus seems to always land on concentrations of credit.

Concentrations are inevitable, especially for community banks. When concentrations arise, better risk management practices are looked for by examiners, including comprehensive stress testing.

Lending officers and credit risk professionals understand their loans very well and stress testing the components is comparatively easy for them to learn and comprehend.

But what about the board of directors? Board members may not be as familiar with loans and their intricacies, but oversight of any stress testing effort would seem to be a natural part of their job.

First, boards must accept the need for stress testing. Then they must explore their appropriate role at each stage of the

stress-testing process.

Why Your Bank Should Stress Test

An effective way to learn about a topic is to learn about past mistakes, and there are actually post mortems of bank failures that anybody with access to a computer connected to the internet can find and read.

FDIC’s Office of the Inspector General (OIG) conducts a look-back analysis, called a Material Loss Review, on failures. You can find these reports here.

Reading these documents is a quick and easy way to learn that asset concentrations are dangerous. Many, if not all, of the recent reports point to the results of concentrations in acquisition, development, and construction projects and CRE lending as the cause of the bank’s demise.

Another source of information is the General Accounting Office’s Report to Congress, titled Enhanced Guidance on Commercial Real Estate Risks Needed.

This report is an intensive study on the regulatory treatment of CRE during examinations. The report found that there were inconsistencies in applying the 2006 Guidance, nothing that the guidance lacked clarity on how to comply with it. As a result, federal regulators are expected to enhance or supplement this guidance in the very near future. Stay tuned!

(Regarding material loss reviews: The Dodd-Frank Act increased the threshold loss to the deposit insurance fund that triggers a review. It shifted to $200 million (from $25 million) for losses that occur between Jan. 1, 2010, and Dec. 31, 2011. However, if the OIG determines there were unusual circumstances involved in the bank’s failure, then a report called an In-Depth Review will also be issued.)

Does Your Bank Have a Stress Test Policy?

Once the bank makes a commitment to include stress testing in its risk management process, a policy must be created, approved by the board of directors, and noted in the board minutes. The policy will vary based on the size and complexity of the bank, but key elements to include are:

1. Opening statement
2. General purpose statement and information
3. Responsibility and independency
4. Reporting and frequency
5. Scope
6. Assumptions and scenarios
7. Thresholds and limits
8. Exception reporting
9. Capital levels
10. Contingency planning

Your Role As A Board Member In Stress Testing

Let’s outline the board’s responsibility for overseeing an institution’s portfolio level stress testing program. A good way to review this is through questions and answers.

Q. Exactly what is stress testing?

A. The Comptroller’s Handbook states: “In Stress Testing, a bank alters assumptions about one or more financial, structural, or economic variables to determine the potential effect on the performance of a loan, concentration, or portfolio segment.”

The handbook also states that “All banks will derive benefits, regardless of the sophistication of their methods, from applying this risk management concept to their loans and portfolios.”

Q. What is the bank director’s role?

A. The director’s role does not differ much with respect to stress testing from their overall role in the management of the institution. It can be summarized generally by the phrase: “Ensuring that management is effectively addressing the risk inherent in the bank’s operations.”

Q. What types of risk are we measuring?

A. There are three:

• Credit: The risk that a borrower will fail to repay the loans as originally agreed.

• Market: The risk that a bank’s earnings and capital might be adversely affected by changes in interest rates.

• Regulatory: The risk to earnings, capital, and reputation associated with a failure to comply with an increasing array of regulatory requirements and expectations.

Q. Why are we performing this exercise?

A. Because credit risk management, including managing commercial real estate, is the primary focus of regulatory examinations in today’s environment.

Q. What is the governing regulatory guidance in this area?

A. There are two key documents:

• Joint Press Release: December 12, 2006--Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices

• Financial Institution Letters : FIL-22-2008--Managing Commercial Real Estate Concentrations in a Challenging Environment

Q. What loans are included in the guidance?

A. The guidance focuses on CRE loans for which the cash flow from the real estate is the primary source of repayment, rather than loans to a borrower for which real estate collateral is taken as a secondary source of repayment or through an abundance of caution. More specifically, loans that are for land development and construction (including 1-4 family residential and commercial construction) and other land loans; loans secured by multifamily properties; and nonfarm nonresidential property where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.

Excluded from the guidance are loans that are relying upon the cash flow from the ongoing operations and activities conducted by the party who owns the property.

Q. What is the purpose of the guidance?

A. The 2006 Guidance reminds institutions that the board has ultimate responsibility for the level of risk assumed by the institution. It also reminds institutions that strong risk management practices and appropriate levels of capital are important elements of a sound CRE lending program, particularly when an institution has a concentration in CRE loans.

Q. What are the supervisory criteria?

A. The Agencies use the following criteria as a preliminary step to identify institutions that are potentially exposed to significant CRE concentration risk:

(1) Total reported loans for construction, land development, and other land represent 100% percent or more of total capital.

(2) Total commercial real estate loans represents 300% or more of the institution’s total capital and the outstanding balance increased 50% or more during the prior 36 months.

The supervisory monitoring criteria do not constitute limits on an institution’s lending activity, but serve as a high-level indicator to identify institutions potentially exposed to CRE concentration risk. The criteria also do not constitute a “safe-harbor” for institutions if other risk indicators are present regardless of their measurement under (1) and (2).

Q. What does the guidance require?

A. Institutions involved in CRE lending should perform ongoing risk assessments to identify and monitor CRE concentrations. If the institution has significant CRE concentration risk, its strategic plan should address the rationale for its CRE levels in relation to its overall growth objectives, financial targets, and capital plan.

In addition, the Agencies’ Real Estate Lending regulations (Part 365) require that each institution adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on or interest in real estate, including CRE loans. Therefore, the board of directors should:

• Establish policy guidelines and approve an overall CRE lending strategy regarding the level and nature of CRE exposures acceptable to the institution.

• Ensure that management implements procedures and controls to effectively adhere to and monitor compliance with the institution’s lending policies and strategies.

• Review information that identifies and quantifies the nature and level of risk presented by CRE concentrations, including reports that describe changes in CRE market conditions in which the institution lends.

• Periodically review and approve CRE exposure limits and appropriate sublimits to conform to any changes in the institution’s strategies and to respond to changes in market conditions.

Institutions with CRE concentrations should also develop a contingency plan to reduce or mitigate concentrations in the event of adverse CRE market conditions. This plan can include whole loan sales, participations, and securitizations, in addition to curtailing new originations.

Effectively reporting and stratifying the CRE portfolio requires a strong Management Information System. The sophistication of the system will vary with the size and complexity of the CRE portfolio and level and nature of concentration risk. But it should provide management with sufficient information to identify, measure, monitor, and manage CRE concentration risk.

An institution with CRE concentrations should perform portfolio-level stress tests or sensitivity analysis to quantify the impact of changing economic conditions on asset quality, earnings, and capital. The sophistication of these practices should be consistent with the size, complexity, and risk characteristics of its CRE loan portfolio.

Q. How is this stress testing typically performed?

A. There are several methods currently available to bankers that include:

• An Excel worksheet.

• Automated solutions for community banks using loan file data and modeling assumptions.

• Report writer type solutions that require a one-time loan data extract.

• Outsourced services provided by a vendor or loan review firm.

Whatever method bank management chooses, board members must become familiar with the techniques, requirements, and limitations.

Q. What questions do I, as a board member, ask?

A. When the bank’s Senior Loan or Credit Officer presents findings to the board, there are several pertinent questions that you can ask to become more familiar with this exercise. These include:

• Source data: Where does it come from? How old is it? How often can it be updated?

• How reliable is the data?: If the method chosen by bank management requires the bank to extract every piece of information from the loan files, such as the Debt Service Coverage Ratio and Loan-to-Value ratios, are we comparing ratios that were calculated at loan origination for some loans while using updated ratios for other loans when the bank was able to obtain updated financial information? If this is the case, what steps did management take to address this inconsistency?

• Scope: Was the exercise truly a portfolio level stress test or was the test performed only on a segment?

• What were the stress test factors?: Was the stress test a multi-variable exercise? In this type of exercise loans were adjusted using more than one variable, such as interest rates rising along with a decline in the Net Operating Income of the subject properties. Can the stress test factors be altered when new economic conditions present themselves in the future?

• Were any new concentration segments discovered during this exercise?: The method employed by the bank should help with concentration analysis in addition to stress testing. Often new concentration segments develop in an institution inadvertently and can go undetected for quite some time. This risk can be substantial, especially because

it’s not being monitored and mitigating steps have not yet been put in place.

A key takeaway: Bank directors are not required to replicate the work of management. However, they should question the source, timeliness, and accuracy of the information that management and others provide. By asking these questions and others, bank directors are performing their oversight responsibilities.

Is Stress Testing Going To Help Your Bank?

Q. What are the results of undertaking stress testing?

A. The guidance requires the results of the stress test to quantify the impact of changing economic conditions on the institution’s asset quality, earnings, and capital.

When the institution’s senior loan officer or credit officer presents the findings, these elements should be clearly addressed. As a director, your job is to determine if the risk to the bank under the stressed situations is manageable.

Community banks are supposed to assume a certain level of risk, otherwise they wouldn’t be making money. But the key question is: Will the bank’s capital base still be protected under these scenarios?

• If the answer is yes, then the exercise was a success.

This doesn’t mean that it’s the last time that the exercise should be performed. On the contrary, stress testing should be performed at regular intervals within the institution.

• If the answer to question is no, then there is work to do.

Addressing the findings of the test is paramount. Directors must take quick and decisive action when they are armed with the knowledge that the viability of the bank could be at risk under the stressed scenarios. Immediate actions include acting upon the steps outlined in the bank’s contingency plan, among others.

Once these steps have been taken, directors should revisit the limits put in place on the various segments and the total CRE portfolio along with any other steps deemed necessary.

Ms. Lucci’s firm, Banker’s Toolbox, offers the Crest commercial real estate stress-testing system. It was recently endorsed by ABA’s Corporation for American Banking.