NOT STRESS TESTING PORTFOLIOS? DON'T WORRY, OCC EXAMINERS WILL DO IT FOR YOU!

National bank examiners to have new "bottoms up" stress test tool

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UNconventional Wisdom is a periodic guest blog, where authors hold up the so-called conventional wisdom to a fresh perspective, or apply common principles in new ways. To propose a guest blog, email Steve Cocheo, executive editor & digital content manager.

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Would you bring a knife to a gun fight?

Of course not. So why would you bring an inferior stress test--or no stress at all--to a bank examination?

Stressing over stress tests

Stress testing continues to be a hot--and controversial--topic.

It is mentioned in supervisory speeches and during conferences and webinars. Guidelines for large banks have been issued, but community banks continue to be confused about their requirements, if any.

During on-site examinations, the requirements for stress testing range very broadly. Some community bankers say that there has been no mention nor discussion about stress testing during the onsite portion of their examinations. Yet other bankers say that field examiners gave them a very detailed and lengthy list of variables that have to be stress tested in the CRE portfolio by the next time the institution is examined. Sometimes stress testing the residential mortgage loan portfolio is also mentioned and required.

Such discrepancies during examinations are resulting in continued confusion in the community banking world. But I think this confusion will abate soon.

Why the clouds will clear

I think there are two primary reasons.

First, as institutions become healthier, risk management examiners will have more time on the job to discuss and evaluate an institution's proactive risk management practices, including stress testing.

Second, there is the imminent release of a portfolio stress testing tool by the Comptroller's Office. This tool will be available on their bank.net site for national banks and federally chartered thrifts only. The tool is Excel-based and can be used only for income-producing CRE assets. There are two versions to this tool--one for bankers and the other for field examiners.

While bankers may have already heard this news, I hope that you are fully considering the ramifications.

The Comptroller's Office, or any agency, cannot force bankers to use their tool. However, if your bank is not performing stress testing analysis, be forewarned:

National bank examiners, at least, will now do it for you.

Examiners at your service

Did that surprise you?

The concept of stress testing should not surprise you. It was required for banks with CRE concentrations in the 2006 interagency guidance on CRE. The Comptroller also issued an updated Concentration Handbook in December 2011 which included the requirement for stress testing.

However, the rollout of the examiner stress testing tool may surprise you.

Its impending release means that examiners, while onsite, will be able to enter information on some loans in your portfolio into their tool.

Using a portfolio multiplier, the examiners will be able to roll up the results to calculate the impact of the stress test on your institution's overall capital and earnings. The examiner's tool will also have predictive economic data and access to historical loss information from within the agency's own database. This combination will enable the field staff to make assumptions about the future performance of the bank's entire CRE portfolio and the impact to the entire bank.

Does this frighten you?

It most definitely should!

If your bank is not performing stress testing for credit concentrations you will not have any defense or ammunition whatsoever when the examiners portray what can happen to your portfolio in the future if certain scenarios play out.

Remember that stress testing is an exercise to forecast what a downturn can do to your loan portfolio, the bank's earnings, and capital base. This is the impact it will have whether the bank is forecasting a down economy or a sensitivity analysis which estimates the impact of key variable changes such as net operating income,

In all likelihood this will not be a favorable situation for you.

It is also not a far stretch to assume that if the examiner-defined scenarios do not portray your institution in a favorable light that there may even be recommendations for increased capital requirements and better capital planning.

Why is this happening?

Where does the impetus for this arise? And do the examiners want to do this?

In my opinion, and speaking in part as a former FDIC examiner, no, to the second question.

I think this tool was created because there has been and still is generally a lack of proactive risk management practices in community banks and midsize institutions.

Examiners have a budgeted amount of time to spend in an institution and I'm sure they would rather just review an institution's stress test, rather than spend time creating one.

Does this seem far-fetched to you?

I hope not--because it's already happening.

On my required reading list is a blog for the ABA Banking Journal website by Jeff Gerrish, who is presently a consultant and was formerly FDIC Regional Counsel.

In a post from June 23, 2011, Gerrish discusses a client bank that had all the classic ratios to be considered a Satisfactory Institution (possibly even a 1 Rating). Yet the examiners rated the bank a Composite 3. The reason: The bank was not performing forward-looking supervision.

Approaches to stress testing

Recently a key regulator spoke on an audio conference and mentioned that banks can perform a simple "Top Down" approach to stress testing. This concept is discussed in the most recent FDIC's Supervisory Insights publication.

When performing the exercise using this approach, inflated loss rates are used to calculate what the "haircut" will do to earnings and capital.

It is very easy to do. But while this approach has been mentioned publicly as acceptable, it is a very simplistic approach.

Soon the OCC field examiners will have at their disposal a more accurate and higher-level tool to perform a "bottoms up" approach to stress testing credit concentrations.

A bottoms-up approach requires loan level information and stress tests the key variables of loans while rolling up the results to portfolio level.

So if you are going to present your simple top down analysis to the examiners it will be like bringing a knife to a gun fight!

The time has come to learn about the stress testing process, implement a program, and integrate the results into the bank's risk management.