

First Look: OCC's community bank stress testing guidance

New issuance gives
banks choice of paths to better
risk control

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Recently the Comptroller's Office issued OCC 2012-33, "Community
Bank Stress Testing: Supervisory Guidance," and it's been a long time
coming!

For some time many community bankers did not understand what they were expected to do--if anything--in regard to stress testing. Now the mystery is solved--at least from the Comptroller's perspective.

But before we discuss the details let's take a look at what led up to this development.

Looking back on
stress and concentrations

In 2006, federal regulators jointly issued the CRE Concentration Guidance, which recommended that banks exceeding the 100%/300% thresholds for CRE perform stress testing. The timing of this release couldn't have been worse. It was delayed and revised during the comment process, because banks soon started to feel the effects of the national recession. Examiners were more focused on the immediate health of loan quality and the institution, rather than promoting future improved risk management practices.

In May 2011 the U.S. Government Accountability Office conducted a study of the federal bank regulators' treatment of CRE during the examination cycle and found inconsistencies in application of the guidance. Both examiners and bankers noted that the document lacked clarity on how to comply. As a result there was no common understanding about the dangers of CRE concentration risks or the specifications of increased risk management practices. The report concluded with the recommendation that the agencies:

- Revise the guidance.

Enhance and either re-issue or supplement interagency CRE concentration guidance in order to provide greater clarity and better examples, to help banks comply. This would also help examiners ensure consistency in their application

of the 2006 Guidance.

- Build it into processes. After issuing revised or supplemental CRE concentration guidance, incorporate steps in existing review and quality assurance processes to better ensure, 1. that the revised guidance is implemented consistently, and 2. that examiners clearly indicate within bank examination reports the basis for requiring a bank to reduce CRE loan concentrations.

In the next evolution, in December 2011 the Comptroller's Office issued a new version of its Concentration of Credit booklet. This booklet is very well written. It includes examination procedures in the appendix, and expands the scope to include any credit concentration on the bank's books, including residential mortgage loans.

The booklet makes it clear that "credit risk management does not conclude with the supervision of individual transactions. It also encompasses the management of concentrations, or pools of exposures, whose collective performance has the potential to affect a bank negatively even if individual transactions within a pool are soundly underwritten".

The booklet goes on to say that:

"Stress testing is an effective tool for identifying correlated pools of loans and can be used to quantify the potential impact from different scenarios on those pools of credit. It is critical to ask the ‘what

if' questions and incorporate the answers into the risk management process. As the bank's knowledge of stress testing grows, it should strive to make the analysis more robust by simultaneously stressing a number of related variables. The overall goal is to quantify loss potential and the impact on earnings and capital adequacy." [Emphasis added.]

OCC's latest iteration on stress testing

The commitment of the Comptroller's Office to better, forward-looking risk management practices is again reiterated in the newest guidance, dated Oct. 28, 2012, which states "community banks, regardless of size, should have the capacity to analyze the potential impact of adverse outcomes on their financial conditions" and that "some form of stress testing or sensitivity analysis of loan portfolio on at least an annual basis to be a key part of sound risk management for community banks."

According to the new guidance the agency does not endorse a particular stress testing method. Instead, it suggests that effective methods can range from a single spreadsheet analysis to a more sophisticated model, depending on portfolio risk and the complexity of the bank.

Scenario analysis discussion

Appendix A of the document discusses, in general, "scenario analysis," where a bank applies historical or hypothetical scenarios to assess the impact of various events and circumstances including extreme ones such as a severe recession, loss of a major client, or a localized economic downturn.

Scenario analysis can be applied at various levels of a bank such as:

- Transaction testing--On an individual loan level, which assesses the impact of changing economic conditions on a borrower's ability to service debt.

- Portfolio stress testing--Helps to identify current and emerging risks and vulnerabilities affecting the entire loan portfolio by assessing the impact of changing economic conditions on borrower performance while identifying credit concentrations and ultimately measuring the resulting change in overall portfolio credit quality and potential impact to earnings and capital. Within this category there are also two different approaches:
 - Bottoms-up--Stress tests at the individual transaction level are conducted by altering the key variable(s) and the results of the test are aggregated.

 - Top-Down--This is a simple method of applying estimated stress loss rates under one or more scenarios to pools of loans with common risk characteristics.

- Enterprise-level stress testing--a method that considers multiple types of risk and their interrelated effects on the overall financial impact under a given economic scenario. The risks include, but are not limited to, credit risk within loan and securities portfolios; counter-party credit risk; interest rate risk; and changes in the bank's

liquidity position.

- Reverse stress

testing--An exercise that assumes a specific adverse outcome, such as suffering credit losses sufficient to cause a breach in regulatory capital ratios and then deduces the types of events that can create such an outcome.

A closer look at
top-down testing

The next part of the new guidance is Appendix B. This section gives readers a very simplistic example of a top-down approach to stress testing.

In the template, a sample bank's loan portfolio from Schedule RC-C of the Call Report is listed in Section 1. The sample bank has a total loan portfolio of \$600 million, primarily invested in construction and land development, 1-4 family residential housing, and nonfarm nonresidential property loans each totaling \$100 million. There are also smaller investments in other types of loans.

The exercise assumes a two-year loss rate from a "stress period" in time and applies the rate to the quarter-end loan balances to derive an estimated loss over a two-year period.

In Section 2 the impact of the stress period dollar loss is used to assess the impact on the sample bank's earnings stream.

The template details the actual net income in the first column and the second column subtracts the estimated loss amount of \$61.8 million (derived from Section 1) from a reduced pre-provision net income. Then it deducts another \$10 million to maintain an adequate loan loss reserve, and adds an income tax benefit of \$14.6 million. These steps lead to a two-year net loss of \$27.2 million.

Section 3 gives the sample bank's Tier 1 capital, quarterly average asset dollar amount, and the Tier 1 leverage ratio of 11.0%. The second column adjusts these figures for the \$27.2 million loss calculated in Section 2 to arrive at an adjusted Tier 1 leverage ratio of 8.2%.

From the simple to
the complex

The template is very simple and easy for any banker to understand. However, it should only be seen as a first "go-around" of this exercise because Appendix C is a detailed table of stress factors, such as interest, capitalization, and vacancy rates that are common to the various property types. (They include land acquisition and development; residential construction; commercial construction; multi-family; residential and commercial condominium construction; leased commercial office space; leased industrial and warehouse distribution; and retail boxes and strip malls.)

If a bank has these types of commercial real estate and residential housing loans on their books then their stress testing exercise should ultimately account for these common factors. That would necessitate a more-detailed analysis that is the basis for the bottoms-up approach previously mentioned. In fact the new guidance refers to the 2006 Interagency CRE Guidance and states that banks that exceed certain CRE concentration thresholds are expected to use more robust stress testing practices to effectively manage the concentrations and maintain adequate capital.

An aside: OCC is providing a new Excel-based portfolio-level stress test tool for income producing commercial real estate loans through its BankNet, available only to national banks and federal savings associations. I have not personally seen it. However, because it is Excel based it will most likely require a significant amount of loan data for each loan to be stress tested.

That brings up a common issue affecting stress testing. Because of all the potential data entry, bankers naturally gravitate towards stress testing loans that are problems or that they know very well and for which they have all the required and most importantly current information.

Bankers should be wary of this practice. The guidance specifically states that "while problem credits are routinely the focus of risk management, the potential effects on credit concentrations or other portfolio segments are the focus of portfolio stress testing".

Pulling it all
together--and acting

- Appropriately plan for and maintain adequate capital levels.

Hopefully this guidance will lead banks that use it to better and more predictive type of information which it can use to guide their bank through future economic storms. It is unfortunate that this guidance does not include FDIC and Fed member institutions, although the FDIC earlier this year released a short article on community bank stress testing in its summer issue of Supervisory Insights.

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