Stress Testing and Defining Risk Triggers and Limits

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During this current regulatory exam cycle, "stress testing" and the sufficiency of risk triggers and limits have come up in many examination discussions and for those organizations that have been ill-prepared, their Asset/Liability Committees (ALCOs) and directors have succumbed to regulatory pressures and implemented a broad array of stress-tests. This has resulted in expanding their risk monitoring process with a litany of additional measures, and assigning board limits for virtually every number in the board package. Consequently, we are seeing a growing number of organizations with overwhelmed directors spending an inordinate amount of time and energy trudging through detailed reports, having to ask an abundance of questions at each meeting, and bank executives expending an undue amount of resources addressing questions and responding to trigger / policy limit exceptions. In some instances, the forward-looking, decision making process examiners have attempted to foster has been overshadowed by management teams and directors spending all of their time looking over their shoulder.

Stress-testing is an important and critical element to successful risk management and prior to regulatory directives to expand stress-testing efforts, most organizations did not do an effective job understanding the risk reward tradeoffs of their business decisions nor the assumptions that went into their risk measurement models. However, examiners have been somewhat overzealous in their attempts to compel banks to introduce or expand their stress-testing activities and a byproduct of this crusade has been a focus on the establishment of risk limits and tolerances.

In January, regulators provided supervisory guidance (Interest Rate Risk Management: Frequently Asked Questions) to address some of the ambiguity and misinterpretation that has arisen from the original 2010 guidance. Key topics the FAQ covered were:

- risk management and oversight,
- measuring and monitoring of IRR,
- stress testing,
- internal controls and validation, and
- assumptions

With regard to defining board-approved thresholds for monitoring stress scenarios, examiners made it clear that management should establish limits, triggers, or thresholds for stress scenarios in order to compare risk measurement results with the institution's risk tolerance. Moreover, nonstandard or less-frequently run stress tests should also be evaluated against established risk tolerances or appropriate trend analyses and reported to the proper management committee. Assuming these stress scenarios are indeed "stressful", it is likely that policy violations will occur with some regularity and, therefore, force management and directors to spend an undue amount of time discussing policy exceptions for scenarios that are intended to inform and educate rather than illustrate core risk.

For interest rate risk measurement purposes, it is not uncommon these days for organizations to run a combination of 20+ different scenarios each period for Net Interest Income (NII) and Economic Value of Equity (EVE) purposes. When added to the numerous measures, scenarios, and stress tests performed on liquidity, capital, and credit risk management, it is easy to see how a board could easily become overwhelmed with too many details and too many items to evaluate – "analysis paralysis." The ultimate unintended consequence of it all is an ineffective backward-looking management team and board who spend all of their time looking at where they have been rather than where they are going.

Establishing the appropriate level of risk triggers and limits is not a simple task – careful thought needs to be applied along with some due diligence. Some practical advice to consider:

1) do not over engineer the risk limits – keep it simple.
2) when possible, compare stress scenarios to already established risk tolerances rather than developing additional ones.
3) analyze historical trends of each measure before assigning triggers or limits.
4) consider the use of a drill-down style of graphical reporting where high level summary reports are supported by more detailed breakdowns.
5) utilize your policy statements to fully describe the purpose and intent of your stress testing scenarios, your rationale for the risk limits defined and how policy exceptions for these types of scenarios will be uniquely managed.

It is critically important for the board to have the proper oversight of the asset liability management process and to make sure that the controls are in place to measure and manage risk. However, there needs to be a balance between managing to the institution's policy framework and risk tolerance and reviewing all of the data available. Stress testing is intended to provide useful information and help in setting boundaries and boards need to be cognizant of the difference between what "is" and what "could be." Additionally, those boards that have been effective in communicating these differences to the examiners have fared best in recent exams. It is something we are conscientious about when working with our clients and it has made a huge impact during recent regulatory visits.

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