Capital Planning and Stress Testing in an Era of Holistic Enterprise Risk Management

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Capital is king these days and regulators are clearly on a mission to ensure that banking organizations have this notion on the forefront of their minds. Regulators have also become insistent that bank management maintain a capital cushion that sufficiently covers their organization's potential risks.

With the onslaught of regulatory pronouncements and guidance, financial institutions of all sizes and structures are actively developing more substantive capital planning and stress testing processes that extend beyond what has traditionally been undertaken. Accordingly, proactive capital planning that incorporates more robust financial and operational risk assessments is rapidly becoming the new norm.

The Need for Dynamic Capital Planning. The capital planning exercise for most financial institutions has traditionally been an extension of the budgeting process with a longer two to three year time horizon. More recently, banks and thrift organizations that have experienced operational challenges as a result of the 2008 financial crisis or institutions that have exhibited concentration risks have been required by Federal and State regulators to assess the potential risks and the related impact that those risks may have on their organization's capital.

More than ever financial institutions need to develop a more dynamic capital planning and assessment process that is forward looking and inclusive of changes in a bank's strategic focus. What's more, such dynamic processes should assess risk tolerance levels, business plans, and the bank's operating environment. In addition, bank management must incorporate and evaluate other factors or events that may materially affect capital adequacy all while developing a *recovery playbook* that specifies how management can successfully prevent or overcome a potential crisis.

As bank asset/liability managers evolve their risk management practices and develop more enterprise-wide risk assessments, the capital planning process should become an integral part of their efforts whereby potential risks are quantified in terms of capital impact. Moreover, potential vulnerabilities such as concentration risks, rapid adverse changes in economic and financial conditions, and adverse physical events, such as natural disasters, that could occur outside the normal planning cycle need to be part of this evaluation process. Ultimately, the capital planning process should become the centralized platform for holistic financial and operational risk assessment and stress testing.

Regulators Weigh ln. Regulators are weighing in on both capital planning and stress testing. For example, recent regulatory pronouncements include the following, a) guidance for evaluating capital planning and adequacy - OCC Bulletin 2012-16, b) the interagency guidance on stress testing for banks $1 OB-$50B - OCC Bulletin 2012-14, and c) community banks - OCC Bulletin 2012-33. These regulatory guidelines collectively provide a clear directive: examiners are expecting a very different capital planning process that includes a stress testing component that resembles a *war gaming* exercise.

While scrapping your bank's current capital planning and stress testing process may not be necessary, those financial institutions that believe that their continued reliance on traditional planning methods will suffice in the eyes of the regulators are most likely going to put their organizations at risk of criticism or possibly even regulatory action. More importantly, if little is done to improve upon the current process and more substantive stress resting is not undertaken, your institution may ultimately be constrained by regulatory prescribed BASEL capital buffers. What's more, these BASEL capital buffers could eventually impede future asset growth, earnings, dividend payments, and executive compensation, particularly as these buffers are increased.

Many financial institutions are taking the time now to preemptively reassess and enhance their current capital planning process. Additionally, most high-performance banks are incorporating some form of stress testing into their planning process. Larger banks and thrifts are already well into this journey as they have been actively deploying CCAR and DFAST models. For the $10b-$50B organizations, much will be learned from these efforts as prescriptive guidance that stipulates specific methods expected is notably absent from the regulations. Moreover, we have recently learned that more expansive modeling that includes quantifiable stress assumptions is expected from the regulators in the near future. Historically, the methods by which these assumptions are derived have varied from simple top-down historical look-back exercises to sophisticated statistical and stochastic simulations that require noteworthy expertise in statistical modeling.

Expanding Your Modeling Process. It is important to recognize that it does not require a rocket scientist to initiate an expanded stress testing process. The first step can be to qualitatively identify and inventory your organization's key vulnerabilities. This process should identify and explore what circumstances or events could lead to a financial crisis and an ultimate loss of capital.

While the obvious capital killer is credit risk, taking the extra step of evaluating what could lead to the credit event can be very insightful. In addition, this information can lead to the development of substantive and informative *Key Risk Indicators* (KRIs) which can serve as an early warning system effectively alerting bank asset/liability and risk managers of a potential threat.

Many high-performance financial institutions are also taking the time to look deeper into their data and, in doing so, are targeting the information that could be used to trigger their early warning systems. Additionally, a deeper data scrutiny can often lead to the identification of stress test parameters that are not being adequately maintained or may not be easily accessible.

Assessing Your Bank's Risks. Now is the time to assess your bank's ability to evaluate your underlying risks such as credit concentrations, i.e., single borrower, industry, credit ratings, LTVs, geography, etc., and finding concentrations, i.e., retail, commercial, and wholesale risks as well as economic or financial market risks. In addition, delving deeper into your bank's various operational risks and their potential impact on the institution's capital base are key elements in most Enterprise Risk Management (ERM) initiatives. Over time, this more qualitative look-back exercise will most likely evolve into a more forward-looking approach with quantifiable assumptions.

In the absence of quantified assumptions, bank management can apply some level of qualitative assumptions supplemented by reverse stress testing. Reverse stress testing is a mathematical exercise that simply measures the maximum allowable loss before breaking a guideline or an established hard limit. This combination should allow bank asset/liability managers to understand the potential impacts relative to a maximum capital buffer. At a minimum, this exercise should allow A/L management and the bank's board of directors to assess the potential impacts of various risks while ranking each risk by likelihood and impact severity. This exercise will help A/L management prioritize the efforts and investment needed to further support and understand their bank's key identified risks.

This critically important process should not end with your bank's risk assessment. When risks are identified and the capital impact is quantified, your institution should develop recovery scenarios that illustrate your bank's ability to withstand the stress of negative economic, financial and market events in an effort to overcome their impact within a reasonable timeframe.

Along with these simulations, well documented contingency plans need to be developed. These contingency plans should include key roles and responsibilities, potential remedial actions to be taken, and a description of any of the additional reporting and communication protocols that may be triggered.

Final Thoughts. Financial institutions that invest the time to develop this *war gaming* mentality are going to be well served when it comes to strategic risk management. Finally, as the processes, data, and technology improve, your enterprise risk management initiative will evolve into a true forward-looking risk evaluation and tactical resolution process.

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