Community Bank Credit Stress-Testing Solution: The New Frontier

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Since the introduction of mandated credit stress testing at the largest banks ($10 Billion and above), there has been a progressive migration toward mid-tier banks (similar to what occurred after the inter-agency guidance on interest rate risk and liquidity stress testing) that is continuing to make its way into the community banking space at an accelerating rate. As a result, a more formalized approach to credit stress testing for community banks is quickly becoming an industry norm.

In a recent DCG poll of community banks, 60% stated that examiners mentioned credit stress testing in their most recent exam. Nearly everyone else stated they expected it in their next one.

What are community banks doing to stay ahead of the curve?

There are several ways community banks are trying to address loan credit stress testing. These approaches often involve bank-specific historical loan or portfolio-level loss analyses, migration analyses or sensitivity analyses whereby key factors (e.g. historical losses, LTVs, debt coverage ratios, etc.) are simply “dialed” up or down by a factor to simulate stress. Organizations that have adopted one or more of these “bottom-up” sensitivity approaches have most often come up short of their desired goal when they come to the realization that:

1) the internal data necessary to drive statistically valid bottom-up stress-test results simply doesn’t exist and
2) the substantial undertaking (time and money) provided little in the way of tangible value that could affect strategic decision making.

Moreover, for those institutions that did not experience any notable losses over the past financial crisis, the mathematics, however sophisticated, will often predict low or no losses – a result that often has been met with the examiner response: “not stressful enough.”

Want to learn more about credit stress testing? Mike Guglielmo and DCG President Matt Pieniazek will share their insights on credit stress testing, its evolution and contribution to holistic (enterprise) risk management and the key features of DCG’s credit stress service during an informative webinar on August 12th. See how you and your institution can benefit – even if you are already doing credit stress testing. Click here to register.
What is needed if credit stress testing performed in the past is not enough?

Community banks are now finding examiners require credit stress tests that also account for “changing economic conditions” – language which clearly invites a statistical approach that relates economic factors to losses (an exercise large DFAST/CCAR banks are now performing annually).

Assessing the potential impact that changing economic conditions (above and beyond internal “gut feel”) can have on loan losses and capital is a growing “hot button” that community banks cannot ignore. Below is an example of a regulatory comment a community bank client ($500mm in assets) received during its most recent exam:

“Management must perform portfolio-level stress tests to quantify the impact of changing economic conditions on asset quality, earnings, and capital. The Board and management must consider setting guidelines to include an updated stress test as part of the annual review process…”

In another instance, a community bank client ($600mm in assets) received the following pre-exam request:

Provide “the most recent portfolio-level or portfolio segment stress tests or sensitivity analysis to quantify the impact of changing economic conditions.”

Clearly examiner expectations are changing, and changing rapidly, and community banks need to prepare themselves for this increased expectation.

What are the key elements your management team and Board need to know?

**Capital Impact:** Knowing how your leverage and risk-based capital ratios are affected by the stress scenarios provides your management team and Board with a clear depiction of post-stress capital levels and the implied capital buffer (or deficiency). For institutions that breach internal or regulatory policy limits, this exercise provides advanced warning and affords the opportunity to preemptively address the potential issues.

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**Upcoming Events**

- **FHLB Cincinnati**
  - Financial Management Conference 2014
  - August 6, 2014
  - Cincinnati, OH

- **FMS**
  - Controllers Clinic
  - August 19-20, 2014
  - New Orleans, LA

- **Graduate School of Banking at CO**
  - Annual Workshop on Community Bank Investments & Asset Liability Management
  - September 4, 2014
  - Las Vegas, NV

- **AICPA**
  - Banking Conference
  - September 10, 2014
  - Washington, DC

- **Pennsylvania Bankers Association**
  - Executive Leadership Program
  - September 12, 2014
  - Harrisburg, PA

- **ICBA**
  - Bank Directors Conference
  - October 17, 2014
  - Scottsdale, AZ

- **New York Bankers Association**
  - Directors & Trustees Workshop
  - October 28, 2014
  - New York, NY

DCG’s consultants are frequent speakers for programs around the U.S. To arrange a speaking engagement or educational program with DCG, please contact Kelly Coletti, Marketing Manager, at 978.463.0400 ext. 173 or kcoletti@darling-consulting.com for more information.
**Economic Factor Attribution:** Having a means to identify the key economic factors that drive expected loss projections for each portfolio can provide tremendous executive insight and inform your management’s Key Risk Indicators (KRIs) and the strategic planning process.

**Forecasted Loss Curves and Rates:** Forward looking bank-specific and broader asset class loss curves provide a valuable perspective and provides institutions that experienced low losses during the last economic crisis with a credible means to apply appropriately conservative assumptions to their capital risk assessment process.

What is DCG doing to help?

DCG has developed a best-in-class community bank credit solution. We have confirmed the soundness of our approach during in-depth work helping larger banks, and effectively brought big-bank analytics to the community banking arena in a very pragmatic and cost-effective manner.

DCG’s credit stress test solution utilizes robust statistical modeling incorporating data from all community banks along with adverse and severely adverse hypothetical economic scenarios the Federal Reserve prepares for the larger bank space. With this *forward-looking exercise*, community banks can now broaden their existing stress-testing efforts to gain insight into the key economic drivers of loan loss and obtain the means to develop more substantive assumptions for capital and strategic plans, to ensure they are being proactive versus reactive by:

- Establishing appropriate capital ratio limits/targets
- Supporting potential growth strategies
Maintaining dividend policies
- Planning for capital needs (operating and contingency)
- Evaluating concentration thresholds

While one could look at this as one of those "regulatory appeasement" drills, having a forward-looking assessment of credit risk that can identify vulnerabilities to changing economic conditions is quickly proving to be a worthwhile exercise. In addition to more substantively informing the capital planning process, institutions looking to advance their enterprise risk management (ERM) framework are finding this analysis beneficial as it fills a void and completes the holistic financial risk assessment.

Institutions are also leveraging this insight strategically at ALCO and now have a more complete picture of potential risks (and opportunities) related to loan strategy. The ALCO process is evolving and greater awareness of credit risk and its impact on business strategy and capital preservation is going to be an integral part of this evolution.