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# Stress Testing

*The benefits for community institutions*

Community institutions may envy their big-asset brethren for any number of reasons – their impressive reach, their seemingly limitless resources, their cutting-edge technology – but there's one area of the large banks' business that they're probably happy to avoid.

Stress testing.

For the big institutions, stress testing is a regulatory and operational way of life, and while vital to the capital planning and risk management processes, not always a particularly pleasant one. Due to the complexity, tax considerations and many moving parts of their large-scale operations, stress testing can indeed be something of a nightmare – a nightmare that many community banks observe from further down the asset scale, comfortable with the sense of gratitude that comes from knowing it's something they themselves don't have to endure.

Yet despite some reservations about the potential hassles, there's a growing school of thought among many community institutions that even if stress testing isn't something they *have* to do, it is perhaps something they should be considering. It might not even be as hard as they think it is.

## Profitable Practice

More and more community institutions are beginning to understand that there are benefits to stress testing that go beyond simply satisfying a regulatory imperative.

"There are benefits well beyond regulatory appeasement," says Michael Guglielmo, Managing Director at Darling Consulting Group in Newburyport, Mass. "When done correctly, stress testing can either provide comfort or confidence that the institution can weather another stressful event, or it can highlight a particular vulnerability that management and the board can proactively address well before examiners identify the potential issue. Through this exercise, response or preemptive strategies can be developed which, in turn, can materially impact the capital and strategic planning processes, contingency planning, business continuity planning, dividend policy, executive compensation, incentive programs and concentration limits."

The notion of stress testing as merely a way to please regulators is something with which Kamal Mustafa also strongly disagrees. The chairman of New York-based Invictus Consulting Group believes there's much more at stake for community institutions with regard to stress testing than just securing a passing grade at inspection time.

"If a bank is doing stress testing as a checkbox exercise to get a pat on the back from the regulators, it's a waste of time and money, because stress testing is a concept that is fundamental to any bank's strategic planning," Mustafa explains. "For all practical purposes the stress test is what is used to determine capital adequacy, which translates to a leverage ratio. So a stress test, in many ways, customizes a bank's regulatory capital needs."

This, Mustafa believes, is where the discussion of stress testing pivots from one of costs and headaches to one of bolstering the bottom line and creating new opportunities. Whereas compliance-weary community institutions may view voluntary stress testing as just one more hurdle that they would rather do without, Mustafa says they should be looking at it as something of an untapped profit center if done properly.

In working with a variety of regulators over the years, Mustafa says Invictus has learned that they generally steer toward the more conservative end of the spectrum when assigning capital leverage ratios for community institutions simply because they lack the resources to do proper stress testing across the board (in contrast, regulators often customize the ratios for larger institutions based on their stress tests). But when presented with evidence that a community institution has done its own stress testing and done it well, regulators have generally been open to

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discussions about reduced ratios – and this is where the practice can easily pay for itself.

"The moment a regulator reduces your leverage ratio from, say, 8% to 7%, you now have 1% of your assets that you can re-leverage and use for other purposes, which can have a major impact on your capital usage and profitability," Mustafa explains. "So the first reason that a community bank should do a stress test is that it's surprisingly easy, and the second is that it creates capital – real capital they can use. It completely changes the competitive profile and the return on capital. Otherwise, they're sitting there complaining about high leverage ratios, but at the same time not taking an action they can and should be taking to reduce the ratio."

### Strategic Planning

Particularly in light of the upheaval of 2008, stress testing also can play a significant role in effective strategic planning for community institutions. While the goal here may not be to protect the economy from the catastrophic effects of one of the very largest institutions going under, the importance to a community institution in terms of what's happening on its own balance sheet can be every bit as critical.

In short, the post-2008 world is one in which historical performance alone is no longer a viable indicator of the health or continued viability of a particular loan category. By incorporating stress testing into a strategic planning system, institutions are able to look at the susceptibility of their different loan categories to different external factors and different combinations of those factors.

**If you don't follow the principles of stress testing as part of your strategic planning process, you're walking blind into the marketplace in terms of potential interest rate risk and liquidity risk.**

*Kamal Mustafa*
*Chairman, Invictus Consulting Group*
*New York, NY*

"Our message to community banks is that stress testing is a byproduct," Mustafa says. "It has tremendous capital value potential because it's the only method by which you can actually get the regulators to reduce your leverage requirements, and that reduction is gold because it frees up capital for growth. More importantly, though, is that that same mechanism and that process is the only way you can do an effective strategic plan. If you don't follow the principles of stress testing as part of your strategic planning process, you're walking blind into the marketplace in terms of potential interest rate risk and liquidity risk."

### Getting It Right

One common misstep that Mustafa sees in terms of stress testing at the community institution level is the habit of mistaking loan review for stress testing. While both are important, they are not interchangeable, as a typical loan review generally does not figure in one of the critical components of a proper stress test – that is, a snapshot of the prevailing economic conditions under which a particular loan was made.

"A lot of banks are doing a loan review extension and calling it a stress test to get good marks from a regulator, but they're not looking at the right things," Mustafa says. "Without vintage – that is, when was this loan made and what was going on then – the methodology is wrong. What causes stress are the conditions under which you made the loan, and the conditions that you're stressing them under today and how they changed."

In fact, Mustafa believes community institutions are uniquely positioned when it comes to the crucial concept of vintage and how the economic conditions at the time a loan was made affect its status today.

"Every community bank is a creature of its footprint or its particular region, which is a great advantage," he says. "Knowing your community so well and knowing how economic developments will specifically impact your community allows you to evaluate things better. It's a more micro view – this is how the economy affected this area."

Despite that perspective, Guglielmo says that community institutions are often still at something of a disadvantage in trying to conduct a proper stress test due to the limited resources available for confronting what can be a complicated process.

"For community institutions, the lack of sufficient data can be a major

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## Stressing the Positive

While the OCC's stress testing requirements apply only to institutions over the $10B threshold, the agency believes that community institutions too can reap significant benefits and gain a competitive advantage by engaging in regular stress testing, pointing out that stress testing can:

- Identify key vulnerabilities and risk exposures
- Pinpoint and quantify risks to earnings and capital
- Help establish and monitor strategic plans and risk tolerances
- Become part of a sound capital planning program

For more details on the OCC's stress testing guidance for community institutions, visit http://www.occ.gov/news-issuances/bulletins/2012/bulletin-2012-33.html. FMU

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impediment to performing credible stress tests," he says. "The absence of quantitative or statistical resources is another challenge. Larger institutions have the ability to absorb the high cost of acquiring and retaining the requisite skills needed to credibly perform stress tests."

The biggest step for most community institutions when it comes to stress testing is just making the initial decision to get started – convincing staff that the effort will be worthwhile and convincing the board that the cost will pay for itself. But both Mustafa and Guglielmo believe that waiting to get started, or worse, deciding not to do it at all, will cost an institution far more in the long run.

"Many institutions are slow to change, so they're missing out on a chance to identify risks before they cause them trouble, not to mention leaving potential profits on the table because without stress testing they can't bring down their capital leverage ratios," Mustafa says. "But it's a mistake for community banks to think that stress testing is such a nightmare and they're happy they don't have to do it. It's surprisingly easy, and the benefits are just so great."

"Do something," Guglielmo concurs. "Many organizations are still waiting until their examiner forces them to act, but regulatory orders requiring stress tests that consider 'changing economic conditions' are showing up in community institutions – those below $1 billion – with greater frequency. So if you're not already doing something, you are behind. More importantly, however, organizations should set the bar high and aim to develop strategic value from the process from the get-go versus simply seeking regulatory appeasement. Those community institutions that have sought the higher purpose are finding themselves actively establishing a competitive advantage." FMU