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Pressure Points

Stress testing continues to gain steam among smaller institutions

Regimented stress testing may have become de rigueur among the country's largest institutions in the wake of the financial crisis, but it wasn't necessarily because they thought it was a good idea. Rather, it was (and still is) a regulatory imperative – a requirement among the biggest of the big to ensure that their massive and massively influential portfolios can withstand the rigors imposed by a variety of extreme financial disruptions. Community institutions and others down the asset chain, meanwhile, have largely managed to avoid such official scrutiny.

However, while there still exists no formal requirement for stress testing below that top tier (and no real rumblings to suggest one is coming), some community institutions are starting to hear from examiners that they may want to consider it, and many others are simply deciding on their own that it might be a good thing to try. Two industry consultants say it's a trend that is likely to pick up steam over the coming quarters and years, especially as a long-anticipated rate increase moves closer to reality.

"Stress testing has definitely become more of a focus within the past few years," says Mark Haberland, a managing director at Darling Consulting Group in Newburyport, Mass. "The bigger banks – the DFAST banks – are required to do it by the regulators, but as with everything it starts with the bigger institutions and trickles down to the community space. The biggest thing for community institutions to take away from it is that the results of ALM models are not absolute, so this additional analysis runs potential stresses to key assumptions to see what the other potential outcomes could be."

Gerry Smith agrees that stress testing is something that community institutions should think about doing, whether regulators are demanding it or not. The managing director at Austin Associates, LLC in Phoenix, Ariz. says that institutions are always better served by having more information upon which to base important decisions, and stress testing is one of those practices that can help round out the array of available data.

"I think (stress testing) is definitely a 'best practice' for management teams and boards of directors in order to have as much information as possible in order to make informed decisions," he explains. "Understanding in advance what might occur in unanticipated and/or extreme economic circumstances allows for effective ongoing execution of strategic decisions. It is always good to be proactive and implement these types of actions before being requested – or ordered – by the regulators."

Challenging Assumptions

Haberland says that determining the viability of its models is the greatest benefit of stress testing for a community institution. Models, after all, are built on assumptions, and no matter how much effort and care goes into crafting those assumptions, under certain conditions they are going to turn out to be wrong. Stress testing allows an institution to figure out what those conditions are, and to decide whether the stressors present enough of a risk to warrant a change in the model.

"Assumptions have the biggest impact on model results because everything that goes in for loan information and deposit information is all contractual, so we have specific information as to how particular loans and instruments will behave," Haberland explains. "What we don't have is the customer behavior, which is where we have to start putting in assumptions for things like prepayments and deposit activity. We can go back and do historical analysis and put in our best estimates for when we expect things to happen, but as with all assumptions, some are going to be wrong."

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Running a stress test allows the institution to understand what might happen if its model assumptions don't play out as expected. The idea is to skew conditions dramatically enough (the difference between stress testing and scenario testing) to get a range of possible outcomes, and then to decide whether management would be comfortable if the results were to fall into that range. If the answer is no, it may be time to start discussing changes to the assumptions in the model.

One of the other major benefits of stress testing in terms of model assumptions is its ability to crystallize those assumptions – whether deposits or prepayments or credit spreads – that stand to have the biggest impact on the institution's results.

"Over the course of two or three or four quarters, stress testing really allows you to say that these are the assumptions that have the most impact on our results, these are the ones we really need to focus on getting as accurate as possible," Haberland says.

Both Smith and Haberland agree that while stress testing these types of assumptions is always useful, it stands to become increasingly more important as we head toward an interest rate increase.

It's not just about regulatory compliance; it's about getting a clearer picture of where the institution stands.

Mark Haberland
Managing Director,
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"I believe interest rate risk has been and will continue to be an important component in the overall management of community institutions, especially as we approach a period when interest rates are poised to increase, perhaps in a substantial way," Smith says.

Getting Started

Of course, there are a lot of great things that community institutions *could* be doing – stress testing among them – but finding the time and resources to actually do them is another story entirely. For those having enough trouble meeting all of their legitimate regulatory requirements, the idea of adding another helpful but optional practice to an already full schedule may seem overly ambitious, if not altogether impractical.

But Haberland says that there are manageable ways for even smaller institutions to undertake some form of stress testing without stressing out the staff. The best approach, he believes, is to keep the focus on those areas that are of the most particular value to the institution (see sidebar), rather than running a full gamut of tests that aren't as applicable.

"A lack of resources and/or expertise is probably the biggest challenge facing community institutions when it comes to stress testing," he notes. "But it becomes even more important as we move into the next rising rate environment. If you're in a position to be able to do it, the key is to be able to come up with stresses that make sense, which is sometimes as easy as taking the current assumption and doubling it or cutting it in half, and that can act as a pretty good starting point for a

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Focus: Stressing Deposits

With neither the time nor the resources to employ a full barrage of stress tests, many community institutions looking to focus on just the most impactful portions of their business should almost always target one specific area, according to Mark Haberland.

"If you look across the community institution spectrum, particularly in light of the economic environment over the last six or seven years and the influx of deposits that has come into the banking system, the biggest, most impactful assumption that is in the vast majority of models is deposits," he explains. "How are we going to price them in the next rising rate cycle? What is the average life that goes into the EVE calculation? What decay assumptions are we putting into the model?

Running stresses on deposit assumptions is absolutely critical, and the most important for any institution. Everyone from $100 million institutions up to $10 billion institutions would get tremendous value out of running deposit stress tests on a very regular basis. What if we double the betas? What if we run off 20% of the balances when rates start to move up? What if we cut the average life in our EVE in half? Those are significant stresses that can have a profound impact on the results. So if an institution is going to look at it in terms of having limited resources and try to decide which type of stress testing to focus on, I would say without question that it should be deposits." FMU

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stressor. But you have to either have control over your model, or an understanding with your model provider to be able to tell them which stresses you want to see applied to the assumptions. You don't manage to the stresses, but you need to be aware of them when you're talking about the risks on the balance sheet."

Smith agrees that focusing on those specific aspects of the institution's business that will yield the most insightful results can help keep stress testing from seeming like just another compliance checkbox without any real practical value.

"Make the process a meaningful planning tool for your entire management team and your directors," he says.

Beyond Appeasement

While a recent study from the consultancy group Sageworks found that almost a third of responding community institutions reported being pressured by examiners to start or expand stress testing, both Smith and Haberland agree that the benefits go far beyond regulatory compliance.

"We are definitely seeing an increase in regulator requests for institutions of all sizes," Smith says. "But regardless, it is always good to be proactive and implement these types of actions before being requested – or ordered – by the regulators."

"Regulatory mandate or not, it really can provide some good, valuable information to management regarding potential risk exposures," adds Haberland. "That's why community institutions should be doing it. It's not just about regulatory compliance; it's about getting a clearer picture of where the institution stands." FMU