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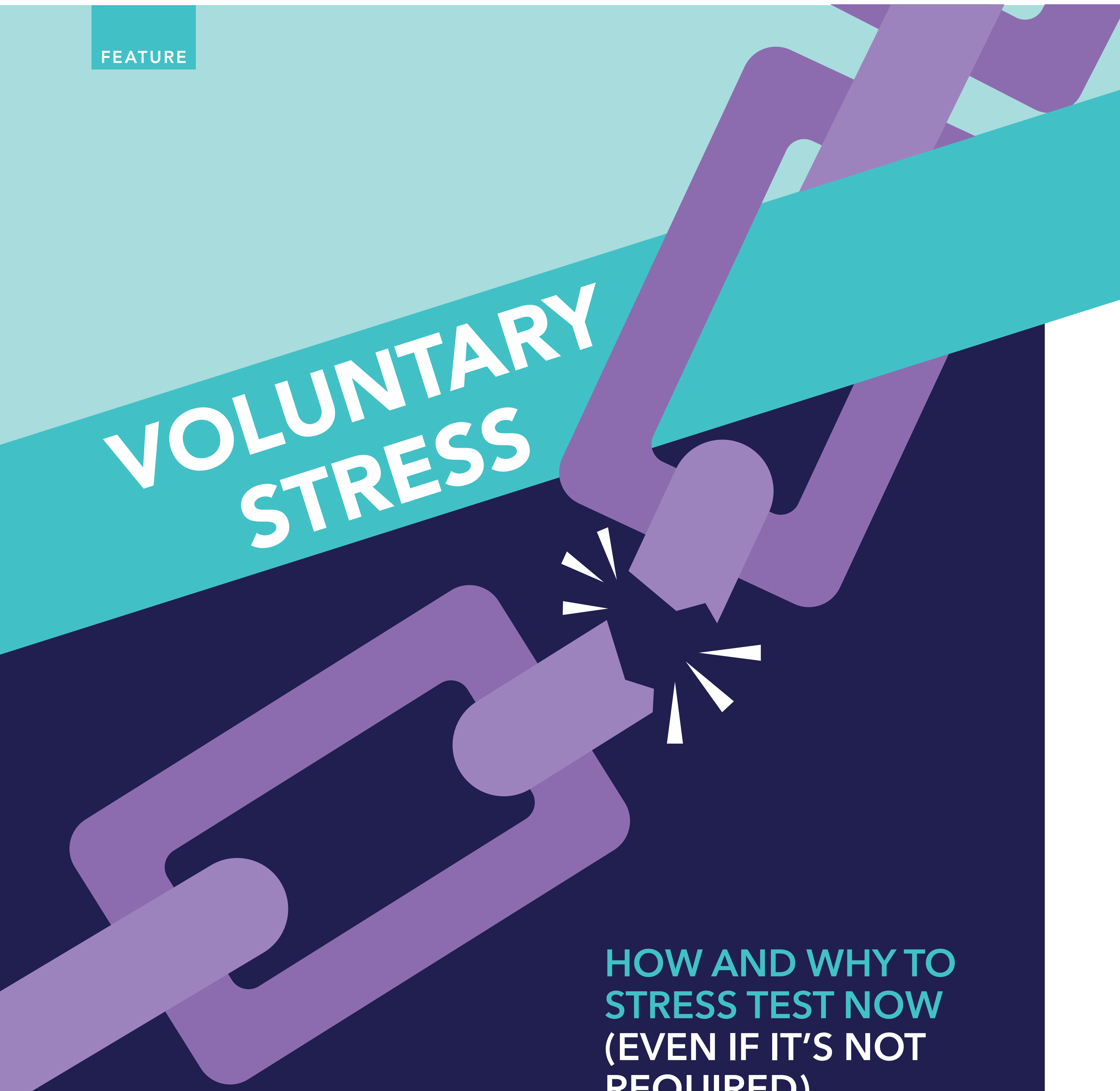
FEATURE



VOLUNTARY STRESS

HOW AND WHY TO STRESS TEST NOW (EVEN IF IT'S NOT REQUIRED)

Experts consistently rail against it. Management often denies it. But whether due to a lack of ambition or a genuine lack of resources, most institutions have to admit they've settled for it at one time or another.

Checking the regulatory box.

That is, doing just enough to send the examiners home happy. In other words, if the regulators aren't explicitly asking for something – regardless of its potential business value beyond the exam itself – it's probably not worth the time, money or manpower to undertake it.

Among the notable victims of this check-the-box mindset, stress testing is probably high on the list. Because even while countless voices from around the industry have long trumpeted the benefits of institutions having a better idea of how events such as rate shocks, economic fluctuations or specific industry triggers will impact their loan portfolios and liquidity levels, many banks and credit unions – particularly those in the smaller asset ranges – have tended to see stress testing as a "big institution requirement" and have thus adopted a there-but-for-the-grace-of-an-extra-few-billion-go-I mentality. But Mark Haberland says stress testing is important for all financial institutions, regardless of size or complexity.

"Stress testing has often been viewed as a regulatory appeasement exercise, but there's much to be gleaned from proper stress-testing practices," says Haberland, a managing director with Darling Consulting Group. "It is important to understand the impact of various stresses – whether on interest rate risk, liquidity or credit – so that we can formulate a plan to help prevent such situations from becoming a reality. Understanding what could cause a problem, and quantifying the size of the problem, is valuable information."

So even though stress testing may seem like a daunting – and potentially unnecessary – undertaking for smaller institutions, Haberland says that while larger institutions could have significant potential exposure to stress testing, the results could be even more material to a smaller institution.

"While stress testing may not be a required exercise for smaller institutions, it can provide tremendous insight into potential exposures before they become reality," he explains. "Take deposit pricing, for example. Determining the correct betas for the risk models is challenging, and can have a profound impact on your overall sensitivity to rising rates. Stressing your deposit pricing assumptions can provide valuable information into the range of exposure/benefits the institution could experience if rates must be increased more than assumed to retain depositors or if attrition levels are higher than expected. This same logic can also be incorporated into your liquidity stress testing to gauge the impact of potential deposit runoff on liquidity levels and how the institution is positioned to cope. One could argue this is more important for smaller institutions, which often have smaller margin for error than their larger peers."

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But deposit pricing is just one area where stress testing can provide potential insight for institutions, with additional value coming in the form of early warning on potential problem loans, broader perspective on the overall level of loan portfolio credit risk and deeper information for the board to use in monitoring portfolio risk against the institution's established risk appetite.

"Stress testing is a way to glimpse what may happen if X, Y or Z occurs," says Mark DeBree, vice president of ALM Services at Catalyst Strategic Solutions, where he has worked with credit unions in a risk consulting role for more than 15 years. "While real-life impact may vary from the modeled or forecasted impact, it allows us to plan potential action steps for certain events. And if certain variables begin to line up in a particular way, we also have some idea of what may happen to our institution and can plan appropriately."

GETTING IT RIGHT

As in the case of other best practices that aren't necessarily mandated by regulators, one of the excuses many institutions give for opting out of stress testing is a lack of resources. Even

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while they can see the value of such an exercise, they simply may not be able to dedicate the necessary time, money or manpower required to do it right. For this reason, Craig Mancinotti says it's important to make sure the scope of the testing is right-sized for the institution.

"You should be trying to calibrate the nature of the stress test to the complexity and size of the institution," says the managing director at ProBank Austin. "Overcomplicating the process adds cost but doesn't add value, so keeping things simple is important. By sticking to a few well-chosen basics, you can get some meaningful information at a reasonable and proportionate cost."

Haberland agrees that if an institution can only afford to dip a toe into stress testing, the focus should be on a few key areas that could really have a significant impact; foremost, in his opinion, are liquidity stresses and deposit assumption stress testing.

"Liquidity is at the forefront of regulatory exams today, and with good reason," he explains. "The expectation for a more forward-looking, dynamic forecasting process is more prevalent, and stress testing liquidity is a key component of an effective liquidity management process. It is important to incorporate stress tests that fit your institution to quantify the impact of what could cause a liquidity crisis, and understand the steps you would take to alleviate that stress – this is critically important today."

DeBree concurs with the focus on liquidity, noting that he's seen a number of credit unions starting to study how they would fare under certain adverse conditions.

"Small to mid-size banks and credit unions may have some significant exposure to potential deposit flows over the next ten years," he explains. "Testing what may happen to their institutions due to a sizable outflow of funds would be very worthwhile to model. Even if this is something that will not happen overnight, there could be a sizable and gradual outflow over a 36-60 month period."

Equally critical, Haberland says, is an institution's deposit sensitivity.

"If you do nothing else for stress testing, it makes sense to incorporate looking at the impact of stressing your deposit assumptions for betas," he says. "As rates continue to rise and deposit pricing lags the market, your ability to effectively manage deposit pricing is critical to maintaining margin. So understanding the impact of higher betas or deposit attrition will be a key component in your risk management discussion."

NOW IS THE TIME

Even if they do see the potential value of stress testing, however, it's easy for many banks and credit unions to put off instituting a program amid what has been a relatively calm and largely positive span over the past several years. But Haberland believes there's no time like the present for smaller institutions that haven't been stress testing to consider doing so.

"Stress testing is important in any rate cycle, but in this current environment it is of particular focus, as bankers have gone so long without experiencing rising rates that we can forget the impact it can have on our various risk exposures," he says.

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DeBree agrees that stress testing is extremely important in the current environment, with a number of disparate factors contributing to an environment that, while placid on the surface, could be harboring a number of potential risks.

"From the rapid growth in technology to the impending retirement of Baby Boomers to the eventual huge wealth transfer from those Boomers to their heirs, the level of uncertainty regarding the future is significant, which strengthens the need and importance of stress testing." ▪

STRESS TESTING TO-DO (AND DON'T) LIST

Just as no two institutions are exactly alike, no two stress testing programs will be identical. But there are a few things that almost every bank or credit union should keep in mind as it heads down this road.

DO keep your stress testing reasonable and relevant in order to get the most out of it.
Mark Haberland says there is often a lack of expertise within institutions to understand just what should be run for viable stress tests, such as whether a stress test should be just different assumptions or a "break the institution" type of scenario. As a result, he says the stresses that are run often do not end up providing much useful information.

"Even if stresses are run only once or twice per year, pick a key assumption or two – such as deposit pricing and liquidity – and incorporate them into your risk management process," he says. "The stress test should be relevant to your institution and provide stakeholders with valuable information to help prevent the stress from occurring down the line. It's more important to include impactful stresses and actually utilize the information than to try and overcomplicate the process."

DON'T throw in the towel early just because all of the data you need isn't readily available.
Understanding some of the relationships between certain economic conditions and the specific impact on an institution's members or customers may require a significant amount of data and some strong statistical analysis that isn't necessarily at the ready.

"Begin saving data now and prepare for the future," Mark DeBree advises. "We all know there will be another large-scale event that will place credit unions and banks under enormous stress, but we don't know exactly where or when."

DO pay close attention to pre-tax, pre-provision earnings in your stress testing model.
Craig Mancinotti says that when an institution enters stressed times it will have higher costs associated with managing non-performing assets. In addition, if things start to go south it might start to de-leverage by pulling back the reins on lending and growth and shrinking the balance sheet to help the capital ratio.

"When you're starting to take actions like these, the impact on the institution's current level of core earnings can be significant," he says. "So you need to have some methodology for estimating where pre-tax, pre-provision earnings will be in those stressed times."

DON'T disregard an analysis simply because it does not fit what you "expect" to happen.
Stress testing is often a mix of some unrealistic events occurring. So while you may want to model and capture the expected future, it's important to have a plan for when things really start to break out.

"Many banks and credit unions tend to look at stress testing results and think 'well, that isn't realistic,'" DeBree points out. "But we have to plan for the unlikely scenarios – those are the ones that close down financial institutions."

DO incorporate your stress testing results into key strategic discussions going forward.
"Use the information to help facilitate strategic discussions at your ALCO meetings, and make sure to consider including stress testing as a key component of all of your risk models (IRR, liquidity and capital)," Haberland says.

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