
ARNOLD & PORTER LLP

Stress Testing for Community Banks



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November 11, 2011

Stress Testing to Assess Capital Adequacy

- Basel Committee on Banking Supervision, Principles for Sound Stress Testing Practices and Supervision, January 2009: an evaluation of the performance of stress testing during the financial crisis.
 - A stress test is “the evaluation of a bank’s financial position under a severe but plausible scenario to assist in decision making within the bank.”
 - Banks should assess the impact of recession-type scenarios, including the ability to react over a medium- to long-time horizon.

Stress Testing to Assess Capital Adequacy (cont'd)

- Supervisory Capital Assessment Program (SCAP): Design and Implementation, issued by the Federal Reserve Board on April 24, 2009
 - Designed to estimate losses, revenues, and reserve needs for the 19 largest BHCs in the United States in 2009 and 2010 under two macroeconomic scenarios: the baseline scenario and the more adverse scenario (not intended as a worst case).
 - The federal bank regulators provided assumptions regarding real GDP growth, the unemployment rate, and housing prices for each of the two scenarios.
 - Each BHC was asked to project potential losses on its loan, investment, and trading securities portfolios.

Stress Testing to Assess Capital Adequacy (cont'd)

- Each BHC was also asked to project the pre-provision net revenue (PPNR) and allowance for loan and lease losses (ALLL) they would have available to absorb losses under each scenario.
- Estimate the ALLL needed as of year-end 2010 under each scenario: comparison of ALLL at year-end 2008 (less the amount needed to absorb credit losses over the 2009-2010 period) to the ALLL needed at year-end 2010.
- Each BHC was then required to achieve a Tier 1 risk-based capital ratio of at least 6 percent, and a Tier 1 common risk-based ratio of at least 4 percent at the end of 2010 under the more adverse scenario.

Allowance for Loan and Lease Losses

- A bank is required to analyze the collectability of its loans and leases held for investment at least quarterly and maintain an ALLL that is appropriate as determined in accordance with GAAP and supervisory guidance.
- “Appropriate” means the ALLL covers estimated credit losses on impaired loans, as well as estimated credit losses on the remainder of the portfolio.
- “Estimated credit losses” is an estimate of the current amount of loans that it is *probable* the institution will be unable to *collect given facts and circumstances as of the evaluation date*.

Allowance for Loan and Lease Losses (cont'd)

- The determination of the amount of the ALLL should:
 - be based on management's current judgments about the credit quality of the loan portfolio;
 - take into account all known relevant internal and external factors that affect loan collectability as of the evaluation date; and
 - consider qualitative or environmental factors, including relevant market conditions, and do not rely on historical loss experience when conditions are changing.

Stress Testing v. ALLL

- **Stress testing** is a risk management tool—it is not used in preparing a bank’s actual financial statements and regulatory reports but as an indicator of whether an institution needs a capital cushion.
 - relies on “what if” scenarios that are plausible, but NOT probable
 - the time frame covered by a stress test is determined by the risk management goals intended to be accomplished (the SCAP was intended as a two-year projection)
- **ALLL** analysis is used to prepare current financial statements.
 - based on an estimate of probable losses based on current conditions, not “what if” assumptions

Interest Rate Risk and Liquidity in Stress Testing

- The regulatory capital ratios take into account a bank's asset quality, because any deterioration in a bank's asset quality will reduce income and, correspondingly, capital. In contrast, Interest Rate Risk (IRR) and liquidity risk are not directly reflected in the regulatory capital ratios.
- Joint regulatory advisory on IRR management issued on January 6, 2010.
- Simple maturity gap analysis not sufficient; IRR simulations needed to assess rate changes on both income and capital.
- Economic Value of Equity (EVE) for banks/ Net Portfolio Value (NPV) for thrifts, used to assess whether risk from rate changes warrants greater capital.
- Standard simulation traditionally was immediate and simultaneous up 200 basis points (bp) and down 200 bp across all maturities.

Interest Rate Risk and Liquidity in Stress Testing (cont'd)

- January advisory emphasizes that stress testing is an integral component of IRR management.
- Run interest rate shocks of up and down 300 and 400 bp.
- Stress scenarios should include:
 - instantaneous and significant changes in levels of rates,
 - substantial changes over time,
 - change in relationship between key market rates, and
 - changes in shape and slope of yield curve.
- Ensure scenarios are “severe but plausible”.

Interest Rate Risk and Liquidity in Stress Testing (cont'd)

- SCAP focus was capital adequacy, but Basel Committee guidance also focused on deficiencies in stress tests on evaluating funding liquidity risk.
- Interagency Guidance on Funding and Liquidity Risk Management issued on April 5, 2010 emphasizes:
 - cash flow projections,
 - diversified funding sources,
 - stress testing,
 - cushion of liquid assets, and
 - a formal, well-developed contingency funding plan.

Interest Rate Risk and Liquidity in Stress Testing (cont'd)

- Banks are required to conduct stress tests regularly for a variety of institution-specific and market-wide events across multiple time horizons.
- A bank should use stress test outcomes to identify and quantify sources of potential liquidity strain; to analyze possible impacts on the bank's cash flows, liquidity position, profitability, and solvency; and to design mitigating measures.
- A bank should also use stress test outcomes to ensure that current exposures are consistent with its established liquidity risk tolerance.
- Moreover, a bank should use stress test outcomes to shape its contingency funding planning.

Interagency Proposed Guidance on Stress Testing

- The federal banking agencies issued the Proposed Guidance on Stress Testing for Banking Organizations with More Than \$10 Billion in Total Consolidated Assets on June 9, 2011.
 - Though applies to banks with assets > \$10 billion, states that all banks should have the capacity to understand their risks and potential impact of stressful events on financial condition.
 - Outlines general stress testing principles:
 - The stress testing framework should include activities and exercises that are tailored to and sufficiently capture the organization's exposures, activities, and risks.
 - It should employ multiple conceptually sound stress testing activities and approaches.
 - It should be forward-looking and flexible.
 - The results should be clear, actionable, well supported, and inform decision-making.

Interagency Proposed Guidance on Stress Testing (cont'd)

- The Proposed Guidance describes various stress testing approaches and applications:
 - Scenario analysis
 - Sensitivity analysis
 - Enterprise-wide stress testing
 - Reverse stress testing
- The Proposed Guidance states that stress testing should be applied in the areas of capital and liquidity in particular, including an evaluation of the interaction between capital and liquidity and the potential for both to become impaired at the same time.
- The Proposed Guidance emphasizes that an organization's stress testing framework will be effective only if it is subject to strong governance and controls.

Dodd-Frank Act Stress Testing Requirements

- The Dodd-Frank Act requires the Federal Reserve to conduct annual stress testing of systemically important financial firms.
- The test should cover three sets of conditions: baseline, adverse, and severely adverse.
- The Act also requires systemically important financial firms to conduct semi-annual stress tests themselves, and requires other financial firms that have total consolidated assets of more than \$10 billion to conduct annual stress tests.
- The Interagency Proposed Guidance was not issued to implement the Dodd-Frank Act stress testing requirements, but the agencies expect to issue implementing regulations that are consistent with the Proposed Guidance.

Raising Capital for a Cushion

- Reasons for new capital include:
 - fund a current deal
 - war chest for future deals
 - organic growth
 - regulatory cushion
- Greater regulatory use of Individual Minimum Capital Requirement (IMCR) and management commitments in examination process to set new capital targets.
- Increased capital without increased earnings increases shareholder pressure—cry for consolidation.
- The market understands the regulatory bar has been raised, but still expects reasonable returns, especially as the broader markets begin to show signs of improvement.
- Result: observing more balance sheet shrinkage to achieve a cushion.

Raising Capital for a Cushion

- Alternative Capital Mechanisms and Sources for Community Banks include:
 - Private placement—accredited investors
 - Friends and family—existing shareholders
 - Rights offering—existing shareholders
 - Strategic investment—private equity
 - Public offering—institutional v. retail

Governance Issues

- Board Risk Committee
- ERM Function/Chief Risk Officer
- Documentation of risk assessments
- Integration of risk assessment into decision making function, particularly capital and liquidity

Disclosure Issues

- SEC, stock exchange, and common law requirements all apply and must be considered.
- SEC standards:
 - MD&A—disclose known trends and known uncertainties
 - Risk factors (Item 503(c) of Reg S-K)—most significant factors that make an investment in the issuer’s security speculative
 - Rule 10b-5: no material misstatements of omissions
 - Forward looking statements are protected
- Stress testing yields results that are in their nature forward looking.
- Nature of stress testing is not trend information, but may reflect a known uncertainty.
- Would a reasonable investor want to know the stress results before making an investment?

Disclosure Issues

- Trends:
 - 300 and 400 bp IRR stress scenarios are being disclosed in Market Risk sections.
 - Regulatory disclosures in 10-K business sections are describing regulatory pressure for capital cushions.
 - Liquidity and capital resources sections of 10-Ks are providing greater information on funding risks.
 - SCAP-like stress test results are not appearing in SEC filings.
- Report of Examination Findings are strict, confidential, and creating tension on how much to disclose about mandated capital cushions.

Questions?



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