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Taking some stress out of stress testing

By Mary Ellen, Financial Writer at Sageworks, Inc.

Day in and day out, banks are making tough lending choices that can help determine which clients get the funding they need to succeed. These decisions also impact the growth of the financial institution and the overall U.S. economy. They're deciding which customers to lend money, which construction projects to support, and so on.

At the same time, banks of all sizes are facing an increasing push by federal regulators to go beyond historical risk-management efforts in the wake of the U.S. housing market's collapse and the 2008 financial crisis. They're being asked to evaluate more thoroughly and to prepare better for worst-case scenarios in the economy and in real estate markets in order to avoid future problems.

Such analysis can be beneficial for businesses, investors and the government. As famed investor and billionaire Warren Buffett once said: "You only find out who is swimming naked when the tide goes out."

The problem is, there's not a lot of specific guidance from regulators on this additional "stress testing," which has led to confusion about which banks must do it, how they should test, and how they'll be graded on their efforts, according to Mike Lubansky, senior product consultant with Sageworks, a Raleigh, N.C., financial information company that provides stress testing and credit analysis software.

"It's new for banks," Lubansky said. "They're being told by the regulators they need to stress test, but banks don't exactly know what to do." Because it is new, there has been less communication and guidance about the proper way to conduct the stress test.

In other words, uncertainty surrounding the process is putting the stress into stress testing for many U.S. bankers.

But Lubansky and other industry players heavily involved in stress testing have some helpful advice about what to expect and how to benefit from the process.

Who's doing it?

"Conceptually, the bank examiners are looking for everyone to do [stress testing]," said Joseph J. Hill, president and chief executive officer of New York consulting firm CEIS Review. "It's a matter of the extent to which it might need to be done that changes."

CEIS, which helps commercial and savings banks conduct loan reviews, hears from a lot of its clients concerned about how to approach stress testing. Portfolio size and the complexity of a bank's loan portfolio to a large extent determine how thorough or complicated stress testing must be, Hill said.

Bank-related stress testing gained widespread attention in 2009 as regulators required the 19 largest U.S. bank holding companies to undergo stress tests demonstrating their ability to maintain minimum capital requirements, even in the event of extreme economic conditions.

But even before that, in 2006, the FDIC outlined guidance for institutions to conduct stress tests if 100 percent of their total capital was in loans tied to construction, development and other land deals, or if they had commercial real estate loans representing 300 percent or more of their risk-based capital. It reiterated that guidance in 2008 in the wake of the housing market's tumble and the U.S. financial crisis.

Under the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, FDIC-regulated institutions with more than $10 billion in assets will be required to perform stress testing. Regardless of their size, however, many banks are feeling pressure to test their commercial real estate portfolios amid concerns that more volatility in real estate markets may be ahead, Lubansky said.

Benefits of stress testing

For many banks, stress testing is a best practice and something they should be progressively implementing in a structured manner, Lubansky said.

"Banks may be trying to do this to satisfy the regulators and check a box," he said. "However, if they can implement an effective stress testing program, banks have found they can manage the risks better."

Rather than a top-down look at capital adequacy that larger banks must perform, stress testing for the smaller banks is more of a bottom-up examination of commercial real estate portfolios.

"Stress testing should help management identify pockets of the portfolio that may be vulnerable to changes in short-term interest rates or deteriorating real estate market conditions," said CEIS managing director of special projects Elizabeth Williams. "Hopefully that gives them a chance to make some changes today or prior to experiencing the actual stress."

For example, a bank might change its loan pricing on certain types of real estate to attract or discourage loans in those areas. Or it might modify its marketing efforts to target one sector or another. Indeed, banks are finding that an effective stress testing program can help them:

- Better understand where the loan portfolio may be overexposed in terms of concentration, either in type of real estate, geography or other factors;
- Better identify which types of loans within a certain concentration have more potential for troubles; and
- Identify and target potentially problematic loans for additional scrutiny, such as more frequent rent-roll reviews or owner-income updates.

Challenges with data collection

Sean Delehanty is the senior credit officer of OmniBank, N.A., a Houston-based bank with about $325 million in assets that has been planning and developing a system for stress testing since around 2008. A good portion of OmniBank, N.A.'s portfolio includes real estate loans, and it began exploring stress testing as executives heard more about the push for more information on banks' commercial real estate portfolios.

He said one of the biggest challenges his bank and others face in developing stress tests is the data collection process. That's because most core accounting systems at banks will have some -- but not all -- of the data needed.

For example, many banks will have a loan's property appraisal, its rent rolls, capitalization rates and income and expense statements in their credit files, but that information might not be in the core accounting system, Williams said. Some banks had those fields set up in their core systems, but many of the fields might be blank, or they might have outdated information such as an old appraisal, Hill added.

Lubansky concurred. "There's a lot of data to gather; they must develop a structured, manageable process to get the data in small chunks from different sources."

Experts recommend that once the software or solution has been selected for the stress tests, banks should start examining and accumulating the data for the largest real estate exposures first, adding data tied to smaller exposures as time goes on.

"I believe the examiners consider that to be reasonable as well," Hill said. "The biggest concern examiners have is to see that banks have a process in place. They understand some of the problems."

Identifying the best reports

Tackling the richest data points first can also help banks generate meaningful reports analyzing risks sooner, according to experts. As you add data, the detail of your analyses can always be stepped up.

Delehanty said that once Omni Bank had gathered substantial data, it began deciding what kind of reports would be most useful. He said that's the time for the bank president and the credit department to be asking: Do we want to find out what loans or what borrowers are struggling? What industries seem to be struggling? Knowing what we know about our market, do we want to stress those industries that maybe having a problem in order to target future problems?

Deciding how often to run the reports and how often to share them with the bank's board is also important, he added.

Finding the reports that make the information as simple as possible but useful can be challenging, Delehanty said, but bank examiners have provided input on the process.

"I sat down with the examiners in June and showed them a segment of our portfolio – the income-producing properties – and said, 'This is what we've focused on for about the past three or four months; we're about 90 percent done with our input and here are some reports and how we plan to use them in the future,' " Delehanty said. "They seemed to be, for one, pretty impressed that … a bank our size was this far along in the process and that we were thinking about that."

Examiners were also encouraged by Omni Bank's ability to demonstrate what kind of potential losses it might have if a certain stress happened, and how that might affect the bank's balance sheet.

At the same time, examiners offered helpful guidance on making sure Omni Bank maintains accurate information for all of its stress tests, an issue that is obviously a challenge for banks. Delehanty said he works closely with his bank's note department to make sure he's aware of adjustments to charge-offs so that he can account for that loan differently in the stress test.

Williams said some banks have found it's more efficient to partner their stress test efforts with the loan-review process already offered by CEIS. Integrating the two also saves money on the processes in the long run, Hill added.

Experts agree that developing a stress test system will go more smoothly if the bank's board and management are supportive of the need. Delehanty recommends having a small group of people assigned to and focused on the project. "Having one person working through it drags it out more," he said.

Hill's best advice? "Just be organized and don't panic," he said. "Take it a step at a time and be intelligent about it. The examiners want to see a process going on … they're not looking for a miracle overnight."