UNDERSTANDING LIMITATIONS

by Steve Brown

In the strange but true category, an analysis by creditcards.com finds the typical credit card agreement requires a 12th grade education to comprehend. That would be just fine, except other studies indicate the US population reads at just a 9th grade level. This information got us thinking about current regulatory demands, industry trends around stress testing and better understanding limitations. While some of the reading materials floating around the industry on this subject are difficult to understand and some are admittedly loaded with legalese, the fact remains that stress testing should be part of any decent bank risk management program at this point.

Before we take flight on this subject, however, we stop to point out that no matter how hard they try, penguins just can't fly. We use our penguin example and relate it directly to stress testing, so stay with us for a moment. Consider that a stress test conducted on only a portion of the loan portfolio doesn't capture the risk of the overall portfolio. Stress testing a single loan sector, such as commercial real estate (CRE), can be interesting, but it just doesn't get off the ground. By definition, the loan portfolio is a 'portfolio' made up of multiple individual loans within multiple different sectors. As such, once you analyze them through stress testing, you will often find some sectors when combined exacerbate problems, while others counter them. In simple fact, stress testing CRE is specifically identified in banking regulations, but so too is stress testing as an overriding concept, utilizing proper risk management techniques and doing robust loan portfolio analysis to understand risks. Stress testing just CRE, pointing to a pile of feathers on the ground and pretending flight has occurred just doesn't make sense if you are trying to ensure your bank has a decent risk management process.

Now that we have that out of the way, we try to remove some of the clutter around stress testing as a concept. Many bankers understandably get bogged down trying to figure out what to do. That isn't surprising when you consider all the potential issues in running a stress testing process that can include choosing scenarios, how extreme to make the stress and what external factors might cause such an event. In short, stress testing is nothing more than one or more "what if" analysis you run that are designed to assess sensitivities your bank may have to various potential events. In its simplest form, stress testing calculates the value of a given portfolio to a particular shock. The goal is to give management and the board an early warning system so they can answer the question "What happens to our loan portfolio, capital adequacy, liquidity and other factors when "X" happens?" Once you have done that, you can then establish a contingency plan to help protect your bank against such events, should this occur.

Getting there is a process, but it begins by defining how you are going to test, what you are going to test, how often, which scenarios, etc. Once you have that down, consider how best to report this to the board and how frequently you are going to do so (quarterly or semi-annual reporting is suggested). On the back end of the process, audit should review assumptions, validate the process and ensure reports are adequately capturing the risks.

The goal of all of this is to make sure you have tools to assess how comfortable your bank is with the risks inherent in the loan portfolio and any potential impact on performance. If the risks are small, just monitor them to be sure they stay within tolerances. If the risks turn out to be outside the comfort zone but cannot be avoided, the goal is to have a plan to mitigate and contain them. Finally, if certain risks are outside the comfort zone and they can be removed from the bank, the process is to take steps to eliminate the risk to the extent possible.

Flying for some birds is impossible, as we see with the penguin. The good news is that banks aren't penguins, so incorporating stress testing into your processes can help your risk management program really take flight.

BANK NEWS

BofA

Operational takeaways from the investor call include closing 10% of their branches; not seeking acquisitions; focused on lowering their cost of funds; expect to do share repurchases and dividends will increase in 2nd half of year (rising to 30% of net income by 2013).

Wells Fargo

Plans to beef up their retail operations in the mid-Atlantic area by hiring 1,000 new employees.

Mortgage Suits

The group of 50 state attorney generals looking into potential mortgage origination violations said they hope to have a settlement (in conjunction with Federal regulators), with the major banks in the next 2 months. In addition, the group also looks to change mortgage foreclosure and servicing policies at all banks.

Muni Issuance

Reflecting significant ongoing stress in the sector, at only $32B currently, municipal bond issuance is on pace to be the lowest in 11Ys.

Interchange

A new ABA white paper is out showing that after factoring in processing costs and time, merchants save about 33 cents over checks and about 12 cents over cash by taking a payment via debit card. In short, the paper extols the virtues of the debit card by touting its savings, broad appeal and guaranteed payment. Read report here.