



## The Case for Stress Testing More Frequently

stress testing

**Summary:** Many CFIs approach stress testing from one perspective. Stress testing from multiple standpoints, however, can help organizations assess new drivers and changes in the macroeconomic environment. But more frequent stress tests can also bring challenges. We discuss how to manage the challenges and reap the benefits.

Some of the most extreme stress testing conditions occur in Death Valley National Park. Automakers around the globe [regularly send their cars to Death Valley](#) in order to see how well they perform under the extreme heat of one of the hottest places on earth, with temperatures regularly above 110 to 120 degrees Fahrenheit. They do this to ensure that their car engines, air conditioning, and transmissions can withstand the heat without failing or losing performance.

Financial institutions don't need to go to such drastic lengths to stress test their businesses, but it is equally important for them to prioritize frequent stress testing endeavors. This especially applies during levels of heightened economic uncertainty.

Like other financial providers, some community financial institutions (CFIs) perform annual stress tests that are designed to see how the institution would fare under various economic scenarios, from a moderate downturn to the most severe hypothetical shockwave.

Some CFIs aren't required to perform annual stress tests. However, if there is one thing the financial industry has learned from these past couple of weeks, it's that stress can arise suddenly, especially in a rapidly changing market environment. Now more than ever, it's crucial for your management team to have tools on hand that can help you be both proactive and responsive in the face of any other challenges that arise within the industry. As a management tool, stress tests help executives identify any potential flaws in their current plans and practices, and also help your team brainstorm and even test solutions.

### What should a stress test cover?

Every CFI is a little different, and its executives are the best judges of what is mission-critical. In general, however, you should ensure that your organization can:

- Maintain capital reserves sufficient to absorb severe losses.
- Keep capital above the minimum requirement.
- Continue lending — the backbone of most CFIs' business.

### What are the potential benefits of stress testing more often?

Even if not required, all institutions can [benefit from stress tests](#). After all, the purpose of stress testing is to ensure your organization can withstand changing economic conditions. The market has been volatile and often unpredictable in the past few years, proving that your organization may not be able to see every change coming down the pipeline that will affect your capital and earnings. Given how quickly these events have happened, stress testing can allow your organization to plot out and anticipate any scenario you can fathom.

If you stress test for these potentialities as the market changes, you'll have time to assess weaknesses in your portfolio and address them, just in case a hypothetical situation becomes a reality. It's far better for your staff, your customers, and your community if you can hash out a plan ahead of time for a scenario than to have to discover and deal with any challenges in real time, when your business is already being impacted. Stress testing can also indirectly help you with your strategic planning, business continuity plans, and various other aspects of your institution that could be affected in each scenario.

For most financial institutions, ensuring that most essential processes can continue even if economic conditions worsen means managing lending concentrations. Given the increased uncertainty in commercial real estate (CRE), and trends in remote work, it makes sense for some CFIs to pay particular attention to the potential effects of different future scenarios on CRE lending. For example, a CFI that holds commercial loans secured by office properties may consider a higher vacancy rate, as we expect that some tenants may not renew their leases at the same square footage (or at all).

### **Here are 5 ways to make stress testing easier.**

Some financial institutions treat stress tests as a very big deal, an annual operation that wars with other priorities for employee time and energy. Instead, incorporate stress testing into your quotidian processes by doing the following:

1. **Avoid dispersed and siloed systems, data sources, and models.** Make it easy for your staff to access all the information they need to test on the transaction level and the portfolio level for both baseline scenarios and severely adverse scenarios. Share data and coordinate processes as what you are: a single business.
2. **Create stress tests that align with business objectives.** When your CFI wants to ask "what if" about any part of your operation, you don't need to redesign the Parthenon. Ask the question, figure out what you need in order to answer it, and move ahead with getting the answer.
3. **Don't involve manually intensive processes to answer your questions.** For example, if you have to collate piles of paper (or electronic files) to determine your current debt service or FICO score upon every deal, then your overall business processes need more automation.
4. **Execute driver-specific stress tests rather than tests based on standalone macroeconomic indicators.** This can help you understand how your strategies may fare under various market scenarios and understand stress thresholds within lines of business.
5. **Include stress tests that use the same data and calculation methods as your daily business practices.** The more you align stress testing to your firm's regular work, the more your CFI will be able to either change direction if and when the market surprises you or plan for an expected economic change.

By making stress testing easier, you make it more likely that your CFI will follow through on asking what might happen to various lines of business as the world changes. You can then use that information to make informed decisions to strengthen your CFI's future, become more resilient, and adapt to market changes much faster.

## **TWO APPROACHES TO STRESS TEST YOUR LOANS**

Now more than ever, it is important to stress test loans of all types from multiple perspectives. Choose your approach and get expert help, as needed. Learn more about [credit stress testing](#) today.

## **ECONOMY & RATES**

Rates As Of: 04/03/2023 05:50AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	4.85	-0.03	0.43
6M	4.94	-0.23	0.18
1Y	4.62	0.02	-0.09
2Y	4.10	0.08	-0.33
5Y	3.64	0.06	-0.37
10Y	3.52	0.05	-0.36
30Y	3.69	0.04	-0.27
<b>FF Market</b>	<b>FF Disc</b>	<b>IORB</b>	
4.83	5.00	4.90	
<b>SOFR</b>	<b>Prime</b>	<b>QREF</b>	
4.87	8.00	4.82	

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