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Alert

Regulators Issue Final Guidance Regarding Stress Testing for Large Banking Organizations

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Yesterday, the Federal Reserve Board (the "Fed"), the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of Currency ("OCC") (collectively, the "Agencies") issued guidance (the "Guidance") clarifying supervisory expectations for stress testing by banking organizations with more than $10 billion in total consolidated assets.[1] The Guidance is a final adaptation of the proposed version released on June 15, 2011.[2]

While the principles in the Guidance can be applied to the stress testing requirements imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act, such requirements are being implemented through separate notices of proposed rulemaking.[3] Rather, the Guidance outlines high-level principles for stress testing practices that are applicable to all qualifying banking organizations. As stated by the Agencies, the Guidance "highlights the importance of stress testing as an ongoing risk management practice that supports a banking organization's forward-looking assessment of its risks and better equips the organization to address a range of adverse outcomes."

The Guidance also makes clear that it does not apply to banking organizations with $10 billion or less in total consolidated assets. This allays concerns voiced by community banks that the potentially costly and cumbersome stress testing would apply to them in the same manner as their larger rivals.[4]

Five General Stress Testing Principles

The Guidance contains five main principles that banking organizations should take into consideration in the development and implementation of a stress testing framework:

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[1] The Guidance is available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120514a1.pdf.

For purposes of the Guidance, the term "banking organization" means national banks, federal savings associations, and federal branches and agencies supervised by the OCC; state member banks, bank holding companies, savings and loan holding companies, and all other institutions for which the Fed is the primary federal supervisor; and state nonmember banks, and all other institutions for which the FDIC is the primary federal supervisor.

[2] *See* 76 FR 35072 (June 15, 2011).

[3] *See* 12 CFR 225.8. For a summary of such requirements, please see our Jan. 11, 2012; Jan. 19, 2012 and Jan. 25, 2012 *Alerts*.

[4] However, a separate statement issued simultaneously with the Guidance, clarifying the inapplicability of the stress testing requirements to community banks, indicated that the Agencies "continue to emphasize that all banking organizations, regardless of size, should have the capacity to analyze the potential impact of adverse outcomes on their financial condition." That statement is available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120514b1.pdf.

1. **A banking organization's stress testing framework should include activities and exercises that are tailored to and sufficiently capture the banking organization's exposures, activities and risks.**

   - Using effective enterprise-wide risk identification and assessment metrics, an effective stress testing framework should cover a banking organization's full set of material exposures, activities and risks, whether on or off the balance sheet.
   - Examples given of risks that should be addressed in a banking organization's stress testing framework include:
     - Credit;
     - Market;
     - Operational;
     - Interest-Rate;
     - Liquidity;
     - Country;
     - Reputational; and
     - Strategic.
   - An effective stress testing framework should capture the interaction between a banking organization's different exposures, activities and risks, as well as their combined effects.

2. **An effective stress testing framework employs multiple conceptually sound stress testing activities and approaches.**

   - A banking organization should employ multiple types of stress testing activities and approaches.
   - A banking organization's stress testing framework should rely on readily available data, including key variables that drive performance.
   - A banking organization should understand and document the assumptions and inputs used in respective stress tests and provide such information to the users of the stress testing results.

3. **An effective stress testing framework is forward-looking and flexible.**

   - Stress testing approaches should be able to evolve over time and be updated as needed.
   - A banking organization's stress-testing framework should be able to incorporate changes in the following aspects of its business:
     - On- and off-balance sheet activities;
     - Portfolio composition;
     - Asset quality;
     - Operating environment;
     - Business strategy;
     - Firm-specific events; and
     - Macroeconomic and financial market developments.

- A banking organization's stress testing framework should not merely rely on historical data to make assumptions, but rather should consider multiple scenarios, even those which may not have ever occurred in the banking organization's history.

4. **Stress test results should be clear, actionable and well supported, and inform decision-making.**

   - All stress test results should be accompanied by descriptive qualitative information, allowing users to properly interpret the results and potential implications in proper context.
   - A banking organization should regularly share stress test results with different levels of the organization to raise awareness regarding both potential firm-wide and level-specific implications.

5. **An organization's stress testing framework should include strong governance and effective internal controls.**

   - A banking organization's senior management team and board of directors should establish a comprehensive and integrated stress testing framework that fits into the broader risk management framework of the organization.
   - The board of directors is ultimately responsible for ensuring a banking organization has an effective stress testing framework, while the senior management team is ultimately responsible for implementation of such framework.
   - A banking organization should have written policies and procedures governing the implementation of the stress testing framework. Such policies and procedures should be approved and annually reviewed by a banking organization's board of directors.
   - A stress testing framework should incorporate some type of validation or independent review consistent with supervisory expectations.

Stress Test Components and Applications

The Guidance discusses four different stress test components and how they can be applied to a banking organization's stress testing framework.

1. **Scenario analysis**

   - Refers to the type of stress testing in which a banking organization applies historical or hypothetical scenarios to assess the impact of various events and circumstances.
   - Particular scenarios should reflect a banking organization's unique exposures, activities and risks.

2. **Sensitivity analysis**

   - Refers to the type of stress testing in which a banking organization assesses its exposures, activities and risks in the face of potential "shocks" to certain relevant variables, parameters and inputs.
   - Such analysis should be conducted periodically to combat potential changes in a banking organization's exposures, activities or operating environment, or in the relationship of potential variables to one another.

3. **Enterprise-wide stress testing**

   - Refers to the type of stress testing focused on the impact of certain scenarios on the banking organization as a whole, particularly with regards to capital and liquidity.
   - Such stress testing should focus on the development of scenarios affecting the banking organization as a whole stemming from macroeconomic, market-wide and firm-specific events.

4. **Reverse stress testing**

   - Refers to the type of stress testing in which an adverse outcome is assumed, leading to the deduction of the types of events that could lead to such an outcome.

- Such stress testing should cover not only events that seem the most imminent or probable in the current environment, but also those scenarios that have the largest firm-wide impact, such as insolvency or illiquidity.

Stress Test Guidance Application to Liquidity and Capital-Related Stress Tests
The Guidance applies some of the aforementioned principles and discusses them in the specific contexts of stress tests to assess the adequacy of capital and liquidity. The Guidance emphasizes the importance of stress testing in these two areas, especially in analyzing how losses, earnings, cash flows, capital and liquidity would be affected in an environment where multiple risks present themselves. The Guidance emphasizes that an effective stress testing framework should explore the possibility of capital and liquidity problems arising at the same time. Below are key comments in the Guidance's discussion of the two respective types of stress tests.

1. **Capital stress testing**

   - Refers to the type of stress testing in which the potential for changes in a banking organization's earnings, losses and reserves is analyzed under a variety of stressful circumstances.
   - Such stress testing should asses the potential impact of material subsidiaries of the banking organization suffering capital problems, even if similar problems are not predicted at the consolidated banking organization level.

2. **Liquidity stress testing**

   - Refers to the type of stress testing in which the potential for changes in a banking organization's financial health is analyzed in light of adverse developments affecting relevant market and asset liquidity.
   - Liquidity stress testing should be conducted not only on an enterprise-wide level, but should at lower levels in contemplation of potential regulatory or supervisory restrictions on inter-affiliate funding and asset transfers.

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