Supervisory Spotlight

A Regulator's Perspective on Issues Facing Western Banks

Banking Supervision & Regulation
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Clarifying Stress Testing by Community Banks

The Statement to Clarify Supervisory Expectations for Stress Testing by Community Banks (Statement) makes it clear that recently issued requirements and guidance on stress testing for larger organizations that require supervisory and bank-run stress tests under specific economic scenarios do not apply to community banks (generally those organizations with assets of $10 billion or less). This special issue of the *Supervisory Spotlight* reminds our supervised institutions about existing regulatory guidance that remains applicable to all institutions, and provides two actual examples of specific stress testing or scenario analysis that may be useful to support decision making.

The Statement does not change current examination procedures for community banks. As the agencies have long emphasized, sound risk management at any banking organization involves a good understanding of the organization's full risk profile. All banking organizations should conduct some type of forward-looking analysis to understand the potential impact of various types of adverse outcomes on their financial condition. This can consist of relatively simple analysis that many community banks already conduct as part of existing risk management.

As a reminder, community banks are still subject to existing supervisory guidance in different topic areas that mention stress testing; the scope of this analysis should be commensurate with an organization's size, complexity, and risk profile. This supervisory guidance includes:

- "Subprime Lending" (SR 01-4) (interagency)
- "Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices" (SR 07-1) (interagency)
- "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies" (SR 09-4) (Board only)
- "Interagency Advisory on Interest Rate Risk" (SR 10-1)
- "Interagency Policy Statement on Funding and Liquidity Risk Management" (SR 10-6)
- "Supervisory Expectations for Risk Management of Agricultural Credit Risk" (SR 11-14) (Board only)

Some examples of the kind of scenario analysis that examiners would expect from a community bank might be helpful. First, consider the case of a bank with total assets of $250 million and non-owner occupied CRE outstandings exceeding 300% of total risk based capital. Using a portfolio stress testing package from a well-known vendor, the bank's board incorporated the results of the testing in its quarterly risk management discussions on capital planning. Based on results under several scenarios, the bank slowed its CRE lending growth until loan loss allowances reflected the portfolio risk. The Board was focused on a number of scenarios and actively discussed how much risk it wanted to incur in its CRE portfolio. Our examination found this level of analysis appropriate for a bank of this size because, although the program was not sophisticated, its results were relevant and importantly used by Board and management.

In another example, a $700 million bank had 47% of its assets in mortgage backed securities (MBS). After developing and running an analysis on the price/yield relationship in this portfolio, management concluded that increasing interest rates would affect the valuations beyond its comfort level. The Board, presented with three rate scenarios and the resulting value of the securities, decided to reduce its holdings of MBS by buying more marketable and less interest rate sensitive securities. This accomplished two purposes: the institution reduced its concentration in MBS and mitigated the potential impact on capital and earnings while also building a more marketable securities portfolio in anticipation of future increased loan demand. Management and the Board identified a risk, ran some reasonable tests, and used the results to make a decision. The examination found that this was an appropriate level of analysis.

I appreciate that there is a fair bit of uncertainty about regulators' expectations for community banks. We are working hard to share our expectations and initiate dialogue on this issue. Please feel free to contact me, Joe Lozano, Director of the Community Institutions Group (joe.lozano@sf.frb.org or 415-974-3318) or the examining manager for your bank if you have questions on this interagency statement.

From the Director of Banking Supervision and Regulation

About two weeks ago, I appeared on a regulators panel at a banking conference and spent some time talking about stress testing at community banks. The issue isn't new; well-managed banks have long known the value of scenario analysis and testing, and regulators have always looked at how banks plan for both expected and unexpected adverse events as part of their risk management processes. However, with all the recent changes in stress testing and risk management expectations for larger institutions, we began to hear concerns from community bankers: "Will we also be expected to undertake the same types of stress testing being required of these large institutions?"

The answer is no. This issue of the *Supervisory Spotlight* explores this answer further in light of the Monday, May 14 release by the federal bank regulatory agencies—the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of Currency—of the "Statement to Clarify Supervisory Expectations for Stress Testing by Community Banks."

Please share with me, or with the examining manager for your bank, any thoughts or questions you have on this issue of the *Supervisory Spotlight*. As always, I very much appreciate hearing from you.

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