

Continual stress tests: Peace of mind for banks and regulators

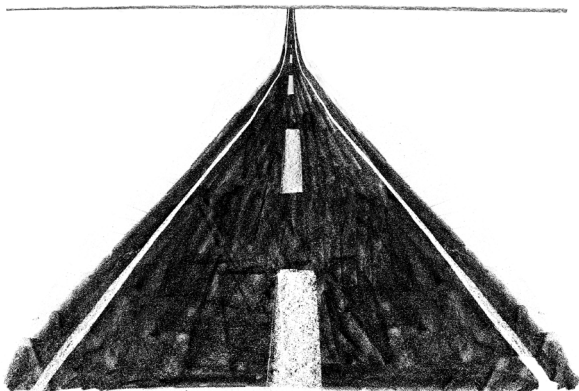
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The slow economic recovery has resulted in a vastly altered landscape for banks and other financial institutions. Regulation and oversight are on the rise as lawmakers and regulators seek to learn from the events of the past few years and mitigate systemic risk. Self-regulation and the adoption of industry best practices are likely to increase.

As regulators seek to toughen the capital requirements governing U.S. financial institutions in an effort to minimize risk to the nation's financial system, stress tests are commanding headlines. Stress tests evaluate the extent of losses a bank would sustain in its major asset categories under a troubled economic scenario, along with the impact those losses would have on the bank's revenue and capital adequacy. If they are implemented effectively, stress tests may turn out to be exceptionally valuable regulatory tools. The Federal Reserve Bank underscored their significance by requiring 19 of the country's largest banks to file comprehensive capital plans and perform stress testing; those banks were required to submit the results of their latest stress tests in January 2011. Those results must show how each bank's operations would hold up during another economic crisis and confirm that the bank would be strong enough during such a crisis to maintain access to funding and to provide credit.

Stress tests are based on actual and projected growth rates in the gross domestic product and in unemployment data. But conducting stress tests on this macroeconomic level alone is unlikely to reveal deep-seated issues unique to individual banks. While such tests are useful because they can be applied widely, they are also limited because they do not fully take into consideration the differences between regional marketplaces or other significant variables. A bank in California may face issues that are irrelevant to a bank in New York. Therefore, bank directors, officers and management all need to move beyond looking solely at macroeconomic factors. This paper details additional key areas executive decision-makers can use to help them manage their liquidity and solvency expectations throughout many types of economic cycles.



Background

During March 2009, the Federal Reserve Bank, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (FDIC) launched their initial round of stress tests to assess the health of 19 of the nation's largest bank holding companies under the Supervisory Capital Assessment Program (SCAP). The banks that were tested — including Bank of America, Citigroup, Fifth Third Bancorp, GMAC, Goldman Sachs, KeyCorp and Morgan Stanley, among others — collectively account for one-half of loans issued in the United States.

The SCAP tests projected how potential losses on loans and securities would affect bank operations, revenue and capital reserves two years into the future, with one scenario based on existing economic expectations and another that projected a long and severe recession. The regulators published the results of their initial round of tests in May 2009. Those results suggested that during a severe recession, these 19 banks would stand to lose about \$600 billion, largely from nonperforming residential mortgages and consumer loans. Subsequently, these banks raised \$195 billion in common equity to shore up their capital reserves.

The importance of having enough capital to offset losses and control leverage is emphasized in the Basel III reforms set forth by the Basel Committee on Banking Supervision. The Basel III framework stipulates that banks must increase their minimum common equity levels from two percent to seven percent of their risk weighted assets by 2019; the framework calls for U.S. regulators to begin enforcement in January 2012.

The bar on bank capital requirements was raised even higher in July 2010, when the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was passed. The importance of maintaining adequate amounts of capital against loan and securities losses was highlighted in the Dodd-Frank Act which mandates that banks demonstrate higher capital levels and bank holding companies eliminate the counting of trust-preferred securities, to the extent that they are not grandfathered, toward meeting Tier 1 requirements. Moreover, the Collins Amendment puts the onus on regulators to make sure that insured depository institutions and depository holding companies retain enough capital to absorb losses during periods of market dislocation. To that end, the Dodd-Frank Act mandates annual stress tests under various types of economic conditions for banks with more than \$50 billion in assets.

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Greater relevance, wider application

The Dodd-Frank Act was aimed squarely at larger financial institutions with systemic risk potential. However, the implications of risk for smaller and midsized regional banks are equally applicable. While larger banks were shoring up their Tier 1 capital levels — the primary gauge of a bank’s strength relative to its assets — community banks took the recession on the chin in 2009. Most banks were well-capitalized before the housing market crisis and economic downturn but the substantial increase in nonperforming loans and defaults sapped loan loss reserves and portfolio performance. Credit for businesses dwindled, and capital for banks dried up. In the aftermath, the number of bank failures soared to 140, according to FDIC statistics.

In 2010, 157 banks failed, a 12 percent increase from 2009. To put those failure rates into perspective, the total for the past two years exceeds the cumulative total for the previous eight years. Despite stabilization in the nation’s equity and debt capital markets and improving economic conditions, the capacity to sustain large loan losses and continue lending in a difficult economic environment remains a questionable prospect for many community and smaller banks.

Regulators have not yet required banks with less than \$10 billion in assets to perform stress tests, but the financial fallout from nonperforming loans is an all-too-real risk for banks of all sizes. Large numbers of distressed residential properties and foreclosures, coupled with declining home prices, continue to cast a long shadow over the housing market. At the same time, sluggish economic growth, troubled commercial real estate assets, and an unemployment rate that the Department of Labor calculates at 9.4 percent (December 2010) are all clouding the horizon for the banking industry.

Federal Reserve Chairman Ben Bernanke underscored the importance of stress testing for all banks on May 6, 2010, when he said that bankers (and other financial services firms) need to conduct their own stress tests. He explained that the tests “force bankers to think through the implications of scenarios that may seem relatively unlikely but could pose serious risks ... Stress tests must be an integral part of [firms’] processes for ensuring their capital is adequate.”

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These developments highlight the need for management and boards of directors to conduct a thorough analysis of their bank’s loan and investment portfolios and operations (including the impact on net interest margin, fee income and other sources of revenue and loss impairment) as well as an ongoing review of internal processes and controls, in order to assess and manage risk appropriately.

While the FDIC has identified the macroeconomic criteria it requires banks to stress-test against, management shouldn’t look only at those criteria. Continual stress testing should be relevant to the bank’s specific portfolios, balance sheet and customer base. In the following paragraphs, we discuss some pertinent factors banks should consider when carrying out stress tests.

Asset concentration and credit quality

Asset concentration issues are hardly new. The value of assets changes with fluctuations in credit markets, interest rates and the overall economy. However, concentrations of loans within credit and trading portfolios don’t change nearly as quickly and can threaten an institution’s financial performance and solvency.

Loan portfolios that are overly concentrated in certain industries, market segments or counterparties can expose a financial institution to greater risk, volatility and losses. Smaller banks and regional players, for instance, have traditionally managed portfolios that are heavily concentrated in commercial real estate loans and consumer mortgages — two areas that have come under stress during the recession and the construction downturn — and concentrated geographically. As a result, regulators have sharpened their scrutiny of credit concentrations within loan portfolios. Likewise, the housing market downturn led to the issuance of new guidelines three years ago with respect to commercial real estate loans and concentration thresholds.

	2008	2009	2010
Assets			
Cash	100	150	200
Loans	200	180	160
Investments	300	320	350
Other	50	60	70
Liabilities			
Deposits	400	420	450
Borrowings	100	110	120
Other	50	60	70
Equity			
Common Stock	100	100	100
Retained Earnings	150	140	130
Other	50	60	70

Approaches to determining and minimizing concentration risks vary. One approach involves setting aside a percentage of capital for concentration exposure to risky categories. (Ratios can provide an approximation for gauging a bank's exposure to concentrations.) Another approach involves paying surcharges if certain set capital levels in risky categories are exceeded. However, the most effective way for an institution to manage its concentration issues is to strengthen its overall risk management procedures. Stress testing can be an important instrument in the corporate governance toolbox. Such testing can be valuable to banks as they explore vulnerabilities in their loan portfolios and operations and formulate strategies for offsetting risks.

Contagion risk

In today's marketplace, the complex links between banks across a variety of markets — from interbank funding to derivatives to equity and fixed-income markets — are well-established. When liquidity pressures surface, the results can be disastrous. During 2007 and 2008, problems in the collateralized mortgage obligation and credit default swaps markets led to substantial write-downs for many commercial and investment banks. The September 2008 collapse of Lehman Brothers caused large declines in the valuation of securities and loans linked to Lehman that were held by other banks. The failure of this single entity sent shock waves across the entire global financial system. This series of events clearly illustrates the link between the world's largest banks and the risk of contagion among financial institutions in times of market dislocation.



The composition of a bank's deposit base and other debt obligations have a significant impact on its funding liquidity risk. The lack of contingency funding during periods of dislocation can have a domino effect, with financial difficulties spreading among multiple financial institutions. If one depositor withdraws funds or discontinues lending to a particular financial institution and too many others follow suit simultaneously, a run on the bank could ensue, forcing an institution to liquidate and potentially causing depositors in similar banks to withdraw funds as well. While this was particularly true with Lehman and other large financial institutions, community and regional banks that rely on brokered deposits or short term funding can be susceptible to liquidity risk.

Fortunately, the implementation of stress tests and the publication of transparent test results may be able to inoculate financial institutions against the worst of the contagion. Banks that regularly conduct stress tests, document how much capital is available to absorb losses and have appropriate funding capacities have a way to bolster consumer confidence: With clear and timely information about the state of their bank's finances, consumers will see no need to withdraw their funds during periods of market upheaval.

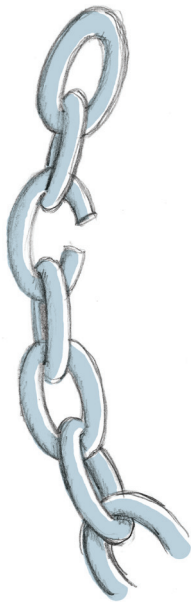
Capital structure and availability

Capital is the foundation of banks, serving as the backstop against losses when adverse economic circumstances arise. Common equity has long been the primary form of Tier 1 capital adequacy. Given the higher capital standards being enacted, it is illustrative to note that if the nation's largest 35 banks were subject to immediate compliance with the Basel III reforms, those banks would be undercapitalized and short on liquidity. That was the finding of Barclays Capital Advisory Group, which modeled the regulatory changes in the top 35 U.S. banks since the Basel III framework emerged in December 2009. According to Barclay's (and based on Q2 2010 numbers), the banks' capital requirements would fall short by \$100 billion to \$150 billion, while their liquidity shortfall would be about \$500 billion.

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Developing a capital structure with the right mix of debt and equity for the risks inherent in a bank's portfolio is important — especially for smaller regional banks — to ensure that there is sufficient capital to weather economic downturns while maximizing returns for their shareholders. Banks with high levels of debt, preferred stock or hybrid equity capital are locked into fixed payments which strain liquidity. For banks with highly concentrated loan portfolios, maintaining higher levels of common equity provides the institution with a better cushion against potential loan losses and impairments, along with the flexibility to ride out economic downturns and weather unpredictable and destabilizing events.

Stress tests should take into account projected revenues, losses and changes in capital reserves, particularly in the event of an economic downturn. Off-balance sheet obligations, contingent liabilities, underwriting practices and counterparty credit loss exposures should also be included in stress-testing procedures. If the results of the stress test indicate that capital will be inadequate, then managers and boards will want to consider bolstering their reserves with additional capital.



More stringent capital standards, coupled with funding challenges and a sluggish economy, heighten the importance of knowing where the weak links are within a bank's operations.

In order to remain compliant with national and international regulations, many banks will need to secure additional funding from the debt markets. This will entail a more difficult process for smaller banks whose portfolios are dominated by commercial real estate loans. More stringent capital standards, coupled with funding challenges and a sluggish economy, heighten the importance of knowing where the weak links are within a bank's operations. The ability to assess liquidity, gauge credit concentration, and predict changes in loan performance across economic cycles is key to understanding risk, remaining in good standing with regulators and managing operations effectively. Conducting regular stress testing can provide management with an integral part of the risk management picture.

Concluding thoughts

As the effects of the economic downturn persist, the banking industry continues to experience change and consolidation. Sharper government scrutiny and stricter regulation are part of the industry's new normal.

Against this backdrop, stress testing and ongoing portfolio reviews are likely to become even more important components of enterprise risk management, especially among smaller community and regional banks that are faced with capital-raising challenges in today's marketplace. While institutions with less than \$10 billion in assets are not yet required to conduct stress tests, managers and boards would be well-advised to incorporate sensitivity scenarios into routine examinations of their operations and also into their corporate governance practices. Given recent changes in collateral value and liquidity, and given the possibility of further market turbulence, every financial institution must take deliberate steps to analyze the risks to its deposits and core lending activities, manage those risks and also evaluate its need for contingency capital. Institutions that take these steps will be best-placed to navigate the changing economic landscape. And the most forward-thinking institutions, unlike their weaker competitors, will be able to capitalize on opportunities to expand.

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