Joint Interagency Statement Clarifies Regulatory Expectations for Stress Testing for Community Banks

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A Statement to Clarify Supervisory Expectations for Stress Testing by Community Banks was issued jointly by the FDIC, FRB, and OCC on May 14, 2012. This statement, while emphasizing the importance of assessing risk under various scenarios for all banks, provided explicit clarification that "… community banks are not required or expected to conduct the enterprise-wide stress tests required of larger organizations under the capital plan rule, the proposed rules implementing Dodd-Frank Act stress testing requirements, or as described in the stress testing guidance for organizations with more than $10 billion in total consolidated assets."

The Statement reiterated that "… all banking organizations, regardless of size, should have the capacity to analyze the potential impact of adverse outcomes on their financial condition." Specific reference was made to existing guidance for three areas of major concern:

<u>Commercial Real Estate (CRE) Concentrations</u>

"Institutions should perform portfolio-level stress tests to quantify the impact of changing economic conditions on asset quality, earnings, and capital. Institutions should consider the sensitivity of portfolio segments with common risk characteristics. The sophistication of stress testing should be consistent with the size, complexity, and risk characteristics of the CRE portfolio." *(Guidance on Concentrations in Commercial Real Estate Lending, December 2006)*

<u>Interest Rate Risk</u>

"All institutions are expected to run … scenarios periodically to fully identify significant positions in the four components of IRR: repricing mismatch, basis risk, yield curve risk, and option risk… Management should establish limits, triggers or thresholds for stress scenarios in order to compare risk measurement results with the institution's risk tolerance."
(Interagency Advisory on Interest Rate Risk Management FAQ, January 2012)

<u>Liquidity and Funding Risk</u>

"Performing extreme shocks to measure IRR should provide useful information for risk management. More extreme stress scenarios can provide important risk management insights about on- and off-balance sheet positions and exposures. Institutions are encouraged to develop robust stress testing scenarios and to adjust scenarios as conditions change. …These systems should include provisions for stress testing an institution's liquidity position under various adverse scenarios." *(Funding and Liquidity Risk Management Interagency Guidance, April 2010)*

In our view this Statement serves an important two-fold purpose: to highlight the importance of stress testing for all banks while mitigating previous concerns that community banks would be expected to demonstrate the same degree of rigor that the largest and most complex institutions have been subject to during recent supervisory stress testing initiatives.

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