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Proposed Guidance on Stress Testing: A Valuable Reminder for All Community Banks

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Although ignorance may be bliss some of the time, community banks with assets under $10 billion are at significant risk if they ignore the June 2011 joint regulatory proposed guidance (and ultimately, the final guidance) on stress testing. Officers and directors of smaller institutions would be hard-pressed to disagree with the proposed guidance's cautionary statement that all banking organizations must have the capacity to understand the potential impact of stress events on their financial condition.

Though specifically directed at institutions with assets in excess of $10 billion, the principles set forth in the proposed guidance will undoubtedly find their way into the work of regional examiners who will look askance at institutions that do not have an adequate stress-testing framework in place. At the end of the day, however, banking organizations should be motivated to review and implement provisions of the guidance not because of the potential supervisory impact, but instead because the guidance sets forth broad principles any organization will find helpful in effectively assessing and addressing risks.

For banking organizations, key takeaways from the proposed guidance that we expect will remain in the final guidance include:

1. Designing the framework. Develop an effective stress-testing framework that is tailored to the bank's specific business activities and risks. One size does not fit all. Banks must use a variety of stress-testing activities and approaches to ensure value in the ultimate stress test results. The framework must be flexible and dynamic, taking into account changing risks.

2. Applying the framework. Banking organizations must apply various stress testing analyses to adequately anticipate risk. These analyses will vary depending on the nature and complexity of the bank, but will typically involve assessing the sensitivity of a bank to (i) stresses (or shocks) associated with changing variables where there is no specific underlying reason; (ii) various events or occurrences that have a logical story as to why they occur, such as loss of a major client or a local economic downturn; (iii) enterprise-wide stresses on the bank as a whole, including the impact of scenarios on capital and liquidity; and (iv) reverse stress testing where a banking organization tries to deduce the types of events that could lead to adverse outcomes.

3. Governance of the framework. Banking organizations must have strong governance and controls over the stress-testing framework to ensure that it works effectively. This framework *cannot* be isolated with a banking organization's risk management function, but instead must be firmly integrated into a bank's business lines, including its capital and asset-liability committees, and ultimately have board-level oversight.

Banking organizations cannot design a single stress test to effectively estimate the variety of events and circumstances that can adversely impact a banking organization, but with an effective framework in place, management can make informed and prudent business decisions that mitigate organizational risk. The proposed guidance is a valuable tool for all banking organizations in achieving that end.

To read the proposed guidance, click here.