

Stress Testing for Community Banks in 2011

LIVE WEBCAST



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Summary

While the financial meltdown was led by the large financial intuitions, community banks suffered mightily from its aftershocks. Community banks are increasingly turning to stress testing so that they can more comprehensively understand their risk & financial health to make it easier to anticipate future problems. While stress testing is a good tool for managing risk, some challenges have arisen such as: should the results be made public? what are the limitations of stress testing, and fears of potential reprisals by regulators to name just a few.

While some sanity and stability has returned to the markets, many risks remain. Your bank needs to be ahead of the curve by having the ability to anticipate risk not simply reacting to it. Stress testing can be an effective tool for this. The Knowledge Group has assembled a key panel of experts to help you make sense of stress testing as it applies to your bank. We'll cover the good, the bad, and the critical points in between.



SEGMENT 3:

Dave C. Cooke
Principal
FinSec Navigator Group LLC

Introduction

David Cooke is a founding principal of the FinSec Navigator Group; a highly qualified advisory group serving financial institutions and their investors. He is a widely recognized expert on financial sector issues with extensive private and public sector experience advising US and foreign banks and governments. From 1989 to 1992, he served as the Executive Director of the former Resolution Trust Corporation (RTC) responsible for the new agency's organization, staffing, and operation. As Executive Director, he oversaw the takeover of nearly 700 failing institutions and the development of innovative sales initiatives for managing and disposing of their assets. Prior to RTC, Cooke was a career FDIC regulator who advanced to become the sole Deputy and key advisor to former FDIC Chairman L. William Seidman where he functioned as chief of staff and directed or served on key management committees.

Community Bank Stress Testing

Presentation by:

**David Cooke, Principal
FinSec Navigator Group, L.L.C.**



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Dave C. Cooke
Principal
FinSec Navigator Group LLC

Stress testing

- Some history
- Balancing costs and benefits
- Community Bank challenges
- Prioritizing and testing
- Managing low probability, high impact risk exposures



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Some History

- Stress Testing for Risk is an Old Idea with New Advocates;
- Long used to assess interest rate risk; and mortgage default risk
- Used in 2003 FDIC study finding high construction lending exposure but low probability ;
- Proposed by regulators in 2006 in response to rising subprime mortgage defaults;
- Inevitable now as risk exposure become more evident:
 - Severe declines in property values, record mortgage defaults & foreclosures
 - Many unprepared bankers and regulators, costly bailouts and failures and many undercapitalized banks



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Stress Testing Becomes Reality as Financial Sector Falters

- Perceptions of Low Probability Risks Become Reality- historic drop in property values, rapid increase in financial sector problems;
- 2009 - Basel Committee recommends supervisors require banks use Stress Tests as integral part of firm-wide management of risks; US Regulators implement Supervisory Capital Assessment Program (SCAP) to measure capital adequacy and restore confidence;
- 2010 - Dodd-Frank Wall Street Reform and Consumer Protection Act requires large banks to regularly stress test capital adequacy under multiple adverse scenarios; and regulators to prescribe details for methodologies, scenarios, publication of results



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Community Banks Should Prepare for Increased Stress Testing Demands

- The level of complexity will be less but all banks should expect to eventually demonstrate survivability in high stress scenarios;
- Expect to document and validate the process; to relate input variables to risk levels; to justify assumptions and scenarios;
- Expect to show management use of results in establishing risk tolerance benchmarks and contingency strategies;
- Expect demands for increased equity capital buffers



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Interagency Stress Testing Guidance

- Use stress testing to help identify, monitoring and manage risk, and develop loss mitigation strategies.
- Perform sensitivity analysis on key portfolio segments to identify and quantify risks in a segment or the entire portfolio;
- Test assuming rapid deterioration in key performance drivers beyond the institution's immediate control.
- Estimate the potential influence on default rates and loss severity.
- Provide direct feedback in determining underwriting standards, product terms, portfolio concentration limits, and capital levels.



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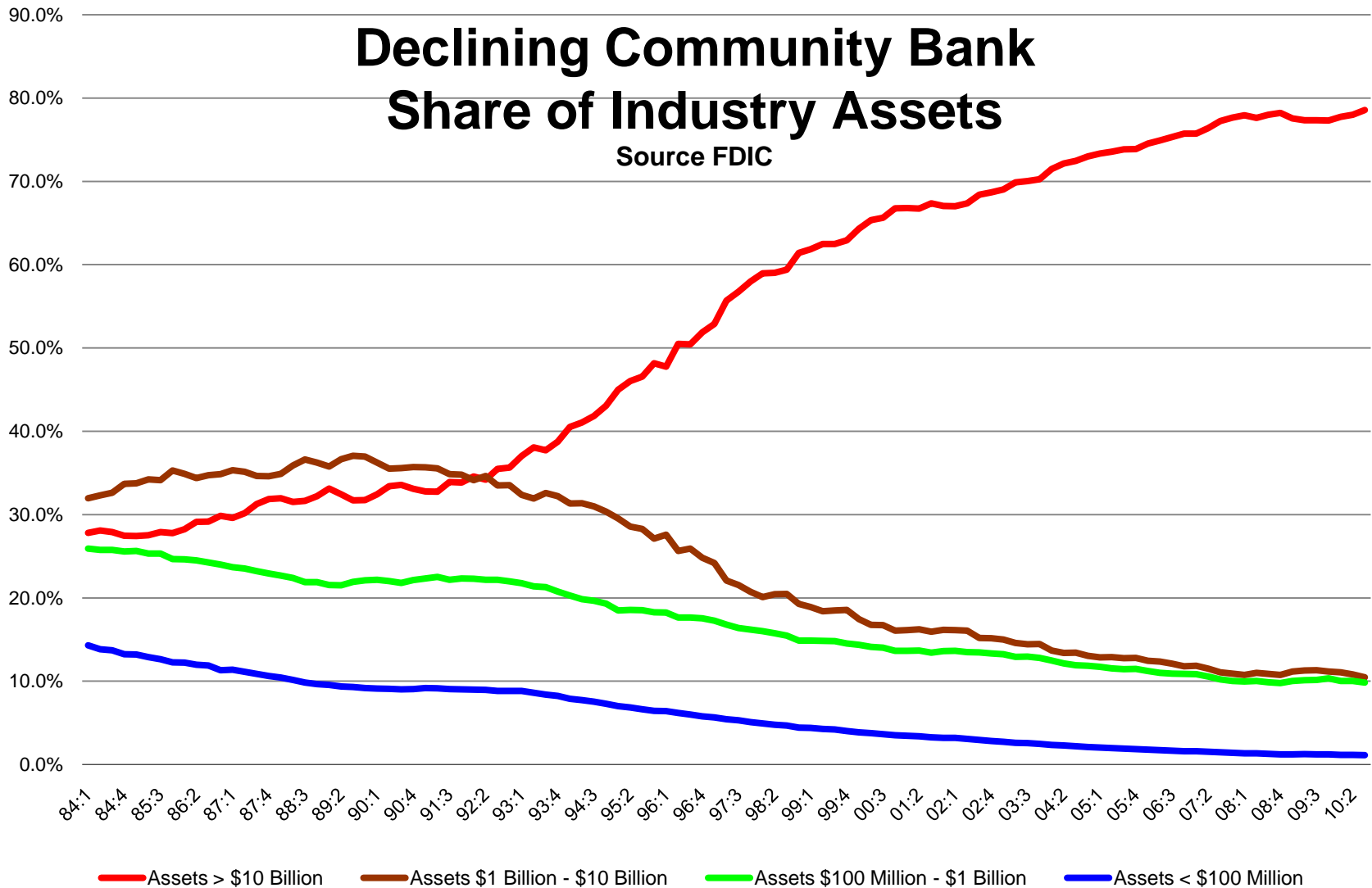
Dave C. Cooke
Principal
FinSec Navigator Group LLC

Community Banks Face Difficult Risk Mitigation Challenges

- Much increased competition for best community bank customers;
 - Declining asset and retail customer share;
- Much more limited product and customer diversification opportunities;
 - Heavy reliance on small local borrowers;
 - Increased reliance on risky real estate loans;
- Much less likely to have internal stress testing resources and skills;
- Limited access to new capital;

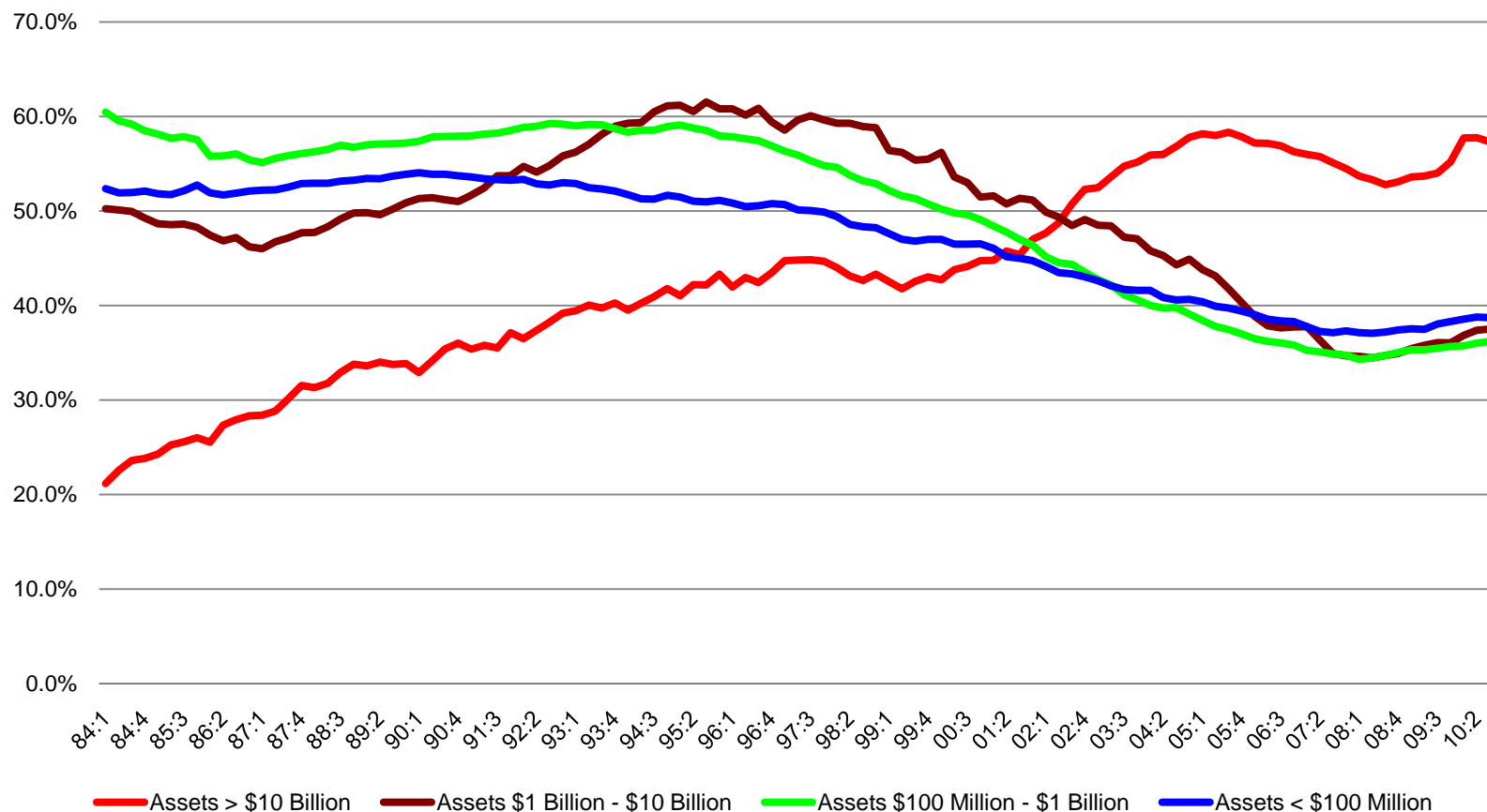
Declining Community Bank Share of Industry Assets

Source FDIC



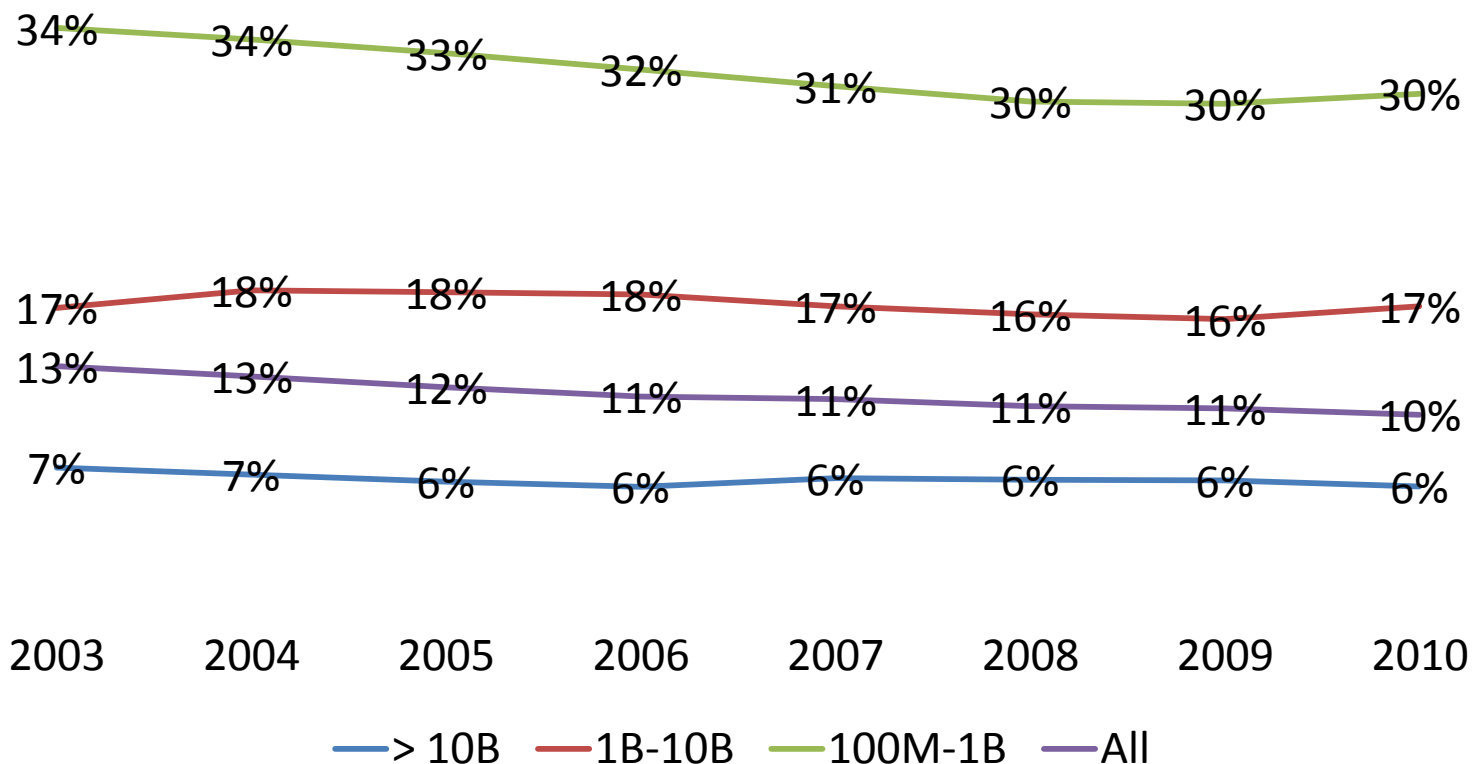
Declining Community Bank Percent Retail Loans To Total Loans

Source FDIC



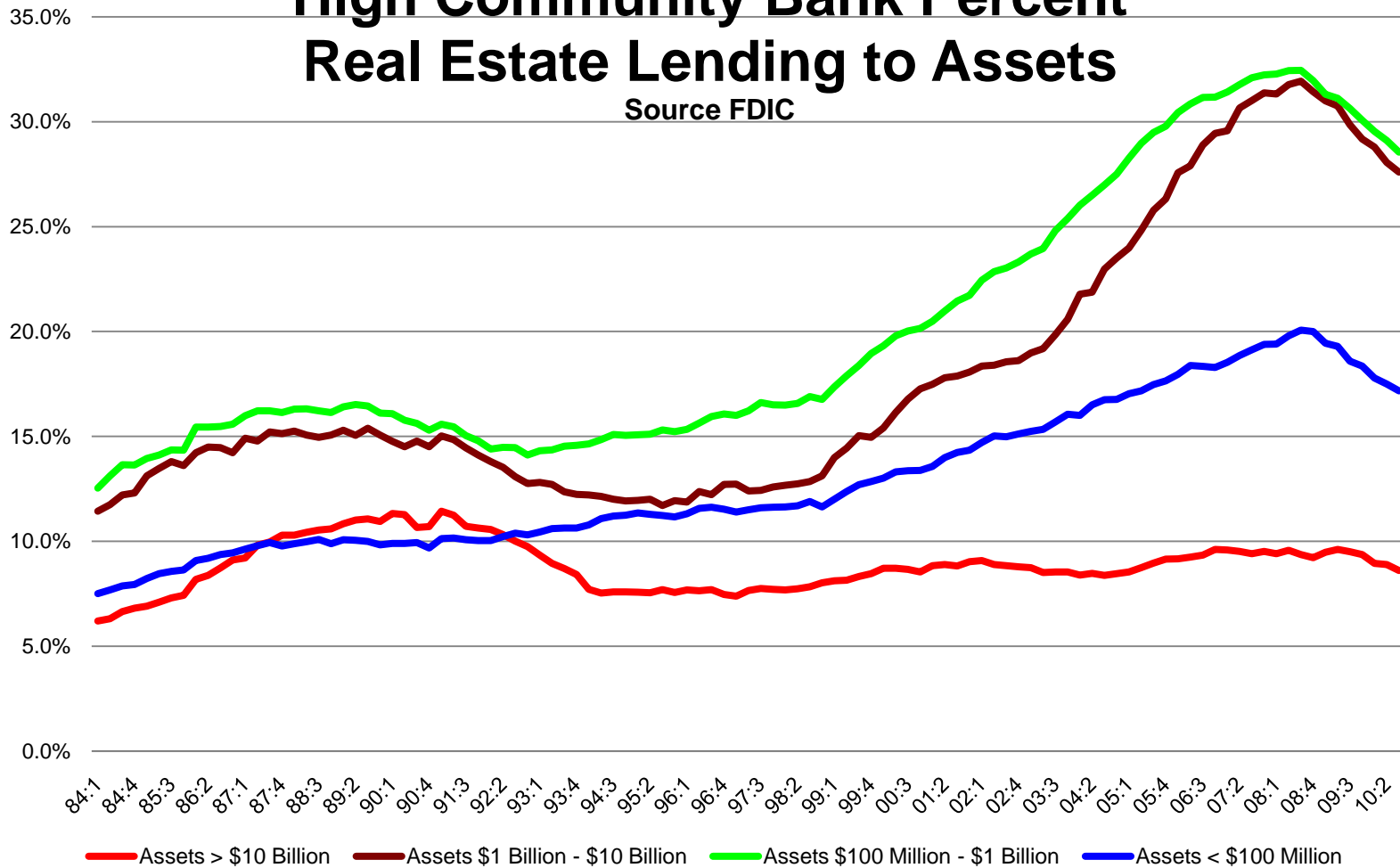
High Community Bank Percent Small Business Loans to Total Loans

Source UBPR



High Community Bank Percent Real Estate Lending to Assets

Source FDIC





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Stress Testing Does Offer Benefits But Can Become A Burden

- Can benefit risk quantification and mitigation strategies for many areas of exposure – Credit, Liquidity, Funding, Interest Rates, Operations, Counterparty and foreign currency;
- But, costs can exceed benefits if:
 - Scenarios and drivers lack credibility and usability;
 - Complexity increases costs and reduces understanding;
- Ensuring benefits do not exceed costs requires active Board and management participation in development



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Managing Those Low Probability, High Impact Risks

- Few banks can prepare for low probability, worst case scenarios – especially when competitors aren't
- History shows there are almost always early warning signs in increasing probability;
- Important to identify & monitor signs closely;
- Resist temptation to ignore any unfavorable signs but estimate impact on probability and size of impact;
- Establish tolerance benchmarks for risk probability;
- Be prepared to implement contingency action plans to mitigate risks



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Prioritizing what to stress & how to do it

- Keep process as simple as possible & involve management in design and review
- Focus first on highest risk exposures;
- Agree on high impact events for each exposure e.g. higher loan default rates & lower recovery rates;
- Identify key internal & external drivers; relevant data sources; linkages to losses and probability;
- Establish risk tolerance thresholds for probabilities of high stress scenarios; develop contingency plans;
- Repeat and validate



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