More Than Checking a Box – The Value of Loan & Capital Stress Testing

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Community banks and middle-market financial institutions should have a well-documented loan and capital stress test available for their regulators.

It is important for community banks and middle-market financial institutions to continually manage their risk and be well prepared for their next regulatory exam. Part of these activities includes having a comprehensive, well-documented loan and capital stress test available to provide to their regulator. Regulators have shown increased interest in viewing stress testing results due to concerns over a potential economic slowdown, the recent decline in commercial real estate values, and concerns over potentially increasing losses in certain loan portfolios.

The Value of Stress Testing

Loan and capital stress testing provides valuable information to financial institutions by forecasting if capital shortfalls arise due to increased losses during multiple stress scenarios. Results often utilize the loss forecasting methodologies from CECL models, which are then incorporated into capital planning forecasts. Loan and capital stress testing helps financial institutions prepare for and quantify the potential capital shortfalls resulting from a period of increased losses during economic downturns.

The complexity of loan and capital stress tests can vary from a limited high-level internal stress test to detailed portfolio-based or loan-level stress testing. The ability to perform detailed modeling needed for stress testing is dependent on the information available that dictates how best to stress the selected portfolio/loans, including collateral values, debt service coverage ratios, occupancy rates, unemployment rates, GDP growth, etc.

Regulatory Capital Ratios & Testing 1-2-3

Reduced to its simplest level, the stress-testing process is about estimating the impact of realistic yet dramatic increases in loan losses on the capital position of the financial institution. Regulatory capital ratio thresholds from the FDIC's Prompt Corrective Action and Basel III Final Rule (which includes a 2.50% capital conservation buffer) are as follows:

Regulatory Ratios	Well-Capitalized Requirement	Capital Conservation Buffer	Basel III Final Rule	FDIC PCA
Tier 1 Leverage Ratio			4.00%	5.00%
CET 1 Ratio	4.50% +	2.50% =	7.00%	6.50%
Tier 1 Risk-Based Capital Ratio	6.00% +	2.50% =	8.50%	8.00%
Total Risk-Based Capital Ratio	8.00% +	2.50% =	10.50%	10.00%

Financial institutions should include the following steps in their loan and capital testing protocols:

- Make a two-year forecast of expected earnings and loan loss estimates (base case).
- Select a custom peer group for comparison purposes.
- Examine the current loan portfolio and asset quality trends.
- Select loss rates and run stressed scenarios.
- Decide if loan-level stress testing is necessary.
- Project deposit and loan balances in stressed scenarios and their impact to earnings.
- Review resulting capital ratios and any capital shortfalls.
- Provide capital contingency plans to address any capital shortfalls.

It is important that loss rates represent an adequately severe test of the financial institution's capital and can be based on the financial institution's loss history, projected losses (CECL), the custom peer group, or national/state loss rates from over the last 15-plus years. The resulting severe stress scenarios can match or even exceed the loss rates incurred during the Great Recession.

Achieving Business Value From the Stress-Testing Process

A stress-testing process that is "rightsized" to the organization, simplified, focused, and properly utilized helps provide value to the financial institution. The board and management teams can gain greater insight, better planning, and a deeper understanding of the interrelationship between the financial institution's loan portfolio and the capital resources necessary to support it. Financial institutions gain the most benefit from loan and capital stress testing when the results are incorporated and layered into the overall risk management and strategic planning processes.

As you prepare for 2024, performing a loan and capital stress test can help satisfy some regulatory concerns given the current challenging and uncertain economic conditions and also help financial institutions have enough capital in a stressed environment of increased loan losses.

If you have any questions or need assistance, please reach out to a professional at **FORVIS**.