

# “CRE Stress Testing” – What is it all about? Will it prevent another 1933 style “Bank Holiday?”



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## What is it all about?

In the fall of 2009, the Federal Reserve put the nation's top 19 financial institutions through a series of economic and credit stress tests known as the "SCAP" - Supervisory Capital Allocation Program. These so-called stress tests followed the collapse of Lehman and onset of the Financial Crisis to try and create a firewall to an advancing financial crisis. Yours truly was engaged in these stress tests as the CRE Risk Specialty Officer to the New York Federal Reserve, and I have been teaching "CRE Stress Testing" to bank examiners in advance of what will become an annual event for both U.S. and European banks.

Stress tests, and the results, will become as common to banks and their depositors in the years ahead as the FDIC insurance logo became to banks and depositors after the Great Depression. Stress tests will become the modern-day symbol that a financial institution is "well-capitalized." Without a passing grade, a bank will likely find it difficult to attract capital for expansion, and its lending activities will be constrained. Further, the stress tests will not be something unique to just U.S. banks. In the spring of 2010, Europe embarked on a much broader and more comprehensive stress testing exercise of 91 banks in 20 countries – compared to just 19 banks in the U.S. Subsequently, both the U.S. and Europe have put banks through a second round of stress tests in the past 6 months.

In December of last year, U.S. banks submitted what were known as "capital plans" to update the results of the original 2009 SCAP. All but one bank of the original 19 institutions was deemed "well-capitalized" and cleared to increase its dividend. The one exception was Bank of America. As a result, the 20 largest U.S. banks have been drawing down their allowance for loan and lease losses (ALLL) reserves into earnings to pay higher dividends. It has been an egregious draining of the TARP money out of the banks while the housing mess and mortgage crisis have worsened. Just reflect on the results of the Q2 bank earnings from the likes of Bank of America. It has been hard to understand how the December 2010 updated U.S. bank stress tests could justify such a release of ALLL, and it calls into question the integrity of these subsequent stress tests in the U.S.

In Europe, the results of the latest stress tests indicate that:

- i. A total of eight banks "failed" or fell below the capital threshold of 5%, with an overall shortfall of EUR 2.5 billion or \$3.5 USD.
- ii. As many as 16 more European banks will need to bolster capital as their core Tier 1 ratio dropped below 6% – just above the assessment's 5% pass-mark; and
- iii. The failing banks were located mostly in Spain (5 banks) and Greece (2). Australia had one bank not hurdle the 5% core Tier 1 capital ratio.
- iv. Europe is considering a TARP-like program that would inject as much as one trillion Euros to insure deposits in all E.U. banks, except those in Greece, Portugal and Ireland. The intention is to create a firewall to contain the spread of the sovereign debt crisis, much like the U.S. did with TARP, and make the bailout palatable to Germany, who has opposed more support for Greece.

As a result of the continuing sovereign debt crisis in Europe and the U.S., we will see stress testing expand globally to all central banks. Central bankers around the globe want to know more about how the debt crises in Europe and the U.S. impacts their own economies and banking systems.

Advancing from the genesis of bank stress testing to what is involved in these economic and credit assessments, the best starting point is with the objectives. Essentially, what a stress test does is assess the impact of movements in relevant economic variables (GDP, unemployment, home prices, etc.) on the liquidity and credit quality of a bank's assets. And, in turn, the impact on a bank's capital position can be measured to determine if it holds sufficient capital to weather a storm. This process relies upon one huge assumption – that the banks are able to provide sufficient line-of-business and loan-level detail to subject the bank's assets to sensitivity analysis. As you will read a little later in this article, this assumption is the "dirty little secret" among the regulators about the banks.

### **The quality and quantity of data to conduct stress testing is atrocious.**

Before we dissect the stress testing process, though, let's start with answering the question:

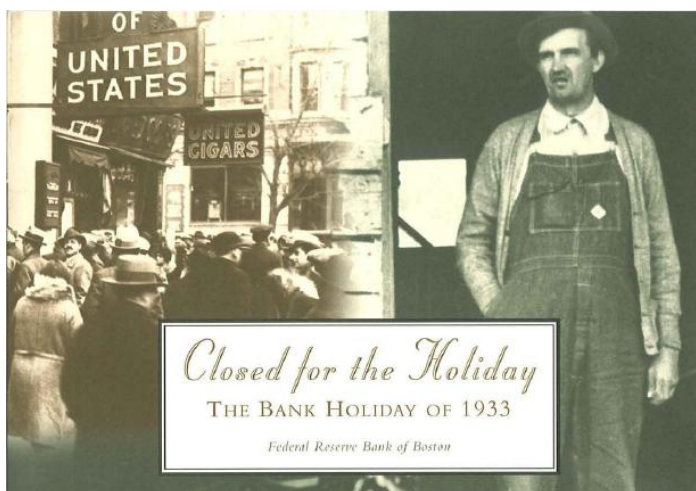
### **Why do we have stress tests today, and what is really the objective behind them?**

The objectives of stress testing to date, and going forward, are threefold:

- **Psychological:** The stress tests were created primarily to calm the markets and convince the public that more Lehman-type failures were not looming, nor is another 1933-style banking crisis.
- **Equalizing:** Prior to the SCAP, the U.S. and European banks had never been analyzed across a myriad of metrics simultaneously under a uniform set of economic scenarios. The stress tests were designed to correct this regulatory failing and provide a sort of “Polaroid” photograph of the largest financial institutions at the same time under a uniform set of economic and credit scenarios.
- **Corrective:** Finally, the stress tests were designed to identify how much capital a large financial institution might need if the U.S. or Europe remained in recession over a protracted period of time - and to then inject that capital to create the firewall needed to halt an advancing financial crisis.

The logical next question, then, is: **Did the stress tests to date succeed at meeting their objectives?**

From a macro level perspective, the answer is yes. From the most basic of perspectives, the U.S. did not have to weather another 1933-style bank holiday - or images like the following from the Great Depression.



The market rebounded on the news, and banks have not been closed or failed at anywhere near the pace of the contraction between 1930 and 1933 - or the S&L crisis of the late 1980s and early 1990s. A comparison of bank failures in the 4 years after the 1929 stock market collapse and the 3 years since the Lehman failure and onset of our modern-day financial crisis is noteworthy.

## Bank Performance 1930-1933

Source: Federal Reserve Bank of Boston

	National Banks	State Banks		Total Banks	
		Federal Reserve Member Bank	Nonmember Bank		Total State Banks
1930	28,828	18,521	16,776	35,297	64,125
1931	27,430	17,406	14,181	31,587	59,017
1932	22,318	13,538	10,448	23,986	46,304
1933	20,813	12,226	7,412	19,638	40,451

## US Bank Failures: 1934-July 2011

Source: FDIC

Decade:	# of Failed banks	High/Year	Low/Year
1934-1940	312	75 / 1937	9 / 1934
1940-1950	99	43 / 1940	1 / 1946
1950-1960	28	5 / 1955	2 / 1951
1960-1970	44	9 / 1969	1 / 1962
1970-1980	79	17 / 1976	2 / 1972
1980-1990	2,036	534 / 1989	22 / 1980
1990-2000	925	382 / 1990	1 / 1997
2000-2010	202	140 / 2009	0 / 2005 & '06
2010	157		
2011 (Jan-July)	55		

Key Note: 23,674 banks closed 1930-1933 compared with just 3,625 bank failures 1934 thru July 2011.

The resulting question is:

**Do we have fewer bank failures today as a result of stress testing, or are the stress tests masking the true underlying problems in our banking system?**

The answer to the question lies in a deeper understanding of what is going on behind the scenes in the banks and with the regulatory process. Many would be surprised to learn how poorly equipped the IT systems in banks are to conduct robust stress testing. A majority of U.S. banks still struggle to aggregate their loans for each line of business in an electronic manner so they can conduct sensitivity analyses by geography or MSA, and loan-by-loan. During the 2009 SCAP, it was a torturous process to collect line-of-business and loan level information from banks for the purpose of conducting consistent stress testing among the 19 largest U.S. banks.

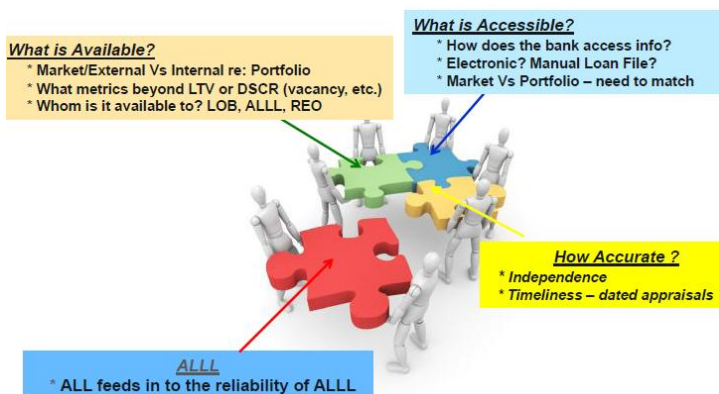
**It was a sausage-making exercise, and the resulting conclusions were a “S.W.A.G.” – Scientific Wild “bleep”Guess.**

It is a common misconception that the regulatory community knows all that is going on in a bank because of its routine

on-site exams; or that the banks provide granular data on their loans and operations through what are known as “Call Reports.” The regulatory community did an atrocious job of monitoring the banks in the decade leading up to this financial crisis. They allowed CRE concentrations, for example, to explode without appropriate enhancements to risk management practices or additions to capital. And, they failed to assess bank’s IT systems to ensure banks were capable of conducting line-of-business and loan-level sensitivity analysis in an electronic versus manual platform. As a consequence of this regulatory failing, and the data deficiencies highlighted in the original SCAP, an interagency data collection effort was initiated in 2010 to assess bank’s capabilities for providing more granular and consistent loan level information for the purpose of conducting future stress tests. It was an eye-opening experience for the Board of Governors and heads of the OCC and FDIC to realize how little information the bank “Call Reports” provide to conduct stress tests - and how much of a manual process it remains in banks - to capture basic information needed to calculate PDs (Probability of Default) and LGDs (Loss Given a Default). The absence of sensitivity analysis conducted by banks at loan origination, and subsequently during the life of the loan, is shockingly poor.

As I teach “CRE Stress Testing” today to bank examiners and bankers, I remind them that stress testing is really all about determining the adequacy of bank capital. Stress testing, aka sensitivity analysis, should be a systemic component of a bank’s risk management practices, and not a regulatory mandate. I also remind bankers and regulatory examiners that the process does not need to be complicated or expensive. I describe the process to banks and regulatory examiners as the “AAA” - Availability, Accessibility, and Accuracy - approach to stress testing – not complicated or expensive! And, I outline the process using the following graphic:

**“CRE Stress Testing to Keep the Regulator at Bay”**



Source: K.C. Conway, MAI, CRE – Colliers International

Stress Testing starts with an assessment of the availability, accessibility and accuracy of information. It then involves identification of the resources within the bank that have the skill and independence to assemble and analyze the information, and to make a forward looking judgment about the adequacy of a bank’s capital to withstand market volatility. The key to the whole process is familiarity with what information is available, how it is accessible and if it’s accurate (i.e., timely and independent).

**The process can be as simple as identifying the 20 largest loans in the bank that account for 100 percent of the bank’s Tier 1 capital and subjecting just them to a series of sensitivity analyses.**

It can be as easy as requiring a sensitivity analysis at the end of an externally prepared appraisal of the two or three most influential variables in an asset’s valuation, and then electronically capturing them into the ALLL forecast process. **In other words, stress testing should be mostly about common sense and prudent banking practices**, but it has become cover for the regulatory regime to diffuse their failings for a decade leading up to the financial crisis, and justification for paralyzing regulation.

**Conclusion:**

The genesis of bank stress testing was the SCAP, following Lehman’s collapse and the onset of the financial crisis, to assure the public that another 1930-1933 style banking crisis was not imminent. Subsequently, it has been adopted by Europe to create a firewall to its worsening sovereign debt crisis. The U.S. has announced that it will expand stress testing to all U.S. banks over \$50 billion in size, on an annual basis, as part of its systemic risk mandate emanating from the Dodd-Frank legislation. The objectives of the stress tests have been mostly psychological (to calm the market) to date.

Because of the burgeoning sovereign debt problems in Europe and the U.S., bank stress tests, and their results, will become as common to banks and their depositors in the years ahead as the FDIC insurance logo became to banks and depositors after the Great Depression.

**Stress tests will become the modern-day symbol that a financial institution is “well-capitalized.”**

Without a passing grade, a bank will likely find it difficult to attract capital for expansion, and its lending activities will be constrained. All we need now is a logo to display in bank windows, adjacent to “FDIC Insured,” that says:

**“Stress Tested with a Well-Capitalized Rating”**