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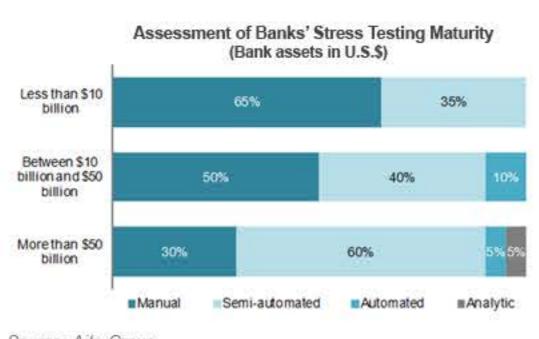
A new wave of regulation has hordes of bankers searching for software Wednesday, August 21, 2013, By Katherine Heires

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Stress testing is not just for the giant, systemically important financial institutions. Formal stress test exercises and subsequent assessments of risks in the loan portfolio are likewise on the agenda for \$3.2 billion-in-assets Opus Bank in Irvine, Calif. It spent two months earlier this year considering its technology options.

"The challenge in selecting a stress testing platform is not insignificant," says Michael Allison, copresident of the 31-year-old commercial bank serving California's Orange County.

After reviewing four platforms, the bank chose the Evolv stress test and scenario analysis offering of McLean, Va.-based Primatics Financial. The system was readily integrated with the bank's accounting software from the same vendor.



Allison says that for banks in Opus' under-\$10 billion asset category as well as those between \$10 billion and \$50 billion, the process of determining needs, selecting appropriate technology and then capturing all of the risk and finance data needed for a truly comprehensive stress test or capital adequacy assessment is not easy. That reality is hitting home at hundreds of mid-size and smaller banks facing regulatory requirements stemming from the Dodd-Frank Wall Street Reform and

Source: Aite Group

Consumer Protection Act of 2010.

Sections 165 and 166 of the law require annual stress tests to be self-administered by March 2014 at bank holding companies, state-chartered Federal Reserve member banks and savings and loan companies with \$10 billion to \$50 billion in assets. As a result, many institutions have been upgrading or assessing and purchasing new technology to facilitate stress tests.

The Basel III capital requirements have also brought greater focus on the issue, and late last year the Office of the Comptroller of the Currency issued a bulletin calling for national banks and federal savings institutions under its jurisdiction — including those below \$10 billion in assets — to perform stress tests at least annually.

The biggest banks have experience with the new stress testing regime, and they were able to call upon significant IT resources. But now, "all banking organizations, regardless of size, will be expected to have the capacity to analyze the potential impact of adverse outcomes on their financial condition, with particular focus on interest rate risk management, commercial real estate concentrations and funding and liquidity management," says Thomas Killian, a principal of investment bank Sandler O'Neill & Partners in New York.

"The \$10 billion to \$50 billion banks are really feeling heat" to upgrade their stress test capabilities and meet the Fed deadline, says John Lankenau, vice president of product management at Primatics Financial.

Regulations Get Attention

Regulatory pressure is certainly a driver. In the recently published eighth edition of its Global Risk Management Survey, citing a survey conducted late last year, Deloitte Touche Tohmatsu found that the most common uses of stress tests were for regulatory compliance: 86% of the Deloitte global sample used them to assess capital adequacy and 84% to respond to regulators' inquiries.

However, stress testing was also being put to strategic uses -- 80% for forward-looking risk assessment, 70% to inform risk-tolerance settings and 66% for capital and liquidity planning -- though more likely by larger institutions than smaller ones.

As C. Eric Larson and David Samuels, managing directors of Washington, D.C.-based consulting firm Promontory Financial Group, have written, "Regulators around the world are now strongly advocating the integration of bank-run stress testing into a wider set of bank decisions beyond capital adequacy and capital planning:" risk governance, risk management, risk-based decision-making and risk-driven planning.

For "Collaborative Risk Management," a report published in October 2012, London-based Chartis Research surveyed a geographically diverse group of 137 risk professionals. Asked to rate their 2012-'13 enterprise risk management priorities on a scale of 1 (lowest) to 5 (highest), stress testing and scenario analysis got the top score, exceeding 3.65. That was .10 to .20 points ahead of the next two priorities, improved capital management and risk management training and awareness.

Boston-based research firm Aite Group projects that the global market for stress testing platforms will grow from \$30 million revenue in 2013 to \$79 million in 2016, as the requirements become broader, more frequent and more complex.

"The market for stress testing and related technology is there and will be strong as long as we continue to have restructuring of the financial markets," notes Sinan Baskan, vice president of capital markets and global banking at software company SAP, which is active in this field.

Aite senior analyst David O'Connell points out that few if any of the available technology platforms were built from the ground up specifically for stress testing purposes. The offerings tend to be add-ons to existing analytical tools. Their newness adds to the difficulty of the selection process.

"It's the Wild West out there" for stress testing solutions, says O'Connell, who issued a report in June on stress testing basics and plans to put out a vendor comparison in September.

Vendors Step Up

Among the system providers vying for mid-tier and smaller banks' business are CRIF, Experian, Fiserv, IBM, Oracle Financial Services, Moody's Analytics, Numerix, Primatics Financial, Sageworks, S&P Capital IQ, SAP, SAS Institute and SunGard Data Services. The major consulting firms and other advisers are also in the mix.

On the most basic level, the forward-looking, risk-focused stress testing process involves three types of scenarios: baseline, adverse and severely adverse. Some are crafted by the Federal Reserve, and some by the banks themselves.

The purpose of the exercise is to test the health and viability of a bank's assets under normal, recessionary and crisis conditions, and to enable accurate estimations of capital adequacy under the respective sets of economic assumptions.

Analysts say regulators will also want to see if a given bank has sufficient monitoring capabilities for its own, unique risk profile.

According to Til Schuermann, a leading stress testing expert and a partner in Oliver Wyman Group's financial services practice, a major challenge — especially for banks below the top tier — will be the need to gather data from disparate parts of the enterprise that regulators think should live under one roof but, in reality, rarely do. "It's going to be a big headache for the smaller banks when they do a stress test for

the first one or two times." Schuermann asserts.

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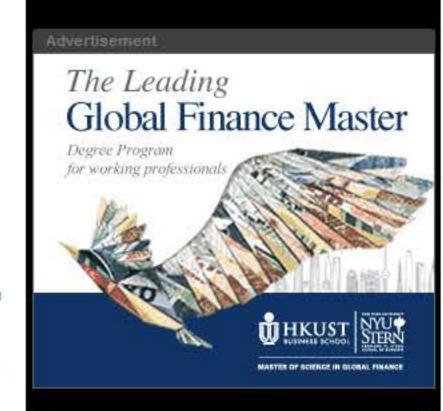
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Long- and Short-Term Goals

O'Connell at Aite Group says that before choosing a system, banks need to understand their objective. Do they simply want to check off the regulatory-compliance boxes in the first round of regulatory stress tests and delay significant technology upgrades? Or should they buy new technology now to significantly improve both stress testing capabilities and risk management overall?

Whitepapers

"Banks that are able to automate stress testing will be better at identifying and assessing the risks in their business models and devising contingency plans," O'Connell says.

His suggestion is to "plan for the worst" in the first round in terms of stress test complexity, keeping in mind that the regulatory burden is only going to increase and will eventually include ad hoc tests. "Being able to automate stress test processes achieves speed and can improve control of processes dramatically, something that the regulators will be focused on," O'Connell adds.

Schuermann, however, believes regulatory expectations for mid-tier and smaller banks' stress tests are likely to be lower than those for designated systemically important institutions. For the former, therefore, vendor solutions promise to keep technology costs under control.

To Dilip Krishna, a director in Deloitte's governance and risk strategies practice, there is no single solution that will meet all stress testing needs.

Stress testing is "a process that deals with 100 components and various models, with any one technology platform addressing only a portion of the many components," says Krishna. He says key questions for any vendor would include: What part of the testing process does a given system address? How well does the platform integrate with data systems? And how responsive is the platform to changes in regulatory guidelines and data sources?

Array of Technologies

According to Aite, relevant technology to assist in the automation and streamlining of stress testing includes database tools and analytics that pertain to business intelligence, budgeting, forecasting, reporting and predictive analysis. While core banking systems and loan origination systems can play a part, they lack the granularity of reporting and analysis that purpose-built analytics can provide and that regulators will require.

Technology providers' approaches and capabilities vary.

Tom Kimner, head of the SAS Americas risk practice, says his firm is in the process of bundling a hosted, stress testing program for small and medium-sized banks. For those that want to run more complex simulations and "what if" stress testing scenarios, the IT investment can be onerous, so an outsourced or hosted alternative "can be an attractive proposition."

SAS can also help with data visualization of stress test analytics, giving bank executives, and in turn regulators, a clear view of portfolio performance.

Baskin says that many of the 30 to 40 biggest banks are already using technology from his company. SAP, notably database and analysis products. He believes there is a market for them in mid-size banks. For stress testing purposes, he highlights the properties of the SAP HANA platform, noted for its in-memory technology that can hold vast amounts of data and conduct complex computations, contributing to real-time analysis of stress testing results and more precise risk calculations.

Related Strengths

Lankenau of Primatics Financial says his company is "a loan shop" that has deep knowledge of bank loan structure and the interaction between valuation or credit units and finance or accounting departments. Primatics got its start doing loan accounting for bank acquisitions, "which required integration of the valuation and accounting view of the world," says Lankenau, and he is confident that the Evolv stress testing platform can be effective where that expertise is key.

While the Federal Reserve's expectations for the biggest banks have gotten more robust, Lankenau says. Primatics has built out its accounting forecasting capabilities - an area where banks of all sizes will see a lot of regulatory change and heightened standards.

Rohit Verma, senior director of product management and strategy at Oracle Financial Services, says the organization has an enterprise stress testing and capital planning product up and running, designed specifically for stress test reporting and analysis. It provides comprehensive coverage across risk and finance and enables institutions to build a stress view of income and balance sheets. "The application provides pre-built regulatory templates required for submission to U.S. regulators," Verma says.

As to any differentiating stress test features, Verma points to Oracle's ability to provide a common infrastructure and data model for managing input data, establishing a consistent framework for periodic testing across data categories and providing one version of "truth" throughout the enterprise.

Verma emphasizes that flexibility is essential in the face of rapid regulatory changes. "Institutions need to plan for rapid changes to scope, scenarios, methods and reporting templates required for addressing stress testing requirements," he says.

Human Element

"At the end of the day, bank managers need to know their local markets and what factors are driving interest rate risk and credit risk," says Sandler O'Neill analyst Killian. He warns that with the reliance on sophisticated models, one can lose sight of the four or five factors that are key drivers of a given bank's profitability.

"A question one has to ask," says Oliver Wyman's Schuermann, is "how do you prevent the model on/brain off syndrome, or overreliance on modeling" -- or where a bank official is unable to explain to regulators how a stress testing solution works. Schuermann says it behooves the mid-tier and smaller banks to insist on transparency from their vendors as to how their stress tests work.

Allison of Opus Bank offers the following advice to his peers: Ask to what degree a stress test offering is relevant to the size of your institution. How applicable is the platform to the market your bank services, and how dependent is it on data content available from the institution? Can the platform align to your systems so that it can drive model results, or not? How robust is the data you will need from the institution to run models, and how flexible are those models to change?

Other questions: If consulting and training services are required to utilize a particular platform, how long will it take for the bank to transition itself to self-management of the technology? (Opus Bank's agreement with Primatics included provision of an in-house staff training program, with the goal of eventually running the system on its own.)

Verma of Oracle suggests that the smaller banks ask data-related questions such as: Is the stress testing system capable of taking data from multiple sources and in multiple formats - files, spreadsheets and manual inputs? Does the system provide for traceability back to source systems? Can the system handle data for multiple scenarios? If a bank does not have all the data it needs for a comprehensive stress test, to what degree can the technology provider assist?

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