

Stress Testing and Technology Stress

A new wave of regulation has hordes of bankers searching for software

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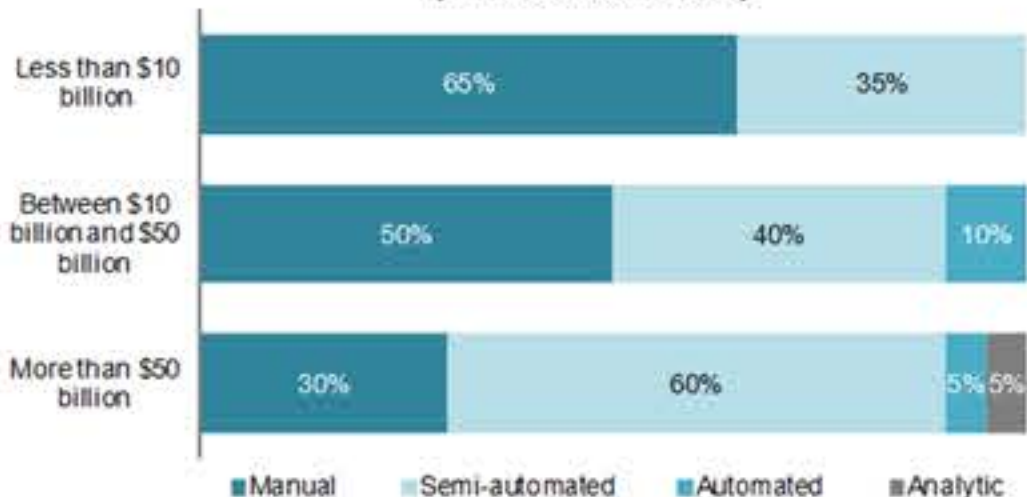
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Stress testing is not just for the giant, systemically important financial institutions. Formal stress test exercises and subsequent assessments of risks in the loan portfolio are likewise on the agenda for \$3.2 billion-in-assets Opus Bank in Irvine, 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, co-president 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.

Assessment of Banks' Stress Testing Maturity
(Bank assets in U.S.\$)



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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