February 2014

# Regulatory brief

A publication of PwC's financial services regulatory practice

## *Stress testing: First at bat for midsized firms*

### Overview

With continued contraction of net interest margins and stabilization of credit losses over the past year, midsized firms (i.e., those with $10-50 billion in assets) are turning their attention to deploying capital in the M&A market to bolster their bottom line. Concurrently, this quarter of 2014 marks the beginning of a new season of Dodd-Frank Act Stress Testing ("DFAST") for banks and bank holding companies ("BHCs") that will likely influence firms' capital deployment decisions.

While the largest and most complex firms face a raised stress testing bar in 2014,[1] midsized firms face the challenge of performing their annual company-run stress tests for the first time. Although banking regulators have stated that they will view these initial DFAST submissions as works in progress,[2] they have also issued clear guidance on what these submissions must comprise.[3] While midsized firms are not required to publicly disclose their 2014 stress testing results,[4] they will need to demonstrate best efforts toward compliance. Particularly, looking forward to their 2015 submissions, firms must provide an analysis of stress testing process enhancements to be completed during 2014 as part of their March 2014 submissions.

In preparation for their first DFAST submissions, midsized firms are focused on plans to enhance their stress testing processes, and on completing capital stress testing efforts and compiling required supporting documents. To that end, resources must be optimally allocated to timely complete the DFAST package for internal approval (by senior management and the board of directors) and submission to the regulators.

This **Financial Services Regulatory Brief** provides an overview of DFAST 2014's qualitative documentation requirements (including process enhancement plans), and our view on what midsized firms must do to meet evolving regulatory expectations regarding (a) assessing capital adequacy, (b) utilizing stress testing as a risk management tool, and (c) addressing internal controls.

---

[1] See PwC's *Financial Services Regulatory Brief, Stress Testing: Failures on the Horizon?* (November 2013).

[2] See PwC's *Financial Services Regulatory Brief, Stress Testing: Getting to credibility – Firms between $10 and $50 billion* (August 2013).

[3] See *the Office of the Comptroller of the Currency, Policy Statement on the Principles for Development and Distribution of Annual Stress Test Scenarios* (November 2013).

[4] Public disclosure of stress test results for midsized firms will be required starting in 2015.

## Qualitative documentation and enhancement plans

While the completion and accuracy checking of stress testing templates may be a task unto itself, the required qualitative supporting documentation, outlining the firm's capital planning and stress testing processes, will be equally formidable. These documents are, in essence, supporting work papers to the quantitative stress test templates and evidence the credibility of the tests. Furthermore, these documents should demonstrate the efficacy of the firm's internal processes, particularly (i) governance framework covering the roles of directors and senior management, (ii) application of stress testing as a tool for risk management and capital adequacy assessment, (iii) model governance, and (iv) stress test scenario design processes including the consideration of idiosyncratic risks.

As we have seen with larger firms, inadequately documented processes tend to raise more questions from the regulators, which then require further action and allocation of resources by firms. A well-structured and cohesive submission will provide supervisors with sufficient upfront information and will reduce the length of on-site examinations. Therefore, it is important that process documentation give supervisors a comprehensive and transparent view of the firm's internal processes, and the consistency of stress testing throughout the firm. Given that banking supervisors have already performed "pre-implementation" reviews of firms' DFAST processes and provided their observations on the quality of stress tests and supporting documentation, it is our view that these reviews will be important to the regulators' views on firms' planned capital deployment actions (e.g., acquisitions).

Firms must also consider the level of detail in their 2014 process enhancement plans. These documents are required as part of the 2014 DFAST submissions and must describe firms' plans to enhance their stress testing and capital planning processes during 2014, in preparation for future testing cycles. Given that regulators are considering DFAST stress testing as a work in progress, firms will need to submit clear process enhancement plans that address timing, prioritization, and materiality of modeled risks. Again, a less than effective gap remediation plan raises more questions for banking supervisors leading to adverse consequences, including substantive "matters requiring attention" within examination reports and downgrades in supervisory ratings.

Overall, DFAST documentation requirements for midsized firms can be successfully met with the right amount of attention to detail and planning. However, the March submission deadline is approaching quickly, and banks should be prioritizing completing compliance efforts now to ensure a timely internal review of the results prior to their submission to the regulators.

## Strengthening processes to meet evolving expectations

As the DFAST supervisory expectations for midsized firms were only recently finalized, those firms that had awaited the final guidance or require a significant build-out of their stress testing and capital planning processes will need to provide regulators with a clear perspective on existing shortcomings that is supported by detailed remedial action plans. Other firms that commenced implementation plans earlier or have baseline processes in place are better positioned and should further enhance their existing practices during 2014, particularly as related to (a) assessing capital adequacy, (b) utilizing stress testing as a risk management tool, and (c) increasing the effectiveness of internal controls. Most of these firms are also considering enhancements that represent the next evolution of stress testing for midsized firms, e.g., more advanced credit models and stronger data capture processes.

### *Assessing capital adequacy*

With the heightened regulatory attention to risk appetite, capital limits, and capital buffers, firm management and directors must ensure that their risk frameworks are both transparent and cohesive. Generally, capital limits are established both in terms of economic capital adequacy and stress testing adequacy, and are built upon required regulatory capital levels. Capital buffers may be established on top of limits to address areas of significant uncertainty, such as the erosion of capital under stressed market conditions, or other uncertainties related to modeled risks, exposure estimates, and perceived weaknesses in capital adequacy processes (e.g., missing risks). For example, buffers placed on top of limits at the lower capital range (e.g., near regulatory minimums) could address the potential erosion of capital due to stressed market conditions, while the next buffer could address model uncertainties.

The derivation of buffers and limits involves a combination of management judgment and quantitative analysis. These efforts should be well-documented and transparent to ensure consistent application across the firm, and to create an effective audit trail for ongoing validation and review.

## *Stress testing as a risk management tool*

As the development of stress testing scenarios begins with a detailed assessment of the firm's risk profile, the interim steps taken should leverage and ultimately inform the firm's internal risk management processes. For example, key risk drivers of loan portfolio quality (e.g., debt service coverage of borrowers and loan to value ratios) should serve as the basis for stress testing models, with the overlay of macroeconomic events driving both the severity and velocity of the stress test parameters.

Key risk drivers should be captured by risk-type, and line of business or business activities. Similarly, the key risk driver identification process can be leveraged to derive idiosyncratic risks. This exercise helps capture the likelihood of the idiosyncratic event occurring and the event's impact on capital adequacy. The exercise also better aligns risk exposure limits (e.g., portfolio concentrations by credit rating) with "capital-at-risk," and allows for improved calibration of those limits.

As stated in the DFAST guidance, regulators expect stress testing efforts to be wholly integrated within the risk management framework and not to be solely a regulatory compliance exercise. Therefore, stress testing results should inform senior management and director decision-making on higher level issues, including strategic planning (e.g., expansion plans), defining the firm's risk appetite, and evaluation of new products.

## *Internal controls considerations*

In summer 2013, the Federal Reserve ("Fed") published a document[5] detailing the "lessons learned" from the 2013 CCAR submissions.[6] While directed at larger firms, the broad categories identified in the Fed document (including data management, process management, and independent reviews) have equally important implications for midsized firms and are likely to be regulatory focal points. As such, firms should ensure that processes and controls established around these categories are well documented in relevant policies and procedures, and prominently identified in their DFAST submissions.

The discussion around modeling methodology choices in the Fed document is particularly relevant to midsized firms and involves both model choices and the evolution of model risk management controls. As many midsized firms are implementing new models in a relatively short time period, there are a number of control factors that need to be addressed simultaneously:

- Adequacy of documentation around the underpinnings of the model design, theory, and logic.
- Documentation of ongoing validation work associated with the model, particularly monitoring model risks and limitations, model performance, and implementation of any model changes.
- Efficacy of model data flows that ensures the accuracy of modeled output.
- The reporting processes to ensure that users of models and model outputs, particularly senior management and directors, are cognizant of the adequacy of stress test models.

---

[5] See Board of Governors of the Federal Reserve System, *Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice* (August 19, 2013).

[6] See PwC's *Financial Services Regulatory Brief, Stress testing: Midterm results improved, but it's all about the final* (September 2013).

www.pwcregulatory.com

# *Additional information*

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:


**Dan Ryan**
Financial Services Regulatory Practice Chairman
646 471 8488
daniel.ryan@us.pwc.com

**David Sapin**
Financial Services Regulatory Practice Leader
646 471 8481
david.sapin@us.pwc.com

**Armen Meyer**
Director of Regulatory Strategy
646 531 4519
armen.meyer@us.pwc.com



**Contributors:** Christophe Cadiou, Kevin J. Clarke, and Kenneth Evola.


To learn more about financial services regulation from your iPad or iPhone, click here to download PwC's new Regulatory Navigator App from the Apple App Store.

Follow us on Twitter @PwC_US_FinSrvcs