INTEGRATED STRESS TESTING: *What are we missing?*

Asset/Liability Management (ALM) is essentially the art of understanding your earnings and risk profile under many different scenarios. And by "art" we mean the skill of managing your earnings and risk profile through practice. The state of the economy over the past few years has heighted the need to manage balance sheets more and more carefully, so understanding your risk positions and earnings profiles is arguably more important than ever.

Asset/Liability managers have been doing a good job of assessing interest rate risk for many decades now. Unfortunately, the risk analyses being performed prior to the issues of 2007/2008 were not broad enough to foresee the problems that would occur. Many variables were not factored into the scenarios being tested, and as a result most institutions were not prepared for the situation that unfolded.

The government reacted to the financial crises in 2007 by performing their own stress tests for institutions under their jurisdiction. A major difference between the governmental stress tests and the institution-performed analyses previously being performed were the variables being stressed. Most institutions focused on interest rate movements but spent little effort on credit deterioration, liquidity and other areas of potential concern. The government began focusing on payment systems, infrastructure, global economies, and areas that could broadly impact the system.

The Dodd-Frank act was put in place in 2010 to bring stress testing into the mainstream. Stress testing quickly grew in many directions, and as a result new industries and expertise have blossomed, particularly in the area of credit/default modeling. But in looking at Dodd-Frank and thinking about why we do stress testing in the first place, integrating these stress testing techniques with our traditional ALM is really where we should be focusing our efforts.

Scenario analysis has virtually always been an area of great discussion in ALM circles. Which scenarios should an institution be running? How many is enough? How should rates move? Should balances be adjusted or should they be kept flat? The list goes on and on. The regulatory view is something along the lines of "the number and types of iterations performed should be commensurate with the risk inherent in your balance sheet."

What this means quite simply is that you need to understand your risk appetite, as one size does not fit all. For example, you may view yourself as a simple organization with a simple balance sheet. You make mortgage loans and fund them with deposits. Theoretically, this simple structure creates interest rate risk. Your assets are fixed, so as rates rise they will not reprice. Your liabilities are shorter-term, so as rates rise they will reprice, shrinking your net interest margin. Of course even this example has flaws. Who knows IF rates will rise, and even if they do how sensitive are your deposits? You will not stand still, so will new business generated during such a period outweigh the effect of the existing balances?

What have we been missing in practice? The credit dimension is a great place to start. Why is credit stress testing assigned to the lending areas in so many institutions? Is it really a good idea to have the line of business that is responsible for producing revenue also monitoring risk levels and setting aside provisions? Risk assessments and provisioning should be part of your overall balance sheet strategy, and as such should be part of your ALM process.

Other types of stress tests you should be considering relate to the ways you do business. For example, how do you set deposit prices? Most likely it is a small group in your institution, so you should stress the pricing assumptions periodically to reflect a change in your pricing behavior. Back to credit, what if you loosen your standards to generate more business? Risk can be managed, so running stress tests against business plans should help you determine the best course of action.

An area that is more difficult to quantify, but where we as an industry are lacking, is macro stress testing. What happens to us if oil prices skyrocket? Or if an earthquake hits the Far East? Or if our biggest competitor merges? It is important to periodically think about what could happen and plan contingencies for these situations, especially if a significant part of your business is tied directly to a specific industry, such as energy or housing.

ALM has evolved to the point where these factors can easily be incorporated into scenarios. Simulation techniques allow you to tie together variables and establish correlations in movements where applicable. As with any model, assumptions must be carefully crafted and documented, then explained to managers before the results are used for decision-making. Integrating these types of stress tests into your balance sheet discussions will position you ahead of your competition and allow you to be better prepared for future events as they unfold. To be successful in the art of ALM, bankers will have to continue to practice – think ahead, think outside the box and continue exploring the many different scenarios that can impact earnings and risk.

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