



Dodd-Frank Act Stress Testing for Mid-Size Banks: No Difference from Large Banks in the Quality and Credibility of Results

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Overview

One of the key features of the Dodd-Frank Act is for certain financial institutions to conduct annual stress tests in order to assess their capital adequacy and ability to absorb losses in a variety of adverse environments. After years of refinement, the regulation for stress testing of these large and mid-sized banks has been “finalized” by the various banking authorities and the regulatory requirements contained therein vary based on company size. Large Banks are quite familiar with these requirements having been under Federal Reserve Board scrutiny over the past five years through Dodd-Frank Act Stress Test (DFAST) and Comprehensive Capital Analysis and Review (CCAR).¹ In contrast, mid-sized companies got their first bite of the apple in 2014, the first year that DFAST requirements applied to them.²

Perhaps not surprisingly, DFAST has been the source of much angst for these mid-sized companies who face a variety of implementation challenges due to regulatory requirements pertaining to new or previously undeveloped process areas. This year introduces new challenges as well as these firms are required to disclose the results of their annual stress test to the public in addition to the reporting requirements to their supervisors.³ This new disclosure, which will include qualitative and quantitative information, will provide external stakeholders insight into the capital and risk management processes at these institutions.

Regulatory authorities have made it clear that the expectations for mid-size companies will be different than large banks however; we believe that there will be no variation in the expectation of a high-quality process and the credibility of results. Therefore, there may be a similar level of scrutiny on certain key aspects of DFAST participants’ capital planning processes as has been witnessed at large banks. As companies continue to enhance their process, there are several recommended focus areas that have been identified from the experience of larger CCAR banks. This article outlines several of these focal points that DFAST participants should consider proactively enhancing to preempt regulatory concern and contribute to establishing a high-quality and credible DFAST process.

Focus Area 1: Data Quality

Data integrity is necessary for ensuring the accuracy of and lending credibility to stress testing results. As the ingredients for stress testing outputs, input data needs to be complete and accurate so as to avoid the old adage of “garbage in, garbage out”. The reliance of supervisors on the data provided by DFAST participants has led to a keen focus on understanding company processes for ensuring data quality. This emphasis not only applies to DFAST required reports (e.g. FR Y-16) but also to reported data that feeds stress testing results, such as the data reported on the FR Y-9C.

Data quality controls are a main safeguard for combating data issues and inaccuracies within the stress testing process. Controls should be embedded throughout the entirety of the process and may include activities such as reconciliation, cross-checking and data cleansing. To support data quality efforts companies must have robust management information systems (MIS) that provide for the efficient and reliable collection, sorting, aggregation and updating of data. This continues to be a challenge for many companies who may have antiquated or incompatible legacy systems and continued investments in MIS capabilities are expected in the upcoming years.

There are clear distinctions provided in supervisory guidance for the difference in expectations for large and mid-sized banks as it relates to *data sources and segmentation*.⁴

1. Large banks are defined as Bank Holding Companies with average total consolidated assets of over \$50 billion.
2. Mid-sized companies are defined as those companies subject to Section 165 of the Dodd-Frank Act with average total consolidated assets of over \$10 Billion but less than \$50 Billion.
3. At a minimum, companies must provide information regarding the supervisory severely adverse scenario.
4. Supervisory Guidance on Implementing Dodd-Frank Act Company- Run Stress Tests for Banking Organizations with Total Consolidated Assets of more than \$10 Billion but less than \$50 Billion.

With regards to data integrity however, the key consideration is more binary, either the data is reliable or it is not, making data quality of paramount importance for all companies.

Some solutions for increasing the level of data integrity within the stress testing process include ensuring that appropriate data quality controls are embedded throughout the process and the roles and responsibilities for executing these controls are clearly defined. Companies should have established data policies and procedures that govern MIS and all data contributing to the results. As a universal theme for all of these focus areas, Internal Audit should perform testing to ensure established controls are operating effectively and identify areas where additional controls may be needed.

Focus Area 2: Model Risk Management

Common to all stress testing processes, models (often highly complex) are used to convert data into projections of losses, revenue, expenses and balance sheet items. The reliance of stress testing results on models has placed model risk management at the forefront of regulatory review. Potentially high volumes of models contributing to the process create model risk management challenges and large banks continue to tackle issues related to model validation and model governance.

DFAST banks should have an effective model risk management framework in place that is consistent with existing supervisory guidance.⁵ In order to implement these concepts, each banking organization should have a comprehensive model risk management policy that outlines the requirements for model inventories, documentation and validation. A policy provides model owners, users and others within the process the appropriate protocols and clearly defines roles and responsibilities for models.

Two elements of model risk management that remain a particular focus are model inventories and model validation. Companies are expected to be able to identify all models contributing to the results of the stress testing process and all DFAST models should undergo appropriate validation procedures. Maintaining a comprehensive model inventory provides companies the ability to demonstrate an understanding of the scope of their models, enables them to track validation status and easily communicate progress to regulators and internal stakeholders.

Unfortunately, there is no easy fix for model risk management issues (or any focus area for that matter) due to the complexity of the activities involved. Model validation is time consuming and needs to be performed by independent parties with the appropriate expertise. The current environment has made finding this expertise difficult and the volume of models that often need validation create additional resourcing issues.

Rating models by materiality to overall stress testing results or by model risk can assist in prioritizing the effort. Clear time frames for the validation of all stress testing models should be established and project plans should be shared and agreed with regulators.

Focus Area 3: Governance

The large number of resources contributing to capital management and stress testing processes makes governance another crucial element for ensuring the reliability and credibility of stress testing results. Due to the large quantity of key decision points inherent within the process, a focus on the review and approval process is warranted. Ensuring that the appropriate parties are providing effective challenge is a key determinant of a strongly governed program so frequent internal assessment of the governance occurring at each key step is recommended.

Regulators have repeatedly stressed the importance of Board of Directors and senior management involvement in the DFAST process. The importance of these activities must be stressed from the top down and these key governing bodies should be an active participant in reviewing and contributing to the results. Many companies are defining a process for review and challenge at these levels to demonstrate that their results go through a rigorous review process.

5. Existing model risk management guidance includes OCC 2011- 2012 and SR Letter 11-7: *Supervisory Guidance on Model Risk Management*.

In addition to Senior Management and Board of Director involvement, Internal Audit needs to play a key role in evaluating capital planning and various stress testing components. *The Comprehensive Capital Analysis and Review 2015 Summary Instructions and Guidance* demonstrates the Federal Reserve Board's attention to Internal Audit's role in the process including requesting information on audit findings and obtaining an understanding of the scope of Internal Audit review. The scope of Internal Audit review should encompass the end-to-end process in addition to deeper dives in identified high-risk areas in order to detect issues across stress testing activities. It is crucial that internal audit staff has the appropriate skill set and training to effectively identify and escalate key issues within the DFAST process and we anticipate further investment in this area.

Focus Area 4: Policy and Documentation

As regulatory agencies conduct their assessment of a company's stress testing process they will rely on the documentation provided by DFAST participants. Policies are expected to govern the entirety of the capital planning process and are often provided as supplemental documentation to support results and promote understanding of the process. Large banks have increased their attention on providing clear documentation as well as enhancing the rigor around detail, consistency and accuracy.

For DFAST participants, stress testing needs to be governed by a suite of policies spanning the end-to-end process. Stress testing policies should articulate a consistent process, be actively adhered to and reviewed and approved annually. There are additional pieces of supporting documentation whose enhancement could ease the assessment process for both internal and external reviewers. These include documents such as review and challenge templates, meeting minutes and results presentations. Augmenting the consistency and detail of these documents will provide a clear look into how the myriad of stress testing inputs get aggregated to produce final results in a controlled and effective manner.

Large Banks vs. Mid-Size Firms: No Compromise on Quality and Credibility

All banking organizations are given a wide range of latitude in their methodologies and approach for capital management and stress testing. This is an important statement as each company has a unique risk profile, risk appetite and risk culture and this should be reflected in their process.

The fundamental difference between the expectations for large banks and mid-size companies is in the complexity of methodology and approach. There is no compromise however on the quality and credibility of the results of the chosen framework.

Supervisors will review methodologies and approaches to ensure they are appropriate for the company, however it is clear from the focus areas described above and through the experience at large banks that execution is also of key importance. It is the marriage of methodology and execution that breeds quality in the process and credibility in the results.

Regulators have provided guidance to CCAR and DFAST participants on both the execution and methodology aspects for these landmark regulations. As companies have their processes independently reviewed (either internally or externally) both execution and methodology should be analyzed. The focus areas above outline four concepts that supervisors have turned their attention toward from an execution standpoint and where many companies continue to face implementation challenges.

As we have seen with larger banking institutions each stress testing cycle has brought a higher focus on the qualitative and more execution oriented elements of the process. Organizations should also place sufficient attention on this aspect, especially in the areas of data quality, model risk management, governance, policies and documentation.

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