News Bulletin

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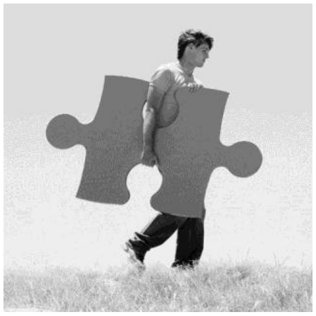

Stress Tests: Guidance for Community Banks

Late last week, on October 18, 2012, the Office of the Comptroller of the Currency ("OCC") published OCC Bulletin 2012-33, *Community Bank Stress Testing Supervisory Guidance*.[1] The Bulletin effectively requires "every bank, regardless of size, or risk profile, to have an effective internal process to (1) assess its capital adequacy in relation to its overall risks, and (2) to plan for maintaining appropriate capital levels." The nature of the testing will vary substantially, depending on the size and diversification of a bank.

This guidance comes on the heels of the final regulations earlier this month for stress testing by banking organizations with more than $10 billion in consolidated assets.[2] Earlier this year, the OCC and the other federal banking agencies clarified that those stress testing requirements did not apply to community banks, although the OCC continues to suggest that larger community banks may find this earlier guidance instructive.

A compliant stress testing regime for a community bank will involve five steps.

Nature of the test. A community bank must decide first on the types of tests to conduct. Depending on its size and credit concentrations, a community bank may conduct stress tests at any or all of the transaction, portfolio, and enterprise-wide levels. Discussions of testing throughout the Bulletin imply that portfolio-level testing may be the most useful approach, but the different tests are not mutually exclusive, and a bank should consider all three. Reverse stress testing may be helpful.

Stress assumptions. The bank must also develop a set of assumptions to use in its testing. The Bulletin does not provide any assumptions about stress conditions that a community bank should use, as the Federal Reserve Board has done in the stress testing by systemically important institutions. The Bulletin notes that common scenarios include a severe recession, loss of a major client, or a localized economic downturn.

Conducting the test. The bank must then conduct the test. Appendix B to the Bulletin presents an example of an acceptable stress test that does not require complex calculations. Rather, taking asset categories as they appear on the latest call report, the bank can apply a simple loss rate for each category over two years to arrive at estimated values and losses.

Test results. The stress testing should generate estimates of three items over a two-year time horizon: loan portfolio stress losses, impact on earnings, and impact on capital.

[1] The bulletin is available at http://www.occ.treas.gov/news-issuances/bulletins/2012/bulletin-2012-33.html.
[2] Please see our News Bulletin, *Stress Testing: Final Rules for Banking Organizations from the Federal Banking Agencies* (Oct. 9, 2012), available at http://www.mofo.com/files/Uploads/Images/121009-Stress-Testing.pdf.

Use of test results in risk management. The immediate purposes of a stress test are to identify possible capital deficiencies over the coming two years and to prompt appropriate capital planning. Beyond this purpose, however, the OCC expects a bank to use the test results to establish risk tolerances, set concentration limits, and adjust its strategies. The OCC also expects that a bank be prepared to increase its portfolio monitoring, adjust underwriting standards, and sell or hedge assets.

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