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To: 'regs.comments@occ.treas.gov'; 'regs.comments@federalreserve.gov'; Comments
Subject: Proposed 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

- 12 CFR Part 325
- Proposed 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

Dear Sirs,

We greatly appreciate the opportunity to comment on your Proposed 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.

Background

Our company has been assisting community banks of all sizes to stress test their loan portfolios since 2007, with over 65 banks using our CREInsight, MyCreditInsight stress testing tools and/or outsourced stress testing services.

We have contributed to industry wide intellectual capital on this subject through conducting webinars, seminars and presentations for bankers organizations and industry groups including the Risk Management Association ("RMA"), the American Bankers Association and BAI. We have been cited or published in many industry periodicals including Bank Director, The American Banker, The RMA Journal and The Independent Community Banker on the subject of stress testing community banks. We have also been fortunate enough to present our findings and approach to meetings of the OCC, FDIC, Conference of State Bank Supervisors and the FFIEC over the past few years.

We actively endorse prudent, proactive risk management practices for community banks – notably stress testing, concentration management and capital planning. We applaud the recent efforts of the agencies to promote relevant - forward looking risk management practices. We believe that stress testing for all banks is a very valuable risk management practice – as it informs the institution of potential risk in the face of adverse economic conditions and better informs bank management as to how to prepare for such eventualities.

We have taught our clients the process of stress testing based on the tenants of the 2006 CRE Interagency Guidance, further reinforced by the article published in the FDIC's newsletter "Supervisory Insights" volume 9, Issue I, Summer 2012 "*Stress Testing Credit Risk at Community Banks*". With that as a context, we would like to comment on the "*Proposed 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*", focusing our comments on the "Question One: What challenges do companies expect in relating the national variables in the scenarios to regional and local market footprints?"

Different Stress Testing Models for Different Banks

Starting with the "*Expanded Guidance for Subprime Lending Programs*" (2001) and further outlined in the "*Guidance on Concentrations in Commercial Real Estate, Sound Risk Management Practices*" (2006) bank stress testing has been outlined by the agencies as being focused on these basic concepts:

- Requiring concentration based portfolio-level stress tests that quantifies impact to asset quality, earnings, and capital
- Expecting Bank management to assess sensitivity of portfolio segments to potential market conditions
- Testing focused on local market conditions, in particular on the more vulnerable concentration segments
- Stress testing should be conducted in a manner appropriate for an institution's size, complexity, lending practices and risk appetite

These concepts were reinforced in the FDIC's newsletter "Supervisory Insights" volume 9, Issue I (2012) "*Stress Testing Credit Risk at Community Banks*" when defining stress testing for community banks:

"Stress tests are most useful when customized to reflect the characteristics particular to the institution and its market area, and can be used to evaluate credit risk in the overall loan portfolio, segments of portfolios, or individual loans."

Starting with the Fed's SCAP capital stress testing exercise in 2009, best practices for stress testing larger banks began to emerge as being based on stressing predicted losses not at the loan portfolio concentration or segment level, but across the balance sheet for any and all lending exposures and product types.

This larger "stress testing framework" was pronounced by the agencies as to not be intended to ever be extended to community banks – as these stress loss models relied primarily on national and international macro-economic scenarios that were not usually significantly relevant to a community bank's footprint or lending practices.

When the Dodd Frank Act ("DFA") stress testing was first outlined – it appeared to be a more transparent and refined version of the large bank "SCAP –Type" stress testing using macro economic factor correlation leveraging national metrics like GDP, Housing Starts and Unemployment rates, with a nine quarter planning horizon.

As you know, this required the $50B and above banks to gather the needed external and internal data to create correlations and formulas associated with the suggested macro economic data points.

Community banks were purposely excluded from this type of stress testing, based on their lending practices, risk appetites and less complex business practices. Instead, regulatory advisories and guidance emphasized that community banks should focus on their local market area, portfolio concentrations, CRE and "simple" capital stress methods.

The "$10 Billion In Assets" Line

It is Ardmore Banking Advisor's contention that it is inappropriate to apply the so called "big bank" or "DFA" stress testing to any bank based solely on their asset size as the proposed Guidance appears to do. While categorizing banks based primarily on total asset size is convenient, with the exception of the extremes of the asset ranges, it is not in our opinion an adequate metric by itself on which to determine appropriate level of banking regulation.

Our concern about the proposed Guidance is based on the fact that there are many banks in the $8B to $18B asset size who practice localized non-national lending practices, and simple "community bank" business models (just as there are some banks below $10B that are involved in national and/or international lending and other complexities).

Forcing banks just because they are near or above the $10B asset line to adopt DFA stress testing practices based on macro economic factors that are irrelevant to their business model and risk appetite is deleterious to the value of the stress testing exercise. For many of these banks it creates additional burden instead of adding value in protection to their investors and depositors. Worse, it may divert a bank's scare resources from performing more relevant, useful local market based risk management practices like smaller bank stress testing based on local markets, events and performance.

We have already seen articles in "The American Banker" and other industry periodicals suggesting that some banks management are purposely adjusting their business strategies to stay under that $10B asset regulatory threshold because of it's consequences.

Suggestions for Consideration

We would like the agencies to consider modifying their Proposed Guidance to apply the "DFA Stress Testing" macro economic nine quarter planning models based on a bank's business strategy and risk appetite rather than the arbitrary $10 Billion asset threshold. We understand that this assessment may add some undesired complexity and subjectivity to the process, but we believe that this is more than acceptable considering the adverse consequences of not doing so.

Some criteria that could be asessed when the agencies have to consider if a bank should use a "local market/concentration based stress testing model" vs. the "DFA national macro-economic model" could include:

- The array and sophistication of lending products offered (including participations)
- The size of the geographic lending footprint (multi region, national, international)
- Local bank leadership (Executive, Board)
- Strategic business focus on rural / agricultural or some other naturally concentrated region

If we use a common concentration definition from the agencies, like 25% of capital, could we perhaps define a "national" or "super regional" bank strategy - one the required advanced risk management practices such as DFA Stress Testing - as one that has none or more of the above levels of complexity? Or maybe two or more?

Could we allow a mid sized bank (as defined in the Proposed Guidance as $10B to $50B in asset size) to submit a written justification to their lead agency outlining their business plan, complexity and risk appetite to exempt them from the DFA Stress testing requirement? This would appear to make sense, and be more along the lines of the stated intentions of the agencies regarding prudent risk management practices.

Conclusion

While the Proposed Guidance does suggest flexibility it also states that the projection results will be based on "a set of conditions the affect the US economy" – and outlines the mandatory use of the DFA macro-economic factors for stress test modeling "consistent with the path of the national variables in the supervisory scenarios."

As outlined above, many banks within the "Mid Sized" asset lines will not find these national variables at all relevant to their business, forcing them to create a risk management infrastructure and set of practices that are in essence implemented "only because the regulators told us to".

When SCAP was announced in 2009, the agencies promised that community banks would never be expected to do this type of risk modeling, yet it now appear that the DFA "national macroeconomic variable model" is becoming the official standard for all banks. While there have been informal suggestions over the years from the agencies and some guidance, there is no formally endorsed smaller/community bank model alternative for banks to follow.

With an adoption of this proposed Guidance -- targeted at even some that employ the community bank model (in the $10B approximate asset range) all bankers will look at what the new Mid Sized Bank regulation says and conclude that this is what regulators will expect them to do – which may force them to abandon more useful local market based concentration stress testing.

We thank the agencies for the opportunity to share our view, and look forward to the continued agency endorsement of prudent, valuable relevant proactive risk management practices for banks of all sizes

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