December 2013

INVICTUS

Bank Insights

What to Expect in 2014: Stress Testing Continues to Gain Favor

Don't be surprised if your examiner suggests that your bank might benefit from capital stress testing. Though it is not required for community banks with assets of less than $10 billion, more and more regulators are emphasizing that stress testing is a best practice that should be integrated into strategic planning. They are writing articles in banking journals and agency publications, recommending it to banks at exam time and proclaiming it at conferences. They're just not mandating it.

"It's all about using tools to understand your risk profile," said Michael Stevens, senior executive vice president at the Conference of State Bank Supervisors. Stevens urged community banks at a November conference in Washington, D.C. to use some sort of capital stress testing or scenario analysis to understand their vulnerabilities, especially when it comes to capital. Stevens first called for all community banks to use stress testing in a **2010 white paper** that he acknowledges was "roundly criticized."

But other regulators have since taken up the call, urging community banks to consider the benefits of stress testing. The Federal Reserve's latest issue of **Community Banking Connections** highlights that "it is always appropriate for banks of all sizes to ask themselves the 'what could happen to us?' questions. Some accomplish this through stress testing," writes Jennifer Burns, senior vice president for supervision, regulation and credit at the Federal Reserve Bank of Richmond.

In "Capital Planning: Not Just for Troubled Times," Burns writes that capital planning "is a key component of a sound risk management framework." She notes that "capital adequacy is broader than just meeting the minimum regulatory capital requirements. It speaks to the level of capital held by individual institutions in relation to their risk profiles and risk management strategies. When bank examiners evaluate and assign a capital rating, they consider both planning and adequacy, among other factors."

She says that capital stress testing "enables management to think through the impact on earnings, and ultimately capital, and make decisions about whether changes to business strategy or the balance sheet are needed." Burns also warns banks not to use PCA well-capitalized guidelines, that banks should "operate well above the regulatory minimums, and the targets should be based upon the quantitative and qualitative assessments of risk."

The Richmond Fed's spring 2012 newsletter featured an article by Jody Martin, "Stress Testing at Community Banks: The Benefits and the Expectations." Martin, a risk and policy team leader with the Federal Bank of Richmond's Charlotte branch, concluded that the benefits of community bank stress testing "far outweigh the costs."

His **article** said "supervisors and bankers are placing renewed emphasis" on forward-looking stress testing. He wrote that banks that incorporate stress testing into their risk management framework "can improve the dialogue between bankers and supervisors regarding the firm's expectations for its markets, exposures and business activities."

Best practices often become de facto requirements among field examiners. The Office of the Comptroller of the Currency has been the most vocal of the banking regulators in endorsing community bank stress testing. It issued **supervisory guidance** on community bank stress testing in October 2012, which said that "regardless of size" banks should have the capacity to "analyze the potential impact of adverse outcomes on their financial conditions" and that the OCC "does consider some form of stress testing or sensitivity analysis of loan portfolios on at least an annual basis to be a key part of sound risk management for community banks." ■

Stress Testing Benefits

Community banks incorporating capital stress testing into their strategic planning are using best practice methodologies that are likely to be more effective, the OCC says. Other stress testing benefits:

- Provides a competitive advantage
- Identifies a bank's key vulnerabilities and risk exposures
- Targets and quantifies risk to earnings and capital that can affect a bank's profitability
- Gives vital information to establish and monitor strategic plans
- Is key to a sound capital planning program

Source: OCC December 2012 **seminar**

Editor's Note: Please join Invictus Consulting Group's new Linked-In group, ***Stress Testing and Capital Planning*** *to network with other bankers, regulators and peers.*

Inside this issue:

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Five Requirements for Effective Community Bank Stress Testing

1. Senior management and the board of directors must accept that historical tools cannot be used to create an effective stress testing system. The analysis must be forward-looking.

2. Management should acknowledge that traditional loan pricing techniques are no longer valid. Factors that were previously considered constants are now key variables in strategic planning.

3. Bankers should recognize that regulatory authorities, by their very nature and mandate, are focused on sustainability and not profitability. That means that regulators are more likely to impose higher capital requirements on banks that don't provide stress tests that show how their capital might fare under adverse conditions.

4. Stress testing must be incorporated into strategic planning.

5. The stress test must be easily understood by both management and the board. A proper stress testing methodology is far easier to understand and to implement than the old school, quant-oriented, highly complex planning and forecasting techniques, such as VaR. ■

Stress testing is the New Capital Calculator

By Adam Mustafa, Invictus Senior Partner

I was on the phone with a banker who mentioned that his bank does a sophisticated analysis calculating their Risk-Adjusted Return on Capital (RAROC), but has not yet started stress testing. I politely told him that, in my opinion, his RAROC analysis then must be flawed and obsolete. Most bankers haven't yet caught onto the concept that stress testing is the new calculator for determining their capital requirements. Look at what the Fed is doing with the largest banks. Their capital plans are being approved or rejected based upon their performance in a severely adverse case scenario. If you rearrange this equation, then it is the unexpected losses under stress that are eating up capital – not average historical losses in a normal environment. The smart banks – regardless of size – will start gravitating toward analysis that looks at their returns on required capital, and away from conventional ratios such as return on assets and return on equity. It takes time and there is a learning curve, but it will happen. Stress testing is a prerequisite for this, because otherwise, you'll make the same mistake as the banker I spoke to the other day.

Stress Testing Easier for Community Banks

The biggest misconception in the marketplace is the belief that large banks are more sophisticated organizations that can better cope with regulatory stress testing requirements than community banks. The reality is these banks are actually less sophisticated in the understanding of their markets than community bankers.

Community bankers already know their marketplace and with the right tools can easily defend the performance, under stress, of their assets.

There are valid reasons for community banks to be apprehensive about regulatory stress testing and its inevitable application to their market. However, the apprehension should be focused on their ability to respond to the environmental factors built into the stress testing scenarios and not the stress testing methodology itself.

Used properly, stress testing is a very powerful and easily implemented tool for community banks, one that allows them to defend and reduce their capital adequacy requirements.

Stress testing is now the new capital adequacy formula/calculation for banks. As radical as it might sound, stress testing provides community banks with considerable advantages over larger and more complex institutions in managing their organizations and communicating with regulators.

The use of the proper stress testing methodology is not only inevitable for community banks, but it is easily implementable, understandable, and extraordinarily powerful for strategic planning and competitive positioning. Management's evaluation of their own bank versus their competitors on a post-stress basis provides a much truer picture of which banks will fail, which will succeed, who will make an acquisition, and who will be acquired.

In this context, stress testing should not be viewed as a one-time exercise, but an ongoing active process integral to all aspects of bank planning, and regulatory and investor communications. ■

*Editor's Note: This article was adapted from a **white paper** by Kamal Mustafa, CEO, Invictus.*

The Importance of 'Three-Dimensional' Banking to Community Banks

Brian Garrett, Invictus Consulting Group's newest executive director, has been a turnaround CEO at five California community banks and started two others during his 45-year career. He talked with Bank Insights about ways community bankers can thrive in today's sophisticated regulatory environment.

Q: Why did you join Invictus?

A: I've had a long career in banking. I've seen dynamic changes in the marketplace. It's not like it was when I got into banking 40 years ago. I've spent most of the last decade helping troubled banks unwind from their problems. I know the mistakes banks make, and I know the hurdles they'll face in the future. Invictus was the only consulting company I had encountered who truly understood all the issues that community banks face in the post-recession environment— and offered a unique solution. I was amazed by their ability to stress test a bank, document its excess regulatory capital, talk to regulators, analyze the competitive landscape for acquisition targets. There are three-dimensional aspects to banking now.

You must incorporate economic trends, portfolio characteristics, and geographic tendencies into your analysis. I loved the approach Invictus was taking, and thought the company offered me a way to help community banks.

Q: Should all banks use stress testing?

A: There's no doubt about it. They should – whether or not they are required to by the regulators. I think it will come down as best practice in the near future. You must understand the stress points in your bank. This must be incorporated into a bank's strategic plan. But remember, in planning, it's measuring the journey, not whether you hit or missed your goals. It is the 'why or why not?' and reflecting back on the data that you based your assumptions on that is important. Smart banks will use stress testing to understand how much FreeCapital they have, whether their plans for the future make sense, and to see if they have the right level of regulatory capital.

Q: What's in it for a good bank?

A: They do better. Banks that do well, it's not by accident. They have good knowledge, they have hired good people, and they're proactive. They're good at their niche. Part of being good is looking around to see how you do better.

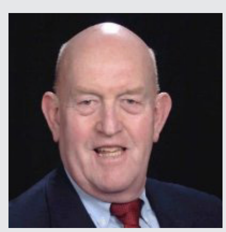
Q: What challenges do community banks face in 2014?

A: Margins and regulatory pressures are the two biggest ones.

Q: What advice do you have for other CEOs?

A: The most important lesson: Don't take anything for granted, anything: borrowers, deposits, loans, employees, regulators. Expect the unexpected. Things change. Thousands of banks bought Fannie and Freddie preferred because regulators told them it was a good thing. I'm one of those. That investment went to hell overnight. There is nothing guaranteed in this life. Bank CEOs need to be part of peer groups. I've been a member of the same one now for 20 years. If you can develop five friends in banking that you can call with questions and share with, that's good. There are no new problems. Someone else has gone through it. If you think you know it all, you're a fool. It's knowing who to call and when to call. ▪

About the Expert



__Brian Garrett__ had five stints as a turnaround CEO, most recently at Bank of the Orient in California. He spent 10 years as CEO of Community Bank of the Bay, where he helped the bank get out from under two C&D orders. He was also a founding officer or CEO in two start-up banks and a director in several others. He has been involved in several high tech companies from initial formation to profitability and sale. He has served as a director on a committee at the American Bankers Association, California Bankers Association, California Independent Bankers, and Western Independent Bankers. He holds a B.A. from the University of Washington and is also a graduate of their Pacific Coast Banking School.

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Read Between the Lines

Each month *Bank Insights* reviews news from regulators to give perspective on regulatory challenges.

Compliance Management under Scrutiny

Make sure your bank has its compliance management system in order, particularly as it relates to board oversight. Recent **OCC guidance** on third-party relationships and independent consultants hired as part of **enforcement actions**, plus several FDIC consent orders, are putting the spotlight on compliance management programs. These bulletins should be seen as a "significant warning," advises Bryan Cave LLC partner John ReVeal in the law firm's Payments **blog**. "It seems safe to assume that third-party relationship management will be a significant focus of the OCC and other federal regulators in coming examinations," ReVeal writes.

Regulators Release Capital Estimation Tool

Community banks can get a "general estimate" of their leverage and risk-based capital ratios under the interim final capital rules by plugging information into a newly released **spreadsheet**. The FDIC warns, however that the tool is "not a substitute for a bank's analysis" of the rule's impact on its financial operations, nor should it be relied on as an indicator of a bank's actual regulatory capital ratio.

Bank Director Lawsuits Mounting

As expected, the FDIC is continuing to file more and more claims against directors and officers of failed banks. The agency reports that it has named 1,038 defendants since 2009, with more lawsuits filed each month. The **stats** show that the FDIC has authorized claims against 296 defendants in 38 lawsuits as of Oct. 30 of 2013.

Liquidity Oversight for Community Banks

The federal regulators' **proposed liquidity coverage ratio rule** for large banks could have implications for community banks, argues the law firm of Nelson Mullins in a November **client alert**. The alert advises banks to read the liquidity coverage ratio proposal carefully because it "incorporates general concepts that are important to a bank of any size in managing its liquidity and preparing a contingency funding plan." Banks that don't follow the concepts in the proposal "may expect conversations" with their examiners about their portfolio of liquid assets, the lawyers contend.

Tools to Measure Interest Rate Risk

All bank examiners expect that banks will assess the potential impact of interest rate risk on earnings and capital, according to "Essentials of Effective Interest Rate Risk Measurement" in the Federal Reserve's **third quarter issue** of Community Banking Connections.The article, written by Emily Greenwald, an assistant vice president at the Federal Reserve Bank of Chicago, and Doug Gray, managing examiner at the Federal Reserve Bank of Kansas City, notes that an economic value of equity analysis is "particularly useful" for community banks with long-term bond portfolios and assets with embedded options, even though it is not required

Fed's 2014 Scenarios Test Stagflation

Coming down the pike, banks will be expected to know how to handle a stagflation-like scenario, according to Invictus Consulting's senior partner Adam Mustafa. The Fed tipped its hand to this in its **updated economic scenario** that defines the adverse case for the largest banks. The adverse case was typically the undercard, with the severely adverse case scenario the main event. However, the 2014 adverse case scenario includes rising long-term Treasury rates. In other words, the Fed is asking the top banks to stress themselves under a scenario that includes both an economic downturn and rising interest rates. ■

About Invictus

Invictus Consulting Group's bank analytics, strategic consulting and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. Bank clients have excellent results when using Invictus reports to defend their strategic plans and capital levels to regulators.

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