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INVICTUS

Bank Insights

FreeCapital™ :The New Bank Metric You Should Know and Use

Examiners are increasingly using a rule-of-thumb capital requirement for community banks of all sizes, no matter their financial condition. Effective risk management tools, such as capital stress testing, can help a bank show regulators the minimum level of capital it needs, even under the worst economic conditions.

The excess regulatory capital a bank saves through that process is known as FreeCapital™, according to Invictus Consulting Group's CEO Kamal Mustafa, who coined the phrase. "FreeCapital and its critical importance is a concept that has not yet been fully recognized by the banking community," Mustafa writes in a recent white paper.

There are very few aspects of strategic planning that are not directly influenced by a bank's level of FreeCapital. In a highly competitive environment characterized by shrinking margins and increased regulatory scrutiny, Free Capital is the paramount ratio that needs to be calculated and recognized by senior management and bank directors.

The only way to calculate FreeCapital and be able to demonstrate it to examiners is to put your bank through a stress test that mimics the standards examiners are using with the largest banks.The regulators want to be assured that your present-day capital will be sufficient even at the end of a two-year severely adverse scenario. The pre-crisis regulatory regime was backward-looking. The new philosophy is forward-looking.

The FreeCapital metric enables risk managers to generate, review and analyze strategic plans and initiatives within the constraints of regulatory capital adequacy. It facilitates intra-bank communications and directives, and provides senior management with a clear and easy story to tell investors, analysts, directors and other bank stakeholders. It also sets targets and guidelines for maximizing shareholder value and minimizing risk.

"Asset purchases, mergers and acquisitions, stock buybacks, even dividend policies, must be reviewed subject to this key metric. M&A, done without calculation of the target's inherent FreeCapital, can be highly irresponsible for both buyer and seller," Mustafa warns.

Likewise, investor evaluation of banks that are based on year-to-date financial performance, without considering the significant forward-looking implications of FreeCapital, may lead to erroneous investment decisions.

While the disclosure of FreeCapital can help weaker banks buy time with regulators, it also allows stronger banks to obtain faster approval for capital actions. And it has major implications for all strategic planning activities:

- Banks with negative FreeCapital have inadequate capital under the new regulatory guidelines. Management must focus on raising new capital, reducing expenses, deleveraging assets or selling the bank.
- Banks with minimal levels of FreeCapital have limited tactical and strategic options. Regulators are not likely to approve acquisitions. The ability to implement organic growth strategies or meet competitive pressures would be compromised by the short-term capital impact.
- Banks with healthy FreeCapital have room to implement strategic and operating plans, including acquisi-

Tips on FreeCapital™ Planning

- Calculate your FreeCapital at least quarterly.
- The only way to do this accurately is through stress testing. Make sure the stress test accommodates loan vintages since performance will vary based on when the loan originated.
- Include your FreeCapital metric in every board of directors' review package. The regulatory environment puts added responsibilities on bank presidents and boards to track and maintain capital.
- Your capital plan should quantify FreeCapital and have a strategy for deploying it.

Inside this issue:

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tions and aggressive organic growth. However, the very existence of excess FreeCapital implies lower returns on total capital. These banks could come under activist shareholder pressure to use their FreeCapital more effectively to maximize shareholder value. The analysis of the marginal return on deployment of FreeCapital should become an important part of strategic planning.

The shift in regulatory philosophy from using historic data to pro forma projections has important implications. Bankers need to calculate and actively manage their FreeCapital. Stress testing their loan portfolios must take into account loan originations or vintages since loan performance varies based on when the loans were booked. The result, if all bankers undertake these actions, will be a far more resilient banking sector – just as the regulators require – and one where individual banks can achieve their fullest potential. ■

Capital Adequacy Redefined

In the new post-recession world, capital adequacy now must be calculated differently.

- Regulators have shifted from analyzing year-to-date performance to evaluating present-day bank capital adequacy in the context of two-year pro forma forecasts.
- Smart banks test how their capital would fare under a two-year severely adverse scenario, the same way the regulators do.
- History is no longer the sole determinant of capital adequacy. It has to be used as a guide for establishing pro forma movements under stress.

Steps for the Estimation of FreeCapital

- **STEP 1:** Start with the current management business plan. Business plans are usually based on expected economic scenarios and small minor variations.
- **STEP 2:** Subject the plan to an economic stress test consistent with a severely adverse scenario. This stress test must take account loan vintages, and not just macroeconomic statistics and probabilities applied to the entire portfolio.
- **STEP 3:** Estimate the bank's capital position and regulatory ratios at the end of the two-year stress horizon. These ratios are compared to their regulatory minimum requirements.
- **STEP 4:** Factoring in the estimated capital decline given by the stress test, calculate the capital required today to meet those minimum regulatory requirements.
- **STEP 5:** The surplus, if any, of the bank's actual capital over what is required to meet the pro forma regulatory minimums is the bank's FreeCapital. If the result is a deficit, the bank has a capital shortfall.

How the Invictus Model Works

Invictus has built a robust database by using its proprietary models to stress test every FDIC-insured U.S. bank each quarter since the beginning of the recession. Our analysts look at regional variances, adjusting the methodology based on real-world changes in financial and operating performance, with a focus on the unique structures and pricing characteristics of loan vintages. Accuracy is verified by analyzing current quarterly results on a bank-by-bank, region-by-region and national basis against our projections.

We have found sufficient vintage and structural data for our community bank clients to easily and rapidly build portfolio models that can be used to calculate capital adequacy within any prescribed economic scenario. The resulting financial models, built using the appropriate data and methodology, create accurate pro forma analyses of management's strategic plans. They provide the ability to stress test these plans under any prescribed scenario and update those plans based on the newly prescribed severely adverse case scenarios. Utilizing these techniques, bank management has very powerful weapons not only in its own strategic planning but also in communicating with regulators, investors, directors, acquirers or sellers and other vested parties.

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Stress Testing As an ‘Offensive Weapon”

Bank Insights sat down with Adam Mustafa, Invictus' Managing Director for Client Services, to discuss common questions he hears from banks.

Q: Why should banks use stress testing?

A: If you look at the first page of Basel III or any regulatory guidance about stress testing, it says that banks should have a certain amount of capital as a buffer against unexpected losses. How do you figure out what that buffer should be? We are using stress tests as the calculator. The purpose of stress testing is to quantify unexpected losses and see whether the bank has sufficient, excess or too little capital to survive hard times. By using stress testing to drive a bank's required capital, banks can avoid having to live with a one-size-fits-all, rule-of -thumb requirement that is designed for the lowest common denominator.

Q: How do you deliver this information so management can present it and explain it to the board?

A: One of our main reports is a board presentation. The spirit of that is less is always more. The report to the board is a very high, 20,000-foot level, document. It walks the board through the stress test, the result, and how it is linked to capital requirements and strategic planning. I've seen other consulting firms' stress testing systems and reports. One of our biggest competitive advantages is our ability to present the information in an understandable and actionable format. Stress testing is meaningless if it's just a stand-alone project that doesn't impact the bank's decision-making.

Q: One of your clients said that its regulator had never seen such a sophisticated report as the one you gave the community bank. Is this a common reaction from regulators?

A: Sophisticated, yes, but its beauty is also its simplicity. To our surprise, regulators welcome the analysis. It provides potentially new and useful information. Seasoned examiners from the OCC sat in on a board meeting when we made a presentation to a bank under an enforcement order. It was prior to the OCC's guidance on stress testing for community banks. They listened closely to what we told the bank. The order had called for the bank to increase its capital requirements to 9, 11, and 13 percent. The bank had been cleaning up its classified loans at the same time. Our capital stress test found that the appropriate capital levels for the banks should be 7, 9 and 11 percent. The bank presented that report to the OCC, which signed off on it, and lifted the order.

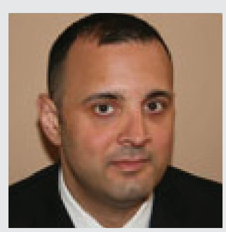
Q: Can banks use stress testing proactively?

A: Yes, banks can and should use capital stress testing to determine their capital requirements before the regulators do. If it's done properly, it's a potentially powerful offensive weapon. In many cases a bank can increase the amount of FreeCapital™ it has without having to raise a single penny of additional capital, avoiding the illiquidity of the capital markets and the inevitable dilution of current shareholders. Banks can also negotiate a capital requirement that is more appropriate than a generic rule-of-thumb. FreeCapital is management's war chest for driving shareholder value.

Q: How often should a bank do this?

A: If a bank is doing interest-rate risk quarterly or monthly, they should be doing stress testing quarterly or monthly too. The results should be updated with actual quarterly numbers so banks and management can accurately measure progress and quantify changes. ■

About the Expert



Adam Mustafa is the Managing Director for Model Development and Client Services at Invictus. He has senior-level experience as a banker, financial services consultant, and corporate CFO. He was CFO and treasurer for Secure Symbology Inc., an early-stage technology company named in 2007 as New Jersey's Emerging Business of the Year. He also worked as a consultant for Deloitte and Touche, where he provided valuation expertise to the financial services sector. He held several Wall Street positions, including as an analyst at BlueStone Capital, a small-cap investment bank backed by ABN AMRO, and at TheStreet.com, where he provided analytical support to CNBC star Jim Cramer. He has an MBA from Georgetown and a BA from Syracuse University.

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Read Between the Lines: What Regulators Are Highlighting

Each month Bank Insights will review enforcement orders, publications, speeches and other news from regulators to give perspective on regulatory challenges and initiatives.

FDIC D&O Lawsuits Name More than 500 Directors

The FDIC has authorized lawsuits against 921 individuals in connection with 114 failed banks, according to the **latest data** it posted in June. So far, 65 D&O lawsuits have been filed, naming 505 former bank directors and officers. The FDIC has also settled with a number of banks. The FDIC has three years to file a lawsuit after a bank fails. In one of its recent cases, the FDIC named nine former Sun West Bank of Las Vegas directors and officers, who together owned or controlled 59.3 percent of the holding company stock, the **D&O Diary** notes. In that case, as in most others, the FDIC alleges that directors approved risky loans that violated prudent lending practices.

Publications

The summer issue of the FDIC's **Supervisory Insights** warns banks that examiners will expect to see an enhanced credit risk management framework surrounding investment securities.

Under the Dodd-Frank law, financial institutions are not supposed to rely solely on credit rating agencies to determine whether their investment securities are creditworthy. Banks should be updating their due diligence methodologies to show examiners they have a process for analyzing their securities before they buy them. And that process should include credit factors other than ratings, the article advises.

"Examiners will expect to see evidence of progress toward compliance with the rules during initial examination reviews," the article notes. But it also acknowledges that "there will be a learning curve as bankers develop, modify and enhance due diligence methodologies."

Speeches

Minority-owned community banks that may have to raise additional capital to meet new rules now have additional leeway in where they get that capital, Comptroller of the Currency Tom Curry told the 2013 Interagency Minority Depository Institutions and CDFI Bank Conference on June 11. The OCC had required at least 51 percent minority ownership in the past. But Curry said the OCC's new policy statement has discretionary language that will allow the OCC to consider a bank as an MDI even if it no longer meets the 51 percent ownership criteria, provided that it still serves the needs of the minority community for which it was chartered.

Changes

Troubled community banks that end up with composite supervisory ratings of 4 or 5 may get a letter about the results of their Federal Reserve safety and soundness exam, rather than a long-form report, according to **SR-13-10** issued on April 25. The change, which affects all community banks supervised by the Fed, took place immediately.

There were 612 problem banks in the first quarter of 2013, according to the FDIC's **Quarterly Banking Profile**. ■

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. Invictus runs a stress test on every U.S. bank each quarter with its patent-pending Invictus Capital Assessment Model™ (ICAM). Bank clients have excellent results when using Invictus reports to defend their strategic plans and capital levels to regulators.

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Next in *Bank Insights:* Director's Risk Responsibilities