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INVICTUS

Bank Insights

Regulators Outline Best Practices for Capital Adequacy Planning

Even well-capitalized banks need a robust, forward-looking process to determine capital needs in relation to risks and strategic direction, regulators have said in repeated bulletins and recent reports. And that means that examiners expect to see such plans, no matter the size or charter of the bank.

"Capital planning is integral to ensuring your bank's safe and sound operations and ongoing viability," states the OCC in ***A Common Sense Approach to Community Banking***, which was published in June. The booklet advises that the capital planning process should be commensurate with the "bank's overall risks, complexity, and corporate structure."

Capital planning must be "forward-looking in incorporating changes in a bank's strategic focus, risk tolerance levels, business plans, operating environment, or other factors that materially affect capital adequacy," the OCC wrote in June 2012, when it issued revised **guidance** on evaluating capital planning and adequacy.

The Federal Reserve struck a similar chord in August's **report** on capital planning for large banks. The report listed seven principles of an effective capital planning process:

- Establish a sound risk-measurement infrastructure that helps identify, measure and assess a bank's risks and exposures;
- Translate those risk measures into estimates of potential losses over a range of economic scenarios;
- Have a "clear definition" of available capital and a plan to estimate available capital resources and projected revenue during a series of stressed scenarios;
- Have a process to bring together the estimates of losses and capital resources to assess their combined impact on capital adequacy and the bank's strategic goals;
- Make sure the bank's capital planning is comprehensive enough to establish appropriate capital levels and capital contingency plans;
- Ensure that there are internal controls over the capital adequacy process and appropriate documentation and review;
- Demand that oversight of the capital planning process and approval of capital planning belongs to the senior management and the board.

Capital planning helps a bank's board and senior management to:

- Identify risks, set risk tolerance levels, and assess longer-term planning.
- Pinpoint vulnerabilities such as concentrations and determine their impact on capital.
- Integrate business strategy, risk management, capital and liquidity planning decisions, including due diligence for a merger or acquisition.
- Have a forward-looking assessment of capital needs, including those that may occur during future economic downturns.

Source: OCC

The OCC's 2012 directive to banks notes that a good capital planning process helps senior management and the board in identifying risks, exploring business strategies and achieving long-term strategic goals. The OCC says that the most effective capital planning takes into consideration short and long-term capital needs, as well as unforeseen events, and coordinates it all with the bank's strategic plans over at least a two-year horizon.

Much of the 2012 directive is repeated in this year's guide for community banks, an emphasis that banks should consider when preparing for exams.

Regulators say that effective capital planning should ensure that a bank has enough capital before any material risks happen. "Because raising capital normally becomes more difficult and expensive once a bank is confronted with problems, optimally any capital raising events should begin before any major issues materialize," the OCC says in its community bank publication. "A well-run bank regularly assesses capital to ensure that capital levels remain adequate, not just at one point in time, but over time."

Inside this issue:

- Boosting the M Score in CAMELS, *(page 3)*
- CFPB Examiner Staff Tops 300, *(page 4)*

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The OCC outlines four essential parts of capital planning:

- Identify and evaluate risks
- Set and assess capital adequacy goals related to risk, for short and long-term needs.
- Maintain a strategy to ensure capital adequacy and contingency planning
- Ensure integrity in the process by requiring board oversight and involvement and reviewing capital goals at least annually.

The OCC cautions banks that regulatory minimum capital ratios are merely standards, and banks should maintain capital "well above" the minimum levels, even if they are well-capitalized.

"Because each bank is unique in its strategic plans, complexity, and products and services, the appropriate level of capital for a bank cannot be determined solely by applying a mathematical formula," the OCC advises. "For example, what may be an acceptable capital level in one $50-million bank may be inadequate in another similarly sized bank with significant concentrations of credit or an aggressive investment philosophy."

Take into account your bank's business activities, risks and operating environment when you prepare your capital planning process. The more complex the bank, the more detail examiners will expect. Mutual savings associations, for instance, have limited means to increase capital fast, so regulators will expect to see comprehensive capital planning.

"Incorporating the results of stress testing into capital planning is an effective means of quantifying the potential impact of identified risks particularly for complex banks and those with higher risk profiles," the OCC says in its 2012 directive.

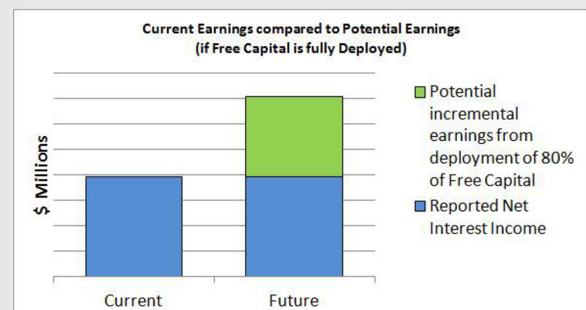
Have a strategy to maintain capital adequacy and build capital, the OCC stresses. Banks should evaluate internal and external sources of capital to define a strategy to raise capital when necessary. Banks must also consider contingency plans to preserve capital during economic downtowns. ▪

Five Knowledge Points for Boards

A smart capital planning process ensures that the bank's leadership team and board of directors are making the right decisions for the bank and its shareholders, says Adam Mustafa, Invictus Consulting Group senior partner. Here are five essential items that every member of the board and leadership team should know:

1. The bank's capital requirements based on its existing commitments and business model. It would be a disservice to shareholders to calculate these requirements using a generic thumb-rule rather than through customized stress testing.
2. Exactly how much FreeCapital (excess capital) the bank has as of the most recent quarter. Understand how FreeCapital changed quarter over quarter, based on its sources (earnings, capital raises) and uses (loan growth, change in asset mix, stress profile).
3. What percentage of that FreeC apital is reserved for the bank's strategic plan over the next two years, which includes capital-intensive actions such as loan growth, dividends, and expense increases.
4. Each strategic action should be assessed based on the amount of FreeCapital the bank needs to allocate or invest, and the prospective marginal return on the investment.
5. The cost to shareholders of NOT utilizing FreeCapital.

FreeCapital is the difference between the capital on a bank's balance sheet today and its regulatory minimum capital requirement, which is calculated via a two-year "Severely Adverse" stress test.



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Risk Management Tools Tied to Better CAMELS Rating

To get high scores on the M, or management, component of the CAMELS composite rating, examiners expect to see an involved board of directors and strong risk-management practices. They want assurance that all risks have been identified, measured, monitored and controlled – and that the bank's leadership can quickly address existing problems and anticipate future ones. Bank Insights sat down with Tom Rideout, Invictus Consulting Group executive director, and discussed how banks can use stress testing tools to improve their M score.

Q: Why is stress testing an effective risk-management tool?

A: It shows banks where they are managing risks well, and where they are not. They are better able to make decisions about where to allocate internal resources, lending officers, assets. It just gives you a more nuanced and sophisticated plan for the bank's strategic options. This will enable you to do a much better job of managing the bank for your stakeholders, investors, customers and employees. You're able to look behind the numbers and see things about your bank you would otherwise not see.

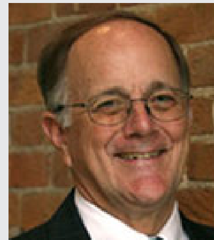
Q: Is there any benefit at exam time for a community bank that does capital stress testing?

A: I believe there are extra points for community banks that do stress testing without a formal requirement. The bank is showing a keen interest in managing its balance sheet, and managing its capital in new and more nuanced ways to better understand its risks. It would probably be noted in the examiner's write-up and would underscore confidence in how the enterprise is managed.

Q: Why would an examiner like to see the test results?

A: It's almost like taking an X-ray that allows you to take a deeper dive into the overall cumulative condition of a bank's assets. It goes beyond a routine examination. Examiners don't look at every loan on the books. They sample loans. What the stress testing report does is allow them to look at the loan portfolio in a different way. It subjects the portfolio to economic conditions not anticipated when the loans were underwritten. It gives the bank and the examiners a better sense of how these loans would perform.

About the Expert



Thomas P. Rideout's banking career spans more than 40 years. As Senior Vice President for Funds Management, he oversaw strategic capital planning and balance sheet management for Wachovia Bank & Trust Co., NA of Winston-Salem, N.C. Later in his career he was President & CEO of Savannah (GA) Bank & Trust Company. After its sale to First Union Corp. of Charlotte, he became Vice Chairman of First Union National Bank of North Carolina. Mr. Rideout was the volunteer president of the American Bankers Association during the passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989. He received a B.A. cum laude from Washington & Lee University, completed the Institute of Investment Banking at the University of Pennsylvania's Wharton School of Business, and is an alumnus of Georgetown University's Leadership Coaching Program.

Q: What happens if my bank has problems?

A: The bank should develop a contingency plan. We helped one of our banks create a contingency cost reduction plan with triggers. When that was overlaid on the stress test analysis, the bank was no longer undercapitalized. Regulators want to see preventive solutions and will reward – not penalize – banks that show any capital deficiencies as long as they have a cure ready.

Q: Do I always share my test results with examiners?

A: No matter what the test says, it probably isn't something you want to withhold. The reason to do a stress test is to understand the true condition of your bank. It's kind of like undergoing a physical. It points out areas of potential risk, potential weaknesses that should get attention. Depending on the results, you present them to your board and the examiners and explain what you discovered and what you are doing about it.

Examiners will say, "These people are on top of their game. They are managing the bank much more effectively than the last time we were in here." Isn't that what every bank CEO wants to hear? ▪

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Read Between the Lines

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

CFPB Examiner Staff Tops 300

The Consumer Financial Protection Bureau has hired more than 300 examiners, with a "significant majority" having experience in federal or state examinations or private industry. The agency's focus on consumer protection means it views risk assessment at institutions differently than bank examiners. It looks at "institution product lines" and compares them across all entities, the CFPB reveals in its latest **Supervisory Highlights**. So far, the CFPB has found that nonbanks are more likely to lack adequate compliance management systems. Banks, however, are missing the boat when it comes to independent compliance audits.

QM Rules Clarified

Confused about the Ability-to-Repay requirements for originating Qualified Mortgage loans? The CFPB compares them in a very helpful **chart**.

Boards Must Be Involved in Dodd-Frank Stress Tests

In March 2014, banks with between $10 billion and $50 billion in assets will be required to publish stress tests under the Dodd-Frank law. The **proposed guidance** reminds banks that the board and senior management must "consider the results of the stress test in the normal course of business, including, but not limited to, the company's capital planning, assessment of capital adequacy, and risk management practices." The ultimate responsibility for stress testing rests with the board, the interagency proposal states, and the bank must "ensure that its post-stress capital results are aligned with its internal capital goals and risk appetite."

FASB Proposal Supported By Regulators

The new impairment standard proposed by FASB has the support of all the federal banking regulators, Comptroller of the Currency Thomas J. Curry reiterated in a **speech** on Sept. 16 in Washington. The proposed standard –the Current Expected Credit Loss Model, or CECL– would replace the existing incurred loss model and could have far-reaching implications for community banks. CECL would require banks to use historical information, current conditions, and reasonable and supportable forecasts to estimate expected shortfalls over the life of a loan.

Regulators want to make sure banks are maintaining appropriate allowances for loan losses, and a revised impairment standard would help bankers maintain reserves, Curry said, adding that smaller, less complex institutions should have more time to implement any new FASB rules.

Appraisals Come Under Scrutiny

Expect scrutiny of your appraisals in your next exam. The OCC has found problems in the oversight of appraisal management companies and in the development, reporting and review of evaluations, Darrin Benhart, deputy comptroller for credit and market risk, told the Mortgage Bankers Association's Risk Management and Quality Assurance Forum on Sept. 11.

"Many of you are making strategic decisions around how your institutions will participate in the mortgage industry going forward. A key part of your decision-making process needs to include the build-out of a strong risk management function to ensure compliance with the myriad of new rules," he said. "In the past, credit risk, operational risk, compliance, audit, and quality control functions sometimes worked in silos. As a result, the systemic nature of problems across different products, platforms, or risk areas often went unnoticed until the issue was significant. Risk management groups today need to be multi-dimensional, and banks need a culture that promotes risk identification across business lines." ■

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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