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Bank Insights

What Community Banks Should Learn from the Fed's CCAR 2015 Scenarios

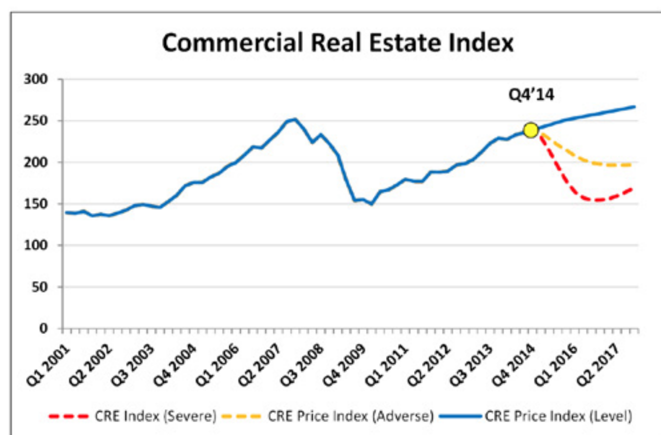
By Adam Mustafa

Last month, the Federal Reserve released the macroeconomic **scenarios** for banks with more than $50 billion in assets that are required to submit capital stress tests under the Comprehensive Capital Analysis and Review (CCAR) program. Each year, the Fed adds a unique twist to these scenarios, a twist which can provide insights into regulatory priorities for all banks. Although stress testing is not required for community banks, smart banks should understand what regulators are thinking, and use that knowledge to get ahead of both their competitors and examiners.

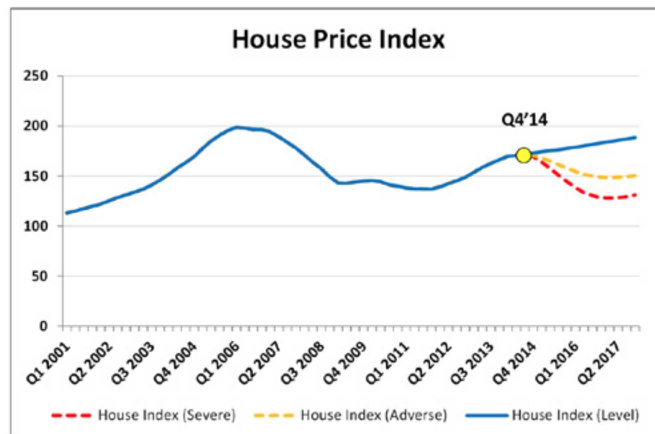
Here are a few key takeaways from the CCAR 2015 scenarios that community banks should follow:

1. **Regulators are worried again about a bubble forming in both residential real estate and CRE prices.** The declines they have simulated in the "Severely Adverse" case scenario are steeper than when the CCAR program began.

   In many markets, real estate prices have fully recovered from the financial crisis of 2008 and, in some places, CRE prices have soared well above their all-time highs. We've heard of multifamily deals taking place in New York City at cap rates around 3 percent. Perhaps regulators have a reason to be concerned, especially as interest rates rise. The bottom line is that community banks should be prepared to demonstrate how their CRE portfolio will perform under a multitude of scenarios.



   A loan review approach will not cut it. While loan review—the categorization of loans into appropriate classifications, ALLL analysis, and the documentation review—is important, it is not a stress test. Similar to traditional balance sheet or call report analysis, loan review is based on historical and current environments. Stress testing is the only forward-looking way to evaluate the performance of loans in different economic environments and determine their impact on capital adequacy *(See story, p. 3)*.



2. **Regulators have introduced the new interest rate risk test – and it includes a mini-recession.** This is the jaw-dropper this year, although the Fed did hint this was coming in the last two CCAR stress tests. While the regulatory focus with the CCAR banks has been – and will continue to be – the Severely Adverse Case scenario, the milder Adverse Case scenario now includes a massive increase in both short-term

Why Stress Tests Are Required

The largest banks undergo annual stress tests to:

1. Ensure that they have "robust, forward-looking capital planning processes"
2. Account for their unique risks
3. Make sure they have enough capital in an economic downturn

Source: Federal Reserve

Inside this issue:

- Loan Review Inadequacies *(page 3)*
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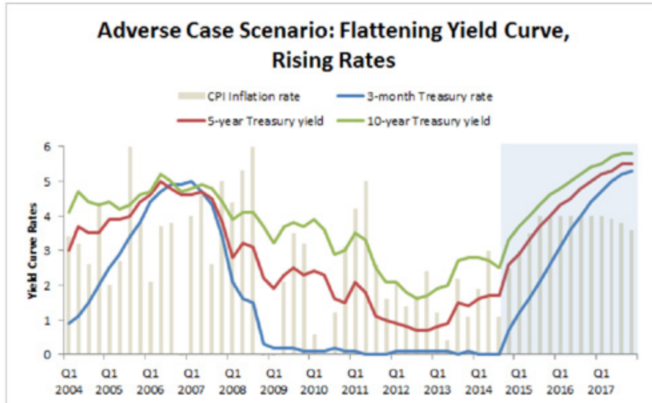
and long-term interest rates, a flattening yield curve, as well as rising inflation.



Banks have been telling regulators for a while that they will benefit when interest rates return to normal, assuming they will just make more loans at the higher interest rates and higher spreads. While this is probably true for the largest banks because they have the sophistication and the hedging strategies in place, many community banks continue to take false comfort in their asset/liability models.

Regulators didn't have the data to push back against the ALM models, but they have found an alternative solution: Have the banks perform interest rate risk assessments in the face of a modest economic recession. This has many ramifications. First, it will limit, if not eliminate, the offset of making new loans at higher interest rates. Second, the increase in debt service for many floating rate loans will lead to spikes in defaults since borrowers' cash flows would be squeezed on both ends. Finally, the bloodshed that would take place in investment portfolios and liability structures would be crippling to some banks.

The Fed may also be using this information to do its own strategic planning here as well. Remember, the situation they are in is unprecedented, and it will be difficult for them to manage an increase in interest rates with an improving economy, while both inflation and deflation remain non-issues.

Will this scenario be required for community banks? Probably not. But if you were a director sitting on a community bank board, wouldn't you want to know how your bank would handle this scenario? Could you think of a better risk management analysis given the current economic climate? Is there a more practical "worst case" scenario that banks are facing today?

3. **Although they don't say it, the Adverse Case scenario is also a disguised liquidity stress test.** Check out this quote from the Fed's instructions for 2015: "…firms should interpret the rise in short-term interest rates embodied in this year's adverse scenario as crystallizing certain risks to banks' funding costs. In particular, commercial deposits should be viewed as being unusually drawn to institutional money funds, which re-price promptly in response to changes in short-term Treasury rates."

   In other words, regulators want to see how you will handle some form of disintermediation in your deposits in the face of a moderate recession. Although many community banks have taken steps forward in terms of collecting better data on their loans, most are sorely behind on the deposit side. Banks should be able to segment their deposits in much greater detail than they are currently doing. Only then will they be able to understand their risks on this front, as CCAR 2015 virtually requires this from the big banks.

To sum it up: The lessons that community banks can learn from the CCAR 2015 stress scenarios are not about scare tactics, regulatory requirements coming down the pike, or best practices in enterprise risk management. Your regulator may never even broach these topics with you. This is about reading between the lines and positioning your bank to take advantage of these scenarios, so that if they do occur, you can take market share from your weaker competitors. ▪

About the Expert

Adam Mustafa is a co-founder of Invictus Consulting Group and has been providing stress testing and capital adequacy advisory services to banks, regulators, bank investors, and bank D&O insurers since the beginning of the financial crisis. Mr. Mustafa has overseen the design and implementation of fully-customized capital stress testing, capital management, and strategic planning systems for community banks ranging from under $100M in assets to Dodd-Frank banks that have in excess of $10B in assets. Within the community banking space, he has advised acquisitive and high growth banks, banks under enforcement action and significant regulatory pressures, and de novo banks. He has also been a featured speaker on stress testing for community banks at a number of conferences, including those hosted by regulators. Prior to joining Invictus, he had senior-level experience as a banker, financial services consultant and corporate CFO. He has an MBA from Georgetown University and a BA from Syracuse University.

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Warning: Traditional Loan Review May Cause Banks Trouble in the Future

There's no doubt that the loans your bank made in the post-recession years are going to change down the road, when interest rates rise and the economy swings yet again. But will your loan review process spot that shift in time?

Odds are it won't.

And that will cause big trouble when it comes to a bank's strategic and capital planning. Any bank that relies solely on their existing loan classification system (whether supported or not with a loan review process) will end up with unanticipated losses and charge-offs.

Regulators who have had the benefit of seeing the impact of the 2008 recession across the entire banking landscape have recognized this limitation. They no longer look at historical performance to assess how your bank will fare in the future. Instead, they now want to see how your capital will perform under a two-year severe economic downturn. The loans your bank has made will each react differently to such a downturn, depending on loan vintages and their concurrent economic conditions.

Seemingly identically classified loans with different vintages will have substantially different probability of default (PD) and loss given default (LGD) levels in the future.

Estimating PDs and LGDs is important for a bank for its own internal use, but it is also vital in M&A analysis. M&A is nothing more than a compressed contribution to a bank's long-term strategic plan. Having the correct assumptions about loan performance becomes even more critical in the evaluation of potential targets.

Traditional loan review worked well in a stable environment and was reflected in the regulatory Basel 1 and Basel 2 structures. But after the 2008 recession, it has become more of a checkbox exercise that measures and validates a bank's internal classification system, based on pre-recession criteria.

"In this new world, the value of the loan review process has become fairly limited, not just for regulatory action, but also for helping a bank with its strategic planning," said Invictus Consulting Group Chairman Kamal Mustafa. "The point is that the traditional loan review process that ignores vintage is useless. Two loans within the same classification level but with different vintages would have dramatically different PDs and LGDs. Banks that ignore these issues –and there are many because community banks are not required to stress test themselves– are compromising their own strategic and capital planning process. And that is an extremely dangerous compromise in these uncertain and volatile economic times."

Some market participants believe that loan review is the same as or a substitute for stress testing. Similar to traditional balance sheet or call report analysis, loan review is based on historical and current environments. Stress testing is the only forward-looking way to evaluate the performance of loans in different economic environments and determine their impact on capital adequacy.

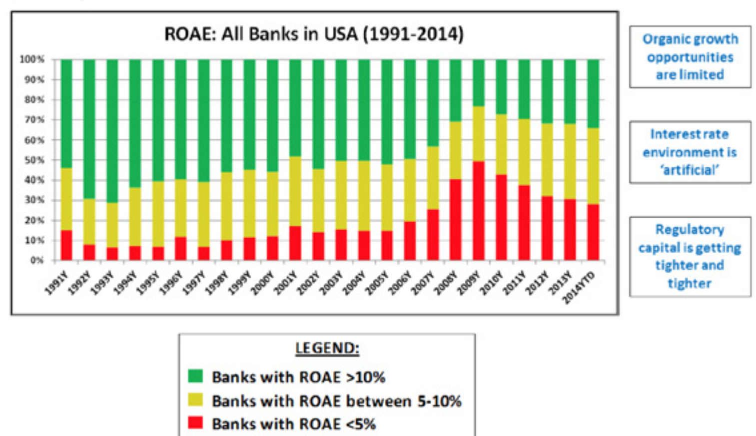
The Office of the Comptroller **considers** "some form of stress testing or sensitivity analysis of loan portfolios on at least an annual basis to be a key part of sound risk management for community banks."

The guidance noted that while many banks routinely conduct interest rate sensitivity analysis, they often don't have "similar processes in place to quantify risk in loan portfolios, which often are the largest, riskiest, and highest earning assets." ▪

The "Catch 22" on Bank Capital

Here's a snapshot of the banking industry that should give every CEO pause. It illustrates the earnings pressure on banks and shows why consolidation is inevitable. Even though the industry has essentially worked through the financial crisis, two out of every three banks in the country still have less than 10 percent ROE, which is higher than in the pre-crisis years. Shareholders will not accept such low returns in the future. Yet regulators want banks to hold even more capital, which creates a "catch 22" for management teams as they navigate banks through a highly competitive and artificially low interest rate environment. As part of its analysis of the M&A market, Invictus Consulting Group estimates that 611 community banks must sell, 542 banks should sell, 710 must buy and 984 should buy to achieve maximum shareholder value. ▪

Pressure on ROE



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Read Between the Lines

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

Fed Releases Banking Application Details

As promised, the Federal Reserve has for the first time released **statistics** on banking applications. A review of processing times for 2013 and the first half of 2014 by bank asset size reveals that M&A proposals submitted by community banks with between $1 billion and $10 billion in assets took on average 77 days, while those submitted by banks with assets below $1 billion took on average 51 days. The Fed received adverse public comments in about 12 percent of the M&A proposals from larger community bank. The Fed reported approving 61 M&A proposals from smaller community banks in the first half of the year, and 35 from larger community banks.

Survey Hints at Coming Wave of M&A

Consolidation is on the agenda next year for more than 20 percent of banks that participated in a survey from the Federal Reserve and the Conference of State Bank Supervisors. The survey and state-by-state town hall **report**, was released as part of the second community bank **conference**, which was held in September. More than 60 percent of the respondents expected greater competition in the future, and while a majority have not received or made M&A offers, many community banks expect such offers next year.

Executive Compensation Still in the Works, OCC Reveals

Comptroller Thomas J. Curry told the Clearing House Association annual **conference** in November that he hoped the incentive-based compensation regulations, which were mandated under Dodd-Frank for banks with at least $1 billion in assets, would soon be a reality. The rule, first proposed in 2011 and not yet finalized, would require reporting of incentive-based compensation deals that could lead to a material financial loss. "Banks should never wait for regulators when it comes to protecting their own safety and soundness or reputations," he said.

Heightened Standards Explained

Curry also revealed why the OCC felt that larger banks needed regulations requiring heightened standards, which were published earlier this year. He said "progress was too slow" when the banks weren't required to institute the standards, so the agency wanted something that was "enforceable."

Under the guidelines, the large banks must "make clear that quantitative limits on risk-taking should be based on sound stress testing processes and other methods, taking into account banks' earnings, capital and liquidity positions."

Fed Reminds Banks of Contingency Funding Plans

Worth reading: The Fed has issued an **overview** of what examiners expect when it comes to contingency funding plans in a liquidity crisis for community banks. Boards must monitor and approve annually the bank's liquidity risk management practices. The contingency funding plan should consider stress events with various time horizons.

OCC Updates Guidelines on Matters Requiring Attention

Deficient bank practices that emerge in exams are sent in writing to bank boards and management teams as "Matters Requiring Attention." The OCC updated its **MRA guidelines**, noting that all such documents are in a "Five Cs" format: concern, cause, consequence, corrective action, commitment. The OCC must verify that the bank has taken corrective action before it will close a concern. Banks that self-identify concerns are "an important consideration" when the OCC assesses the bank's risk management system. The guidance reinforces the need for timely and effective communication with bank management and boards.

FDIC Videos Help with CFPB Mortgage Rules

The FDIC has produced the first in a series of three **videos** that will help banks comply with CFPB mortgage rules. The videos are part of the FDIC's efforts to help bank officers understand complex regulations. The hour-long video covers ability-to-repay and the qualified mortgage rule. ▪

About Invictus

Invictus Consulting Group's bank analytics, strategic consulting, M&A 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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