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INVICTUS

Bank Insights

Lessons from a Community Bank Turnaround: Capital is King

This is the story of how a Seattle community bank on the brink of failure in 2009 turned itself around, went public despite the odds, and is now positioned for growth. HomeStreet Bank's five-year odyssey offers lessons for community bank CEOs everywhere.

And they begin at the top, with turnaround CEO Mark Mason, a 28-year banking veteran. Regulators had already deemed the bank troubled when the board appointed him to run the floundering bank in 2009. Classified assets had hit $760 million, the bank's Texas ratio was at 160.7 percent, and its net interest margins was 1.04 percent. The bank was under an FDIC cease and desist order, and it had to get its Tier 1 Capital ratio to 10 percent, or risk closure.

"When I was interviewing for the job, I told the board what I thought I could do," Mason recalled. "I said I would recapitalize by taking the bank public."

Most investment bankers had told him it wasn't possible. He proved them wrong. After two failed attempts, the bank closed its IPO in February 2012, yielding net proceeds of $88.7 million. The FDIC removed the bank from its troubled bank list.

Mason was experienced at turning around troubled banks, and the problem asset levels didn't intimidate him. He saw a bank with high quality, long-tenured employees, strong management and the potential to generate income to pay for the bank's losses.

He quickly came to the conclusion that the bank's woes were "a story of unintended consequences," not poor management, all centered on residential construction. The bank had been around for 90 years, and even had the distinction of being Fannie Mae's oldest continuous lending relationship.

Ironically, the loans that got into trouble weren't no-doc loans or subprime. They bank's conservative board and management had stayed clear of such loans. Instead they committed too much capital, as it turns out, to home builders. "They breached the cardinal rule of diversification," Mason said.

He helped the bank grow its mortgage business four-fold. When MetLife announced it was closing its home loan division in 2011, HomeStreet recruited its lenders and operations staff in the Pacific Northwest. Today it is the largest purchase mortgage originator in the region, surpassing Wells Fargo in recent quarters.

From the start, Mason maintained close contact with the bank's regulators. "They are your primary constituents. They determine how much time you have," he said. "To create credibility, you must be transparent."

He met monthly with the regulators and developed a reasonable plan to turn the bank around. He kept in touch to show them how he was progressing and made sure they never heard a "surprise" from someone else. He has maintained close relationships with his state and federal regulators, speaking with the FDIC several times a quarter and meeting in person with the regional director at least twice a year.

"To create credibility, you must be transparent."

—Mark Mason

"For a leader, you must be supremely confident. You are absolutely convinced of success," he said. "Everyone around you thinks you are going to fail, including the regulators." The big challenge is to maintain and improve the bank's capital ratios. He says you can do that, even if you lose money on assets, because capital is a ratio. But don't forget revenue, he cautions.

He also made sure he retained the bank's special assets staff. He had to convince them that in a turnaround situation, with falling asset values, the most important thing is the speed at which you get rid of the assets, not the price you get for them.

"Get rid of assets quickly, and move on," he advises.

That's not as easy as it sounds, Mason notes, because special assets people view success differently. So he celebrated velocity.

He made sure he had the right leadership in the bank's business segments. "It's easy to say hire the right people. Great people go where they are attracted. Understand who you are trying to attract and how to be attractive," Mason advises.

And he was aggressive. "Don't be afraid to take risks. Not just credit risks, capital risks, risks with opening offices, risks with expanding. If you have the right people, you'll largely be successful."

Inside this issue:

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In the fourth quarter of last year, HomeStreet Bank acquired two banks. Its long-term strategy is to establish a significant mortgage banking share through the opportunistic hiring of high-performing teams of originators in existing and new markets. Mason wants to grow the traditional bank business by following mortgage expansion.

Today the bank has $3.1 billion in assets and its pro forma net income was $2.8 million in the first quarter, excluding acquisition-related expenses. For the long-term, Mason is aiming high—he plans on an ROE of more than 15 percent, once growth is stabilized.

Key Elements of HomeStreet Bank's Turnaround Strategy

1. Improve and maintain superior regulatory relations. Be transparent and meet monthly, in person, if possible, to review the bank's performance and its forecast. Don't allow surprises.
2. Retrain the bank's workout and REO personnel. Maximize speed, not recovery. Do the hard things, but be flexible when necessary. Take deeds in lieu to speed resolution.
3. Parallel track foreclosure and negotiation.
4. Remember that capital is king. Maintain and improve capital ratios, no matter what. Sell assets at a loss, so you can improve asset quality and capital ratios.
5. Develop the people you have. Challenge them to figure out how to meet your ever-increasing expectations.
6. Create a reasonable but aggressive plan and set achievable goals. Then set the next round of goals even more aggressively.
7. Don't forget revenue. Cost-cutting won't turn around a company, but improving and expanding existing businesses will. Figure out the missing pieces.
8. Exhibit confidence. ▪

HomeStreet By the Numbers

	Dec. 31, 2009	Dec. 31, 2013
NIMS	1.04 percent	3.17 percent
Non-performing assets	$482 million	$38.6 million
Net Income (loss)	$(110.3) million	$23.8 million
Classified assets	$570 million	$51 million
Total assets	$3.21 bllion	$3.07 billion
Tier 1 Leverage Ratio	4.53 percent	9.96 percent

Stress Testing Myths and Realities

There are four misconceptions about stress testing that plague the community bank market, Invictus Consulting Group's senior partner Adam Mustafa said on a KPN webinar this month.

The myths:

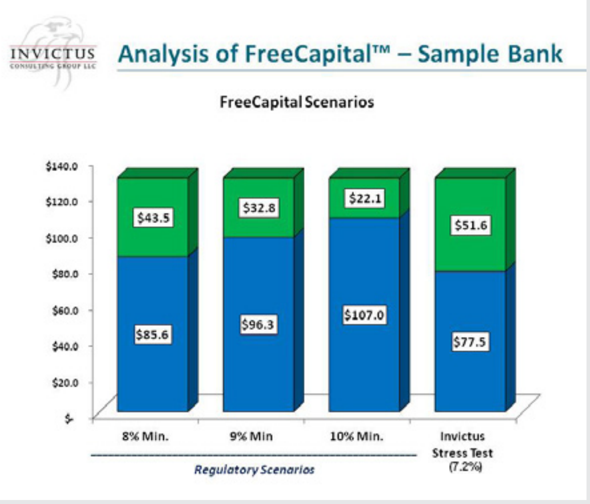
1. It's required for all banks.
2. It's primarily an ERM exercise.
3. It's really an extension of a loan review.
4. It's driven by historical loss experience.

The reality is that stress testing is only required for banks with assets of $10 billion or more. But community banks that follow stress testing best practices can often better defend their capital ratios and strategic plans to regulators.

Mustafa also described stress testing best practices. Those include:

1. Treat stress testing as a strategic planning exercise first and foremost.
2. Use it to look at your loan portfolio in a dynamic and not a static way.
3. Make sure it's a forward-looking approach.
4. Use it as the centerpiece of a capital plan.

Stress testing is the only way to calculate the amount of FreeCapital™ a bank has for descretionary purposes, such as acquisitions and dividends. The graphic below shows that a capital stress test gave the bank the equivalent of raising $8 million at no extra cost to the bank.



If you'd like to listen to the webinar "Stress Testing is FreeCapital™," please **contact George Callas** for access.

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How Stress Testing Strengthens CAMELS

A Client's Perspective

After Community First Bank's last safety and soundness exam, regulators told CEO Charles W. Daily that capital stress testing had strengthened the bank's management rating in its CAMELS composite score. The examiner was "especially impressed that were doing this complex stress testing as a small bank," Daily said.

Community First Bank, a $208.2 million bank in Fairview Heights, Ill, a suburb of St. Louis, isn't required to do stress testing. Bank regulators now mandate capital stress testing only for banks with assets of $10 billion or more, though most regulators say it is best practice for smaller banks.

"It's not mandated, but we decided to do it anyway," Daily said. "Small banks like ours that are not doing it are not going to be downgraded, but he said it helped strengthen it, for sure."

Daily, one of the bank's founders, has been CEO since the bank opened in 1988. He attended a regulatory conference hosted by the Conference of State Bank Supervisors in 2011, where Invictus Consulting Group chairman Kamal Mustafa and partner Adam Mustafa were speaking on a panel. He was impressed by their knowledge of banking, and the explanation of the Invictus stress testing process.

Other firms also presented stress testing plans, but their processes seemed "like window dressing for regulators," Daily said. The Invictus stress testing "had a lot of merit," offering the bank "meaningful information" it could use, he added.

"I'd been in banking a long time, but we really hadn't done stress testing before. We always kept extra capital. We never quantified it. Examiners could never tell you that it was enough. They would say that it's good you're keeping extra."

Regulators Reward Bank

Flash forward a few years, and Daily couldn't be happier. Not only have regulators rewarded him for being proactive, but he and his board have confidence that Community First has enough capital to continue on its strategic growth plan, even if there is another financial crisis.

"The Invictus stress test model is a tool that has helped us evaluate our capital adequacy in conjunction with our strategic plan for future growth. We want to grow, but we want to keep an eye on our capital to make sure we have enough to survive a severe economic downturn," he said.

He likes the fact that the Invictus model gives "absolute results" because it incorporates the bank's specific loan makeup, internal loan ratings, loss history and risk migration. Trends in stress testing over the past few years have also been revealing. "Analyzing a compilation of individual stress tests done over time has been important in validating the model as a tool in capital planning," he said. "The Invictus model also helps us look at the migration of risk in our ALLL model. We've gotten more insight into that process and it helps us do a better job of allowance for loan losses."

Management presents the stress test results to the board semi-annually. Graphics make it easy for the board to read and comprehend the results. "The board relies on them to understand our capital adequacy under a combination of growth and adverse scenarios," he said. "We tell them the bank's growth goals and what capital is needed and they can look at all that and see we would be able to have adequate capital, even in a crisis."

And he appreciates the individualized, flexible service he gets from Invictus, which includes conference calls and a willingness to tailor graphics to the bank's needs. "They are very accommodating. They take the time to learn about the uniqueness of our bank," Daily said. "Over the years, they have been very willing to change and customize various managerial reports when requested."

The bank incorporates the stress testing results into its overall enterprise risk management program. "Everything revolves around having capital. We're a small bank. Our ability to get new capital is limited. We have a strategic plan on the direction we want to take the bank without putting strain on our capital," he said. "The Invictus test results show that if we have a severe economic downturn, even worse than the last one, that we would have the reserves to survive it."

The process allows Daily to demonstrate to regulators that the bank understands what is happening with its capital. "At our most recent exam, the regulator mentioned that since our bank had been stress testing for several years, it helped demonstrate our bank's proactive management approach, which is what they want to see at community banks," he said. ■

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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 Experiments with Off-Site Loan Review

The Federal Reserve is reviewing a pilot program that cut in half the on-site exam time for community banks by allowing examiners to look at loan documents off-site. The banks that participated in the experiment gave examiners secure access to loan portfolio information and the actual electronic loan documents needed for a credit review, the Fed reveals in this quarter's **Community Banking Connections**. There were technical issues with the quality of some images of loan documents, and some bankers were concerned about their inability to share insights with examiners about asset classifications. The Fed said it plans to institute off-site credit review to interested banks in the future, saying "the effective use of technology can be a key tool to enhance the bank examination process." The FDIC has for years used an off-site rating tool (a statistical model known as SCOR that predicts the probability of a CAMELS downgrade) as an early-warning system for troubled banks.

Fed Reviewing Community Bank Supervision

The Federal Reserve is conducting a "zero-based review" of its community bank supervision program, and will likely eliminate some guidance and revise others, according to the main article in the **latest issue** of the Fed's Community Banking Connections.

The article, "Board Staff Perspective on Community Bank Supervision: One Size Doesn't Fit All," emphasizes that the Fed treats community banks differently than larger banks. It says that Washington is "mindful" of community bank concerns that large bank requirements are often viewed as best practices that trickle down to community banks "in a way that is inappropriate."

Regulators Outline HELOC Challenges

Regulators have **issued guidance** to banks to deal with the impending wave of home equity lines of credit that are reaching their end-of-draw periods. The guidance recommends that banks begin conversations with borrowers about what will happen when their loans reset or reach maturity.

It encourages banks to work together with borrowers to avoid defaults and gives tips on how to manage potential exposures and risks.

How to Set the Tone for Effective Cyber Risk Management

Build a security culture from the top to make sure your bank is timely monitoring cyber risks, according to a recent community bank **presentation** from the FFIEC. Management must identify, measure, mitigate and monitor risks; develop plans according to the bank's risk and complexity; make sure that the bank's IT strategy is aligned with its business strategy, and get regular metrics on its vulnerabilities. Questions to ask: How does the bank test its plans to respond to a cyber-attack and do those tests include key internal and external stakeholders?

About 500 community banks will undergo cybersecurity assessments as part of their regular exams under a **new FFIEC pilot**. Regulators will use the information from the assessments to assess how banks are managing cybersecurity and whether they are prepared to mitigate increasing risks. The FFIEC has also published a **webpage** about cybersecurity issues.

Which Regulations Are Unnecessary or Too Much of a Burden?

Every 10 years, the Fed, the OCC and the FDIC review their regulations to identify those that are outdated, unnecessary or "unduly burdensome." Now is your chance to chime in with what you think. Comments can be submitted to the agencies' **website**. Jay Messenger, president of Muleshoe State Bank in Muleshoe, Tex., for instance, **says** it takes too much time for both the bank and its holding company to prepare and process the FRY-8 document.

More Time for Stress Testing

All the prudential regulators want to shift back the timing of the annual stress testing cycle by 90 days. The largest banks that are mandated to conduct stress tests would also not have to calculate their capital ratios using the **Basel III advanced approaches** until Jan. 1, 2016.

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.

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