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Bank Insights

How the Proposed Liquidity Rule for Large Banks Could Trickle Down to Community Banks

By Leonard J. DeRoma

The proposed liquidity coverage ratio risk measurements do not apply to community banks. Yet a careful reading of the proposed rulemaking suggests that there are unintended consequences that may hit the community bank market anyway.

The public comment period for Regulation WW, **"Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards and Monitoring,"** ended on January 31 with 108 comment letters. The rule has been modeled on the Basel III Liquidity Coverage Ratio.

As we have discussed with our clients, community banks are not subject to Basel III LCR or the Dodd-Frank derivatives regulations. However, most regulations flow downhill at some point. The LCR application for community banks in a reduced format, or through industry best practices, is almost inevitable.

In particular, the proposed rule recommends that large U.S. banks should not include municipal bonds munis in the effective portion of the High Quality Liquid Asset (HQLA) computation. That will put a lot of pressure on the banks to find comparative yielding assets that qualify for HQLA treatment. It will also affect the municipal bond market.

A 2012 165-page **SEC report** on munis noted that there were approximately $3.7 trillion municipal bonds outstanding. Issuance runs in the $400 billion to $600 billion a year range. Commercial banks hold about 8% or approximately $300 billion of munis. Many community banks feel morally obligated to participate in offerings, (as owners, selling group members or in the case of larger banks, underwriters) of local governmental entities in their respective geographic footprints. (It's good business and it's what a community bank is supposed to do—help support the community).

The SEC report further points out that the default rate of munis rated Baa or higher was actually lower than corporate bonds rated Aa or higher, which only fuels banker objections. There is also a similar rule change for corporates, although the impact is not as great for community banks.

If the rules are adopted as is, and if regulatory recommendations/best practices continue moving in their current direction, we may see a glacial shift in the ownership structure

*(see **Liquidity Rule**, page 3)*

Liquidity Red Flags

Significant increases in the following are liquidity red flags:

- Reliance on wholesale funding
- Large certiificates of deposit, brokered deposits, or deposits with interest rates higher than the market
- Borrowing
- Dependence on funding sources other than core deposits

Declines in core deposits and decreases in short-term investments are also trouble signs.

Source: **OCC**, *Detecting Red Flags in Board Reports*

ICBA Raises Concerns about GSEs, Brokered Deposits

The Independent Community Bankers of America has pointed out some aspects of the liquidity proposal that could affect community banks. In its **comment letter**, the ICBA said it had "great concerns" about restricting large banks from holding GSE assets in their pools of High Quality Liquid Assets. Such a restriction could affect the "future fair value risk to GSE securities" if large banks had to liquidate their holdings. The ICBA wants regulators to look at the impact of GSE liquidations on mortgage funding costs and the availability of credit for mortgages.

Also of concern are provisions that establish outflow rates on fully-insured reciprocal brokered bank deposit products. "Although community banks are not subject to the LCR based on proposed financial institution size, the penalties placed on these deposits raise larger questions about whether these deposits are currently or will in the future be scrutinized by the agencies," the ICBA notes. Such scrutiny could affect the number and quality of deposit products that community banks offer.

Inside this issue:

- How Stress Testing Helped MBank *(page 2)*
- Bank Directors Expected to Know Risk Appetite *(page 3)*
- An Effective Risk Appetite Framework *(page 3)*
- Fed to Disclose Bank Application Details *(page 4)*

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How Stress Testing Is Helping A Troubled Bank Look To The Future

A Client's Perspective

When MBank CEO Jef Baker took over the troubled bank in 2011, there was a 95 percent chance that the Oregon-based bank would fail. But Baker isn't your ordinary turnaround CEO – he is an accountant who had been the bank's CFO, and he likes to beat the odds.

Flash forward three years, and Baker is describing the $173 million Portland bank as "the little engine that could." Regulators just lifted the bank's PCA directive, and the bank closed out 2013 with $2 million in earnings. Although still under a consent order, MBank is now diving into strategic planning for the future.

Baker heard Invictus Consulting Group chairman Kamal Mustafa speak at a conference and knew he had to hire the company to make sure the bank's capital plan and projections were supportable. The strategic plans contained actions to improve the bank's risk profile, but were they enough?

At its board of directors meeting in February, two Invictus executives presented the results to the six-member board and explained what they meant and the assumptions that were used. Invictus showed what would happen to the bank with the strategic actions, and what would happen without them.

"They did a nice job of educating us as a client in how this worked, in walking us through all the data," Baker said. "They demystified the black box to help us better understand our risk profile, as well as helping us feel confident in talking about our stress testing with regulators."

The board package included information about the bank's loan portfolio and what kind of losses the bank could expect if the current economic environment were to significantly worsen. The Invictus model is able to dig into the loan portfolio to give a snapshot of asset quality by vintage and by concentrations, and pinpoint exposures that would lead to a potential loss of regulatory capital. In a comprehensive way the model also recognizes increasing overhead and reduced revenues, beyond just loan losses, in projecting results in a tougher economy.

"It was great to understanding our capital position better," Baker says. "Looking at the portfolio mix and the vintage is critical in understanding our balance sheet. I think it gave our board a deeper understanding of our loan portfolio, and a better appreciation of the stress tests we were doing."

Since the bank had never done a robust capital stress test before, the Invictus presentation was "brand new" to the board, Baker said. "I think they were very impressed. They recognized that this was a very high quality product and process. I think they felt comforted that we were 1) educating ourselves and understanding better our loan portfolio and potential impacts to capital and 2) being proactive in management, knowing that capital stress testing is not technically required. From a regulatory perspective, we believe it will be viewed as very positive."

Baker said he loves the Invictus model because it provided him with a perspective on what happened to the bank's portfolio historically, and it allowed him to take that loss experience and apply it going forward. "I think it's great that this model can use our historical loss experience along with information from the banking industry to focus on the actual portfolio today."

The bank submitted a capital plan to regulators about where it wanted to go, and the Invictus stress test indicated that the plan was acceptable. While the real benefit is a better understanding of a bank's risk profile, Baker admits he hopes that regulators reward the bank in its M rating for using stress testing as a risk assessment tool, even though it's not required for small banks. "If the regulators recognize our efforts, that will be the icing on the cake."

Why Board Input is Vital

Getting the board involved in capital stress testing is essential, especially when it involves strategic planning. To get high scores on the M component of CAMELS, regulators expect to see an involved board of directors and an extensive risk management program, as the **October issue** of *Bank Insights* explained.

Capital planning helps a board to identify risks, set risk tolerance levels and assess longer-term planning. It can also pinpoint vulnerabilities such as concentrations and determine their impact on capital.

For more on board responsibilities, see "Bank Directors Expected to Know Bank's Risk Appetite, Challenge Management," on p.3.

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*(from **Liquidity Rule**, page 1)*

of the municipal bond market. Banks with longer-dated munis may need to either sell prior to maturity, with potential losses, or increase the size of the asset books by adding HQLA qualifying securities into their portfolio from a now smaller pool of "less risky" securities.

In a future article, we will address the role of the investment portfolio, the strategic implications of the liquidity coverage rule and some tactical solutions. ▪

About the Expert

Leonard J. DeRoma is a founding partner and CFO at Invictus. He began his career at Citibank in the 1970s working with Kamal Mustafa in corporate finance. Using new techniques, together they developed sophisticated financial planning and modelling tools to help provide financial advisory services to Citibank's corporate finance clients. At Lehman Brothers, he managed global financing activity; for Barclays Capital, U.S. Fixed Income investment banking, trading, capital commitment, derivatives, sales, underwriting, foreign exchange and research. As the President of Barclays U.S. securities business, he was in charge of product development, was an advisor to the U.S. ALCO committee and chaired the U.S. Risk Management Committee. He managed the same businesses for McDonald Investments and KeyCorp. He has a Bachelor of Science in Electrical Engineering from the Massachusetts Institute of Technology and a Masters of Business Administration from the Harvard Business School. He has served on several industry boards and associations, including the Public Securities Association and the Bond Market Association.

Bank Directors Expected to Know Bank's Risk Appetite, Challenge Management

Community banks should read carefully the **OCC's latest proposal** to hold directors at large banks more accountable for risk management. While the proposed rule is aimed at banks with assets of $50 billion or more, the OCC is making it very clear that all banks, regardless of their asset size, should be aware of regulators' increased expectations.

Charles Taylor, the OCC's deputy comptroller for capital and regulatory policy, said as much in a **March 3 speech** during the Institute of International Bankers' annual Washington conference. While emphasizing that the proposed rule was designed for the largest banks, Taylor said "the OCC reserves the authority to apply the rules to an insured entity, including a Federal branch, irrespective of asset size, if that entity has operations that are highly complex or present heightened risk." The proposal says the OCC would consider "complexity of products and services, risk profile and scope of operations" of smaller banks to determine if they should comply.

An Effective Risk Appetite Framework

The **FSB** says a good risk appetite framework:

- Is driven by top-down board leadership and bottom-up management involvement
- Embeds the concept of risk appetite into the bank's risk culture
- Evaluates appropriate risk-taking and halts excessive risk-taking
- Allows the risk appetite statement to be used by the board to challenge and debate management recommendations
- Changes with business and market conditions

The proposal calls on bank directors to understand the bank's risk appetite "and to question, challenge and oppose management proposals that could lead to excessive risk taking or pose a threat to safety and soundness," Taylor said, adding that at least two of those board members would have to be independent of management. The OCC wants large banks to establish an actionable risk appetite framework, a recommendation made by the Financial Stability Board in November.

The OCC proposal also would mandate that banks use "three lines of defense" to ensure an effective risk framework: front line business units, independent risk management and internal audit. Those units should address all risks to earnings, capital, liquidity and reputation and use "sound stress testing processes" to help them. It emphasizes that bank directors must be engaged to understand whether the bank is well-managed or taking excessive risks.

Regulators already expect all bank directors to monitor their institutions for risks, and challenge management to make sure the bank is operated in a safe and sound manner. That's why when banks fail, the FDIC often files lawsuits against a bank's board members, holding them personally liable. There have been 1,089 defendants in FDIC D&O lawsuits from 2009 through the end of February.

The FDIC has produced a series of **technical videos** for community bank directors to make sure they understand their responsibilities. ▪

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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 to Disclose Bank Application Details

The Federal Reserve will start publishing a semi-annual report with statistics on how long it takes to process acquisition and expansion applications, the number of approvals, denials, and withdrawals – and the primary reasons for withdrawals. The first report will be released in the second half of this year, and include filings from January through June.

A careful reading of **SR Letter 14-2** offers clues about what it takes to win approval. Here are some highlights:

- Banks in in "less-than-satisfactory condition" – usually a CAMELS rating of 3 or worse – usually don't win approval. A 3 in risk management or capital can doom a bank's chance to expand. An overall rating of 3 usually means it will be hard to get approval for an acquisition unless the bank can prove to the Fed that the move would "strengthen the organization."

- Experience matters, especially on bank boards. The Fed will review the background, finances and professional expertise of officers, directors and shareholders when looking at applications. Proposed directors or managers with insufficient banking experience can kill a deal. Someone who has worked at an investment bank may not be right for a community bank, the Fed says. The Fed also is also wary of those officers who were "associated" with troubled banks or ones that failed.

- Banks' business plans must make sense. The Fed has problems with overly aggressive plans, ones that would lead to concentrations of assets, or those that don't address known deficiencies or risks.

FDIC's Gruenberg on Consolidation

While the community bank market is consolidating, the good news is that community banks are often those doing the acquiring. That's the takeaway from FDIC Chair Martin J. Gruenberg's **videotaped remarks** to the ICBA's national convention. An upcoming FDIC analysis will show that about two-thirds of the community banks that merged between 2002 and 2012 were acquired by another community bank. Most of the consolidation has been concentrated in banks with less than $100 million in assets, and 85 percent of those banks were acquired by other community banks.

OCC: Stress Testing is 'Fundamental Tool'

Risk management is essential in distinguishing the winners and losers in the banking market, according to Comptroller of the Currency Thomas J. Curry. He encouraged community banks to use stress testing tools to analyze commercial real estate, agriculture and other loan portfolios. In **virtual remarks** to the ICBA, Curry said stress testing tools help community banks understand how their portfolios will perform under different economic conditions. "I can't think of a more fundamental risk management practice than subjecting your credit book to rigorous testing," he said.

Interest Rate Risk Worries Examiners

The latest **FDIC quarterly report** shows the impact of rising longer-term rates on unrealized gains on available-for-sale securities. Banks reported $9 billion in unrealized losses on their available-for-sale securities. "Interest rate risk is an ongoing concern for bank regulators. And it will continue to be a focus of attention in our safety and soundness examinations," said FDIC Chairman Gruenberg. Community banks are seeking higher asset returns by going out further on the yield curve, leaving them vulnerable to interest rate risk.

CFPB Wants to Work with State Banking Regulators, AGs

The Consumer Financial Protection Bureau is already working with banking regulators in 14 states to share consumer complaints it receives on a real-time basis. **CFPB Director Richard Cordray told the National Association of Attorneys General** that every state AG's office should also partner with the bureau. He pointed out that the CFPB has "the ability to write new rules that create substantive law governing the operations of consumer financial markets. It is striking to me just how extensively the experience and perspective of attorneys general have been and will be informing these initiatives." ▪

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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