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Bank Insights

How Stress Testing Can Become a Bank's Profit Center, Not a Cost Center

Stephen Lange Ranzini, CEO of University Bank in Ann Arbor, Mich., used capital stress tests to convince his primary regulators that the \$125 million bank had excess regulatory capital. He says that the knowledge then gave the board of directors "the courage" to begin paying monthly dividends to the bank holding company.

Like Ranzini, many community bank CEOs across the U.S. are using capital stress testing as a tool to communicate their unique scenarios to regulators. (See Q&A, p.2) In today's post-recession regulatory environment, banks must be able to show regulators that the bank's strategic plans are workable, even if there is an economic downturn.

Invictus senior partner Adam Mustafa says stress testing should be a starting point for smart banks. "Our clients know that there are many stress testing applications. For starters, stress tests are the new calculator of capital adequacy for specific assets," he says. They also help management identify vulnerabilities and key issues.

In its **stress testing guidance** for community banks, the Office of the Comptroller of the Currency noted that stress testing of loan portfolios was a key part of "sound risk management." The OCC pointed out that those community banks that have incorporated stress testing analyses into credit risk management and strategic and capital planning "have demonstrated the ability to minimize the impact of negative market developments more effectively than those that did not use stress testing."

Beyond using the results of capital stress testing to mitigate capital requirements, banks can also use the tests to win approval for strategic initiatives. Invictus' community bank clients have used their stress testing analyses to:

- Get permission from regulators to move capital from the bank to the holding company to service trust-preferred securities that were in deferral.
- Redeem Small Business Lending Fund money before dividend increases.
- Obtain approval for acquisitions.
- Get out from under enforcement orders or Memorandums of Understanding.
- Satisfy regulatory concerns outlined in Matters Requiring Board Attention.

Stress Testing as a Competitive Advantage

The OCC advises community banks that stress testing provides "significant benefits" and can even be "a competitive advantage." That's because stress testing:

- Identifies key vulnerabilities and risk exposures
- Pinpoints and quantifies risk to earnings and capital
- Helps establish and monitor strategic plans, risk appetites and tolerance levels and operating plans.
- Is part of a sound capital planning program.

Source: **OCC** *handout*

- Win approval for capital plans.
- Convince regulators that their organic growth plans were not too aggressive.
- Identify specific loan segments that are more vulnerable under stress.

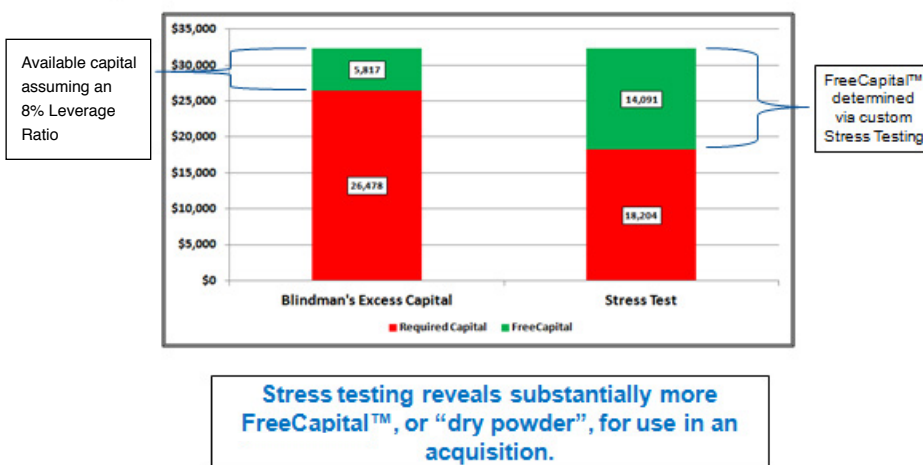
Invictus Consulting Group Chairman Kamal Mustafa, a frequent keynoter at industry conferences, advises banks to think of capital stress testing as "a profit center, not a cost center."

Stress testing can reveal the total amount of capital required to support a bank's unique asset mix. Regulators don't have the resources to stress test every community bank. As a result, their customization of a bank's regulatory leverage ratio tends to be within a narrow and understandably conservative range. A lower capital requirement increases the bank's level of FreeCapital™, the difference between the capital on a bank's balance sheet today and its regulatory minimum requirement calculated under a two-year pro forma severely adverse scenario. And that capital comes at essentially no cost, which turns stress testing into a profit center.

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FreeCapital™ can be used to maximize a bank's acquisition war chest, increasing the list of potential targets it might be able to buy. For instance, consider a \$350 million bank with a 9.8 percent leverage ratio. The bank used Invictus' custom stress testing to lower its required leverage ratio to 6.5 percent, leaving the bank with \$14.1 million in FreeCapital™. Using a ratio of 8 percent, the bank would have only had \$5.8 million in excess capital. The extra \$8.3 million increased the bank's number of potential acquisition targets by 71 banks. The graphic to the right illustrates this:



Stress Testing Gives Bank Board Confidence to Issue Dividend

A Client's Perspective



University Bancorp included the results of the bank's capital stress tests in its **July press release** announcing the bank's second quarter profits. Stephen Lange Ranzini, President and CEO, noted that the Invictus tests showed that the bank would have 14.8 percent Tier 1 Capital in a two-year adverse case scenario, and 12.9 percent Tier1 Capital in a severely adverse case. Ranzini recently answered questions from *Bank Insights* about his experience with Invictus and capital stress testing.

Q: The bank cited its Invictus stress test results in its press release. Can you explain how the stress testing process helped the bank and its board?

A: By demonstrating through rigorous and defensible capital stress tests that the bank has excess regulatory capital, we convinced our primary regulator that our current capital was more than adequate. This gave the board of directors the courage to resume paying monthly dividends from our profits to our bank holding company. That has allowed our bank holding company to rapidly eliminate its double leverage and to position our bank holding company to begin to pay dividends to our shareholders.

Q: Why did you decide to do capital stress testing?

A: The FDIC would never commit to a specific targeted level of capital ratios we needed to achieve our goals of having adequate capital. They always wanted to assert that the answer "depends" on future developments. By telling them the answer, which they accepted after probing the assumptions underlying our capital stress

test, we eliminated the need to know their own views, since they accepted our view.

Q: How critical has it been to integrate stress testing into the strategic planning process?

A: Knowing that the bank has excess capital has allowed us to eliminate a need for capital raising from the strategic plan. While we currently have no plans to do so, it does give us the flexibility to add new lines of business or to expand capital intensive lines of business.

Q: How have regulators reacted to your stress testing results?

A: The regulators accepted the stress test results after probing the assumptions underlying our capital stress tests, and they agreed that the assumptions were reasonable.

Q: How has the board reacted to the stress testing?

A: It gives the board great confidence that the bank is well capitalized to sustain itself through a Depression-like environment. Having lived through the Recession, regaining this confidence is critical and helps us to retain talented directors.

Q: What advice would you give other bank CEOs about the benefits of capital stress testing?

A: It is money well spent. I like and respect the work that Invictus has done for us. Our bank is atypical in some ways and Invictus was able to customize and modify their model to accurately capture these unique variables in our own bank's capital stress tests. ■

Understanding the Tax Implications of Bank Mergers

If your institution is contemplating a merger, there are a variety of tax issues to consider. Two key issues today are the dividend versus capital gains treatment of cash payments in a tax-free merger and the preservation of deferred tax assets. It's also important to conduct thorough due diligence to uncover any tax liabilities you might inherit from the target bank.

Even in a "tax-free" merger, any portion of the purchase price paid in cash rather than stock (commonly referred to as "boot") is taxable to the acquired bank's shareholders. The question then becomes: Is boot taxed as a dividend or as a capital gain? The answer is important for several reasons:

- Historically, capital gains have been taxed at a lower rate than dividends, although currently qualified dividends are taxed at the capital gains rate.
- If the target bank's stock is held by a C corporation, the C corporation will likely prefer dividend treatment. This allows it to take advantage of the dividends-received deduction (or, if the parties to the merger are part of a consolidated group, to treat the payment as a nontaxable intercompany dividend).
- In some cases, dividend treatment may run afoul of regulatory dividend restrictions.

Determining whether boot is taxed as a dividend or a capital gain can be complicated. The first step is to recharacterize the transaction as if the acquiring bank purchased the target bank's stock with its own stock and then immediately redeemed a portion of the stock in exchange for the boot. Generally speaking, this fictitious redemption is considered a sale or exchange (taxed as a capital gain) if it terminates or substantially reduces the shareholder's interest in the corporation. Otherwise, it's treated as a distribution.

A distribution isn't automatically taxed as a dividend, though. It's only treated as a dividend to the extent of the shareholder's proportionate share of the corporation's earnings and profits. Any distribution in excess of that amount is taxed as a capital gain.

Deferred tax assets

One potential benefit of a merger is preservation of the target's deferred tax assets, such as net operating loss (NOL) carryovers, which otherwise might be lost. However, the use of the NOL could be potentially limited by Section 382 if there is a change in control greater than 50 percent. Also, in a loss situation, watch out for the Unified Loss Rule (ULR). Although the rule is complex, it's important to consider it before a merger

because it can result in the loss of valuable tax benefits.

Suppose, for example, that your bank wishes to acquire the stock of another bank that has substantial NOL carryovers. The target is part of a consolidated group owned by a common bank holding company (BHC), which will recognize a loss on the sale of the target's stock. The ULR, which is designed to avoid "duplicate losses," may wipe out the NOL benefits. One way to avoid this result is to negotiate with the BHC for a protective election that reduces its potential loss and preserves the target's NOL carryovers.

Due diligence

Many bank mergers are "statutory mergers." These transactions are relatively simple because their terms are generally dictated by state or federal law. One of the terms, however, is that the acquiring bank automatically assumes all of the target bank's liabilities, including tax liabilities. Thorough due diligence is critical to identify any potential liabilities for income, employment, or other taxes that your bank may inherit from the target and to adjust the purchase price accordingly.

Alternatively, consider a "purchase and assumption agreement." These agreements are more complex, but they provide some flexibility to specify which liabilities you will assume. ■

Editor's Note: This article was provided by **Brady Nitchman** and **Steve Schick**, partners at Plante & Moran LLC, an accounting firm based in Chicago.

Regulators See Credit Risks Increasing

Regulators at two recent conferences offered insights into what problems they are seeing at community banks, according to Invictus executives who attended the seminars in California and Nebraska.

The Federal Reserve sees interest rate risk as a central issue, though credit risk is coming in a close second. Banks are beginning to breach their CRE thresholds, a concentration risk that led to bank failures during the financial crisis.

The OCC is also looking closely at credit risk. The OCC expressed some surprise that not all community banks have chief risk officers.

In addition to interest rate risk, the FDIC said it was seeing many banks buying investments and securities they didn't understand. Banks need to do better due diligence and monitor their unrealized losses, even if they are not required to hold capital against those losses. The FDIC also indicated that banks with increased interest rate risks would get closer scrutiny of the S component in their CAMELS composite.

Read Between the Lines

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

Timing of Exam Reports Tied to CAMELS Scores



The OCC mailed exam reports to more than 90 percent of 1 or 2-rated community bank boards within 90 days of the exam start date, while those that were rated 3, 4 or 5 usually get their findings within 120 days,

Senior Deputy Comptroller Toney Bland **testified** before the Senate Banking Committee earlier this month.

While community banks are healthier than they were during the crisis, economic recovery and job creation is still a problem, Bland said. He noted that many community bankers can't find profitable lending and investment opportunities "without taking on undue credit or interest rate risks." Strategic risk is also a concern for bankers looking to generate earnings in a low interest rate environment.

Regulators to Congress: One-Size Approach to Supervision Doesn't Work



Regulators told the Senate Banking Committee this month that community banks deserve a break from too much regulation. Comptroller Thomas Curry reiterated that a "one-size-fits-all approach to bank supervision

is not appropriate" for community banks. Curry **testified** that the OCC tailored its supervisory programs to the risks and complexity of a bank's activities. He also pointed out that the OCC has been working to avoid "unnecessary regulatory and compliance burden on small banks."

Maryann Hunter, Deputy Director of the Federal Reserve's Division of Banking Supervision and Regulation, delivered the **identical message** to the committee. Hunter said the Fed uses a "risk-focused approach" to community bank supervision. Banks engaging in non-traditional or higher risk activities will get greater scrutiny, while examiners will have a "lower level of review" for banks with low risk activities. She said that the Fed began a process last year that actually reduced exam testing at community banks that performed well during the crisis and is increasing its use of off-site monitoring.

Fed Governor Daniel Tarullo **told the committee** that "regulatory compliance can impose a disproportionate burden on smaller financial institutions." He said the Federal Reserve supports excluding community banks from certain "statutory provisions" that are "less relevant to community bank practice," such as the Volcker rule and incentive compensation requirements.

"Even where a practice at a smaller bank might raise concerns, the supervisory process remains available to address what would likely be unusual circumstances," he noted.

Doreen Eberley, the FDIC's Director of the Division of Risk Management Supervision, was **less vocal** about exempting community banks from existing regulation. "We believe the evidence strongly supports the idea that the best way to preserve the long term health and vibrancy of community banks, and their ability to serve their local communities, is to ensure their core strength is preserved: strong capital, strong risk management and fair and appropriate dealings with their customers. We also believe our own supervision plays an important role in obtaining corrective action to address problems where this is needed, and that this also promotes the long term health of community banks," she said.

CFPB Needs Data Controls



Community banks have been grumbling about how much data the Consumer Financial Protection Bureau has been collecting, and what it intends to do with it all. The Government Accountability Office **now says** that the CFPB needs to beef up its written procedures and standards regarding the collection and use of consumer financial data. The GAO made 11 recommendations to enhance the CFPB's privacy and information security processes.

Mortgage Lending Decreases, 2013 Data Shows



The Federal Financial Institutions Examination Council released HMDA data for 2013, showing that loan originations declined by 11 percent from 2012, refinancings dropped by 23 percent, and home purchase lending increased by about 13 percent. The **data** came from 7,190 institutions, down from 8,900 lenders in 2006. ■

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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