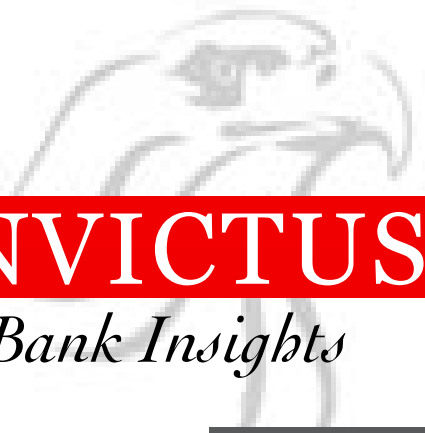




# INVICTUS

## Bank Insights

### Regulatory Scrutiny Focuses on Inadequate Strategic Planning

Once again, regulators are zeroing in on inadequate strategic and capital planning processes at many community banks.

The Office of the Comptroller of the Currency listed “strategic planning and execution” as its first supervisory priority for the second half of 2015 in its mid-cycle status **report** released in June. That echoes concerns from the OCC’s semiannual **risk perspective**, which found that strategic risk was high for many banks as they “struggle to implement their strategic plans effectively.”

FDIC Chairman Martin J. Gruenberg **said** in May that regulators expect banks “to have a strategic planning process to guide the direction and decisions of management and the board. I want to stress the word ‘process’ because we don’t just mean a piece of paper.”

He said that effective strategic planning “should be a dynamic process that is driven by the bank’s core mission, vision, and values. It should be based on a solid understanding of your current business model and risks and should involve proper due diligence and the allocation of sufficient resources before expanding into a new business line. Further, there should be frequent, objective follow-up on actual versus planned results.”

In writing about strategic risk, the Atlanta Federal Reserve’s supervision and regulation division said that “a sound strategic planning process is important for institutions of all sizes, although the nature of the process will vary by size and complexity.” The **article** noted that the process “should not result in a rigid, never-changing plan but should be nimble, regularly updated (at least annually) and capable of responding to risks and changing market conditions.”

Given economic changes and increased market competition, community banks must understand how to conduct effective strategic planning. This is more important now than ever, says Invictus Consulting Group Chairman Kamal Mustafa.

The smartest banks are using new analytics to develop their strategic plans – not because of regulatory pressure, but because it gives them an edge in the marketplace and a view of their banks they cannot otherwise see, Mustafa said.

“Strategic planning is useless without incorporating capital planning. The most effective capital planning is built from the results of stress testing. These critical functions – strategic planning, capital planning and stress testing – must be integrated if a bank truly wants to understand its future,” he said.

### Banks Struggle with Strategic, Capital Plans

The OCC says that many community banks are struggling to “execute strategic and capital plans given the current operating environment.” Examiners want to make sure that bank boards and senior management have developed adequate strategic, capital and succession planning processes with realistic plans and appropriate risk controls.

**Source:** OCC mid-cycle status report, semi-annual risk perspective

He advises banks to use the same fundamental methodology for both capital planning and strategic planning, or else they will run the risk of getting misleading results.

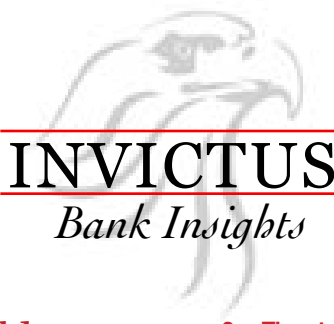
OCC Deputy Comptroller for Supervision Darrin Benhart also advises community banks to use stress testing to determine if they have enough capital. “Boards also need to make sure the institution has adequate capital relative to all of its risks, and stress testing can help,” he **said** in a February speech.

“We also talk about the need to conduct stress testing to assess and inform those limits as bank management and the board make strategic decisions. The most valuable and often most difficult risk management decision is knowing when to say “no” because you have exceeded your risk limits,” he said.

**Editor’s Note:** *Invictus has developed proprietary forward-looking risk analytics that focus on portfolio risk/reward. They show a very different pro forma picture of community bank performance than the traditional pre-recession methodologies used by community banks, researchers and M&A investment bankers. These new analytics, which are integrated with stress testing and capital planning, are an essential part of Invictus’ strategic planning advisory services.* ■

### Inside this issue:

- Takeaways from the Dodd-Frank Stress Tests (page 2)
- Exclusive: What Uniform Dodd-Frank Stress Tests Would Look Like (page 3)
- New Examiner Concerns: Indirect Auto Lending, Oil Prices (page 4)



## Five Takeaways from the Dodd-Frank Stress Test Results

*By Adam Mustafa, Invictus Senior Partner*

Under the Dodd-Frank law, banking institutions with consolidated assets of between \$10 billion and \$50 billion were required to conduct company-run stress tests and release the results publicly for the first time in June. These banks performed stress tests for regulators last year, but the results were private since they were considered a test run.

This is far different than the Comprehensive Capital Assessment and Review (CCAR) tests mandated for the largest U.S. banks and run by the Federal Reserve since 2010. Those tests are much more stringent, are subject to supervisory approval, and require the submission of an annual capital plan, which regulators can reject.

Regulators do not react publicly to the results of the mid-sized banks' stress tests, but they do provide feedback through the confidential supervisory process. So what lessons can be drawn from this month's release? From our perspective, here are five key takeaways on both the process itself and the results:

### 1. The regulators are not thrilled with the caliber of the stress tests.

The regulators think that the stress tests submitted by these banks are lacking. Too many of the DFAST banks did not take the process seriously or treated it like a 'check-the-box' exercise. Senior management took a "no news is good news" approach when delegating the stress testing process to middle management. Only a few did a good job in properly tailoring the stress tests to their business model and geographic footprint.

Many of these banks (and the vendors with whom they work) acted as if their success meeting the requirements should be 'measured in pounds' – so they prepared and submitted voluminous paperwork. If you asked 10 risk officers at Dodd-Frank banks to name the two areas on which their bank spent the most time on during the stress testing exercise, they would unanimously say "documentation" and "validation." While these two functions are critical for best practices in stress testing, they also created analysis-paralysis, drowning the key insights at the CEO and board level. One regulator who is heavily involved in reviewing the DFAST stress tests told me that, next year, those banks which can demonstrate they actually used the DFAST stress tests to help make a strategic decision will score "a lot more points" than those banks that submit a 5,000-page report.

### 2. The stock market by and large ignored the results of these stress tests.

When discussing the results with our bank investor clients, most said they either didn't care or didn't place any weight on the stress test disclosures. Indeed, there was little change in the trading of bank stocks before and after the stress test releases. There are several reasons: This first is that the results are not comparable among banks. The second is that most disclosures lacked an analytical narrative. Where were the vulnerable points? Why were the results the way they were? And most importantly, what does this mean moving forward from a strategic perspective? As one institutional investor told me, all of the stress test results basically said the same thing: "Hey, we will still make money, just not as much, but our assets will grow faster than our earnings because of Basel III, which is why our capital ratios go down."

### 3. Banks failed to focus on idiosyncratic risks in their stress tests.

This is what bothered the regulators the most – and for good reason. Many Dodd-Frank banks took the national severely adverse case forecast published by the Federal Reserve and treated it as gospel. They should have designed a customized scenario more specific to their own footprint and idiosyncratic risk profile, while ensuring that it was comparable to the Fed's stress scenario by using the amount of "pain" as the common denominator. For example, a bank that concentrates in a "lower beta" market should have identified the macro risks in its market. On the other hand, a bank with a large asset-based lending and factoring portfolio should have concentrated more heavily on operational risk and fraud as opposed to a systemic national recession (which could actually help it gain business). This is a huge lesson for community banks and Dodd-Frank-light banks. The mission is NOT to show how your bank would handle a national recession, but instead to show how your bank would handle severe events specific to your bank's risk profile.

### 4. There is a significant gap in the loan loss rates between the CCAR and DFAST banks.

We define loan loss rates as the projected two-year loan losses under the stress test divided by the average loan balance. The median loss rate for the largest 30 banks that participated in CCAR was 5.1 percent. However, the loss rates we have observed from the Dodd-Frank banks that reported their results range from 0.6 percent to 2.5 percent. In other words, there is a MASSIVE gap between the stress test results of the CCAR and DFAST banks. On the one hand, there is plenty of controversy surrounding

the stress tests of the CCAR banks since the Fed trumped the results submitted by the CCAR banks with their own models. Therefore, one could argue that the CCAR loss rates are too high and stringent. On the other hand, the loss rates projected by the mid-sized banks hardly feel like stress in comparison. Until investors understand this gap and what is driving it, it will become very difficult to unpack value from the results of either group of banks.

**5. Invictus' proprietary analytics reveal that not all DFAST banks are the same.**

The graphic below shows what would happen if all the DFAST banks were subject to a consistent stress test. While it is important to recognize that each bank would have different stress drivers based upon geography and business model --as we noted in point 3 above -- the results have validity in terms of measure of pain.

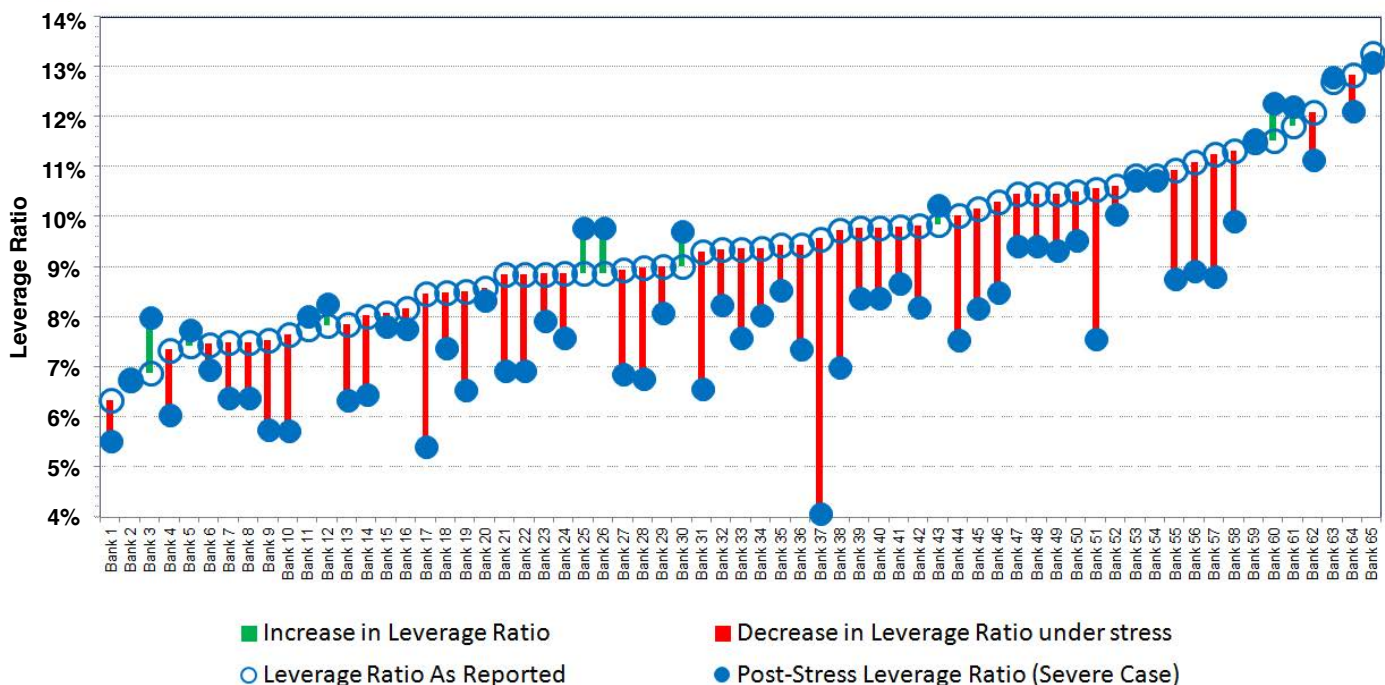
Invictus uses publicly available data and the Fed's economic factors to stress test every U.S. bank each quarter to see how they would fare in a severe downturn. Our methodology has proven to be an excellent indicator; when we get access to loan file from our bank clients, the stressed results are generally similar.

This graph shows considerable variance in bank performance under stress -- although no bank drops below the 4% minimum, some may be surprised to see their performance, and many lose 2% or more in leverage ratio.

When we studied the results further, we found something that surprised us: The primary difference between the strong performers and the weak was the vintage profile of their loans. Those banks with heavier exposure to loans originated early on in the recovery (circa 2009-11) performed exceptionally well, while also generating better interest income. On the other hand, banks that have experienced recent growth have more exposure to higher risk loans with lower yields. The other interesting, but related finding, was that most of the banks have, for all practical purposes, weaned themselves off pre-crisis loans (circa 2004-08), which have either been paid off, refinanced, or charged-off by now.

In conclusion, the stress tests the DFAST banks conducted are a step in the right direction, but many banks need to probe their own bank more deeply to generate actionable results. ■

**Dodd-Frank Banks: Application of a Uniform Stress Test Yields Strikingly Different Results**



## Read Between the Lines

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

### Indirect Auto Lending, Oil Prices are New Concerns for Examiners



The Office of the Comptroller of the Currency wants banks to pay attention to the “changing risk environment” for indirect auto lending and energy portfolios. It has **instructed** examiners to begin “taking additional supervisory action and acquiring additional analytical tools” to monitor and assess the risk in underwriting. The OCC also says it will spend the rest of 2015 monitoring the risk to banks “from the rapid decline in crude oil prices.” Other supervisory priorities for the rest of the year include cyber threats, interest rate risk and consumer compliance.

### Boards Need to Step Up as Credit Underwriting Standards Decline

Examiners are seeing a decline in underwriting standards as banks reach for yield and loan growth, Comptroller Thomas J. Curry said in a **speech** at the Prudential Bank Regulation Conference on June 15. “Our goal as prudential supervisors is not just to ensure compliance with laws and regulations—important as that is—but to identify weaknesses in lending, liquidity, and operational risk management, as well as other threats to safety and soundness, and then to compel change,” Curry said. That starts at the top—with the board of directors and senior management, he said.

### FDIC Seeks Comments on Small Bank DIF Assessments



The FDIC wants to change the way banks with less than \$10 billion in assets are assessed for deposit insurance to reflect lessons it has learned since the financial crisis. The **proposal**, the first change since 2007, would be revenue neutral and would assess banks on a forward-looking basis, based on a model estimating the probability of failure. The FDIC has published an online assessment calculator to allow banks to estimate their assessment rates and is accepting comments for 60 days.

### Fed Vows to Make Exams Shorter



Smaller community banks with low risk profiles should have less intensive exams, Federal Reserve Governor Jerome H. Powell **said** at the New York Fed’s annual Community Bankers Conference. Powell said that the Fed has asked

examiners to begin risk assessments before they arrive at the bank, which since 2014 has allowed them to spend more time on higher-risk concerns. He said the Fed has asked examiners to spend less time on uncommon areas of consumer compliance. As a result, in the last 16 months, the average length of time for exams has decreased. “Bankers have told us that the examiners seem to have a better grasp of the key issues and that exams are, as we intended, more closely tailored to the business characteristics and risk profile of individual institutions,” he said.

### New York Fed Using Automated Tools at Exam Time

The New York Fed is trying to reduce the amount of time examiners spend onsite at community banks, F. Christopher Calabia, Senior Vice President, **said** at the New York Fed’s Community Bankers Conference. He said the Fed is doing “more homework” to evaluate a bank’s capital adequacy, earnings and liquidity before showing up at the bank, so it can then spend more exam time asking pointed questions about its concerns. It is also adopting “a variety of automation tools” to simplify the exam process. Banks will be asked to submit responses and data online before an exam, which should also help speed up the process. The New York Fed is eager to find community banks that want to experiment with using electronic loan review files, which would enable the Fed to conduct off-site loan reviews, as other districts are doing. Calabia revealed that the new automated tools recently cut by 40 percent the onsite time examiners spent at one community bank, from 32 days to 18 days.

### CFPB Reveals Exam Findings



For insights into what the Consumer Financial Protection Bureau is focusing on, be sure to read the Summer 2015 **issue** of its Supervisory Highlights. ■

## 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. For past issues of Bank Insights, please go to the **Invictus website**.*

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