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Bank Insights

What Regional and Community Banks Can Glean from CCAR/DFAST 2016 Scenarios

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The Federal Reserve's new economic stress test **scenarios** for large and mid-sized banks, which were released in January, do not on first blush apply to community banks, since the banks are not mandated to undergo stress testing. But these scenarios – particularly when compared with last year's – serve as a 'tell' in terms of where the regulators may begin to focus their attention, and perhaps more importantly where the Fed thinks the economy and monetary policy is headed.¹

Banks with more than \$50 billion in assets are subject to the Comprehensive Capital Assessment Reviews (CCAR) and the Dodd-Frank Act Stress Tests (DFAST), while banks with more than \$10 billion in assets but less than \$50 billion are only on the hook for DFAST. The primary difference is that CCAR requires banks to overlay their planned capital actions for the next 9 quarters, and DFAST looks at the 'run rate' for capital activities, such as dividends and stock repurchases. The economic scenarios are the same, although banks are urged to apply them as appropriate to capture the idiosyncratic nature of their footprint and business model.

Here are a few key takeaways for community bank CEOs to ponder:

1. The Severely Adverse Case scenario now includes a negative interest rate environment.

In a scenario that assumes GDP contraction of 6 percent, a spike in the unemployment rate to 10 percent, and 30 percent declines in housing and CRE prices, the Fed is also modeling in a decline in the 3-month Treasury rate to -0.50 percent and the 10-year Treasury rate falls to 0.25 percent. In other words, the Fed is floating a trial balloon of creating a negative rate environment. Don't expect the Fed to wait for things to get this bad before it pulls this type of tool from the toolkit.

A negative rate environment would have a major impact on community banks on all sides of the balance sheet. It would represent a significant drop in liquidity and

¹Although for all scenarios the CCAR document claims: "It is important to note that this is a hypothetical scenario designed to assess the strength of banking organizations and their resilience to adverse economic conditions [or "unfavorable economic conditions" in the severely adverse case]. This scenario does not represent a forecast of the Federal Reserve.

CCAR and DFAST: A Primer

Banks with more than \$50 billion in assets:

- Subject to both Comprehensive Capital Assessment Reviews (CCAR) and Dodd-Frank Act Stress Tests (DFAST)
- Required to overlay their planned capital actions for next nine quarters

Banks with \$10 billion to \$50 billion in assets

- Subject to DFAST only.
- DFAST looks at the 'run rate' for capital activities, such as dividends and stock repurchases.

The economic scenarios are the same for each test. Banks are urged to apply them as appropriate to capture the idiosyncratic nature of their footprint and business model.

the widening of credit spreads in other securities. At the same time, banks could experience a new surge in deposits as money looks for a place to hide. Community banks need to learn to be nimble and be prepared for a negative rate environment (irrespective of it being paired with an economic downturn). If you're not talking about how your bank would handle and perhaps find ways to be opportunistic in this scenario in the boardroom, you should be. Banks should also enhance their analytics at both the granular ALM level and the strategic and capital planning level to assess these types of scenarios.

- 2. The Severely Adverse Case is even more severe than prior years.** A primary side effect of the zero interest rate policy-fueled economic recovery is that the economy has more room to fall the longer this policy continues. As a result, the Fed is modeling an even more severe recession than in prior years. For example, the unemployment rate has to increase 5 percentage points to reach 10 percent, as opposed to say 4 percentage

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points last year when the rate was around 6 percent. This makes it even more dangerous from a current lending perspective because newer loans are becoming more fraught with risk and have more room to fall.

Without opining on the congruence of the various economic indicators in a severely adverse environment, we believe community banks should note the following implications:

- A 25 percent decline in home prices would suggest a return to prices that existed in approximately September 2002. Homes underwritten in the pre-recession period of December 2004 to July 2008 (ignoring seasoning), and between June 2014 and the present, would have upside down LTVs.
- A 30 percent decline in commercial real estate prices would imply a return to prices that existed in April 2011, August 2008, and May 2006. Many of the more recent CRE transactions would have been originated in environments with higher CRE indices.
- The widening of the credit spreads (ie. 10-year BBB bonds less 10-year US Treasuries) from approximately 200 basis points to 500+ basis points -- and the increased likelihood of a liquidity crisis -- will show many more banks with OTTI credit-based securities losses negatively affecting capital.
- Negative interest rates, other than occasional money market or repo market distortions, have never occurred in the U.S. With spreads already compressed and depositors showing rate fatigue, the likelihood of charging a depositor to keep his deposit at your bank is about nil.

In short, the Fed is signaling that the longer the current environment continues, the worse the next severe downturn will be. Keep in mind that it doesn't matter if this scenario ever occurs; your capital requirements will be based upon it, either directly through stress testing, or indirectly by your regulator mandating that you need to maintain a 10 percent Leverage Ratio instead of 8 or 9 percent.

3. **Perhaps the Adverse Case scenario should be the new "Baseline" scenario.** Although the Fed is quick to cite a third-party (Blue Chip Economic Indicators report) for the 'baseline' economic scenario for the next two years, this scenario seems more like a dream than reality. In this "baseline" scenario, GDP growth runs at roughly 2.5 percent per year, the unemployment rate falls to 4.5 percent, property values

continue to increase – all in the face of rising interest rates and an increase in the prime rate to 5 percent by the end of 2017.

The Adverse Case scenario assumes GDP contraction of 1.75 percent, an uptick in unemployment to 7.5 percent, a 25 percent decline in the stock market, and a 12 percent decline in housing prices and CRE. At the same time, short-term interest rates remain at current levels (no more rate hikes), albeit the 10-year Treasury rate reaches 3 percent and there is a continued widening in credit spreads on corporate bonds. The Adverse Case also assumes deflation in the CPI index, which is a new feature of this scenario – more about this in the next point.

We are not economists, but we are already seeing some wobbling in the economy and in capital markets. One could easily reason that this is a more likely scenario than the 'Baseline' scenario. It would make for healthy community bank boardroom and C-suite discussion to debate if and how you should adjust your strategic plan accordingly.

4. **The change in the Adverse Case Scenario versus last year's highlights the shift in the Fed's "worry basket".**

Last year, the Adverse Case scenario featured a spike in inflation to 4 percent per annum along with rising short-term rates (3-month Treasuries would exceed 5 percent) and a flattening yield curve. The concern was that quantitative easing would eventually lead to inflation, which would cause a shock in short-term interest rates. This year's Adverse Case scenario is nearly the exact opposite – this time it models nearly a 1 percent decline in the CPI and no change in short-term interest rates. The deflation embedded in this scenario is an acknowledgement of what we've seen in energy, copper, aluminum, etc. Deflation plus stagnant nominal interest rates implies increases in real interest rates, which can have devastating effects on your borrowers.

What does this mean at the end of the day? Who knows, but it's a stark reminder that the economy is in unprecedented territory. The impact of the Fed's monetary policies in response to the 2008 financial crisis is still a mystery – especially to the Fed itself. So tread carefully, and make sure you are relying on sound forward-looking analytics to help navigate your bank. ■

Why Community Banks Need ‘Large Bank’ M&A Tools to Gain a Competitive Edge

Community bank executive teams and boards of directors don’t have the same analytical tools as the larger banks when it comes to evaluating mergers and acquisitions. And that leaves most community banks at a distinct disadvantage.

“It’s a tragedy,” said Invictus Consulting Group Chairman Kamal Mustafa, the former head of global M&A at Citibank, in a presentation at *Bank Director’s* “Acquire or Be Acquired (AOBA)” Conference in Phoenix. “Large banks have very powerful tools that allow them to go into an M&A deal with an extraordinary amount of knowledge.”

So what can community banks do? Mustafa wants to arm community banks with analytical tools that will bring them big bank knowledge and take into account post-recession changes in economic, monetary and regulatory policies. “Community bank M&A tools need to be adapted and reconfigured for CEOs and executive teams,” he said.

At several AOBA sessions, investment bankers and others touted the use of legacy analytics, such as loan review, to extrapolate future bank performance when analyzing an M&A deal. Mustafa, however, contended such tools were useful prior to the recession because they were an adequate predictor in a stable environment. That is no longer the case.

“Now, they would give you the completely wrong answer,” Mustafa said. “You need answers that address variations in capital, rapid fluctuations in the economic environment, and interest rate changes as a result of our historically untested monetary policies. These changes cannot be ignored.”

To start, community banks must devote more time to the pre-due diligence phase of M&A, he said. Otherwise they risk wasting enormous time and resources on deals that they won’t – or shouldn’t – win. Every phase of pre-due diligence should then be confirmed, analyzed and drilled down in the actual due diligence phase.

His presentation showed that a traditional loan review process fails to take into account when a loan was originated. Yet vintage is a key tool that community banks should use in evaluating a target bank – and itself. As Mustafa stressed, the one thing a bank cannot change when it buys another bank is the yield on the loans it acquires.

If community banks don’t truly understand their own portfolios, they won’t know which potential target will be the best strategic fit. Invictus uses a LoanLayering™ system to break down portfolio loans by vintage, and then subjects the

portfolio to a capital stress test to understand how changes in monetary and regulatory capital policies would affect those loans over time. That analysis leads to a risk/return assessment of a bank’s loan portfolio, and it is essential in evaluating an M&A target, Mustafa said.

A static pro forma analysis, looking at a loan portfolio, might show 10 percent growth in the next three years. Yet a vintage/stress testing analysis that takes into account the risk/reward environment would reveal that a 40 percent turnover of the portfolio is required to achieve that 10 percent growth. A bank that doesn’t have access to such information is entering into an M&A transaction blindly, Mustafa argued.

“Community bank M&A tools need to be adapted and reconfigured for CEOs and executive teams,”

All large banks are required to undergo stress testing as part of changes in the post-recession regulatory environment. Most community banks don’t use stress testing as a tool. But Mustafa showed that community banks that used capital stress testing were able to lower their required capital ratios, and use the excess capital to increase their M&A war chests. He also showed how that excess capital--FreeCapital™--affects the value of a deal. Banks with negative FreeCapital™ are more expensive, and those with more FreeCapital™ than is apparent via a traditional analysis are actually better buys.

Mustafa urged the banks in the audience to evaluate a deal in the appropriate strategic context of their own bank. Using the right tools, they can then understand the threshold at which an acquisition is actually better than organic growth. He showed how analytics can quantify a target’s value to an attendee’s bank.

Figuring out the return on an acquisition versus the return on organic growth enables a bank to make a bid or no bid decision. It also helps quantify at what ceiling price an acquisition makes sense.

“If you already have a range of prices for every potential target, you will know when to walk away,” Mustafa said. “Traditional methods of evaluating potential transactions only to reach a decision not to bid is a waste of time, money and resources.”

He also showed why it makes sense for community banks to be proactive in M&A instead of waiting for investment bankers to bring deals to them. If a bank can identify targets it wants to buy – even ones that are not for sale – it can use analytics to make a smarter case to the target that a private deal is a win-win for everyone. ■

Read Between the Lines

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

Dallas Fed Paper: Are Community Banks Too Small to Succeed?



Community banks may hold the largest share of small business and agricultural loans, but they are struggling to survive in the post-recession regulatory world, according to “Too Small to Succeed?—Community Banks in a New Regulatory Environment,” a paper **published** by the Dallas Fed. The paper discusses the “alarming” fact that almost no new de novo charters have been issued since the recession. The paper notes that in that time period the community bank compliance burden has magnified, with lengthier Call Reports and added regulations. It cites Minneapolis Fed research that found that the “median reduction in profitability (return on assets) for the smallest banks—those banks with assets less than \$50 million—is 14 basis points if they have to increase staff by one-half of a person and 45 basis points if they increase staff by two people.” The Dallas paper concluded that unless regulatory oversight matches the level of risk an institution poses to the entire economic system, then “more banks may become too small to succeed.”

Worth Reading: OCC Updates Procedures on Civil Money Penalties



The average civil money penalty has increased in recent years, and directors should take note. The Office of the Comptroller of the Currency has revised its **Policies and Procedures Manual** that addresses these penalties, replacing a 1993 manual. The revision includes a new matrix that awards points for violations and then calculates those points into suggested fines. (No fine can exceed 1 percent of the bank’s assets). Penalties are typically imposed for misconduct and blatant disregard for safety and soundness rules and BSA/AML issues. Remember: Directors cannot use a bank’s **D&O policy** to cover an individual civil money penalty; they must either pay out of pocket or purchase an individual policy that specifically covers the officer.

FDIC Outlines Cybersecurity Framework



The Federal Deposit Insurance Corp. has once again outlined the serious cyber risks facing banks, in a lengthy cybersecurity **framework** published in the Winter issue of *Supervisory Insights*. The article warns that “a bank’s board and senior management must understand the seriousness of the threat environment and create a cybersecurity culture throughout the organization.” Banks should ensure that they

have cybersecurity awareness programs “across all business lines and functions,” from entry-level staff to the board. (For more on cybersecurity, see the cybersecurity chapter in the Bank Insights 2016 **Regulatory Outlook**.)

M&A Applications Increasing: Fed Data



Merger and acquisition proposals made up 23 percent of all approved Federal Reserve proposals in the first half of 2015, the Fed disclosed in its latest **report** on banking applications. The Fed reported that the number of approved M&A proposals increased to 136 in the first half of 2015, compared with 114 a year earlier. Community banks with assets below \$1 billion increased the number of branch applications, from 44 in the first half of 2015 compared to just 28 a year earlier. On average, the larger community bank M&A deals (\$1 billion to \$10 billion in assets) took 63 days to go through the final approval process, while the smaller deals (less than \$1 billion) took 59 days.

FDIC Releases New Interest Rate Risk Videos



Manage interest rate risk in a prudent manner, the FDIC has once again urged. More balance sheets “reflect a heightened mismatch between asset and funding maturities that, coupled with tighter net interest margins, have left financial institutions more vulnerable to rising interest rates,” the FDIC said. In response, it has issued updated **videos** that address recent data, trends and board and management responsibilities, types of interest rate risk, risk measurement systems, modeling assumptions and other topics. The videos include a 33-minute one tailored for **directors** and another series for **key management and staff**.

FDIC Chairman Martin J. Gruenberg also cited interest rate risk when releasing the fourth quarter FDIC bank **data**. “Banks must remain vigilant as they manage interest rate risk, credit risk, and evolving market conditions. These challenges will continue to be a focus of ongoing supervisory attention,” he said.

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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