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DISRUPTIVE BANK INTELLIGENCE FOR THE C-SUITE AND BOARDROOM

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RISING RATES

By Adam Mustafa
Invictus Chief Executive Officer

THE CALM BEFORE THE STORM

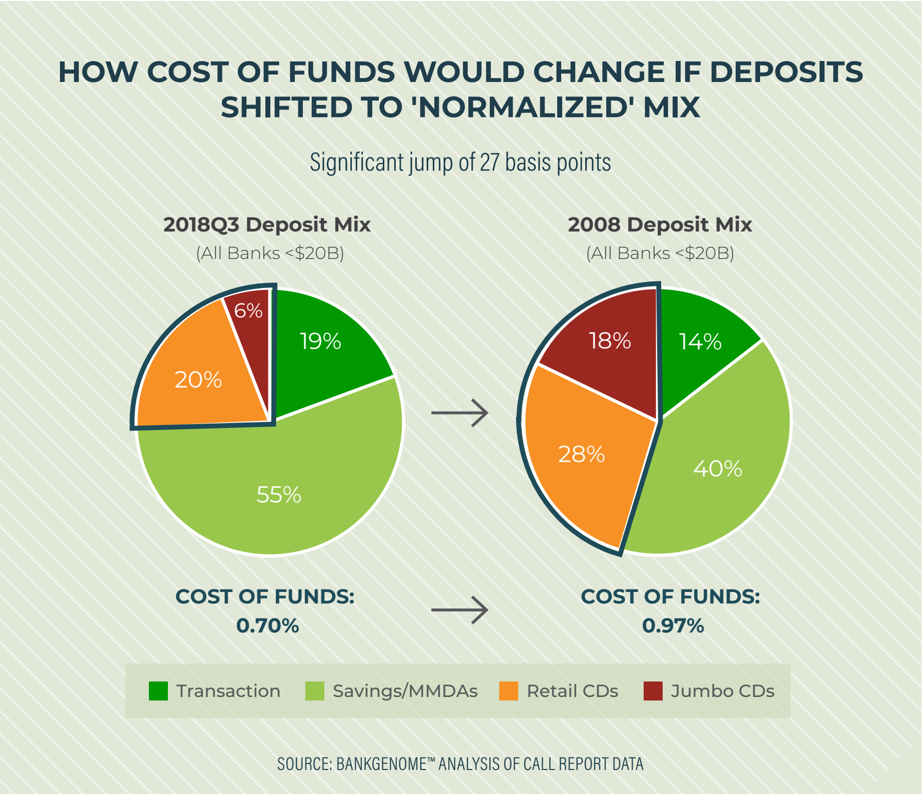
Rising interest rates are already causing pain in the community banking industry. The most visible sign is the increasing cost and diminishing supply of deposits. But there are additional problems bubbling beneath the surface you cannot see with traditional bank analysis. A Perfect Storm is forming, though how long it will last and when the eye will arrive is uncertain.

Best case scenario, this storm will lead to historically compressed net interest margins (NIMs) and reduced profit margins for many banks. In the worst case, it will cause liquidity challenges that will force many banks to find a merger partner.

Our BankGenome™ bank intelligence system, which is driven by loan-level and deposit-level data from across the country, has been flashing warning signals for months. We wrote about the hidden challenges that banks will face in a rising rate environment in the August 2016 issue of Bank Insights. This was viewed as contrarian, since most experts predicted that rising interest rates would be a boon, citing history in previous rate cycles.

The Fed is preaching a 'patient' approach toward further rate hikes, so the good news is that this buys a little time, but banks need to take advantage of the lull. Absent an economic downturn (which would present even bigger problems), the Fed

RISING RATES (cont. on p. 2)



CAPITAL PLANNING

By Lisa Getter
Bank Insights Editor

WHY OPTING INTO THE COMMUNITY BANK LEVERAGE RATIO SHOULDN'T BE AUTOMATIC

Every community bank should assess its own situation and business model before deciding to opt in to the proposed new community bank leverage ratio (CBLR) framework, regulators advised banks in a December teleconference.

The CBLR framework would consider most banks with assets of less than $10 billion and at least a 9 percent leverage ratio to be well-capitalized, allowing them to forego risk-weighting calculations, file simpler Call Reports, and bypass future risk-based capital rule changes. But that doesn't mean it makes strategic sense for all community banks.

"The agencies are not in a position to say what the advantages of the framework are," regulators said on the teleconference. That regulatory

CAPITAL PLANNING (cont. on p. 4)

RISING RATES (cont. from p. 1)

needs to continue to increase interest rates over the mid- to long-term. This is not so much because of inflation, but because the Fed is desperate to restock its ammunition to combat the next recession, without actually triggering it. Don't make the mistake of thinking that sunny days are ahead when it's really just the calm before the storm. Now is the time to act.

The first step each community bank should take is to educate its management team on the potential problems and quantify their impact. To do so properly, bankers must breakdown the Perfect Storm into the following three components:

1. The Loan Portfolio's Ability to Absorb Higher Rates

How well positioned is your bank's loan portfolio to absorb higher interest rates? For most community banks, the answer is not very well at all. We performed an analysis using BankGenome™ to test this. Shockingly, over 4 out of 10 community banks have a poor loan portfolio rate absorption profile, with less than 50 percent of their loans scheduled to mature or reprice over the next three years.

This statistic flies in the face of what most ALCO models are telling bank executives. In prior rate cycles, increases in loan yields exceeded the rising cost of funds to the point that the NIM would expand. However, unlike prior rate cycles, banks accumulated loans with historically low interest rates over a prolonged period following the 2008 Financial Crisis. Many of these loans are 'locked in' at these low rates over the next three years. As cost of funds rise AND because increasing the loan-to-deposit ratio is no longer an available lever for banks to pull, the NIM will be under assault.

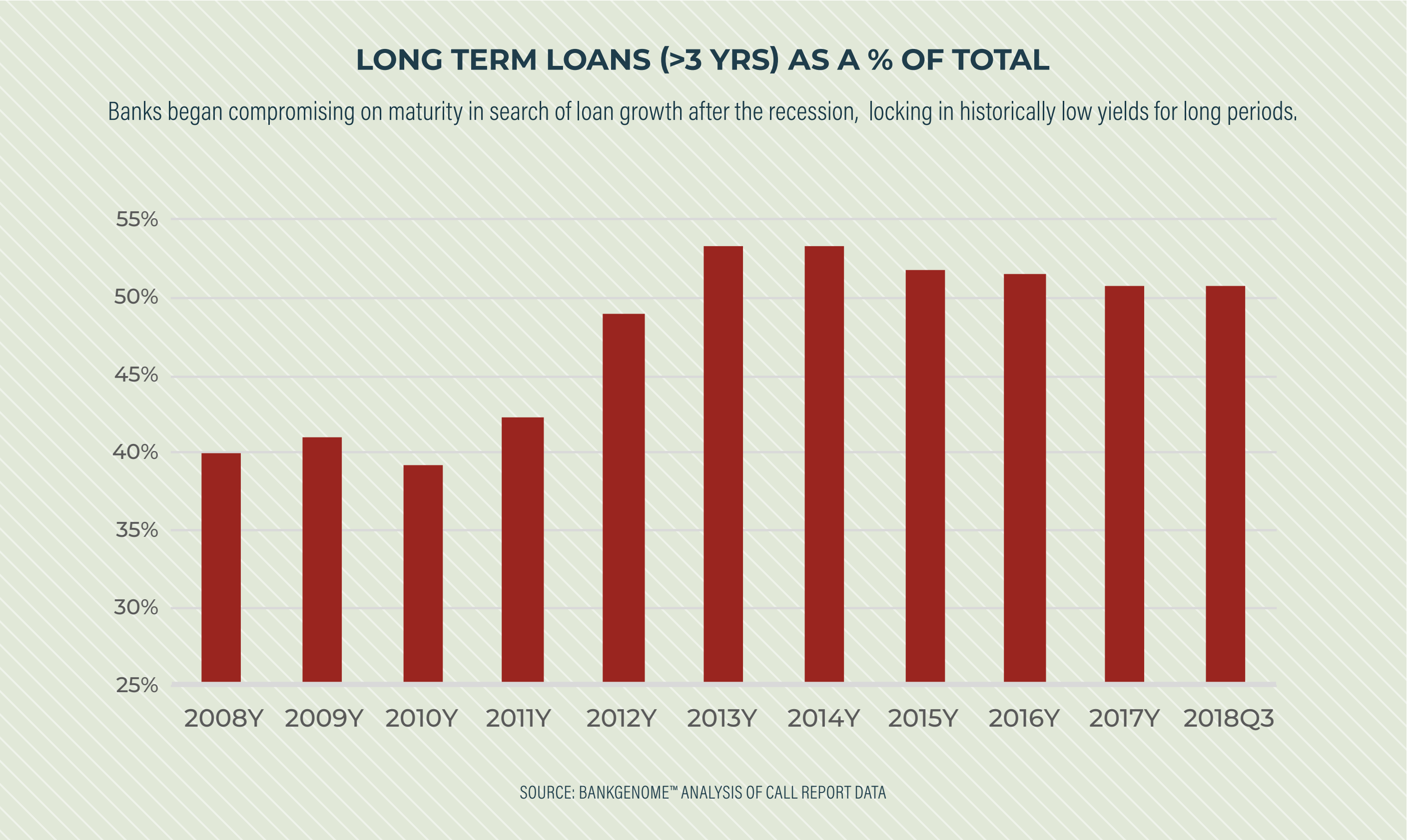
Every bank will have a different rate absorption profile. The characteristics of its loans will be different in terms of loan type, vintage, structure, and duration. It is critical that banks calculate their rate absorption profile on their loans. This is the part of the balance sheet that the bank controls the least, so any meaningful analysis must start here.

2. The Deposit Portfolio's Ability to Absorb Higher Rates

The cost of deposits is likely to increase at an accelerated rate. The first reason has to do with the supply of deposits. The Fed's policy to normalize its balance sheet represents a never-before-seen massive headwind. Competition will only intensify, which will exacerbate the rising costs. The second reason has to do with the mix of deposits. Interest rates had been so low that there was little incentive for customers to have money tied up in money market accounts and CDs. The percentage of deposits in non-interest-bearing accounts was significantly higher than the historical average, as the chart on Page One shows.

As interest rates normalize, we are already seeing the percentage of non-interest-bearing deposits decline and a corresponding increase in the more expensive deposit products such as CDs, as the graphic on page 3 shows.

Think of this as "intra-disintermediation". Deposits may



RISING RATES (cont. from p. 2)

not leave the bank, but they will move from lower yielding products to higher yielding ones. This can impact the cost of funds in a significant way. The turbulence experienced so far this year is going to get worse, not better. This must be quantified in advance of the storm so that all potential strategic actions can be properly measured.

3. The Marginal Cost of Funds to Drive Growth or Replace Lost Deposits

The cost of the next additional dollar of funding will not be the weighted average of the cost of funds, but instead will be skewed toward the cost of the most expensive source of funding available. For most community banks, this usually means CDs, brokered funds, or FHLB money. As of the writing of this article, the costs of these sources of funding are approaching 3 percent. As these very expensive and price-sensitive products become a larger percentage of the liabilities portfolio, the marginal profitability of new loans will fall off a cliff and compression of the NIM will quickly accelerate.

THE PLAYBOOK BANKS SHOULD FOLLOW IMMEDIATELY TO PREPARE FOR THE STORM

Not everyone will be losers in the Perfect Storm. There will be winners, so the Perfect Storm also presents an opportunity. Here is a roadmap every bank should follow immediately:

1. Quantify your unique rate absorption profile by breaking down the impact into the three aforementioned components.
2. Benchmark your rate absorption profile against your peers.
3. Educate your board.

If you have a vulnerable profile, you need to act immediately. Your ALCO process is not designed to solve this challenge. It is also important to recognize that tactics and gimmicks to increase deposits via organic means, such as opening new branches, hiring consultants to help with marketing, branch staff training, or creating trendy new deposit products will be very difficult and take too long in an environment where the pie is not growing.

The best way to address these vulnerabilities is through acquisitions, but you need to move fast because those targets that address these needs will be soon picked off. First-movers will win, but the approach to M&A and the way acquisitions are analyzed needs to be dramatically different; EPS accretion and TBV dilution analysis does NOT work in this situation. Neither does waiting for banks to come up for sale in an auction.

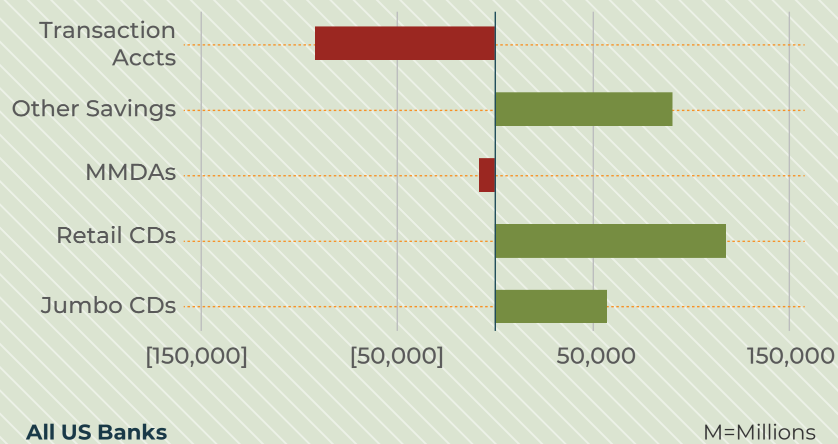
WINNERS AND LOSERS TO EMERGE

The Perfect Storm is coming. This is not a prediction, but a simple extrapolation of a trend that will inevitably continue. We're in the calm before the storm. We don't know when it will arrive or whether it will be sharp but fast, or gradual but very long, but it will create carnage either way. Yet the Perfect Storm is as much as an opportunity as it is a threat.

Winners will be those banks that are already well-positioned so they can exploit the weaknesses of those that are not, as well as banks that are vulnerable today, but immediately act to shore up those vulnerabilities via acquisitions. Losers will be those banks that fail to recognize or accept the fact the storm is coming .

DEPOSIT CHANGE BY PRODUCT (Q12018 TO Q32018)

The only deposits growing are expensive price-sensitive ones.



SOURCE: BANKGENOME™ ANALYSIS OF CALL REPORT DATA

ABOUT THE AUTHOR

Adam Mustafa

Adam Mustafa is President and CEO and co-founder of the Invictus Group. He has been providing strategic analytics, M&A, CECL and capital adequacy advisory services to banks, regulators, bank investors, and bank D&O insurers since the beginning of the financial crisis. Mr. Mustafa has overseen the design and implementation of fully-customized capital stress testing, capital management, CECL, and strategic planning systems for community banks ranging from under $100 million in assets to those with more than $10 billion in assets. He has also been a featured speaker on CECL, M&A and stress testing at conferences across the U.S., including those hosted by regulators. Prior to founding Invictus, he had senior-level experience as a banker, financial services consultant and corporate CFO. He has an MBA from Georgetown University and a BA from Syracuse University.

CAPITAL PLANNING (cont. from p. 1)

> *A meaningful amount of capital would be unnessarily encumbered."*

message is consistent with an April 2018 *Bank Insights* article that referred to the ratio as "fool's gold" because it would lock banks into a capital regime that may be unnecessarily high.

Banks must realize that if they opt into the framework they will be forced to hold at least 9 percent leverage capital, which may be much more than is needed. And that could be a serious threat to shareholder value because a meaningful amount of capital would be unnecessarily encumbered.

The Invictus Group recommends that banks use capital stress testing with the right analytics to quantify their own capital requirements. Banks that do this, while integrating stress testing into their overall strategic planning and risk management processes, have found overwhelming success, both from a regulatory and strategic standpoint.

A Deloitte global risk management survey, released in January, noted that regulators "have come to rely increasingly on stress tests to determine if a financial institution has sufficient capital." The survey found that 71 percent of smaller institutions, or those with less than $10 billion in assets, were relying on capital stress tests to guide their banks. Overall, 87 percent of financial institutions reported using capital stress tests for strategy and business planning.

The agencies estimate that 83 percent of community banks with less than $10 billion in assets would qualify to use the framework, as well as about 150 bank holding companies with assets between $3 billion and $10 billion. But a BankGenome analysis, the Invictus Group intelligence system, found that 92 percent of community banks could safely operate with an 8 percent leverage ratio, even in a severe downturn. Those banks would benefit most from using stress testing to prove their case.

The proposed rule lays out some specifics for what the new capital framework would look like, but expect those to change before the proposal is final. The proposal was mandated under the Economic Growth, Regulatory Relief, and Consumer Protection Act, the Republican-led bill that amends Dodd-Frank. It would replace the Basel III guidelines for all banks that decide to use it.

Lawmakers had called for a leverage ratio of anywhere between 8 and 10 percent. Industry groups had lobbied for an 8 percent ratio, but regulators decided more was needed to ensure safety and soundness. The proposal notes that the framework "should be calibrated not to reduce the amount of capital currently held" by qualifying banks.

Once a bank opts into the framework, they would use these CBLR ratios instead of PCA ratios, as this chart shows.

CBLR LEVELS AS PROXIES FOR PCA CAPITAL RATIO CATEGORIES

	THRESHOLD RATIOS				
PCA CAPITAL CATEGORY	TOTAL RBC RATIO	TIER 1 RBC RATIO	CET1 RBC RATIO	TIER 1 LEVERAGE RATIO	CBLR
WELL CAPITALIZED	10%	8%	6.5%	5%	> 9.0%
ADEQUATELY CAPITALIZED	8%	6%	4.5%	4%	> 7.5%
UNDERCAPITALIZED	< 8%	< 6%	< 4.5%	< 4%	< 7.5%
SIGNIFICANTLY UNDERCAPITALIZED	< 6%	< 4%	< 3%	< 3%	< 6.0%
CRITICALLY UNDERCAPITALIZED	TANGIBLE EQUITY/TOTAL ASSETS ≤ 2%*				

*If a bank's tangible equity ratio falls to 2% or less the bank would become subject to the standards in the existing PCA framework

Source: FDIC slide

CAPITAL PLANNING (cont. from p.4)

"It is for banks that exceed 9 percent. This language is very intentional," regulators said on the teleconference. "It is not equal to. It is in excess of that."

Bank lawyer Peter Weinstock, a partner with Hunton Andrews Kurth in Dallas, said he had heard that regulators wanted the ratio to be even higher. He predicted that some banks would look at the simpler framework as a "panacea" while "other banks will simply shrug."

Until the actual rule is written, it will be hard to predict the impact of the proposal on acquisitions and other strategic initiatives. "My general viewpoint is having to comply with fewer capital guidelines is a better thing," Weinstock said.

The proposal is vague on many details, including how the new framework would be used to calculate bank assessments, currently based on Tier 1 capital. The proposal notes that if the CBLR framework were to be used, more than 90 percent of banks would have the same or lower assessments.

One drawback for some banks is that the proposal would no longer treat trust-preferred securities as Tier 1 capital instruments, noted Bryan Cave Leighton Paisner law partner Robert Klingler in a recent analysis. He concluded that qualifying BHCs between $3 billion and $10 billion would likely not want to opt into the new framework with that restriction.

Under the proposal, CBLR tangible equity would be defined as total bank equity capital or total holding company equity capital prior to including minority interests, and excluding accumulated other comprehensive income (AOCI), DTAs arising from net operating loss and tax credit carryforwards, goodwill, and other intangible assets (other than MSAs). Average total consolidated assets would be calculated similar to the current tier 1 leverage ratio denominator in that amounts deducted from the CBLR numerator would also be excluded from the CBLR denominator.

Qualifying banks would be able to opt into the framework at "any time." But getting out won't be that simple.

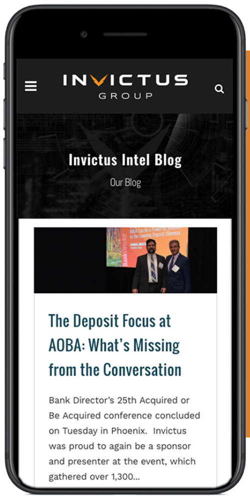
The agencies said they anticipate switching out would be "rare and typically driven by significant changes in the banking organization's business activities." Banks that want to opt out once they are in the framework would have to "provide a rationale" to regulators.

Banks would also have to demonstrate to regulators that they have enough regulatory capital to meet the existing rules at the time of opting out.

RULES FOR THE NEW FRAMEWORK

To qualify for the new leverage ratio, banks must have:

- Total assets Less than $10 Billion
- Leverage ratio of at least 9 percent
- Total off-balance sheet exposures (excluding derivatives other than credit derivatives and unconditionally cancelable commitments) of 25 percent or less of total assets
- Total trading assets and trading liabilities of 5 percent or less of total assets
- Mortgage serving assets (MSAs) of 25 percent or less of CBLR tangible equity
- Temporary difference DTAs of 25 percent or less of CBLR tangible equity



NOTE FROM THE EDITOR:

Be on the lookout for more banking insights on the Invictus Intel Blog, which we're updating regularly. We've recently discussed the importance of new analytics in M&A and why the WARM method might not make sense for SEC filers as they implement CECL.

VIEW FROM AN EXPERT

With Trump appointees now settling in, community bankers have become more optimistic that they will experience less stringent exams. Bank Insights reached out to Peter G. Weinstock, law partner at Hunton Andrews Kurth in Dallas, for his perspective.

"We're not seeing it at the Fed all, no difference," Weinstock said. "Maybe that will come in time," he added, noting that new Fed Governor Michelle W. Bowman, the former banking commissioner in Kansas, had recently been confirmed to fill a community bank seat.

"The OCC and FDIC are tending to be less gotcha in exams. There's more of a willingness to discuss issues before they turn into enforcement actions," he said. "I never understood the one-bite-of-an-apple rule," he said, explaining that in the recent past examiners marked down banks for any pitfall without allowing for a give-and-take.

So, what are examiners focusing on? "Liquidity, deposits, cost of funds. Deposit longevity studies. All of these are being discussed," he said. Banks "heavily into wholesale funding" are also under scrutiny.

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EACH ISSUE BANK INSIGHTS REVIEWS NEWS FROM OR ABOUT REGULATORS TO GIVE PERSPECTIVE ON REGULATORY CHALLENGES.

OCC Outlines Concerns about Deposits, Rate Risk and CECL

Rising interest rates, increased competition for deposits and CECL implementation are among the issues that will be monitored closely by bank supervisors in the coming months, the Comptroller of the Currency revealed in its latest Semi-Annual Risk Perspective. The OCC noted that "untested depositor behavior," coupled with changes in technology, will make it difficult to forecast liability costs. Bankers should also be aware of easing commercial credit underwriting practices, the need for sound CRE concentration risk management, and the strategic and operational risks that may accompany CECL implementation. Community banks especially must be aware of how liquidity requirements for the largest banks may increase competition for stable insured retail deposits.

FDIC Chair Pushes Transparency Initiative

The FDIC is making available previously unpublished information, such as exam turnaround times, to help bridge the trust with banks, Chair Jelena McWilliams said at a recent American Bar Association Bank Law meeting. (Safety and soundness exams with favorable outcomes took 24 days in the first half of 2018, while those with unfavorable findings took 34.5 days). McWilliams said the agency is also instructing examiners not to treat guidance the same as law. She also revealed that regulators are working on ways to "tailor the risk-based capital rules" for banks that don't qualify for the new community bank leverage ratio framework, hoping to simplify "some of the more complicated calculations and risk-weightings."

Brokered Deposits Under Review

The Federal Deposit Insurance Corp. is reviewing whether its rules for brokered deposits make sense in today's ever-technical banking environment. It wants to know what issues have changed since the FDIC began regulating brokered deposits in 1989, whether it collects enough information on Call Reports, if the interest rate restrictions are still valid, whether the right types of deposits are considered brokered, who constitutes a broker, if rates make sense and if banks understand the rules correctly. About 41 percent of all U.S. banks hold brokered deposits.

FASB Roundtable Fails to Halt CECL

The Financial Accounting Standards Board held a late-in-the process roundtable to consider an alternative approach to CECL, but don't expect much to come out of it. The board issued a 16-page defense of its eight-year deliberative process on the new accounting standard, before listening to banks argue for changes. FASB staff in January also released a Q&A on whether banks can use the WARM method—a methodology that should raise red flags with SEC filers, according to a blog post from Invictus Group CEO Adam Mustafa.

Longer Exam Cycles for More Community Banks

The OCC, the Federal Reserve and the FDIC have finalized rules for allowing more community banks to qualify for an 18-month exam cycle. Qualifying institutions with CAMELS ratings of 1 and 2 that have less than $3 billion are now eligible for the longer cycle.

FDIC Pushes for More De Novos

No banks failed in 2018. But de novo activity is also low—and the FDIC wants that to change. It points out that only 11 banks have opened since the end of 2009. Prior to the recession, the only time fewer than 20 new banks opened in a single year was 1942, in the middle of World War II. The agency has issued a request for information seeking comments on how to improve the deposit insurance application process, published a handbook for investors and speeded up the process for reviewing applications. According to its website, two applications for deposit insurance were approved in the first half of 2018, one was returned and three were withdrawn. It took about six months to process each application.

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Invictus gives its clients a competitive edge in M&A targeting, CECL readiness, strategic and capital planning and more. Its unique analytics are powered by

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