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Between a Rock and a Regulator: How Troubled Community Banks Should Use Stress Testing

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For banks under enforcement action or significant regulatory pressures, stress testing can easily be viewed as incremental work that only reinforces regulatory capital requirements. However, the proper application of stress testing is critical to defining the best path for the bank on behalf of its shareholders, while simultaneously improving regulatory interactions.

A troubled bank faces intensive operating, financial and regulatory pressures. Senior management must focus on meeting regulatory demands and attempting to correct identified deficiencies under the bank's existing framework and structure. Generally, strategic planning and a focus on profitability take a back seat to individual problem loan categories and overall capital shortfalls.

In a defensive posture, management cannot see light at the end of the tunnel. The bank is trapped into an ongoing scenario of limited organic growth (including pressures to deleverage specific loan assets) and the inevitable reduction in profitability.

It's in this environment that stress testing becomes extraordinarily powerful. It's the only way that management can quantify key operating and financial insights and ratios that are crucial to the bank's future.

Focusing directly on enforcement action items inevitably leads to reductions in problem loan areas and lower profitability. This creates a scenario that makes raising capital difficult. Certain information and analysis that is critical to evaluating the possibility of raising or increasing capital and protecting existing shareholder interests is out of reach and some very important questions remain unanswered.

Key Questions for Senior Management

- What is the quantified impact of capital constraints on the bank's immediate and long-term viability and profitability?
- What is the true potential of the bank within its geographical footprint?
- What plan is the bank sacrificing due to its capital issues?
- What is the maximum price the bank should be willing to pay for incremental capital?
- What is the likelihood that the bank can raise the required capital within a reasonable time?
- What steps does management need to take to maximize the potential of the bank within its geographical footprint?
- How can regulatory communication be improved to ensure survival of the bank as a profitable entity?

The Solution: Applying Stress Testing

This "between a rock and a regulator" problem can only be solved through the following application of stress testing. At each stage, management will receive insights and data vital to understanding and solving the bank's issues and maximizing shareholder value.

STEP 1 : Stress test the bank's latest financials to estimate the minimum regulatory capital requirements based on its asset mix and historical experience. Compare the results generated under the CCAR 2013 economic scenario, which should be localized to the bank's footprint, with any leverage ratios required under the enforcement action. This will give the bank considerable insight into its ability to negotiate with regulators. The difference between the CCAR 2013 stress test and the enforcement action ratios will have considerable impact in the final analysis.

STEP 2 : Prepare a five-year financial forecast that limits organic growth within the prescribed regulatory leverage ratios. This is essentially a strategic plan that is constrained by the bank's capital limitations under the enforcement action. The five-year financial forecast will focus heavily on the first two years. This forecast generates an approximation of the bank's return on capital/shareholder capital. Essentially, this would be the bank's true performance if management limited itself to playing defense with the regulators. The results will give management a better perspective on the best possible return achieved by their defensive actions.

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STEP 3 : Prepare a five-year financial forecast that ignores any regulatory constraints and limits organic growth to practical market considerations. Use the results to calculate the return on capital. This unrestricted scenario represents the potential return on total capital if the bank could fully exploit its marketplace. Equally important, management has quantified the true potential of the bank within that marketplace. If the bank, after the five-year forecast, has performance consistent with a viable and profitable entity, then management can proceed to the next step. If not, then management needs to evaluate other options, including the possible sale of the bank.

STEP 4 : Stress test the unrestricted five-year financial forecast adapting the CCAR 2013 methodology and economic scenarios. This would generate the bank's regulatory capital requirements under an unrestricted growth scenario.

Going Forward: How to Understand the Analysis

- The difference between the returns of the restricted (Step 2) and the unrestricted (Step 3) scenarios will give management a clear-cut incremental value generated by the unrestricted scenario.
- The difference between present-day capital and the regulatory capital required to achieve the unrestricted scenario (capital calculated in Step 4) will quantify how much additional capital the bank would need to achieve its unrestricted growth scenario.
- The ratio of the difference in returns between the two scenarios and the additional capital required would generate a very critical and important marginal return on capital value. This value will essentially determine the feasibility of raising new capital, if not today, then in the near future.
- If this return is low, then bank management should recognize it has very limited options and a sale of the bank might be the best way to protect shareholder value.
- If this return is high enough to attract capital in a normal market, but not sufficient in the present market, bank management has the opportunity to prepare a customized report for the regulators highlighting the results. That report should request time from the regulators to allow management to guide the bank in the unrestricted growth scenario with the reasonable probability of raising capital in the near future. The report would also emphasize that the alternative, restrictive scenario could, over time, threaten the bank's sustainability, possibly only delaying the inevitable. Most regulators won't subject a bank to restrictions that will inevitably lead to the bank's demise, if there are other options. Obviously, management would have to vigorously defend its ability to achieve the unrestricted growth scenario and its implied profitability. Regulatory leeway would come only with management's commitment to provide regular and timely updates so that regulators could monitor the bank's progress and protect their position.
- If the return is strong, management has the ability to provide an incentive to existing shareholders and external capital sources for raising additional capital. Most importantly, the return generated in the calculation would reflect a ceiling on the cost of incremental capital. This process would give a far better understanding of the most the bank can pay for capital before existing shareholder interests are negatively affected. Furthermore, management would now have the data and information

Make Sure the Methodology is Right

Community banks that use stress testing should make sure they are adapting the forward-looking methodology that the Federal Reserve has spelled out for the largest banks in its Comprehensive Capital Analysis and Review (CCAR) tests and the Dodd-Frank Act Stress Tests. No matter the size of the bank, this adapted methodology that will ensure complete and accurate results that are acceptable to regulators.

Unfortunately, many consultants and vendors have attempted to adapt either traditional loan review processes or general consulting planning programs into stress testing systems. As the regulators have learned the hard way, stress testing is an entirely new approach that shuns traditional backward-looking systems that were designed for the Basel I and Basel II frameworks.

Assuming the basic methodology is appropriate (and it can be simplified), the application of stress testing must be designed for the bank's unique structure, footprint, and most importantly, its individual regulatory capitalization. Without this adaptation, stress testing will be no more than a time-consuming, check-the-box exercise paying little or no dividends.

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to approach regulators and request flexibility while attempting to raise capital. In many cases, stepped capital raises would reduce existing shareholder dilution and regulatory latitude could permit this approach.

In summary, these steps allow management to stop playing defense, which invariably forces the bank into a restrictive growth scenario. Instead management can play offense, armed with the key quantification that will directly influence the future direction of the bank and the protection of its shareholder value. This calculation is necessary to evaluate the possibility of a capital raise and/or the ceiling pricing to be paid for incremental capital. It cannot be derived any other way than through the proper application of stress testing. ▪

About the Author

Kamal Mustafa is the chairman and CEO of Invictus, which he formed in 2008. His more than 40-year career in banking began at Connecticut Bank and Trust where he headed corporate finance/credit. He opened up all of Citbank's domestic origination offices, and then became head of Global M&A He was the managing director of M&A at the merchant banking group at Paine Webber, and then ran KSP, a billion-dollar LBO fund for John Kluge. In the late 1980s, he established BlueStone Capital, which became a leader in middle market corporate finance. In 2002, he formed Wildwood Capital, an investment bank that advised both middle market companies and some of the world's largest financial institutions. He has served as a trustee for the University of Connecticut.

FDIC Spells Out Benefits of Community Bank Stress Testing

Community banks gain the most benefit from stress testing when it's incorporated into their overall risk management and strategic planning processes, a senior FDIC examiner advises. The examiner, Robert Long in San Francisco, referred to stress testing as a "key risk management tool."

Long held a teleconference in August on "Stress Testing and Model Governance" that spelled out reasons why community banks should use stress testing, even though it isn't strictly required for banks with assets under $10 billion. He said that banks that implement stress testing can make better strategic decisions, determine the risk level of their current loan portfolio and even gain information about whether to make loans to a particular segment of its geographical footprint.

Regulatory Guidance that Calls for Stress Testing for Community Banks

- Joint Policy Statement on Interest Rate Risk (1996)
- Interagency Advisory on Interest Rate Risk (2010)
- Guidance on Concentrations in Commercial Real Estate, Sound Risk Management Practices (2006)
- Expanded Guidance for Subprime Lending Programs (2001)
- OCC Community Bank Stress Testing: Supervisory Guidance (2012)

Community banks that have loan portfolios with "speculative, risky, or concentrated" elements can use stress testing to identify potential vulnerabilities, which allows the board to make informed strategic decisions, Long said. This also helps banks strengthen their credit risk management practices, a key area that examiners look at when reviewing a bank.

Results of portfolio-level stress tests can help a bank board and senior management analyze lending concentrations, capital adequacy and the allowance for loan and lease losses, as well as the overall risk at the bank, he said. It can help determine which balance sheet components can threaten a bank's safety, sharpen a bank's focus on current and future trends, and even show a client's ability to repay a loan.

Stress testing can also be used to calculate interest rate risk and provide metrics on projected losses on loans, counterparty credit and outstanding securities.

Long advised banks that use stress testing to make sure that the board approves a system of controls on the methodology, updating such reviews every quarter. ▪

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Read Between the Lines

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

Lessons from the Large Bank Stress Tests

Regulations and policies that begin with the largest banks often eventually trickle down to community banks. So what lessons can be learned from the Federal Reserve's August **report** on capital planning at large banks after they underwent required capital stress testing?

1. Make sure that the stress scenario is tailored for your bank, a practice followed by Invictus when it stresses banks. The Fed found that the best scenarios took into account a bank's unique business model and risks, its geographic region, product lines or asset classes.
2. A bank's internal control framework should address its entire capital planning process and risk management practices.
3. Capital planning should combine a comprehensive identification of a bank's business activities and how they may evolve under stressful conditions, and what that evolution may mean to the bank's capital needs.
4. Capital policies must clearly state a bank's capital goals and targets, with analytical support for how they were determined. The policies should be detailed enough to provide guidance about how the bank will respond as its capital position changes under different economic scenarios.
5. Have strong board and senior management oversight of capital planning processes.

Publications

The Federal Reserve's latest **FedLinks** deals with internal control functions. "It is the responsibility of an institution's board of directors and senior managers to consider the cost of implementing and maintaining strong controls versus the potential impact from the risk of lax or weak internal controls," the July document states.

The publication reveals what examiners find when reviewing internal control procedures at community banks:

- A failure to link risks and internal controls
- Weak internal controls often signal financial problems
- Built-in system controls are usually more effective than manual controls
- Not enough emphasis on consumer fairness
- Banks tend to think information flow equals monitoring, a misconception
- Internal audit is not solely—or even primarily—responsible for internal controls

Interest-Rate Risk Videos Released

As promised, the FDIC has released a **video** for bank directors that explains the "increasing concern" over interest-rate risk. Dan Fry, head of the FDIC's Boston office, tells bank directors while they don't need to be an expert at interest rate risk, they need to understand enough to have a comprehensive risk management framework. The half-hour video addresses the key elements of an interest-rate risk framework and discusses lower bank profitability with net interest rate margins at historical lows. A longer **video** is intended for bank management.

The videos follow last year's interagency FAQ **advisory** on interest rate risk management that answered frequently asked questions about what regulators expect. Regulators want banks to measure the potential effect of changes in market interest rates on earnings and capital, the advisory noted. All banks, regardless of size, are expected to run stress scenarios to identify the four components of interest-rate risk: repricing mismatch, basis risk, yield curve risk and options risk. ▪

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. Invictus runs a stress test on every U.S. bank each quarter with its patent-pending Invictus Capital Assessment Model™ (ICAM). Bank clients have excellent results when using Invictus reports to defend their strategic plans and capital levels to regulators.

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