April 2014

INVICTUS

Bank Insights

Lessons from the Fed's Stress Tests

By Adam Mustafa, Invictus Partner

The Federal Reserve's **CCAR 2014** proved that the regulators mean business. Next up are those banks with between $10 billion and $50 billion in total assets. Many of these so-called Dodd-Frank banks are going to be in for a rude awakening when their results are disclosed in June. Those banks, along with the rest of the community banks, can learn a few critical lessons from CCAR 2014:

- **Involve regulators as early in the stress testing and capital planning process as possible.** Speed is critical. Your stress testing system has to be nimble and repeatable. Invite and encourage feedback. Treat regulators as a partner. This will allow you to identify and address their concerns early in the process. The CCAR banks don't really have this luxury because the Fed has to appear strong in public. It was a given that some banks would fail.

- **The uniqueness of your loan portfolio matters.** The loss rates by loan category within CCAR 2014 were all over the place. Regions Financial Corp's commercial real estate loss rate was 7.6 percent of loans, while SunTrust Banks' was 3.6 percent, even though they have fairly similar footprints in the southeast. Your bank has a unique mix of assets, and the underwriting profile of your loans matter. Banks that can properly demonstrate this with data and analytics will be able to support lower loss rates under stress. "Simple" stress tests that use generic loss rates by loan category have limited value.

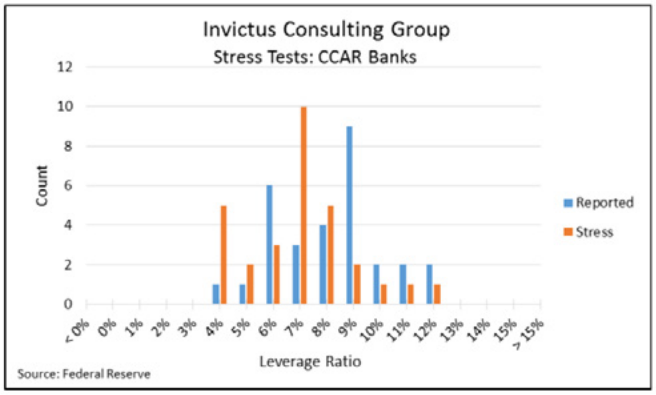
- **Risk management processes and controls make a big difference.** Citigroup failed the 'qualitative' CCAR because regulators weren't comfortable. The bank CEO must be at the helm of your stress testing. Regulators will have qualms if you isolate this to your CRO and middle management.

- **Every bank should track, understand, and manage its Pre-Provision Net Revenue (PPNR).** PPNR is a geeky way of saying "Pre Tax Earnings excluding Loan Loss Provisions." The best way to think about PPNR is it is becoming the EBITDA for banks. Many buy-side analysts love this metric and treat it as important as Net Interest Income and Net Income. Why? Loan loss provision expenses are highly volatile and subjective. Regulators will be the first ones to tell you that the stronger the bank's earnings model, the safer the bank is under stress. The banks that did best in CCAR 2014 were the ones with the strongest levels of PPNR. This is where Zions Bancorp fell flat. PPNR should be a primary focus of every bank's board package every quarter.

Elements in Effective Stress Tests

1. Asks plausible "what if" questions about key vulnerabilities
2. Concludes what impact the stress factor or event might have on earnings and capital
3. Incorporates overall analysis into bank's strategic and capital planning and risk management processes

Source: **OCC**, *Community Bank Stress Testing Guidance*



- **Community banks should focus on the leverage ratio.** Yes, this is contrary to CCAR and DFAST, which highlight the Tier 1 Common Ratio, a transition ratio to Basel III. Regulators look at all four capital ratios and banks must be within the boundaries of them all. The leverage ratio may take center stage now that regulators have adopted a **supplementary leverage ratio** for the top eight banks, forcing them to retain an extra $95 billion of capital over the next several years to be in compliance. We will see how this impacts CCAR 2015, but when you cut through the noise, the bottom line is that regulators are zeroing in on the leverage ratio because the assets are not risk-adjusted and they can trust it more. The leverage ratio is already the primary focus of regulators for

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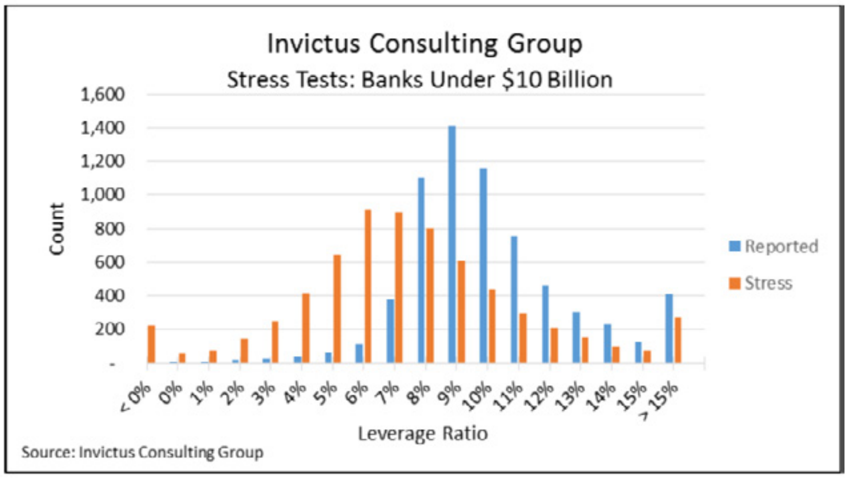
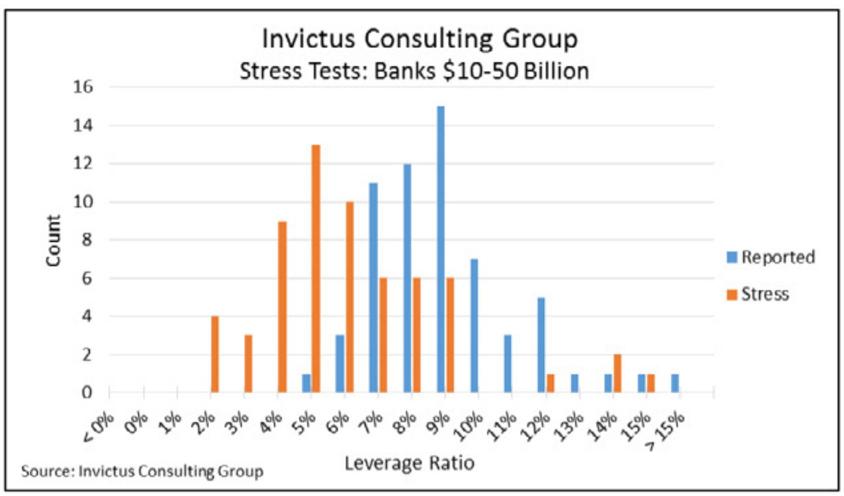
most community banks anyway, and it's also the capital ratio best understood in the board room.

▪ **Don't assume your assets will shrink under stress.** While nobody knows for sure why the Fed's stress test results differed so substantially from many of the banks' stress test results, those of us who closely follow CCAR and DFAST attribute some of this to differences in asset growth. The Fed put out a notice in December that said it anticipated loans will grow by 1 to 3 percent per annum at the peak of a recession. This differed from what the top 18 banks assumed in last year's CCAR. The Fed likely trumped the 'denominators' of the capital ratios with larger numbers, which in turned resulted in lower post-stress ratios. We think that loan growth should be treated like a capital action and banks should assume the same growth as in their strategic plans. This may sound conservative, but the ultimate objective is for a bank to get its strategic plan and supporting capital plan green-lighted. Let's not lose sight of this. ▪

Invictus Stress Test Analysis Shows Leverage Ratio Trouble for 10% of Banks

Don't be surprised if at least one Dodd-Frank bank fails the upcoming stress tests out right and a handful of others come under pressure from regulators with post-stress leverage ratios of 4 percent or less. To produce the charts below, Invictus Consulting Group performed public data stress tests on every U.S. bank, except for the CCAR banks, whose stress tests results were released by the Fed in March. The charts show the post-stress leverage ratios of the Dodd-Frank banks (with assets of $10 billion to $50 billion) and the remaining community banks (assets below $10 billion) under a severely adverse scenario.





The average post-stress leverage ratio of the CCAR banks was 6.1 percent, declining 2.3 percent from the current average of 8.4 percent. Both the Dodd-Frank and community banks start and end with higher ratios than the CCAR Banks, but have a greater decline as a result of stress.

Under our analytical framework, more than 10 percent of the non-CCAR banks could see their leverage ratio drop below 4 percent, a level at which they would be under pressure from regulators to cut dividends, raise capital or take other measures to increase their equity cushion. Three percent of the smaller banks would have negative capital in a severely adverse scenario. Troubled and healthy banks can use stress testing to have constructive conversations with regulators about their capital requirements and strategic plans. ▪

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ALLL Impact Still Uncertain: Credit Loss Model Changes Debated

By Steve Schick and Chris Ritter

In the wake of the recession, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) began working with the financial world to address concerns around the current credit loss model. The boards' intention was to propose one global loss model.

However, FASB and IASB split off in separate directions. FASB wanted to concentrate on a current expected credit loss model and IASB focused on a "three bucket" approach that reflects the general pattern of deterioration of the credit quality in loans.

The boards issued their first exposure draft of a new standard and requested comment from the public in the second quarter of 2013. They met last September to deliberate. FASB decided that:

- An entity should use its historical average loss experience for future periods beyond which it can make or obtain reasonable and supportable forecasts.
- An entity should consider all contractual cashflows over the life of the related financial assets.
- An estimate of expected credit losses should always reflect the risk of loss, even when that risk is remote. However, an entity would not be required to recognize a loss on a financial asset in which the risk of nonpayment is greater than zero yet the amount of loss would be zero.

The IASB had other findings:

- It clarified that the model's objective is to recognize lifetime expected credit losses on all financial instruments for which there has been a significant increase in credit risk, whether on an individual or portfolio basis. All reasonable and supportable information, including forward-looking information that is available without undue cost or effort, should be considered.
- It confirmed 12-month expected credit losses as the measurement objective for instruments in Stage 1.
- It will require a default definition consistent with credit risk management practices, and emphasized that qualitative indicators of default should be considered when appropriate (for example, financial instruments that contain covenants).

To date, there has been much discussion and debate as to the ultimate impact to a bank's allowance for loan and lease losses. FASB published a Q&A document in response to the exposure draft that included the question of the board's expectation for larger allowances. FASB contended that it did not intend to increase allowances based on this standard alone. However, policy makers and industry professionals expect a 20% to a 40% increase to the allowance for loan and lease losses.

The Office of the Comptroller of the Currency estimated that the impact on the allowance would be "in the neighborhood of 30 to 50 percent," Comptroller Thomas Curry **said in September**.

While expressing support for the FASB proposal, Curry said he was concerned "about the operational impact the proposed standard may have on community banks" and urged FASB to modify disclosure requirements and the implementation time for smaller banks.

While the current expected timeline for a final standard is set for the first half of 2014, due to the lack of agreement on one model, a converged model appears unlikely. Should the current expected timeline not be adjusted, it is anticipated that a final standard will be issued by the FASB and convergence won't occur.

While still speculative, the required timeline for implementation of the new standard could be as early as 2015 for public companies and 2016 for private companies. ▪

Editor's Note: **Steve Schick** and **Chris Ritter** are audit partners at Plante Moran. This article reflects their views.

Community Banks Object to Proposal

Changes to the credit loss models could harm community banks, argues the Independent Community Bankers of America in an **online petition**. ICBA contends that the FASB proposal is too complex. It wants a more straightforward credit loss approach.

ICBA objects to community banks being required to front load credit losses when originating portfolio loans and says banks should be able to recognize losses over the life of the loan. It also says that transition to a proposed expected credit loss model would have "an immediate adverse impact" on capital.

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Read Between the Lines

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

Expect Examiner Focus to Remain Strong

Comptroller of the Currency Thomas J. Curry **told an OCC-Boston University conference** that the "cornerstone of a healthy financial system" is supervision and examiner judgment, especially "examiner boots on the ground." He also cited rules, stress tests, capital levels and data analytics as keys ways regulators should evaluate a bank's health.

Third-Party Oversight Reasons Revealed

Why are regulators so concerned about third-party due diligence? Deputy Comptroller for Operational Risk Carolyn DuChene offered some clues in a **speech** before OpRisk America. She said regulators began seeing "misaligned compensation and incentive schemes" in third-party relationships involving direct marketing activities to bank customers. Banks were also becoming lax in risk management of outsiders because they didn't have the expertise to know how to spot risky activity or to negotiate dispute resolutions.

Community banks need strong audit functions and "robust governance and oversight" when leveraging third parties, she said. "Frankly, as a supervisor, I've seen numerous examples where the quality of risk management simply hasn't always kept pace with the velocity and breadth of change and the rapidly evolving threats in the environment," she warned. Do not silo risk controls to one area of the bank, she said. Include risk awareness, identification, assessment and controls throughout the organization.

FDIC Letter Reminds Banks about Technology Outsourcing

In other signs of a sharpened emphasis on third-party risks, the FDIC sent out a **financial institution letter** on April 7, reissuing three documents that community banks can use to help guide them in selecting technology service providers. The documents remind banks to make sure that confidential bank information is protected and that any outsourcing meets the bank's objectives and strategic plans. **One document** details how banks can develop service level agreements to measure performance and monitor risk.

The law firm of Bryan Cave **notes** that "it is increasingly plain that we are seeing a significant sea change in how regulators approach the relationships between banks and their third party vendors. Examiners are digging deeper — especially into the content of bank contracts - and the scope of review is extending to more and more vendors."

Understanding Asset-based Lending

Credit risk is the biggest risk associated with asset-based lending, according to a **new OCC handbook** designed for examiners. The handbook notes that ABL "requires intensive controls and supervision." Even though the risk of loss might be less than with other type of lending, bankers must have a "thorough understanding of the borrower's business, good reporting systems, and in-depth knowledge and evaluation of the collateral."

Standards for Appraisal Management Companies

All the bank regulators have issued a **proposed rule** that sets out standards for states that will oversee appraisal management companies.

Bank Director Liability Leading to Resignations

More than 15 percent of banks responding to an American Association of Bank Directors survey said they either had a director resign over fear of personal liability or had a candidate refuse to serve on the board for that reason, the AABD revealed in a comment letter to the OCC.

The **letter**, written in response to the OCC's proposed rule to increase director responsibilities at large banks, points out that many community banks have parent companies with identical boards. The OCC has said the proposal could be applied to banks of any size if they were deemed risky. "Forcing those institutions to have bank directors who cannot serve on the parent company does not make much sense," the AABD writes. ▪

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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