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INVICTUS
Bank Insights

FDIC Wake-up Call: No More Regulatory Carve-Outs for Community Banks

A special *Read Between the Lines* report

Community banks have gone too far in asking for special exceptions from bank regulation, according to Federal Deposit Insurance Corp. Vice Chairman Thomas Hoenig. And that signals a tough new stance for community banks going forward.

In a **speech** earlier this month at the North Carolina Bankers Association convention in Palm Beach, Hoenig told community bankers that their banks "are dying a slow death waiting for regulators to carve them out as special." He noted that the cost of increased regulation "contributes to the trend toward consolidation as smaller banks work to control costs and to survive within a highly regulated industry."

It won't work any longer to argue that rules written after the crisis to stem the misdeeds of large commercial banks weren't intended for community banks, Hoenig warned. "But in fact they were intended for commercial banks, which you are," he said. He called on community banks to have "the courage" to stop missteps in the industry, the only solution that would lead to what he termed "regulatory balance."

"Rather than rely on the hope of a 'carve out,' they should insist on discipline across the entire commercial banking industry," Hoenig told the community bankers. He said commercial banking will never be one industry if the largest banks get subsidies that community banks don't, such as requirements that allow them to have less capital.

The speech is a game-changer for the community bank world, says Invictus Consulting Group Chairman and founder Kamal Mustafa, and it's all about capital.

The largest banks that have had to undergo mandated stress testing as part of the CCAR and Dodd-Frank programs have been able to customize and fine-tune their capital ratios, leaving them with less stringent leverage requirements than most community banks. Most community banks have ignored stress testing since it is not yet mandated by regulators for banks of their asset size.

But Hoenig is signaling to smart banks that they should now read carefully the intent of the stress testing, capital and liquidity rules and the methodologies behind them, and begin applying them to their own banks.

What Community Banks Should Do Now

Here are tips from Invictus partner Adam Mustafa about what banks can do:

- Hold yourself to the same standards of the larger banks. Don't wait for regulators to force those rules upon you.
- Tell your story to regulators. Big banks use stress testing to make the case for their capital and strategic plans, which allows them to essentially customize their capital requirements. You can do the same.
- Take a forward-looking and strategic approach to the new regulatory landscape.

Community banks, as commercial banks, "for starters" are already subject to Basel III, QM, QRM, escrow requirements, balloon mortgages and compliance exams, Hoenig said.

The response from trade associations has been muted, probably because groups such as the Independent Community Bankers of America publicly support Hoenig's prior proposals to restrict banks to core banking activities as a way to prevent extension of the federal safety net and reduce systemic risk. In effect, Hoenig is now telling those groups to get on board with him all the way. He is saying profitable and smart banks will succeed if they adapt to the new rules in the marketplace.

"The community bank business model is viable, but its success relies on a market system that is being undermined," he said. "To prosper as an industry, commercial banks must be allowed to compete and succeed or fail based on the fundamentals of commercial banking and individual bank performance." ■

Editor's Note: "Read Between the Lines" is a monthly *Bank Insights* feature. Read more on p.4.

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Takeaways from the FDIC Speech

By Thomas P. Rideout

FDIC Vice Chairman Thomas Hoenig's address to the North Carolina Bankers Association Convention offers several opportunities for community banks.

While community banks have traditionally been able to position themselves among their legislators and regulators as institutions that deliver a special personalized brand of financial services – and thereby deserving of special treatment—the banking crisis of 2007 and 2008 has changed the regulatory pendulum, perhaps forever. It is doubtful that we will see again another era of benign regulation.

In the process of passing the Dodd-Frank Act, banking associations worked hard to achieve a variety of carve-outs for community banks that would either exempt them or, at the least, minimize their regulatory burden. The hope was this would assure sufficient manpower and resources to focus on enterprise survival and sustainability.

Unfortunately, while well-intentioned, Dodd-Frank did not solve issues such as "too big to fail" and the inability to control financial market segments and businesses that shifted to the shadow banking system. Now FDIC Vice-chairman Hoenig is saying that all banks are going to be treated in an even-handed way, with no more exemptions going forward.

Two lessons can be drawn from this important address: one of a public affairs nature and the other dealing with management and leadership.

First, community bankers will be tempted to ask their trade associations to reaffirm the Dodd-Frank carve-outs and even extend them. This is likely to fall on deaf ears in Congress and would be a waste of lobbying clout.

"Regional concerns and the apparent lack of understanding of regulatory initiatives have failed to reinforce to the political establishment the primary reason requiring the "special treatment" of community banks," Invictus Consulting Group Chairman Kamal Mustafa says. "Community banks are a creature of their limited and unique geographical footprint. Their loan portfolios and deposit composition are entirely dependent on the characteristics of the community within their footprint. These unique characteristics meet the needs of the community in a manner that is impossible for larger institutions."

Community banks are special-purpose commercial banks vital to the health of the U.S. economy, Mustafa notes. "This message to the political establishment seems to have been lost in translation. In this context, it is important to recognize that the regulators are the cops enforcing political actions and directives."

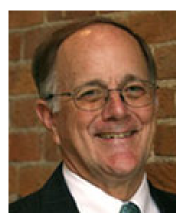
Hoenig issued a clarion call when he said community banks "should insist on discipline across the entire banking industry" and seek to create "one industry" by demanding that large bank subsidies, reduced capital and leverage requirements and less robust supervision, be removed as both an unfair competitive advantage and one that balkanizes market segments. It is time for community banks to seriously consider this message. There is little prospect that this regulatory climate will change any time soon.

> Community banks "are dying a slow death waiting for regulators to carve them out as special."

Second, this upheaval in the assumptions about the operating climate will demand the very best of bank CEOs and their top management teams as they adjust to a new regulatory landscape. A premium will be placed on the ability of individual bank leaders to understand their market opportunities and to adjust their commercial and consumer banking service and lending profiles to the "new normal." Planning for 2015 will not go well if it merely replicates a traditional budgeting exercise. Regulators will look favorably on banking leaders who understand their markets and opportunities and the detailed data analytic consequences of their strategic financial plans and franchise options.

Smart bank leaders may look to strategic business partners to help management deal with the details of their current business profiles and explore, both broadly and through in-depth analytics, their strategic business options in the future. Bank management needs to rethink budgeting, capital and strategic planning in light of new regulatory requirements and take an analytical approach in loan targeting, marketplace assessments, interest rate risk positioning and capital assessments.

Bank regulation now requires forward-thinking analytics and planning. Bankers that rely on historical performances and projections will be left in the dust. ▪



Thomas P. Rideout, a former bank CEO, is an Invictus Executive Director. He is also a former volunteer president of the American Bankers Association. Rideout's 40-year banking career includes stints as a VP at Wachovia, President & CEO of Savannah (GA) Bank & Trust Company, and Vice Chairman of First Union National Bank of North Carolina.

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THE CEO CORNER

How to Get a Green Light on Your Future Plans

By Vito Nardelli

A large "capital war chest" may not be enough to gain regulatory approval to move forward on a planned merger or acquisition – or even just a strategic plan. We have seen indications that regulators are showing red and yellow flags to banks that want to acquire another institution. Some of these would-be acquirers had demonstrated strong capital positions. At issue was whether they provided enough assurance to their regulators that they fully understand the new regulatory environment.

Banks should incorporate capital stress testing into their strategic planning if they want to pass muster with examiners. The OCC has said strategic planning is a top focus in the coming year. (See p.4)

For acquisitions, bank executives will need to show that they know that the new regulatory paradigm entails more than the historical requirements of accretion to earnings, cost savings, economies of scale and capital to support any shortfalls. CEOs are now expected to provide detailed facts not only on their capital strength against their assets and all other areas that threaten their capital, but they also must be able to shoulder the burden of the target bank's regulatory capital profile.

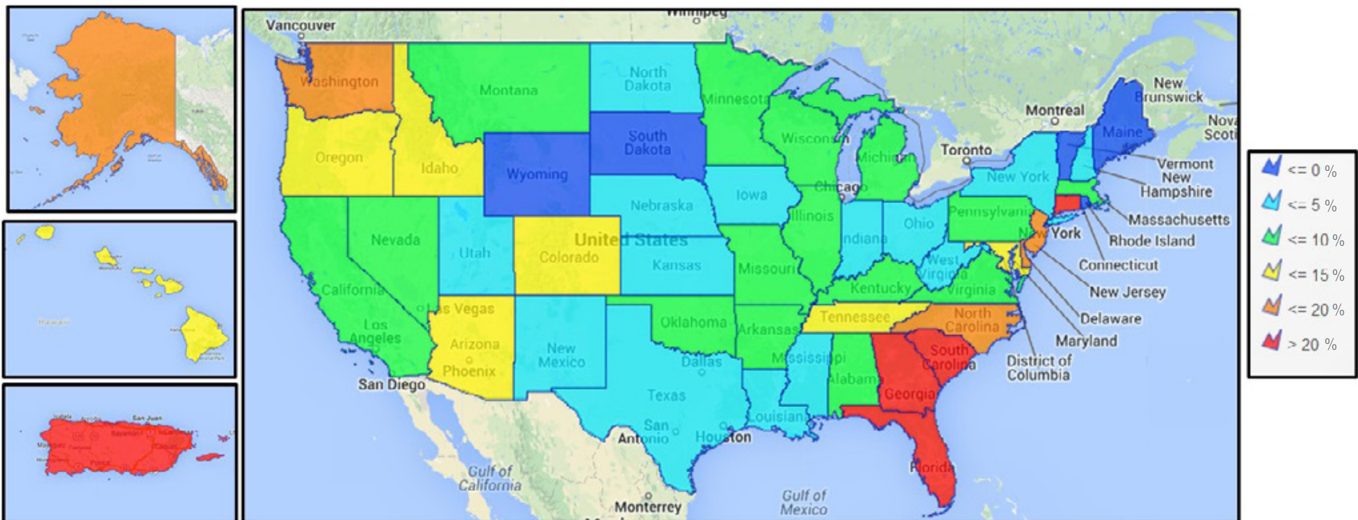
The process of due diligence must be enhanced to incorporate the concerns of regulators. Make no mistake: Dodd-Frank and Basel III as a practical matter are impacting all banks. Astute executives and their boards of directors are taking a proactive strategy by using capital adequacy stress testing to pre-empt unnecessary delays to their plans.

Editor's Note: You can email the **Invictus M&A team** to learn more about our services.

About the Expert

Vito R. Nardelli is an Invictus executive director. He served as the president and COO of OceanFirst Financial Corp, and the president of OceanFirst Bank in New Jersey before retiring in 2012. Prior to that, he served as the Senior Vice President and Retail Banking Director for Trust Company Bank. He held several leadership positions at First Union National Bank, including president of the Central New Jersey region. He also was executive director of the New Jersey Economic Development Authority in the 1990s. Mr. Nardelli was a Lieutenant Colonel in the United States Air Force Reserve. He received his BS and JD degrees from Fordham University and has an MBA in Executive Management from St. John's University.

Exclusive Data: Must Sell Banks in the U.S.



*This map shows the percentage of "Must Sell" banks in each state in the U.S., based on first quarter of 2014 data. This proprietary Invictus analysis is part of **"Leaders and Bleeders,"** which is updated quarterly. Overall, the analysis finds a slight improvement over fourth quarter data, with 12 percent of banks in the Must Sell category (818), compared with 14 percent (897 banks) at the end of 2013.*

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Read Between the Lines

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

OCC to Focus on Strategic Planning, Interest Rate Risk

Expect your OCC examiner to pay attention to the adequacy of your bank's strategic, capital and succession planning procedures, according to the OCC's **Spring issue** of its Semiannual Risk Perspective. Examiners will want to make sure that strategic initiatives take into account these risks. (One way to do this is to make sure your bank incorporates capital stress testing into its strategic planning.)

Examiners also want to make sure your bank has effective interest-rate risk measurement processes. Examiners will monitor portfolios for changes in risk appetite, and they want assurance that management not only can assess the bank's vulnerability to interest rate changes, but also has tools to monitor and control the risk. "A key focal point" will be a bank's ability to identify and quantity IRR in both assets and liabilities under varying model scenarios.

Other areas of focus for community banks will include corporate governance, stress testing (for Dodd-Frank banks), operational risk and cyber threats. The report notes that a recent review of asset-based lending found evidence of "gradual loosening credit policies," so the OCC will also pay increased attention to underwriting standards.

The report notes that community banks have high strategic risk as they adapt their business models to the changing economic environment, and the sector's earnings outlook is uneven due to weak loan demand and declining investment yields.

Higher CAMELS Scores Returning

More than 85 percent of the 491 community banks in the OCC's Central District are rated a 1 or 2 on their CAMELS composite, a level not seen since 2009, the OCC **reports**. In Ohio, more than 92 percent of banks had a 1 or 2, up from 78 percent in 2009. The OCC says that banks in Chicago and Minneapolis saw the greatest decline in problem banks. "Community banks and thrifts supervised by our Chicago team had been in survival mode for several years," noted Nathan Perry, Assistant Deputy Comptroller in Schaumburg, Ill. He attributed the improvement to better risk management practices and a healthier economy.

FDIC Adds Community Bank Data

The FDIC has added a **new section** to its quarterly banking profile to report "insight into the condition and performance" of the community banking sector. Although net income at community banks of $4.4 billion was down 1.5 percent from the previous year, the percentage decline was less than the 7.6 percent decline in earnings reported by the entire banking industry.

Fed's Tarullo Questions Small Bank Regs

Policymakers should take a look at exempting community banks from the Volcker Rule and the incentive compensation requirements in Dodd-Frank, Fed Governor Daniel K. Tarullo **said** at the Federal Reserve Bank of Chicago Bank Structure Conference in May. (A month later, FDIC vice-chair Hoenig say it was time to end community bank carve-outs. See p.1)

Tarullo noted that banking regulators have tried to "avoid unnecessary regulatory costs for community banks, such as fashioning simpler compliance requirements and identifying which provisions of new regulations are of relevance to smaller banks." But he conceded that there is a risk of "supervisory trickle down," where "supervisors informally, and perhaps not wholly intentionally, create compliance expectations for smaller banks that resemble expectations created for larger institutions."

Risks in Internal Audit Outsourcing

Although community banks have often turned to third parties for internal audit functions, there are risks that boards need to mitigate, according to an **article** in the Fed's Community Banking Connections. The article advises boards and management teams to make sure that the outsourcing arrangement meets regulatory expectations.

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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