April 2015

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Bank Insights

Spotting Issues in the Community Bank Boardroom: Five Emerging Trends in 2015

By Adam Mustafa

Now that we're into the second quarter, it's time to assess some of the emerging trends in the community banking market. The Invictus Group™ works with many banks of all shapes and sizes across the country. In addition, we have built a proprietary model that allows us to analyze post-stress data of every FDIC-insured bank in the U.S. This gives us a unique vantage point from which to spot issues as they bubble up in bank board rooms, and offer solutions before they become problems. Here are five challenges that smart banks should be thinking about:

1. Subordinated debt is becoming a popular conversation topic with bank directors and CEOs.

There are several reasons. For those banks large enough to access the capital markets, sub-debt offers an affordable source of capital at a cost of anywhere between 4.5 to 6.5 percent (before taxes). That price could be short-lived with the increasing possibility of interest rates returning to normal. Today, private deals generally cost more, anywhere from 6 percent to 9 percent.

In addition, the recent change in the Federal Reserve's definition of a Small Bank Holding Company from $500 million to $1 billion in assets expands the number of institutions that do not need to maintain regulatory capital ratios at the holding company level. This will strongly incentivize banks that qualify to raise subordinated debt. We believe the rule's unwritten purpose is to enable more banks within that asset range to raise cheap capital to acquire smaller banks, which are large in number and low in significance to the regulators. We are working with a number of banks in this size range looking to take advantage of this massive M&A opportunity.

Also, banks with assets greater than $1 billion are looking at sub-debt as a way to better optimize their capital structure. Sub-debt proceeds can be potentially used to pay down TARP or SBLF, or fund dividends and stock repurchases. That being said, banks should be very careful with these options. The risk/return tradeoff of using these proceeds for these types of purposes should be evaluated, and the structuring of the sub-debt will be critical for managing regulatory capital within the context of Basel III (see next point).

2. The new Common Equity Tier 1 (CET1) Ratio created by Basel III will become more of a focus for the regulators.

This is especially true at the holding company level, which is regulated by the Federal Reserve. Many bank holding companies have other forms of capital, including preferred stock, TARP, SBLF, subordinated debt, and TruPS that may count as Tier 1 capital, but will not count as CET1.

We work with many banks to help them use stress testing as a calculator for customizing their own capital requirements. Before Basel III, the Total Risk-Based Capital ratio was always the first ratio that would be breached in a stress scenario. However, in a post-Basel III world, that flip-flops for many bank holding companies. Under stress, common equity absorbs most of the losses. For those institutions that still are funded by TruPS, the loss of Tier 1 capital begins to hemorrhage because the TruPS can only count for up to 25 percent of Tier 1 capital under Basel III. In other words, stress causes common equity to shrink. As common equity shrinks, the amount of TruPS that can count as Tier 1 capital shrinks as well. Ironically, the TruPS that are excluded from Tier 1 Capital can count as Tier 2 capital without limitation. As a result, a bank holding company can find itself with a shortfall of CET1 under stress, on the brink in terms of the Tier 1 Leverage ratio and Tier 1 Risk-Based ratio, but be just fine on the Total-Risked Based Capital ratio.

At the end of the day, it becomes clear that one of Basel III's main purposes was to encourage common stock, which absorbs unexpected losses the best, and discourage other forms of equity. A stress test, which is not required for community banks, can shed light on this. Banks under $10 billion of assets shouldn't necessarily adjust their strategic plans, but they should be prepared to have these capital discussions with regulators and have a contingency plan in case they are required to make adjustments.

3. Banks are having to make a "Sophie's Choice" about their loans…every single day.

Let me know if this sounds familiar: One of your best loan customers has come back to you, looking for a lower interest rate, and looking to lock it in for as long as 10 to 15 years. They even went to another bank, which drafted a term sheet, and they are giving you a chance to beat it.

The loan doesn't sit well with you. The new terms are reducing the interest rate by 200 basis points, which means you will lose more than one third of the revenue that you're generating from the relationship today.

(continued on page 2)

Inside this issue:

- Proposals to Reduce Regulatory Burden *(page 2)*
- FDIC Looks at Pre-Exam Requests *(page 4)*
- Is Your Lawyer a Deposit Broker? *(page 4)*

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It will be locked in for seven years and the new LTV will be 75 percent and include a cash-out refinance. The debt-service coverage is fine, albeit at these interest rate levels. If you make the loan, then you will be stretching your comfort zone from an underwriting perspective. If you make the loan, your earnings will be better in the short-term. Heck, making a 4 percent loan still beats buying some short-term T-Bill or GSE security with a 2 percent "yield" (in quotes by design). So do you make the loan?

These are the tough choices being faced by bankers every day in the trenches. As the artificially low interest rate environment prolongs and your 'wreckless' competitor down the street is making loans at all costs, these issues are exacerbated.

Most banks are treating these loan questions as a series of knee-jerk reactions without realizing the implications. Other banks are approaching them as loan pricing issues. Loan pricing models can help, but only so much, since the term sheet the borrower got from the bank down the street will box you in. Banks need to recognize that this is first and foremost a strategic planning issue. The strategic plan must set the tone for this new reality. This is a main focus for us right now with our clients.

4. Everyone is tired of talking about interest rate risk, although not for good reason.

Yes, regulators and consultants have been ringing the interest rate risk alarm bell for years now. Most banks are comfortable with their ALM models, even though the regulators continue to challenge them with tools such as model validation. We will not go into why we think most ALM models are flawed in this column. Instead, we will make the simple point that just about every loan on a bank's books today consists of a loan originated in a near-zero-interest rate environment that this country has never seen before. The only exceptions are pre-crisis loans still on a bank's books, and well, you know the story there. These loans have extraordinary low interest rates, many of them fixed over a long time horizon. The loans that have floating rates either (i) have floors associated with them, (ii) consist of strong borrowers who will immediately look to refinance or take their business elsewhere on the first rate increase, or (iii) consist of borrowers who are middle-of-the-road from a credit quality perspective and will increasingly struggle to service their debt and meet underwriting standards as rates rise. There are other issues that have recently emerged that are very serious. Be on the lookout for some groundbreaking industry analysis coming from Invictus in the near future, though!

5. Banks in agricultural and energy markets are looking at a "new normal".

With oil prices and most commodity prices down since last fall, both agricultural banks and energy banks are facing new uncertainty. The issues are unique and complex for each, but in both cases, this shift represents a sea change for the banking landscape in these markets. Any increase in interest rates that leads to an even stronger dollar can exacerbate agricultural and energy prices further in the near future. Regulators are beginning to ramp up their scrutiny of these banks, and management teams are beginning to become more conservative from an underwriting and growth perspective. That being said, uncertainty and change also means massive opportunity if you have the right strategy and right toolkit. We are working with several banks in both of these sectors to take advantage of this opportunity. Too often, banks trot out their defense in these situations, when they should be trotting out their offense. ▪

About the Expert

Adam Mustafa is a co-founder of Invictus Consulting Group and has been providing strategic analytics 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, and strategic planning systems for community banks ranging from under $100M in assets to Dodd-Frank banks that have in excess of $10B in assets. Within the community banking space, he has advised acquisitive and high growth banks, banks under enforcement action and significant regulatory pressures, and de novo banks. He has also been a featured speaker on stress testing for community banks at a number of conferences, including those hosted by regulators. Prior to joining 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.

Changes to Call Reports and Capital Among Proposals to Reduce Regulatory Burden

Congress has been hearing testimony for months about tailoring bank supervision to reduce the burden on community banks. Meanwhile, the prudential regulators have been tasked with reviewing all bank regulations to identify outdated or unnecessary ones, with a report due next year. The bottom line is that some changes will happen.

(continued on page 3)

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But whether there will be wholesale modifications – such as a **recent proposal** from FDIC Vice-Chairman Thomas Hoenig to boost capital requirements for community banks – remains to be seen. More likely is a **push to simplify or improve** Call Reports, which has the support of community bank trade groups and has been brought up repeatedly by industry, and longer exam cycles for the healthiest of banks.

Hoenig, a vocal critic of the largest banks and a fierce supporter of the Volcker Rule, wants to provide regulatory relief for community banks that have zero trading assets or liabilities. Such banks would be eligible for reduced compliance burdens as long as they maintain a ratio of GAAP equity-to-assets of at least 10 percent.

Invictus Consulting Group Chairman Kamal Mustafa says that Hoenig's proposal is short-sighted and misguided since most community banks rely on earnings as the primary source of capital. In the long-run, requiring banks to maintain such high levels of regulatory capital will reduce earnings and profitability, he says.

"Mr. Hoenig is putting the interests of shareholders way below the interests of depositors. By responding to banks' complaints about over-regulation, he would be making them pay the price in a higher leverage ratio. This simplifies the regulatory process, but at the same time, he is forgetting the fact that with that cushion, banks' future earnings will be less and less, and their accumulation of capital will be less and less, and their ability to make loans will be less and less. Hoenig's approach may make sense on a national scale, but it doesn't make sense for a community bank business model," Mustafa said.

Banking attorney Steven Loftchie, a partner at Cadwalader, Wickersham & Taft, and a senior fellow at the Center for Financial Stability **noted** that banks are already turning away cash deposits because cash adversely affects capital ratios, which suggests "that the ratios are encouraging counterintuitive behaviors."

Capital levels are not always the main reason why community banks thrive, according to a recent **research study** by the St. Louis Fed. The study, which looked at community banks that thrived during the financial crisis, found that while 39 percent of the "thriving banks" had Tier 1 leverage ratios in the highest quarter of distribution, 18 percent of the best banks had ratios in the lowest quarter. Those banks assumed relatively low credit risk. The researchers concluded that community banks that will do well in the future will have "strong commitments to maintaining standards for risk control in all economic environments and business plans that work for their individual markets.'

While regulators may reduce some of the compliance burden, it is doubtful they will scale back on the major risk controls put in place after the financial crisis. Instead, they are scouring rules to find ways to simplify regulation without putting the banking system in danger.

"Guiding our consideration of every proposal to reduce burden on community banks is the need to ensure that fundamental safety and soundness and consumer protection safeguards are not compromised," **said Toney Bland**, OCC senior deputy comptroller for mid-size and community bank supervision at an April 23rd House subcommittee **hearing** on "Examining Regulatory Burdens – Regulator Perspective."

The FDIC's Doreen R. Eberley, the director of the Division of Risk Management Supervision, and the Federal Reserve's Maryann Hunter, Deputy Director of the Division of Supervision and Regulation, also testified. Each mentioned efforts by a regulatory task force to simplify Call Reports for community banks.

One proposal would allow "certain banks" to file a short-form Call Report for two quarters a year, Bland noted. The task force is looking at every line item of every schedule to see what can be deleted, as well as considering a simplified Call Report for community banks that would eliminate some schedules and data items.

Eberley said regulators "will pursue several actions in the near term" to improve the Call Report process. She also said that regulators are looking at the length of the community bank exam cycle and whether the $250,000 thresholds on appraisals and limits on currency transaction reports should be changed.

"It is our intention to continue looking for ways to reduce or eliminate outdated or unnecessary requirements as we move forward with this review, rather than wait until the end of the **EGRPRA** process," she said.

Bland said the OCC supports "changing current law to allow more well-managed community banks to qualify for a longer, 18-month examination cycle. Raising the threshold from $500 million to $750 million for banks that would qualify for this treatment would cover more than 400 additional community banks." The OCC also supports exempting most community banks from the Volcker Rule.

"As the vast majority of banks under $10 billion in asset size do not engage in the proprietary trading or covered funds activities that the statute sought to prohibit, we do not believe they should have to commit resources to determine if any compliance obligations under the rule would apply. We do not believe that this burden is justified by the nominal risk that these institutions could pose to the financial system," he said.

Hunter said the Fed was working on ways to calibrate exams to make them more commensurate with a bank's risks. She said the Fed was using "Call Report data and forward-looking risk analytics to identify high-risk community and regional banks, which would allow us to focus our supervisory response on the areas of highest risk and reduce the regulatory burden on low-risk community and regional banks." ■

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Read Between the Lines

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

FDIC Looking at Pre-Exam Requests

The FDIC has formed two work groups to explore ways to improve the pre-exam letters sent to community banks, Doreen R. Eberley, director of the division of risk management supervision told the FDIC Community Bank Advisory Committee at its April 2nd **meeting**. Some bankers have complained that they can't tell how the agency is using the information that examiners are requesting. The FDIC has also launched several studies, including one that looks at the challenges and opportunities for small, closely-held banks and one that looks at the structural profitability of community banks, with an emphasis on banks that consistently out-perform their peers and those that under-perform.

Is Your Lawyer a Deposit Broker?

The FDIC has revisited the **question** of whether lawyers or accountants who refer clients to your bank are deposit brokers. If professionals refer folks to your bank informally without receiving a fee, then the deposits are not brokered, the agency now says. George French, deputy director of the division of risk management, explained to the FDIC Community Bank Advisory Committee, that the agency was referring to "programmatic or fee-based referrals," not "informal one-offs." He said the **FAQs** issued in January did not establish new policy and were a "living document going forward."

Small bank Holding Company Rule Includes Savings Banks

The asset threshold for small bank holding companies has been increased from $500 million to $1 billion in assets, according to the Federal Reserve's **final rule**, which also applies to savings and loan holding companies. The rule allows small bank holding companies to operate with higher levels of debt, and excludes them from consolidated capital requirements. Banks that are now considered small bank holding companies "should revisit their financial projections to consider whether introducing debt funding at the holding company can increase returns on equity without taking on unwarranted financial risk," advises the law firm of **Bryan Cave.**

OCC Supports Thrift Changes without Charter Conversion

Thrifts that want to expand their business model would be able to do so without the burden and expense of a charter conversion under a new OCC **proposal** outlined by Senior Deputy Comptroller Toney Bland. "Under our proposal, federal thrifts could retain their current governance structure without unnecessarily limiting the evolution of their business plan. As the supervisor of both national banks and federal thrifts, we are well-positioned to administer this new framework without requiring a costly and time consuming administrative process," Bland told Congress.

Required Reading: Regulatory Capital FAQs

The prudential regulators have compiled 13 pages of **frequently asked questions** about the new rules for regulatory capital, based on queries from many community bankers. The questions address the definition of capital, high-volatility commercial real estate exposures, other real estate and off-balance sheet exposures, investment funds, credit valuation adjustments and other topics.

FDIC: Examiners Taking Interest Rate Risk 'Very Seriously'

Community banks need to be prepared for a period of rising interest rates and show examiners that they are ready for different scenarios, according to George French, FDIC deputy direct of the division of risk management. He recommends that all bankers read the winter issue of ***Supervisory Insights***, and make sure that management and the board of directors are involved in mitigating risk.

Volcker Proposal Would Eliminate OCC, Tailor Community Bank Supervision

The Volcker Alliance, a group begun by former Federal Reserve Chairman Paul Volcker, has called for revamping the federal regulatory system that oversees the financial system in a report called "Reshaping the Financial Regulatory System, Long Delayed Now Crucial." The **report** calls for a new prudential supervisory authority. The FDIC would keep its deposit insurance function and orderly liquidity authority, while the OCC would be eliminated. Community banks would be supervised under a special division "to help ensure appropriately tailored treatment." The report describes true community banks as those that recycle deposits in the form of loans to the community it serves. ▪

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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