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Bank Insights

Stress Testing and Vintage Analysis are Key to Managing CRE Concentration Issues

Appropriate stress testing is essential to showing examiners that your bank is managing its commercial real estate concentrations appropriately – but most community banks are using stress tests the wrong way. That’s the message from a recent *Bank Insights* webinar featuring Invictus Consulting Group co-founder Adam Mustafa.

Examiners across the country are **ratcheting up the pressure** on banks with growing CRE loan portfolios, Mustafa warned, and in some cases they are writing MRAs for banks with no capital plans and CRE concentrations above recommended **thresholds**.

OCC examiners told Suffolk Bancorp in New York that it had to curtail lending and increase capital because of its CRE concentrations – an example Mustafa highlighted in the presentation. The bank announced it was being acquired at the end of June, a sure sign that not dealing with CRE concentrations can have significant consequences for community banks.

Banks think they can solve the CRE problem with stress testing alone, but Mustafa outlined five reasons why that’s not working:

1. Only the CRE loan portfolio is being stress tested, which does a disservice to parts of the bank that are strong.
2. Data gathering for loan-level stress tests is a nightmare. Most banks don’t have it centralized. (This will be an issue for banks when CECL is implemented as well).
3. Banks are treating the stress tests as a ‘check-the-box’ exercise, without including top management to guide the process or use the results to position the bank for success.
4. Management doesn’t understand the results, so they are not in a position to have effective conversations with examiners. “They rubber stamp it and give it to the regulators. It won’t work,” Mustafa warned. “If regulators don’t think management understands it, the mission fails.”
5. Most banks are not applying the stress test results toward strategic and capital planning. “Think of it as a strategic exercise, not a compliance one. If you do that, it will be worth the reward,” Mustafa said. Banks should and can use stress test results “for offense, as well as defense.”

4 Keys to Success

1. Recognize stress testing as the ‘right tool for the job’ – not the ‘end game’
2. Genuinely treat stress testing as a strategic exercise, not a compliance one
3. Invest the time into the process – it’s well worth the ROI
4. See the Big Picture – what are the regulators really doing?

Source: *Bank Insights* June 16 webinar

“Stress testing is the right tool for the job. It’s the tool, not the job,” Mustafa said. “Most banks think of it as an end game. Think of it instead as a tool to provide insights and the ability to show regulators that you can handle CRE concentrations.”

Mustafa showed banks how they can use a combination of top-down and bottom-up stress testing to demonstrate to examiners that they “can be trusted with elevated levels of CRE concentration.” Key to that analysis is using loan-level data to analyze the portfolio by vintage – another lesson that will be important for banks when they implement CECL. Mustafa said you cannot underestimate the importance of vintage, since it identifies the economic and competitive conditions on the day the loan was originated.

Banks must be able to show regulators they have risk management and capital planning infrastructure and skill-set to manage their portfolios, regardless of their CRE concentrations. “If they get that sense of comfort from you, believe me, you will be able to operate well above the thresholds.”

Mustafa urged banks to see the big picture and understand what regulators are really thinking. “If you can read between the lines, and not just the rules itself, then you can see the spirit of what is happening and use sophisticated techniques to achieve the end result,” Mustafa said.

Editor’s Note: If you want more information about the webinar, “Powerful and Practical Techniques to Manage CRE Concentrations amid Regulatory Scrutiny,” please contact George Dean Callas at gcallas@invictusgrp.com. ■

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How Banks Can Get Ready for CECL

The Financial Accounting Standards Board (FASB) this month issued **new standards** for how to estimate credit losses on loans, but they won't go into effect for several more years. The standards, known as current expected credit losses (CECL), will affect every bank, no matter its size.

FASB did not specify a method for measuring expected credit losses. Instead, it opted to allow banks to "leverage its current systems and methods for recording the allowance for credit losses." But banks will need to use "reasonable and supportable forecasts" as part of their calculations.

Bank regulators issued a **statement** on the standards, encouraging banks to assess the potential impact on capital before the standard goes into effect.

Regulators also stressed that banks will need to collect additional data, depending on which methodology they choose. (See story on "Stress Testing and Vintage Analysis" on page 1.) Although some trade groups had opposed the use of a vintage analysis for community banks, others say it is an essential tool for CECL. The American Bankers Association noted in a **backgrounder** that "vintage analysis of charge-offs may best enable analysts to observe how underwriting standards and the economic cycle impact a current loss expectation."

The ABA's analysis concludes that CECL may make it more costly to operate a bank. "Bankers will likely be expected to integrate the assumptions used in their CECL loss estimates (mainly those pertaining to forecasts of the future) with those used in asset/liability management, capital management, and overall budgeting," the ABA noted. "CECL's requirement to record a life of loan loss estimate at origination (in other words, recognize the cost up front), for practical purposes, will force a bank to weigh the potential risks much more closely before expanding its business. This can change bank behavior."

Regulators stressed that they expect the new standard to "be scalable" to banks of all sizes. "The agencies do not expect smaller and less complex institutions will need to implement complex modeling techniques," regulators said. They said they would "be mindful of the needs of smaller and less complex" banks when developing future guidance about how to implement CECL. They also said they would establish benchmark targets or ranges for the change in allowance levels.

Regulators advised banks to prepare for CECL before it goes into effect by:

- Reading and understanding the new standard.
- Having in-depth discussions with the board, peers,

auditors and regulators about the best way to implement CECL, taking into consideration the bank's size and risks associated with lending and debt securities investments.

- Figuring out which allowance and credit risk management practices can be leveraged when applying CECL.
- Identifying data needs and system changes that will be needed to implement CECL and additional supervisory expectations.
- Determining how and when to start collecting the additional data.
- Calculating the potential impact on capital. ■

10 Things Community Banks Should Think About After Brexit

By Leonard J. DeRoma, Invictus Co-Founder

Britain has voted to exit the European Union. The Federal Reserve says it is monitoring the situation for potential disruption to the U.S. economy. Here are a few things (in no particular order) to think about as the world economy sails into uncharted waters:

1. **The dollar has strengthened versus the euro and pound.** The dollar strength will make it difficult for the Fed to raise rates significantly. Why? Because any increase in rates will bring additional strength to the dollar, which in turn makes our exports more expensive and less competitive.
2. **The dollar strength combined with the uncertainty in Europe will attract more foreign capital to the United States.** Safe money will invest in U.S. Treasuries and gold. Other money will be attracted to hard assets such as commercial and residential real estate, as both wealthy individuals and companies look to park assets. Already inflated real estate values could become even more inflated, particularly in high profile areas such as New York, Boston, San Francisco, and Miami.
3. **Rate volatility will continue.** The Volcker rule, which was required as part of the Dodd-Frank Act, affects the levels of bond inventory large banks can carry in trading assets. The reduced inventory leads to less liquidity, which leads to more volatility. That being said, the Federal Reserve issued a statement that it is prepared to provide dollar liquidity to central banks through existing swap lines. And it's also conceivable that the Fed could

discuss another round of quantitative easing, which would artificially alter economic growth.

4. **The trough in rates that commenced in the 2008-2009 recession will most likely continue for the foreseeable future.** Rates have actually declined. As of this writing, the U.S. Treasury 10-year note, a benchmark for many lending assets including home mortgages, is approximately 100 basis points below where it was a year ago. More than anything else this will continue to put pressure on banks' NIMs as banks write new loans and replace higher yielding, maturing loans.
5. **It will continue to be difficult to buy securities for liquidity or investment purposes that achieve the necessary or desired yields.** Banks with excess deposits having to acquire assets will simply find it impossible to replace or increase the size of the securities portfolio at adequate rates without taking on greater risk.
6. **Bank customers with international operations, revenue sources, or supplies may be affected.** While the largest 100 banks have both the most international customers and American customers with international revenues or operations, the community bank market is not insulated. Banks need to examine their customer bases that have international exposure. The risk to the customers and ultimately to the bank depends on the kinds of business, geographic markets, and exchange risk absorbed by those customers.
7. **Don't be surprised if your regulator comes to you and asks about your exposure to European markets and whether you have a stress test that looks at the capital adequacy in the current scenario.** While the CCAR and DFAST stress testing did not include a specific scenario for something like this, the success of the larger banks in passing the Severely Adverse Case both last year and this year provides some comfort to the regulators. It might make sense to identify those customers with European exposure and apply a different set of stresses to them.
8. **It's possible that regulators might increase capital requirements and tighten credit processes.** Banks should do their best to negotiate their true capital requirements with regulators now.
9. **Weaknesses in large bank stocks may follow through to the community bank market, or community banks with little or no international exposure may do better.** No one knows for sure, but equity markets will continue to be volatile. This could change the traditional valuation of acquisition multiples for buyers and sellers. However, proper analytics of the core lending portfolios will still be able to discern the wheat from the chaff in acquisition targets. The volatility and reduced multiples could create interesting opportunities for banks with FreeCapital™.
10. **The success of the Brexit vote may increase the confidence of other European countries to dump its membership in the EU, which will cause more instability.** Such a situation will bring more unemployment to Europe and reduce global growth; the U.S. will not be immune.

The only thing we know about the above list is that it will change. These are very fluid times, and banks need to be prepared for both the problems and opportunities that arise. ■

About the Experts



Leonard J. DeRoma is a founding partner and CFO at Invictus. He began his career at Citibank in the 1970s working with Kamal Mustafa in corporate finance. Using new techniques, together they developed sophisticated financial planning and modelling tools to help provide financial advisory services to Citibank's corporate finance clients. At Lehman Brothers, he managed global financing activity; for Barclays Capital, U.S. fixed-income investment banking, trading, capital commitment, derivatives, sales, underwriting, foreign exchange and research. As the President of Barclays U.S. securities business, he was in charge of product development, was an advisor to the U.S. ALCO committee and chaired the U.S. Risk Management Committee. He managed the same businesses for McDonald Investments and KeyCorp. He has a Bachelor of Science in Electrical Engineering from the Massachusetts Institute of Technology and a Masters of Business Administration from the Harvard Business School. He has served on several industry boards and associations, including the Public Securities Association and the Bond Market Association.

Read Between the Lines

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

Fed Clarifies Risk Roles of Board in New Guidance



The Federal Reserve issued new supervisory **guidance** for risk management at banks with less than \$50 billion in assets. The guidance makes clear that the role of risk management rests firmly with the board of directors and senior management. It instructs examiners to assess the quality of board oversight by making sure the board has policies for risk tolerance, and that it periodically reviews risk exposure limits to make sure they are aligned with the bank's strategies and market conditions. Senior management must identify and review risks associated with new products or activities. Even at smaller institutions, senior management is expected to modify policies and procedures to address risk when conditions change, and alert the board in a timely manner.

Former Bank CEO Given Prison Time for Obstructing Examiners



A Minnesota federal judge sentenced a former bank CEO to 18 months in prison for lying to Fed examiners. The **case** was investigated by the FDIC's Office of Inspector General and the FBI. Former Voyager Bank CEO and Chairman Timothy Owens pleaded guilty to giving bank examiners a misleading policy statement after they began questioning insider loans he had received. "The integrity of the examination process is central to ensuring the safety and soundness of the nation's banking system," said Fred W. Gibson, Jr., Acting FDIC Inspector General. "When a bank official misuses his position of trust to obstruct that process, he needs to be held accountable."

FASB Publishes CECL Video and Explainers



FASB has published a video and several explainers about why and how it developed the new accounting standard for credit losses known as CECL. One **document** explains that the board only issues new standards when the benefits justify the costs. It says that CECL will result in more timely reporting of credit losses and greater transparency. "The FASB's assessment of the costs and benefits of issuing this ASU is unavoidably more qualitative than quantitative because there is no identified method to objectively quantify all costs to implement the new guidance or to quantify the value of improved information in financial statements," it notes. (See more on CECL on page 2).

CFPB Issues Special Mortgage Servicing Report



Don't expect the Consumer Financial Protection Bureau's focus on mortgage servicers to end anytime soon. In a special **report**, the CFPB noted that the "magnitude and persistence of compliance challenges" persists in the areas of loss mitigation and servicing. "Outdated and deficient servicing technology continues to pose considerable risk to consumers in the wider servicing market. These shortcomings are compounded by lack of proper training, testing, and auditing of technology-driven processes, particularly to handle more individualized situations related to delinquencies and loss mitigation processes."

Worth Reading: FSOC Annual Report

The Financial Stability Oversight Council, created as part of the Dodd-Frank Act, has released its **annual report**. The Council notes that it is concerned about risk management issues in "an environment of low interest rates and rising asset price volatility." It also notes that financial regulators need "to be attentive to signs of erosion in lending standards."

OCC Contemplates a FinTech Charter



The Office of the Comptroller of the Currency is continuing to lead the way on how banks can innovate with fintech. At a forum on responsible innovation this **month**, the agency revealed it had created a working group to look into creating a charter for fintech companies that would operate as banks. "Innovation has always been an integral part of banking and the federal banking system," Comptroller Thomas J. Curry said. The law firm of Nelson Mullins has a good **report** on the forum. Community banks should consider partnerships with fintech companies, the law firm said. It also suggested that banks develop a technology strategy since it is likely regulators will require one in the future. ■

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. For past issues of Bank Insights, please go to the **Invictus website**.*

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