# INVICTUS BANK INSIGHTS

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DISRUPTIVE BANK INTELLIGENCE FOR THE C-SUITE AND BOARDROOM

info@invictusgrp.com (212) 661-1999 275 Madison Avenue, New York, NY 10016


## EXAM TRENDS

**By Adam Mustafa and Lisa Getter**
Invictus Group

### CONCENTRATION RISK MANAGEMENT REMAINS AN EXAM FOCUS: STRESS TESTS ARE VITAL

Make no mistake about it: If your bank has commercial real estate (CRE) concentrations that are at or above the suggested regulatory guidelines, examiners will expect to see a current comprehensive stress test that supports your concentration risk management plan.

Stress testing has never been mandated for community banks—but it is a tool that examiners expect banks to use if they have concentration issues in their portfolio. And this isn't going to change, no matter what bills are adopted by Congress to ease the community bank regulatory burden.

In the past six months, many community banks have had regulators question their concentration risk management practices, which remain a high priority. Examiners have informed a number of banks at the front end that the stress tests will be the primary focus, and in some cases, the only focus, of the inquiry.

In several cases, regulators downgraded the bank's CAMELS score for not having adequate stress testing in place. Regulators are less focused on the technicalities of the stress test than they are on management's command of the tests, and how they use the results to help make real and critical decisions related to capital and strategic planning.


**EXAM TRENDS** (continued on p. 2)



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## CECL ISSUES

**By Adam Mustafa**
Invictus Group President and CEO

### UNPACKING THE BIGGEST CECL CHALLENGE

Lack of data is by far the biggest obstacle for banks as they begin figuring out how to implement the new current expected credit loss (CECL) accounting standard, which will go into effect for many public banks in 2020. Even the simplest of methods, such as the open pool method, require a certain amount of historical loan-level data.

Banks face a litany of problems with respect to leaning on internal data for CECL, but here are the three most common obstacles:

1. **They don't have enough historical data.** Some banks have kept internal data for the last three or four years. Some can't even amass that much data. Perhaps a bank did a core conversion and lost all of the data that was stored on the previous core. Maybe it has data that goes further back, but it's incomplete and riddled with mistakes, so the management team isn't confident in its use. Maybe the bank is relatively new to a certain type of lending, so no historical data exists. Whatever the reason, if a bank lacks history, it is very difficult to derive life-of-loan-loss estimates for CECL, irrespective of the methodology it deploys for a given pool.


**CECL ISSUES** (continued on p. 4)

**EXAM TRENDS** (cont. from p. 1)

CRE concentration risk management is not a new issue, but regulators are especially targeting banks that are newbies – those that do not have a long history of managing CRE concentrations, and are growing their CRE book at excessive rates.

A BankGenome™ analysis shows that 2,004 banks have grown their CRE portfolios by more than 50 percent in the last three years, a level that has regulators concerned. As of the first quarter of 2018, 293 banks are over the 100 percent construction threshold and 420 banks are exceeding the 300 percent total CRE guidelines. Of these banks exceeding the thresholds, 54 banks also had 50 percent or more CRE growth within the last three years — a sure sign they will face increased scrutiny under current guidance.

## ANTICIPATE EXAM SCRUTINY

If you are one of these banks, the worst thing you can do is underestimate your next safety and soundness exam because your last exam went well. Anticipate that the regulators will come in with 'guns blazing' and prepare yourself accordingly.

The cold hard truth is that your bank is a prime regulatory target. It will be difficult for your examiner to report back to his or her boss that your bank is doing everything perfectly. There will be findings and perhaps even formal Matters Requiring Attention (MRAs), no matter how prepared you are for the exam.

## MAKE MINOR FINDINGS A GOAL

However, the key is to manage those findings. You want only minor infractions, such as not having enough loans with Debt-Service Coverage Ratios (DSCRs) in your core, or having to deal with model risk and model validation. Those are easy to address, while allowing examiners to show their boss that they extracted blood from you.

## HOW THE NEW CRE FOCUS EMERGED

The Federal Reserve was the first to sound the alarm about a new potential issue with commercial real estate concentrations, according to the Government Accountability Office. The Fed told the GAO it began monitoring CRE concentrations in mid-2013 after it noticed they were increasing.

The OCC began actively monitoring CRE loan growth in the middle of 2014, with a mandate to examiners to focus on CRE risk management in 2015 exams. The FDIC's Regional Risk Committees identified the issue as a concern in 2015 and notified the National Risk Committee.

The regulators then began meeting in 2015 to discuss what they could do to help banks manage the mounting CRE concentration risks. Those meetings led to a strong December 2015 joint statement on CRE concentration risk management that told banks they might have to raise additional capital to mitigate the risk associated with CRE exposures. The statement noted that examiners would focus on banks that "recently experienced, or whose lending strategy plans for, substantial growth in CRE lending activity" or those that operate in markets with increasing growth or risk.

You do NOT want examiner concerns to include statements such as: "Management does not understand the stress tests" or "Management does not use the stress tests". Those type of findings are far more serious and are likely to lead to CAMELS rating downgrades or worse.

## REGULATORS EXPECT STRESS TESTS

Examiners expect banks with CRE concentrations to conduct portfolio stress testing, so bank management and the board can determine the correct level of capital the bank needs.

Banks with concentrations would be smart to follow the stress testing best practices outlined in "Managing Risks of Commercial Real Estate Concentrations," written by the Federal Reserve Bank of Richmond's Jennifer Burns, who was recently appointed by the Fed Board of Governors as deputy director for the Large Institution Supervision Coordination Committee. Those include:

- Running multiple scenarios to understand potential vulnerabilities
- Making sure that assumptions for changes in borrower income and collateral values are severe enough
- Varying assumptions for what could happen in a downturn instead of just relying on what happened to a bank's charge-off rates during the recession
- Using the stress test results for capital and strategic planning
- Changing the stress test scenarios to stay in sync with the bank's current strategic plan

The article, which appears on the Fed's Community Banking Connections website, also notes that one new area of concern is owner-occupied CRE loans, which for years were considered extremely safe.

"As bank supervisors, we understand that the business models of many community banks rely on CRE lending, and we appreciate the benefit that bank lending provides to the economic activity in their communities," Burns wrote. "Our objective is to help bank leaders develop and implement risk management and capital planning practices that support well-informed decision-making and an ability to balance risk-taking with safety and soundness."

**EXAM TRENDS** (cont. on p. 3)

**EXAM TRENDS** (cont. from p. 2)

## REPORT FINDS INCREASED SCRUTINY AND RISK

The Government Accountability Office issued a report in March that warned of increased risk from CRE loan performance, though it was lower than the levels associated with the 2008 financial crisis. The GAO found that banks with higher CRE concentrations were subject to greater supervisory scrutiny. Of 41 exams at banks with CRE concentrations, examiners documented 15 CRE-related risk management weaknesses, most often involving board and management oversight, management information systems and stress testing.

Prudential regulators acknowledge that proper concentration risk management is a supervisory concern for 2018.

"FDIC examiners now devote additional attention during the examination process to assessing how well banks are managing the risks associated with concentrated credit exposures and concentrated funding sources," the FDIC's 2018 Annual Performance Plan for its supervision program stated.

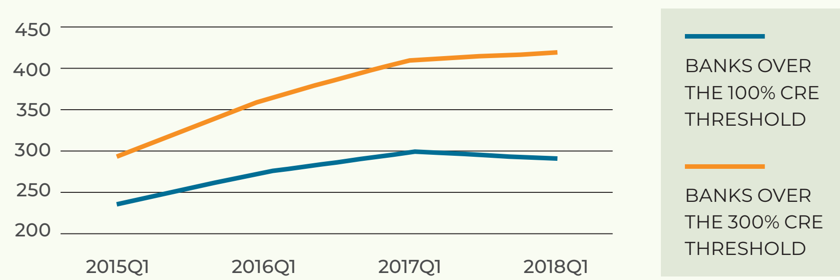
The Office of the Comptroller of the Currency's 2018 Bank Supervision Operating Plan noted that examiners at mid-sized and community banks would focus on assessing concentration risk management practices.

The OCC's latest semi-annual risk perspective noted that "midsize and community banks continued to experience strong loan growth, particularly in CRE and other commercial lending, which grew almost 9 percent in 2017. Such growth heightens the need for strong credit risk management and effective management of concentration risk."

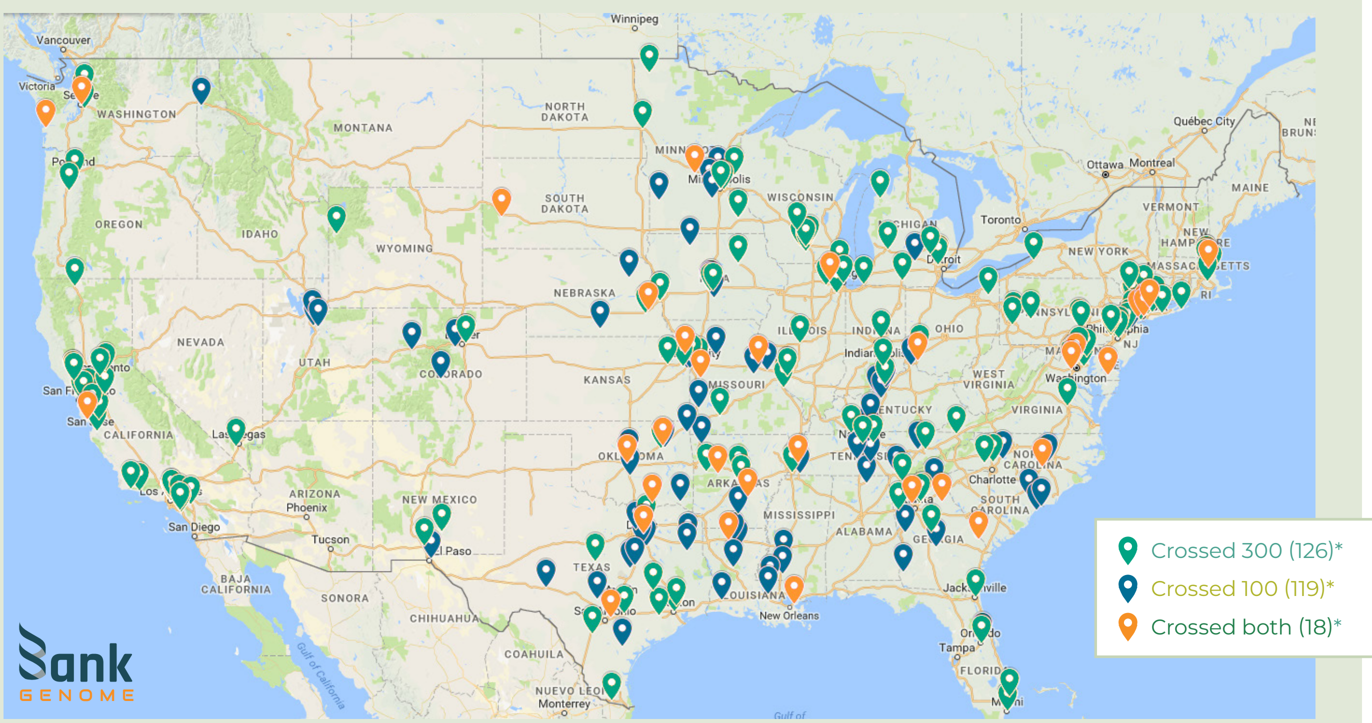
New Comptroller Joseph M. Otting testified before the Senate Banking Committee in June that mid-sized and community banks had an almost 9 percent increase in commercial real estate and other commercial loans last year. "Such growth heightens the need for strong credit risk management and effective management of concentration risk," he warned.

### GROWTH IN CRE LENDING:

NUMBER OF BANKS OVER EACH THRESHOLD




### NEWLY CONCENTRATED: BANKS THAT HAVE CROSSED THE CRE THRESHOLD IN THE LAST THREE YEARS




Source: BankGenome analysis

* Also had 50 percent growth over three years

## CECL ISSUES (cont. from p. 1)

2. **The bank's loan loss history will not provide the data it needs.** The last six or seven years have been relatively good for banks. So even if a bank has data that can go back that far, it may still struggle with calculating observed loss estimates to use as a starting point for CECL. This is a particular problem for banks that grew rapidly since 2008, and any de novos that began in 2006 or later. These banks made nearly all of their loans during our so-called good times. Not having many loan losses is supposed to be a good thing, but apparently not when it comes to CECL data needs. As the financial crisis showed, past performance is not indicative of future results. That is the very reason why the Financial Accounting Standards Board created the forward-looking CECL standard. It is both impractical and illogical to calculate CECL reserves from a small loss history. Absent a solution, the net result will be over-reliance on qualitative factors, and that may lead to an unnecessarily high reserve and unhappiness from your auditor.

3. **Banks are missing critical data elements.** Many banks don't have loan-to-value (LTVs) metrics in their loan level data and the vast majority don't have easy access to other critical metrics such as debt service coverage ratios (DSCRs) and credit scores.

> **"I have discussed CECL with hundreds of bankers and only a handful can say with confidence that they have enough internal loan-level data to calculate their CECL reserves."**

### WHAT CAN BANKS DO TO SOLVE THE PROBLEM?

- **Start collecting the missing data points going forward.** While this may not help solve the entire issue, it will be useful by the deadline for CECL implementation. Having a deeper history would give banks a stronger hand in terms of supporting loan loss estimates, but at least collecting missing data is a start.
- **Begin looking for external data.** The right external data can not only fill gaps, but it also can augment and strengthen the reliability on internal data.

CECL will have winners and losers. Winners will preserve precious capital by making sure their CECL reserve is optimized. The losers will undoubtedly wind up burning shareholder value because of excessively high reserves driven by overreliance on qualitative factors. What will separate the winners from the losers will be the quality and quantity of data they use to support their conclusions.

I have discussed CECL with hundreds of bankers and only a handful can say with confidence that they have enough internal loan-level data to calculate their CECL reserves.

What can banks do about these internal data challenges? The truth is there is no panacea. However, more data is always better than less. The banks that have the best data and analytics will end up with a competitive advantage. Banks that approach CECL seriously will recognize they cannot just rely on their internal data and will take steps now to find external data to enhance their CECL process.

*Editor's Note: To address the data problem, Invictus will soon be inviting banks to participate in the BankGenome™ Project, a data-sharing cooperative.*

## An Example of Why Data Matters In CECL

**EXAMPLE:** A bank has a significant concentration of its commercial real estate loans risk rated a 4. Those loans will have a range of debt service coverage ratios (DSCRs).

Some will have DSCRs greater than 2 and deserve to be in a pool with a lower loss estimate, everything else being equal. Other loans will have thinner DSCRs, perhaps even closer to 1. Those loans should have relatively higher loss estimates.

If the bank doesn't have the data history to back up its estimates, it will end up erring on the conservative side, putting more than it needs in reserves. The right external data, however, can help the bank optimize — and justify — its reserves.


### ABOUT THE AUTHOR

**Adam Mustafa**
Invictus Group
President and CEO

Adam Mustafa is President and CEO and co-founder of the Invictus Group. He has been providing strategic analytics, M&A, CECL 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, CECL, and strategic planning systems for community banks ranging from under $100 million in assets to those with more than $10 billion in assets. He has also been a featured speaker on CECL, M&A and stress testing at conferences across the U.S., including those hosted by regulators. Prior to founding 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.

# READ BETWEEN THE LINES

**OUR REGULAR FEATURE THAT REVIEWS NEWS FROM OR ABOUT REGULATORS TO GIVE PERSPECTIVE ON REGULATORY CHALLENGES.**

## New FDIC Chair Takes Over, Vacancies Remain

Jelena McWilliams officially took over the helm of the Federal Deposit Insurance Corp. in June. Her resume includes stints as chief counsel of the Senate Banking Committee, an attorney at the Federal Reserve, and chief legal officer at Fifth Third Bancorp, a Cincinnati-based regional bank. She replaces Martin J. Gruenberg, who, for now, remains on the FDIC board. Some Democrats would like him to take over the open vice-chair seat, left vacant after Thomas J. Hoenig retired at the end of April. Gruenberg has not indicated what he wants to do. His board term is over at the end of 2018.

## Comptroller Reveals His Priorities

Look for Comptroller of the Currency Joseph Otting to spend this year "reducing unnecessary regulatory burden." He told the House Committee on Financial Affairs that his short-term goals are to modernize the regulatory framework around the Community Reinvestment Act , help consumers with "short-term, small-dollar credit needs," make anti-money laundering compliance more efficient, simplify capital requirements and the Volcker Rule. "Bankers understand the risks facing their banks better than at any point in my 35-year banking career," he said.

## OCC to Focus on Credit Risk, Concentrations, Interest Rate Risk

While Comptroller Otting revealed his personal priorities for the OCC, the agency also disclosed its regulatory areas of focus in the Spring 2018 Semiannual Risk Perspective. With strong loan growth, especially in commercial real estate, regulators are emphasizing the need for strong credit risk management, especially for concentrations. Examiners are also concerned about how rising interest rates will affect deposits. "Banks may experience unexpected adverse shifts in liability mix or increasing costs that may adversely affect earnings or increase liquidity risk," the OCC warned. It also noted that history may not serve as a good guide for what will happen due to the high levels of non-maturity deposits that were acquired during an unnaturally low interest rate environment.

## Goodbye ALLL, Hello ACL

The primary regulators have proposed a revision to capital rules to help banks identify which credit losses under the CECL accounting standard are eligible for inclusion in regulatory capital. The proposal also replaces the term "ALLL" with ACL (allowance for credit losses). The proposal will allow banks to phase in over three years the adverse impact of CECL on regulatory capital.

## Agencies Simplify Volcker Rule

Five years after the Volcker Rule was finalized, agencies have issued a 494-page proposal to improve the rule, which banned banks from risky proprietary trading. Regulators said the final rule was "unclear and potentially difficult to implement in practice." The rule would be tailored "based on the size and scope of a banking entity's trading activities," which should reduce compliance costs for smaller firms. It would also exclude from the definition of proprietary trading any securities sold as part of a liquidity management plan.

## Coordinating Enforcement Actions

The Federal Financial Institutions Examination Council issued a new policy statement for ensuring that bank regulators coordinate on formal corrective actions. The regulators say they want to make sure that all the agencies are on the same page as early as possible, especially if more than one regulator has an interest in the outcome. Regulators may, for instance, want to bring a complementary action against both a bank and its parent holding company. In such a case, the agencies "should coordinate the preparation, processing, presentation, potential penalties, service, and follow-up of the enforcement action," the statement says.

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**EDITOR** Lisa Getter
**E-MAIL** lgetter@invictusgrp.com
**WEBSITE** invictusgrp.com

Invictus gives its clients a competitive edge in M&A targeting, CECL readiness, strategic and capital planning and more. Its unique analytics are powered by

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For editorial, email Lisa Getter at lgetter@invictusgrp.com. For information about Invictus, email info@invictusgrp.com.

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