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INVICTUS

Bank Insights

Getting Your Risk Officer from the Back Room to the Board Room

Kamal Mustafa

Enterprise risk management (ERM) has become essential for banks of all sizes. The regulatory response to the recession of 2008 increased the responsibilities for risk officers, giving them greater visibility and opportunity in a new – and more restrictive – banking environment.

This comes at a time when declining net interest margins and increased competition are putting intense demands on community bank revenues, while rising ERM expenses are pressuring earnings and often offsetting savings from operational cost cuts. Losses in capital and increasing regulatory capital requirements are reducing the financial leverage that is vital for banks to maintain their returns on capital.

Chief risk officers and enterprise risk managers are stretching resources, struggling with increasing costs and gaining unaccustomed attention. Their responsibilities have multiplied. Their oversight of capital adequacy has changed almost overnight. This has the potential to intensify the compliance dark cloud or, if properly handled, create a "silver lining" within it.

The Silver Lining – Capital Adequacy

Capital adequacy calculations evolved from the simplistic Federal Form for Analyzing Bank Capital of the 1970s to a variation of Basel I and Basel II. While these methodologies increased in complexity, they were all based on calculations of historical loan performance.

Bank regulators used these calculations as a check-and-balance tied to the latest call report. Regulatory approval was essentially a checkmark against year-to-date performance. Banks had to reflect poor performance in their reported financial data for regulators to take action.

The 2008 recession changed the regulatory approach.

How Bank Management Can Use Stress Test Results for Strategic Planning

A capital adequacy stress test is a tool that must become part of a bank's strategic capital planning. The results can be used proactively with examiners to defend against arbitrary capital requirements. Management can also use stress test results to gauge:

- Capital adequacy under new guidelines through the stress horizon. That affects every capital action, such as dividend policy and stock repurchases
- The impact of different strategic initiatives on profitability and capitalization
- Liability strategies to optimize strategic loan initiatives
- Competitive constraints and positioning
- Profitability and regulatory capital implications of asset acquisitions or M&A
- Implications of different pro-forma interest rate scenarios

The best definition of capital adequacy was described in the first CCAR stress testing exercise, and is reinforced in the CapPR program and Dodd-Frank. It is also hidden within the risk ratios and capital definitions in Basel III. Capital adequacy is now defined as an acceptable capital level/ratio after a bank has been subjected to a forward-looking, two-year severely adverse scenario.

The examination process today is an affirmation of a bank's strategic capital plan. What was a static defensive form filing exercise handled in the back rooms of a bank now demands close attention from senior management and bank boards.

Bank executives responsible for ERM activities were rarely trained and staffed with the resources necessary to tackle this crucial activity. Properly handled, the risk manager and the ERM function can move into the board room from the back room. Improperly handled, risk managers are in danger of jeopardizing their bank's sustainability and profitability, and also their jobs.

[See "Risk Officer," Page 3]

Inside this issue:

- Stress Testing and Loan Details *(page 2)*
- What Regulators Are Highlighting *(page 4)*

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Stress Testing Without Loan Origination Detail Is 'Absurd'

When a bank originated its loans is crucial to understanding how that loan portfolio will perform over time, says Invictus Consulting Group's CEO Kamal Mustafa.

It's also what distinguishes Invictus' stress tests from the rest of the market – and one reason why Invictus is "one of the first legitimate alternatives to the credit rating agencies," says Jason Voss, director of content for the CFA Institute.

The Invictus stress testing process involves a patent-pending methodology called **LoanLayering™**. The company takes loan balance data, released quarterly for every bank in the U.S., and uses a long-term history and a sophisticated algorithm to estimate origination dates for portions of the loan balance. That is combined with market data and projected forward, which results in likely balances and income from each layer.

Mustafa says any company that tries to stress test a bank without considering the vintage of the loans is doing the bank a disservice. "Treating each pool of loans as if it were created yesterday is absolutely absurd," he says.

LoanLayering™ provides:

- An accurate estimate of the maturity profile or "loan run-off"
- An accurate estimate of revenue contribution by loan category (quarterly yield by layer magnitude, using assigned interest rates and spreads)
- The ability to apply different stress factors for different vintages of loans: pre-recession and recession-era to present
- Pro-forma future balances on a quarterly/semi annual/annual basis

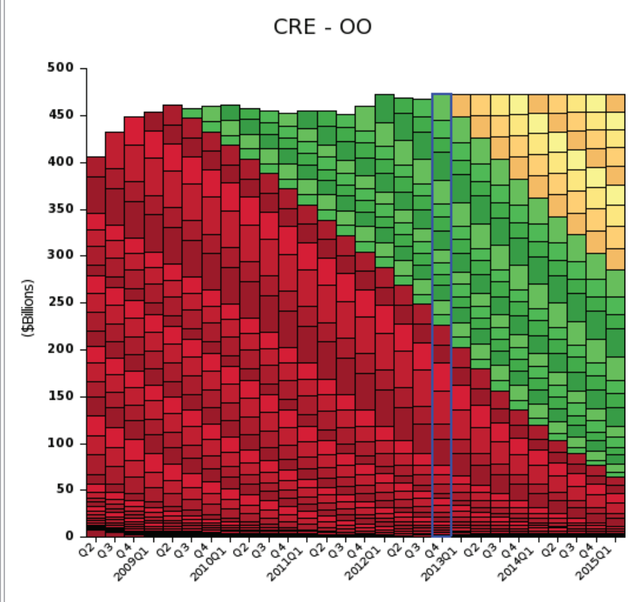
Invictus uses the results from its layering to also estimate:

- Earnings contribution to capital of existing portfolios as loans mature during the stress horizon
- Liquidity created by loans maturing in existing portfolios
- Profitability due to redeployment strategies such as liquidity created by loan maturities
- Stressed capital under different redeployment strategies incorporating earnings contribution of redeployed assets.

Invictus runs its model on more than 7,000 FDIC-insured banks each quarter, which also enables it to combine data for banks in a geographic area and spot regional and national trends.

To hear more of Kamal Mustafa's conversation with the CFA Institute, go to www.invictusgrp.com. ▪

Invictus Data Snapshot: Commercial Real Estate Loan Runoffs



Invictus' LoanLayering™ model estimates the origination and likely run-off of all loans by loan category for every FDIC-insured bank in the U.S. This graph is the aggregated result from all banks of owner-occupied commercial real estate loans.

The red squares are bubble loans, originated prior to mid-2009 in the era leading up to the financial crisis. Those in green are non-bubble, which means they should have a safer risk profile due to a more conservative underwriting environment. The gold section stands for originations in the future that will be required to maintain the balance. The data show that approximately 47% of CRE owner occupied loans on banks' books were originated during the bubble era. These loans typically contribute a disproportionate level of stress on a bank's capital and usually have a riskier profile than the more recent non-bubble loans.

From "Risk Officer," Page 1

Capitalizing on the Silver Lining

The new capital adequacy world has no textbooks. Rules are in flux. Traditionally accepted analytical techniques are invalid and dangerous.

Unfortunately, many companies with ties to banks are marketing "adjusted" loan review services as a proxy for **stress testing**. These organizations are confusing the issue, giving false assurance to banks and enterprise risk managers that their loan portfolios have been "stress tested."

Even the smallest community banks must instruct their risk managers to focus on the CCAR, CapPR and Dodd-Frank exercises. The regulatory response to the top 20 percent of banks, which account for 80 percent of U.S. banking assets, is the only clear-cut way to understand regulatory direction and calculations. Using those exercises as a guide, risk managers must focus on their own approach to represent the bank's long-term interests.

Clarity on New Regulatory Capital Adequacy Guidelines

The stress test exercises demanded by regulators are labor-intensive and complex for even the largest U.S. banks. However, they provide community banks with an excellent roadmap to make their cases with examiners.

Community banks must use their knowledge of their portfolios and geographical footprints to fine tune, present and defend the risk characteristics of their assets to regulators and avoid the imposition of generic conservative macroeconomic risk ratios. Defensive analyses of risk assets should be done in conjunction with management strategies over a two-year horizon, while considering existing and targeted portfolios.

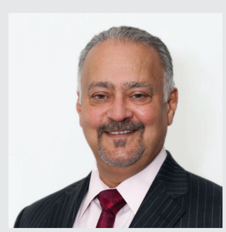
A bank must estimate its capital adequacy requirements and then look at its strategic plan. If the plan falls afoul of estimated pro-forma capital ratios, it has to be amended to avoid regulatory action. (An enforcement order can cost a community bank at least $1 million). The capital adequacy component of ERM is a vital contributor to this process. Done right, it keeps regulators at bay.

Unfortunately, regulators have inadvertently created serious confusion. They have announced that banks below $10 billion in total assets do not have to stress test themselves. This ignores several vital facts:

- Apart from stress testing, there is no practical tool or methodology that would enable a bank to defend itself from the imposition of macro generic risk asset ratios.
- Stress testing for community banks is a simpler, exercise than for their larger counterparts.
- A community bank has a better understanding of its customers and geography than larger banks.
- The very nature of community banks implies concentration issues. These have to be defended, since generic macro risk asset rules are designed to avoid concentrations.
- The cost of the stress testing process is a rounding error relative to the imposition of higher generic risk asset ratios.

The bank's ERM team should build an effective defense against the imposition of outmoded generic macro risk asset ratios that would affect their bank's sustainability and profitability. While this activity is alien to decades of ERM practice, and puts additional responsibilities on already overburdened ERM professionals, silver linings do not come without adopting new perspectives. ▪

About the Author



Kamal Mustafa is the chairman and CEO of Invictus, which he formed in 2008. His more than 40-year career in banking began at Connecticut Bank and Trust where he headed corporate finance/credit. He opened up all of Citbanki's domestic origination offices, and then became head of Global M&A He was the managing director of M&A at the merchant banking group at Paine Webber, and then ran KSP, a billion-dollar LBO fund for John Kluge. In the late 1980s, he established BlueStone Capital, which became a leader in middle market corporate finance. In 2002, he formed Wildwood Capital, an investment bank that advised both middle market companies and some of the world's largest financial institutions. He has served as a trustee for the University of Connecticut.

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Read Between the Lines: What Regulators Are Highlighting

Each month Bank Insights will review enforcement orders, publications, speeches and other news from regulators to give perspective on regulatory challenges and initiatives.

Enforcement Orders

How much capital are regulators demanding? Enforcement orders often give clues about examiners' marching orders. In Tennessee, the FDIC ordered Peoples Bank to maintain a Tier 1 leverage ratio of 8.5 percent of the bank's average total assets, a Tier 1 risk-based capital ratio of 11 percent and a total risk-based capital ratio of 13 percent, the March 4, 2013 order shows. In California, the FDIC ordered Monterey County Bank to get its Tier 1 leverage ratio to 9 percent and its total risk-based capital to 12 percent.

Publications

The OCC is about to release a new publication for community banks called "A Common Sense Approach to Community Banking," according to Comptroller Thomas J. Curry. The publication will say that all banks should make sure they do three things:

1. Identify and monitor risks
2. Make sure your strategic and business plan includes sufficient capital support.
3. Understand how the supervisory process works.

Speeches

A bank's risk culture is key to its success. That was the message from Carolyn G. DuChene, OCC deputy comptroller for operational risk, in a speech delivered on April 25 to the ABA Risk Management Forum.

Bank directors need to make sure they "fully understand the significant risks involved in implementing the institution's strategic plans," she warns. "It's only when directors are appropriately informed that they can pose credible challenges to management's risk assessments, decisions, execution, and contingency planning," she said.

Bank directors should take note. Regulators are telling them loudly and clearly that they had better know what management is doing, especially when it comes to strategic planning. There is no doubt that regulators believe risk management is a board function.

FDIC Launches Video Training for Directors

Examiners explains why the 'M' in CAMELS is also a board measurement. Here's the first **installment**.

This is another signal that the FDIC wants bank directors to get up to speed on risk management tools and oversight.

Federal Reserve's Community Bank Publication Delves into ALLL

The Federal Reserve has launched a new publication for community banks, which Fed Chair Ben S. Bernanke says "will inform and clarify expectations and give a better sense of the Federal Reserve's perspectives on supervisory matters.

One **article** in the latest issues talks about how Fed examiners will evaluate negative provisioning.

If a bank reports lower allowance through negative provisioning, the examiners will demand documentation, the article notes, including "peer analysis conducted by the bank and board minutes." ■

About Invictus

Invictus Consulting Group's bank analytics, strategic consulting and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. Invictus runs a stress test on every U.S. bank each quarter with its patent-pending Invictus Capital Assessment Model™ (ICAM). Bank clients have excellent results when using Invictus reports to defend their strategic plans and capital levels to regulators.

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