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Invictus White Paper (February 2016)

Forward-Looking Risk Analytics Emerging as Essential Tool for Community Banks

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Executive Summary

Bank regulations have changed since the financial crisis of 2008, and so have risk management best practices. While regulators have not mandated that community banks change their analytical approaches to strategic and capital planning, the paper trail is convincing: Supervisors are now using forward-looking risk analytics on well-managed and potentially troubled banks, and they expect community banks to use them as well. These new analytics are essential to managing CRE concentrations and interest rate risk, calculating proper ALLL levels, and determining capital requirements for strategic plans and potential mergers and acquisitions.

Community banks should ensure they are ready for examiners armed with forward-looking risk analytics. Even if your bank doesn't have CRE concentrations, the use of forward-looking risk analytics to stress test capital, strategic plans and any potential acquisition is a worthwhile investment. Invictus' clients that have used stress testing results with examiners have seen their capital requirements ***decrease,*** *their management piece of their CAMELS composite increase, and their strategic plans win fast regulatory approval.*

Introduction

The Great Recession of 2008 showed banking supervisors that a risk management system based on historical data was insufficient to determine the amount of capital needed to absorb losses in an economic downturn. That realization led to a focus on forward-looking bank supervision in the U.S., with an early public emphasis on the largest banks. The 2009 Comprehensive Capital Analysis and Review (CCAR) stress tests on the largest banks were followed by mandated stress tests for all banks with assets between $10 billion and $50 billion. Regulators publicly declared that community banks were not required to conduct similar stress tests, despite calls from the Conference of State Bank Supervisors that stress testing would "ensure the economic viability" of community banks.

Behind the scenes, however, regulators began changing their own methods for examining community banks, relying more and more on forward-looking analytics. In recent months, with signs that community banks are again accumulating higher concentrations of risky commercial real estate loans, regulators are reminding community banks that stress testing is indeed required to manage concentration risk in their portfolios and to develop realistic scenarios for interest rate risk management.

Regulatory actions in the waning months of 2015 should serve as notice that ignoring forward-looking analytics will lead to lower CAMELS scores, more examiner scrutiny and higher regulatory capital requirements. The new current expected credit loss model (CECL), which is expected early in 2016, is also a forward-looking tool.

The large banks have already adopted forward-looking risk analytics and are using the results with regulators. Although community banks are not subjected to the same stress testing requirements as the large banks, the regulatory trend is in the same direction. Those community banks that fail to incorporate new analytics into their risk management systems will find it difficult to communicate effectively with regulators.

The Regulatory Paper Trail

1. The Federal Deposit Insurance Corp.

The FDIC, the prudential regulator for most community banks, quietly began training its examiners for a new "forward-looking supervisory approach" as early as 2009. The FDIC revealed in its 2009 annual strategic report that examiners were taught to "carefully assess the institution's overall risks, and base ratings not on current financial condition alone, but rather on consideration of possible future risks." The FDIC said it would use both on-site and off-site reviews and "accurate metrics" to identify risk in balance sheets.

A December 2010 audit by the FDIC Inspector General noted that the forward-looking supervision training emphasized that examiners "should consider bank management practices as well as current and prospective financial performance and conditions or trends when assigning ratings." It noted that risks and capital maintenance were even more significant than a bank's financial condition. Examiners were instructed to look for evidence of "dominant management," which can be a red flag.

The FDIC's 2015 annual performance plan discussed the need "to implement more forward-looking supervision techniques" for well-rated banks, including those with CAMELS composites of 2, so it could spot deficiencies before they require formal action.

The FDIC has also proposed changing the way it assesses deposit insurance for community banks. The forward-looking proposal counts construction and development loans as higher risk under a new loan index, which could lead to a higher assessment --- unless banks increase their capital levels.

2. The Federal Reserve

The Federal Reserve hinted early in 2015 that it was using forward-looking risk analytics to ferret out weaker community banks. Maryann Hunter, deputy director of the Federal Reserve's Division of Banking Supervision and Regulation, Community Banks told a Senate subcommittee in February that the Fed had an initiative "to use 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." In April, Hunter told a House subcommittee that the program also included Call Report data.

Fed Chair Janet Yellen testified before Congress in November that the Fed was using the financial data it collected from banks to "calibrate our examination procedures based on risk. We believe this will help us to be more forward looking in addressing emerging risks and to ensure that community bank examiners with specialized expertise and experience are allocated to the institutions exhibiting the highest risks," she said.

The Fed ended the year by announcing it had made its supervision framework "more forward-looking and data-driven." The new program includes the use of forward-looking metrics to target high-risk banks "for enhanced supervision," while identifying "low-risk" banks that would merit more of a "streamlined supervisory approach."

The program will include an outlier list and a watch list that would identify banks "with expanded or new areas of risk-taking" and flag those in the early phases of financial trouble. The algorithms used in the data modeling were first tested on community banks, the Fed wrote, but they are now being expanded and customized for all banks. Some metrics are still being developed and full implementation is not expected until 2017.

Community banking organizations supervised by the Fed may receive a surveillance write-up if their rating drops from the previous quarter, or if a new contributing risk factor is identified, the Fed wrote.

3. The Office of the Comptroller of the Currency (OCC)

The OCC issued a memo to examiners in 2011, noting that one of the tenets of good forward-looking supervision is assigning an adverse rating to the management component of a CAMELS composite before a bank had deteriorated financially, a 2013 OCC audit revealed . The memo noted that the M score should focus on actions and results, not commitments. (Invictus' community bank clients that have submitted stress testing results to examiners have seen their M scores increase. See "How Stress Testing Strengthens CAMELS").

Of all the regulators, the OCC has been the most vocal in advocating for forward-looking community bank analytical tools. It issued guidance for community bank stress testing in 2012, reiterating that "some form of stress testing or sensitivity analysis of loan portfolios on at least an annual basis" was "a key part of sound risk management for community banks. The guidance noted that community banks that incorporated stress testing into their strategic and capital planning processes were more effective than those that did not or just used it as a check-the-box exercise, a refrain the OCC has repeated in recent years.

In June 2012, the OCC also issued revised guidance on capital planning. The document said capital planning must be "forward-looking in incorporating changes in a bank's strategic focus, risk tolerance levels, business plans, operating environment, or other factors that materially affect capital adequacy."

Then, in December of 2015, the OCC announced that it had updated its guidance for its Risk Assessment System to clarify the "forward-looking elements" of both the system and CAMELS. The guidance "broadens the concept of risk" to include its impact on a bank's projections. It also expands the definition of strategic and reputation risk assessments to include both the quantity and quality of risk management. The guidance notes that under the new definitions, "financial condition includes impacts from diminished capital and liquidity," and that capital includes potential impacts from losses, reduced earnings and market value of equity.

The OCC stressed that strategic risk was a key risk and top concern for examiners. The updated guidance is now reflected in the OCC's handbook on Community Bank Supervision.

Warning Signs in Late 2015

As 2015 came to a close, regulators began calling on community banks to manage the growing credit risks in their portfolios. In December, the three primary regulators issued a statement about CRE concentrations. They emphasized that banks need the right strategies "to ensure capital adequacy and allowance for loan losses" that support a bank's lending strategy and are consistent with the level of CRE risk in their portfolios. The regulators advised banks to perform "market and scenario analyses" to quantify the potential impact of changing economic conditions on asset quality, earnings and capital – in other words, forward-looking capital stress tests.

The regulators said that examiners "will pay special attention to potential risks associated with CRE lending" in 2016. "The agencies may ask financial institutions found to have inadequate risk management practices and capital strategies to develop a plan to identify, measure, monitor, and manage CRE concentrations, to reduce risk tolerances in their underwriting standards, or to raise additional capital to mitigate the risk associated with their CRE strategies or exposures," regulators advised.

The CRE levels are of utmost concern to regulators because post-mortem reviews of community banks that failed during the crisis showed similar concentrations – yet regulators did not act in time to save the banks. An overlooked Government Accountability Report said that in response to that failure, regulators had all embraced forward-looking risk supervision. The 71-page June 2015 report, "Lessons Learned and a Framework for Monitoring Emerging Risks and Regulatory Response," discussed how regulators are using "forward-looking elements" in exams and in

CAMELS ratings, particularly the management component. The report also noted that it would monitor the regulatory efforts.

The GAO report offers some clues about how forward-looking bank supervision will affect banks. Regulatory staff, for instance, told the GAO that they had previously been reluctant to downgrade the management component if earnings and capital were strong, a mistake it now realized. Examiners are now directed to use the management score in the CAMELS composite to reflect the bank's underlying risks. Federal Reserve staff "noted that the stress test is the best way to communicate to bank management that risks have built up and need attention, because it is data driven."

Conclusion: Forward-Looking Risk Analytics as a Solution

So what can community banks do to ensure they are ready for examiners armed with forward-looking risk analytics? ***Be proactive***. Even if your bank doesn't have CRE concentrations, use forward-looking risk analytics to stress test your capital, your strategic plans and any potential acquisition you might be considering. Present the results to regulators. Invictus' clients that have used stress testing results with examiners have seen their capital requirements decrease, their management piece of their CAMELS composite increase, and their strategic plans win fast regulatory approval.

Banks whose strategic plans call for an increase in CRE lending have no choice. They must stress test their portfolios. Acquisitive banks should also take special note of the CRE warning. Many potential acquisitions will result in a crossing of the 300 percent threshold, especially with cash-heavy transactions that are dilutive to tangible book value. Expect regulators to increase scrutiny during the application process, and perhaps make an example of a bank or two. Acquiring banks must be prepared to demonstrate in their applications that they have the capital management infrastructure to manage concentration risk. They cannot do that without forward-looking risk analytics.

The CRE warning that came out in December was broad: Banks that will come under scrutiny do not need to have exceeded concentration limits. They must merely be contemplating an increase in CRE loans, have already increased CRE lending or "operate in markets or loan segments with increasing growth or risk fundamentals."

Forward-looking risk analytics are here, and their use will only expand. Embrace them to smooth the regulatory path, and give your bank a competitive edge in the marketplace.

About the Author:

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Lisa Getter is the partner in charge of communications at Invictus. She was formerly the director of finance and tax analysis for Bloomberg Government in Washington, D.C., where she led a team of economists and analysts exploring the impact of Dodd-Frank and other regulations on the financial sector. She spent six years as the editorial director of UCG, where she created and published the award-winning Bank Safety & Soundness Advisor newsletter. She spent 23 years in the news business, working as an investigative reporter at the Los Angeles Times and the Miami Herald. She was a member of two Miami Herald Pulitzer Prize-winning teams and was twice a nominated Pulitzer finalist. She was a 1995 Nieman Fellow at Harvard University and received a BSJ from Northwestern's Medill School of Journalism.

About Invictus

The Invictus Consulting Group is the industry thought leader in bank analytics. The data-driven company's groundbreaking tools and forward-looking analytical approaches have changed how bank executives approach strategic and capital planning, stress testing and mergers and acquisitions. Invictus' analyses give banks, insurers and investors the competitive edge in executing their plans and developing their businesses.

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