Perspectives

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SIMPLE IS NOT ALWAYS BETTER: THE COMMUNITY BANK LEVERAGE RATIO PLAYBOOK

By: Adam Mustafa, CEO – Invictus Group

In September, the Federal Deposit Insurance Corporation finalized the Community Bank Leverage Ratio ("CBLR"). Community banks with less than $10 billion in assets can opt into the new capital framework and forgo risk-based capital rules as long as they maintain at least a 9% Tier 1 leverage ratio. The rule is a byproduct of S.2155, adopted in 2018 to roll back much of the Dodd-Frank Act. The bill called for regulators to create a new simpler capital framework for community banks, with a CBLR between 8% and 10%. Predictably, the regulators settled on the midpoint of that range. The CBLR is on track to go into effect on January 1, 2020. Since banks will use their Call Reports to report their capital levels, the framework will first be available on March 31, 2020.

Banks that opt into the CBLR and remain above the 9% threshold would no longer be required to comply with the "Basel III" capital rules, or even calculate their risk-based capital ratios. Touted as easing the regulatory burden, the new framework will primarily free community banks from the paperwork hassle of calculating these ratios.

However, this will come at a severe – yet hidden – cost to shareholders. Invictus has calculated that 96% of community banks could justify a leverage ratio requirement of less than 9%. In other words, a $1-billion bank that can support a customized capital requirement of 8% would be burning $10 million of capital to the ground simply by opting into the CBLR.

Fiduciary Responsibility to Know Your Bank

Every community bank is unique. Each operates in a discrete footprint with its own strategy. The composition and risk characteristics of their assets are distinct. Their income streams, cost structures and efficiencies are different. Yet any one-size-fits-all approach to capital adequacy such as the CBLR will be based upon the lowest common denominator bank. It's no coincidence that examiners often tell banks they must hold a minimum Tier 1 capital ratio of at least 9% – that is the fall back, de facto level.

The management team of every community bank must take it upon itself to calculate the minimum capital requirement commensurate with its risk profile. Blindly opting in to the CBLR is a disservice to shareholders. At the same time, if a community bank decides NOT to opt in to the CBLR, it must be prepared to support and defend that requirement to its board of directors and regulators. Choosing not to opt into the CBLR but not having a customized capital requirement calculated and backed by data and analytics is also unacceptable. It will give your regulator cause for concern because you do not have strong command over how your capital is allocated.

To be frank, even if your regulator ignores or doesn't accept your calculation, management's job is to not go down without a fight. Simply bemoaning that your regulator won't be willing to have such a conversation is no excuse for not having one. That's weak, short-sighted and a disservice to your shareholders. And in our experience, regulators will listen – and they will look at documentation you provide to make your case.

Stress Testing – The Right Tool for the Job

So how does a community bank go about calculating its own capital requirement? The only answer is stress testing. Community banks must realize that stress testing is the perfect weapon to control their own capital requirements. Yes, the Comprehensive Capital Analysis and Review (CCAR) is designed for large banks, not community banks. However, community banks need to quit looking at stress testing as simply a check-the-box exercise to please their regulators or to adhere to the 2006 interagency guidance on managing CRE concentrations.

By taking this approach, community banks will be pleasantly surprised to discover that their regulators will often respond positively. For the regulators, it's all about trust. Can they trust a given bank to properly manage its capital? In defense of regulators, how can the answer possibly be yes if a given bank can't even estimate its own capital requirement or support it with data?

Most community bank regulators will be receptive to a customized capital requirement, even if they are not trained in stress testing, under three conditions:

1. **The bank is genuinely using stress testing to help create and manage its strategic and capital plans.** In other words, the bank is not just running a stress test to appease the regulators. The regulators' conscious or subconscious litmus test will be "would this bank be using stress testing even if they were not regulated?" The answer needs to be yes. Banks cannot fake this. They need to embrace stress testing, or it will never work, no matter how much money, quants or data they throw at the exercise.

2. **The stress tests CANNOT be a black box that management does not understand.** Do not purchase a model from a vendor without understanding how it works, or what the results mean, and then hand a report to the regulators and say, "here is my stress test". Management does not need to be experts in stress testing, but they do need to have a strong understanding of how their stress test works, why the methodologies utilized are appropriate and how their inputs (loan-level information) translate into outputs (ultimately their customized capital requirement).

3. **The stress tests must be forward-looking, driven by loan-level information and able to be validated.** Simply using your historical loss experience from the Great Recession or the 75th percentile worst bank is insufficient. The heart and soul of a bank's vulnerability to stress will be credit risk embedded within the loan portfolio. Therefore, it is crucial to utilize loan-level information that contains these risk characteristics to drive the loan portfolio stress test component of your capital stress test. It is the only way to perform forward-looking analysis. Validation is also important to regulators, so make sure your model is designed in such a fashion that it's easy to do so. Validation should also be important to you because if you are adhering to condition #1 above, you want to make sure you are relying on a model that you can trust.

A Decade of Community Bank Stress Testing Mistakes

Most community banks are using some form of stress testing. But while they are often checking the box with regulators, most are also not doing so in a manner that can be used sufficiently for calculating capital requirements and figuring out whether to opt into the CBLR. Below is a list of the most common shortfalls we see with community bank stress tests:

- They are only stress testing their loans. They cannot connect the results to the impact on capital because they are not stressing the rest of their balance sheet or their earnings.

- Only the CRE loans are being stress tested – residential mortgages and consumer loans are not included. The irony is that many banks will find they are most vulnerable to losses within the C&I portfolio under stress due to the 'soft' nature of the collateral, but they are not stressing those, either.

- They are performing capital stress tests, but they are shortcutting the calculation for loan loss provisions and net charge-offs by using historical losses from their own bank or other banks, or by applying some multiple to their net charge-offs in "good times." What they are missing is a forward-looking analysis using loan-level information. Today's loans were originated under completely different economic and interest rate conditions than loans that were on the books in 2008. Underwriting philosophies and standards have also changed. This all gets missed with a "look back" approach that is used simply to plug in a number.

- They are sending "flat files" to a vendor and getting a report back in return, but don't understand the report and aren't using it to make any real decisions about strategic or capital plans.

- They are unable to incorporate planned actions such as loan growth, dividends, stock repurchases, mergers and acquisitions or investments in new business lines into their stress tests.

- Stress testing is being done in a vacuum as the sole responsibility of either the Chief Credit Officer or Chief Financial Officer, and there is little to no collaboration across various departments within the bank.

- Stress tests may be done on a recurring basis, but each stress test is its own mutually exclusive exercise with zero trend analysis. What community banks often miss is that the most valuable insights from stress testing are unlocked from performing trend analysis across previous stress tests.

- Stress testing is an imperfect exercise. It is not and never will be a proverbial crystal ball. However, if the same general test is performed over multiple periods, then changes in the results from one period to the next are screaming to tell you a story. The most important result, perhaps, is the capital requirement estimated for a given bank. But this is not a static number. A given bank's capital requirement will change over time as its loan portfolio turns over, as its earnings model changes, as its mix of assets and liabilities fluctuates, etc. Has the stress loss rate on the CRE-non-owner-occupied portfolio increased or decreased versus the prior analysis? And why?

Community banks need to take the next step with respect to stress testing. They need to run CCAR-style stress tests and fill in the above-mentioned gaps, if applicable. Most community bankers brave enough to have read up to this point are gasping right now, asking themselves: How are we going to do something that is this complex? How much will it cost?

But this type of stress testing is not that difficult or expensive. Most community banks have much simpler business models than the large money center banks, which often include international operations, investment banking and massive off-balance sheet derivative exposures. Most community banks gather deposits and make loans, and that is their primary business. Some may have additional revenue streams such as loan sales of mortgages and SBA loans, wealth management and loan servicing, but these are not overly complex business models, either. Most community banks have plain vanilla securities portfolios, so analyzing those aren't too difficult.

Community banks are also in a better position today to ensure the stress testing of their loan portfolio is forward-looking and using loan-level information. This is because they (hopefully) are at some sort of stage in the process of preparing for CECL.

Don't Miss the Opportunity

In many ways, the decision regarding the CBLR provides a tremendous opportunity for community banks. They can use this process to support and defend a customized capital requirement. It allows them to put a stake in the ground with their regulators, so they do not have to succumb to a rule-of-thumb that was ultimately based on the lowest common denominator bank.

Banks that do nothing or blindly opt into the new framework risk encumbering unnecessary capital that can be used to drive shareholder value and ensure their ongoing independence in a world where generating the appropriate levels of ROE is becoming increasingly difficult.

By our calculations, $44 billion may be at stake.

Disclaimer: The views and opinions expressed in this article are those of the author and do not necessarily reflect the official policy or position of the Financial Managers Society.

ABOUT THE AUTHOR

As a co-founder and CEO of the Invictus Group, Adam Mustafa has overseen the design and implementation of fully customized capital stress testing, capital management, CECL and strategic planning systems for financial institutions. Prior to joining Invictus, he had senior-level experience as a banker, financial services consultant and corporate CFO.

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FMS Financial Managers Society
1 North LaSalle St., Ste. 2225 | Chicago, IL 60602 | info@FMSinc.org
Contact: mloehrke@FMSinc.org | 312-578-1300
FMSinc.org/IndustryInsights