RISK AND THE STRESS TEST IN PERSPECTIVE

by Steve Brown

Risk - it is hard to define. We will submit that jumping out of an airplane without a parachute does not contain a single element of risk. Why? - Because the outcome is certain. Our best working definition (and it is evolving) for "risk" is that it is the uncertainty around achieving goals. This could be financial or non-financial, but to us, risk is central to both limiting downside and optimizing upside. When it comes to financial goals, stress testing is a key element to testing current and future operations and strategy.

Yesterday's premature release of the stress test results gave the industry another view into risk. The Fed reported that 15 of 19 of our largest banks could maintain adequate capital levels in this test. This is largely good news, as when the Fed did this back in 2009, almost 50% failed. Now, with lower leverage, better credit and more capital; only Citibank, Ally, Suntrust and MetLife failed.

As mentioned yesterday, the Fed's recession scenario was a 13% unemployment rate, a 50% drop in stock prices (not our favorite metric to give for a stress test) and a 21% decline in house prices. Given that scenario, the average Tier 1 capital ratio for this group fell to 6.3%, compared to a current base-case ratio of 10.1%. Those banks that failed dropped under the minimum 5%. The Fed then looked at forward-looking capital strategies to understand about planned future capital raises, share buyback programs and dividends, before finally passing judgment.

Since our credit stress product is one of the most adopted by community banks in the industry, we want to highlight a couple of key points. First, banks should realize that this scenario wasn't easy to stress test. The Fed's scenario (assuming historic relationships to other key metrics hold) implies about a 2.5x standard deviation move, in addition to already elevated current industry delinquency levels. Statistically, this will cover about 98% of all market movement, based on where these indicators have been over the last 10Ys. In our eyes, this was probably too severe of a shock, as we ask the question whether you really have to be 98% sure you are not going to use the capital, before you can invest it or return it to shareholders? That threshold dramatically drives up the cost of capital and ironically makes the attraction of capital less likely. That could have a negative iterative effect and serve to increase, not decrease, long-term risk for the industry.

The second takeaway is that while loans and trading positions accounted for 85% of the potential loss at large banks, loans compose about 96% of potential loss for community banks. Geography, lending class allocations and the amount of leverage carried by the community bank are the 3 biggest drivers in determining losses in a normal credit shock scenario. Ask yourself, while you talk about geography in terms of marketshare and sales, when was the last time you discussed setting your lending areas based on risk? Do you proactively choose asset allocations and price loans accordingly? Do you choose a capital leverage target as a metric to manage? Most likely the answer is "No" to all, which means you may arrive at the most important determinants to survival with little forethought.

Finally, we underscore that your stress testing, loan loss reserve, investment portfolio, ALCO, relationship profitability and budget processes all need to run in concert, as results in one can impact others. Having the same set of methodologies and analytics is helpful and aids in understanding (plus adds transparency) when you work with homogenous results.

Stress testing your whole balance sheet is an important step in making decisions about your future. For some banks, a 5% to 10% capital change is sufficient, while others with different risk profiles may require more cushion. If we can help your bank better manage risk to increase performance, contact us today.

If you just want to understand more about how to put your results into action, come to our annual EMC Conference coming up in May in San Francisco, as this will be one of the key topics we will be focusing on.

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PCBB 2012 Executive Management Conference

BANK NEWS

M&A

Northfield Bancorp ($2.4B, NY) will buy Flatbush Federal Bancorp ($143mm, NY) for about $8.1mm. The deal combines two mutual holding companies.

M&A

Great Western Bancorp ($8.5B, SD), a unit of National Australia Bank, will buy North Central Bancshares ($434mm, IA) for $41.5mm or about a 39% premium over Monday's price. Great Western now has 200 branches in 7 states.

Less Regulation

The FHA will not require community banks with less than $500mm in assets to meet financial and compliance audit requirements.

Another Run

BB&T has agreed to assume $285mm in BankAtlantic's trust preferred securities obligations for a 95% preferred interest in a new corporation that will hold $440mm in loans and other assets that BankAtlantic would have kept under the original acquisition transaction. BankAtlantic will also provide an additional $35mm guarantee.

Regulatory Costs

A new study finds regulatory costs for all US corporations over the past 3Ys have risen 500%.

TARP

Regions Financial will raise $900mm in common stock as part of its TARP exit. The bank will use proceeds from the raise and from the sale of Morgan Keegan to repurchase $3.5B shares of preferred stock under TARP.