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FINANCIAL LENDING NOTES

STRESS TESTING AND COMMUNITY BANKS: Regulatory Guidance Provides Some Clarity

Community banks with $10 billion or less in total assets are not required by the Dodd-Frank Wall Street Reform and Consumer Protection Act to perform stress tests on their loan portfolios. But, this doesn't fully clear up the confusion among many community bankers with regard to stress testing.

> ***Some form of stress testing or sensitivity analysis of loan portfolios on at least an annual basis is a key part of sound risk management for community banks.***

That's because while community banks aren't required by law to stress test their portfolios, they are strongly encouraged to do so by the regulators. In fact, the Office of the Comptroller of the Currency (OCC) expects community banks to have "the capacity to analyze the potential impact of adverse outcomes on their financial conditions," as it stated in guidance that provides some regulatory clarity for community banks regarding stress testing.

Sound Risk Management

Bulletin OCC 2012-33, Community Bank Stress Testing: Supervisory Guidance, helps community banks with $10 billion or less in total assets determine how they can best use stress testing to identify and quantify risk in their loan portfolios.

"Some form of stress testing or sensitivity analysis of loan portfolios on at least an annual basis is a key part of sound risk management for community banks," states the OCC bulletin. "Community banks that have incorporated such concepts and analyses into their credit risk management and strategic and capital planning processes have demonstrated the ability to minimize the impact of negative market developments more effectively than those that did not use stress testing."

Regardless of its size, the OCC expects every bank to have an effective internal process for assessing its capital adequacy in relation to its overall risk, and to plan for maintaining appropriate capital levels. The OCC believes that stress testing is a prudent way for community banks to identify their key vulnerabilities to market forces and assess how they will manage these risks should they emerge.

CRE and ADC Concentrations

According to the OCC bulletin, the financial crisis demonstrated how an unexpected economic downturn and rapid deterioration in market conditions can significantly hurt a bank's financial condition. It noted that concentrations of credit, especially in commercial real estate (CRE) and in acquisition, development and construction (ADC) loans, have been a common factor in community bank failures.

What makes this guidance unique, and has caught the attention of many community bankers, is the fact that it moves stress testing beyond just interest rates to include other potentially adverse factors and outcomes (e.g., falling rents/sale prices, slowing absorption, increasing operating expenses, rising capitalization rates). In addition, the guidance indicates that community banks should perform stress testing not just on individual loans, but on their entire portfolio in the aggregate, on at least an annual basis. Meanwhile, the Federal Reserve recommends a quarterly, two-year stress testing horizon for community banks.

The OCC bulletin acknowledges that well-managed community banks routinely conduct interest rate risk sensitivity analysis. "Many community banks, however, do not have similar processes in place to quantify risk in loan portfolios, which often are the largest, riskiest and highest earning assets," it notes.

Your goal should be to determine the potential impact of your borrowers' collective abilities to service debt and maintain proper margin collateral on your overall loan portfolio. Start at the borrower level and then roll up to the portfolio level to determine what percentage of your portfolio is non-performing.

Deciding which factors your bank should stress test for (other than interest rates) will depend on the nature of your concentration risk. The OCC bulletin suggests that stress tests may be conducted on identified credit concentrations and other loan portfolio segmentations, in addition to being conducted at the individual loan level. "A community bank's

Regulatory Guidance Provides Some Clarity, cont.

approach to stress testing should fit its unique loan portfolio strategy, size, loan types, composition, operations and management," it states.

Stress Testing Methods

The guidance does not recommend or endorse any particular stress testing method for community banks, and it acknowledges that their stress tests may be less complex and sophisticated than big banks' tests and not require third-party consultative support. A simple, stressed loss-rate analysis based on call report categories may be all that's needed to determine if additional analysis is necessary, according to the guidance.

However, it does identify four different types of stress tests that community banks might consider using:

1. Transaction stress test – Estimates potential losses at the loan level by assessing the impact of changing economic conditions on a borrower's ability to service debt.
2. Portfolio stress test – Helps identify current and emerging portfolio risks by assessing the impact of changing economic conditions on borrower performance.
3. Enterprise-level stress test – Considers multiple types of risk and their interrelated effects on the overall financial impact under a given economic scenario.
4. Reverse stress test – Deduces the types of events that could lead to a specific adverse outcome assumed by the bank.

In addition, the guidance suggests a few elements that are common to effective stress tests, including the following:

- The test asks plausible "what if" questions about key vulnerabilities.
- The test makes reasonable determinations of the impact the stress event or factor might have on earnings and capital.
- The test's analysis is incorporated into the bank's overall risk management process, asset/liability strategies, and strategic and capital planning processes.

For more guidance and details on stress testing, please contact your Mueller Prost advisor 314.862.2070.

Rising Rates Are Coming

The inevitable rise in interest rates at some point in the future — whether this is after 2015, as Fed Chairman Ben Bernanke has indicated, or sooner — makes stress testing for rising rates especially important right now. Higher interest rates could have a significant effect on borrowers' cash flow and debt service ability.

For borrowers with variable rate debt, go back and add several hundred basis points to their interest rate and see what impact this would have on their debt service capacity. What would be their incremental interest expense? Would they still be able to generate enough cash flow to service their debt? If not, it's better to know now so you can be proactive in helping these borrowers before it's too late.

Meanwhile, given the potential for rates to rise (perhaps significantly) in the near future, community bankers would be wise to reconsider issuing new fixed-rate debt on income property and owner-occupied real estate. In a stable interest rate environment, balloon mortgages of five-to-seven years might not be considered especially risky.

But if rates rise 300 basis points or more within a couple of years and you're making five-year balloon mortgages today at 4 percent, you'll be underwater on these loans when rates rise. And when the balloon matures, you may not be able to refinance it at a higher rate without creating a non-performing loan, or a troubled debt restructure (TDR) if you refinance it at a below-market rate.

Due to the fact that they have so much liquidity and so few good lending opportunities (especially with income property), many community banks are doing just this. But this is tantamount to betting that there won't be a significant rise in interest rates within the next five years — something almost nobody believes is realistic.

In short: Avoid making risky underwriting decisions just to close a loan. As the financial crisis demonstrated, this strategy never pays off in the long run.

SURVIVAL STRATEGIES:
Are You Pursuing Multi-Faceted Customer Relationships?

As we have discussed in previous issues of Financial Lending Notes, the Dodd-Frank financial reform legislation included provisions that have made it more difficult for community banks to thrive — and in some cases, even survive. These provisions include higher capital and equity requirements, and heavier regulatory burdens and costs.

This has made it more important than ever that community banks pursue multi-faceted relationships with their small business customers that go beyond just loaning them money. With this in mind, now is also a good time to refocus on the competitive advantage community banks have always had (and still have): the ability to serve as a trusted advisor and add value to their relationships with small businesses.

One way to add value is to recommend appropriate bank products and services that can help your small business customers grow. Broadening and deepening your small business relationships is one of the best ways to increase their loyalty to your bank. A loan customer that is using several of your bank's other products and services is much less likely to shop around for a lower interest rate than one that only has a loan.

Make Strategic Recommendations

In your role as a trusted small business advisor, you should be proactive in making strategic product and service recommendations that are appropriate for your customers at various stages of business development. Fast-growth companies, for example, can often benefit from treasury management, capital markets and risk management services. Mature and aging small businesses, meanwhile, often need help with succession and estate planning.

In the past, offering additional products and services beyond loans and bank accounts was a "nice to have" differentiator for community banks. Today, it is quickly becoming part of the price of admission for working with small businesses. These value-added products and services typically include:

- **Cash and treasury management** – The days when only middle-market and large corporations used cash management services are long gone. Many small businesses today are utilizing ACH and EFT, remote deposit capture (RDC), cash concentration and Positive Pay as a part of their daily operations.

- **Online and mobile banking** – Similarly, most small businesses expect their community bank to offer at least basic online banking services. Mobile banking (or M-banking) is also gaining a foothold among small business owners who spend much of their time on the go.

- **Merchant processing and currency services** – Retail businesses rely heavily on both of these services, while merchant services are integral to Internet and mail-order/telephone order (MOTO) businesses.

- **Wealth management and private banking** – Many small business owners are also high-net-worth individuals who will pay a premium for personalized, high-touch wealth management and private banking services from their community bank.

- **Investment and estate planning services** – Asset management accounts, alternative investments, buy-sell agreements and trusts (e.g., Directed Dynasty, charitable remainder, revocable and irrevocable) are all profitable services that many small business owners are looking to their community banks to provide.

- **Qualified retirement plans** – These may include SIMPLE plans, traditional and solo 401(k)s, and SEP-IRAs.

Build It Yourself or Outsource?

Of course, it takes internal systems and qualified employees who specialize in these areas in order to offer these products and services. Instead of hiring full-time employees and creating these systems from scratch, some community banks are partnering with local service providers like wealth management and financial planning firms to offer them. Note that the Consumer Financial Protection Bureau (CFPB) offers guidance in CFPB Bulletin 2012-03 to help banks reduce the risk involved in relationships in which third-party vendors are given access to sensitive customer data.

Regardless of how they are offered, it has become increasingly important that community banks do offer value-added products and services as they strive to develop multi-faceted relationships with borrowers. This is a key component to becoming the kind of trusted advisor small business owners turn to not just for loans, but for all of their business financial needs.

Please contact your Mueller Prost PC advisor at 314.862.2070 to discuss competitive strategies in more detail.

The Latest on UDAAP and Disparate Impact

Some community banks believe that they are not subject to the unfair, deceptive or abusive acts or practices (collectively referred to as UDAAP) provisions of Dodd-Frank. These provisions prohibit all such acts or practices affecting commerce, including banks.

However, UDAAP provisions apply to all banks, regardless of their size. In fact, 43 percent of UDAAP violations cited by the FDIC were for banks with total assets of $250 million or less. UDAAP violations have resulted in unsatisfactory CRA ratings, downgraded consumer compliance ratings, restitution to customers and the pursuit of civil financial penalties, which can be significant.

An act or practice is considered to be unfair if it is likely to cause substantial consumer injury that cannot be reasonably avoided and is not outweighed by consumer or competitive benefits. One is considered to be deceptive if it misleads, or is likely to mislead, the consumer. And an act or practice is considered to be abusive if it materially interferes with the ability of a consumer to understand a term or condition of a financial product or service or takes unreasonable advantage of the consumer.

A similar provision community banks should be aware of is the "disparate impact" standard, which is part of the Fair Housing Act (FHA). According to this provision, a member of a protected class can challenge a policy he or she believes is discriminatory based on a prohibited ground, rather than on a blatant intent to discriminate.

Earlier this year, HUD published a new rule formalizing the use of disparate impact under the FHA. Since the rule took effect in March, the Consumer Financial Protection Bureau (CFPB) has been using a disparate impact test in fair lending examinations and investigations under the FHA, Equal Credit Opportunity Act (ECOA) and Regulation B.

Lawsuits are currently pending that challenge the legality of disparate impact, including one that the Supreme Court has agreed to hear. We will keep you informed about developments affecting disparate impact in future issues of Financial Lending Notes.

Contact us at 314.862.2070 if you have more questions about UDAAP provisions and the disparate impact standard.

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