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Customer Case Studies

How Invictus Strengthens CAMELS *A Client's Perspective*



After Community First Bank's last safety and soundness exam, regulators told CEO Charles W. Daily that capital stress testing had strengthened the bank's management rating in its CAMELS composite score. The examiner was "especially impressed that were doing this complex stress testing

as a small bank," Daily said.

Community First Bank, a \$208.2 million bank in Fairview Heights, Ill, a suburb of St. Louis, isn't required to do stress testing. Bank regulators now mandate capital stress testing only for banks with assets of \$10 billion or more, though most regulators say it is best practice for smaller banks.

"It's not mandated, but we decided to do it anyway," Daily said. "Small banks like ours that are not doing it are not going to be downgraded, but he said it helped strengthen it, for sure."

Daily, one of the bank's founders, has been CEO since the bank opened in 1988. He attended a regulatory conference hosted by the Conference of State Bank Supervisors in 2011, where Invictus Consulting Group chairman Kamal Mustafa and partner Adam Mustafa were speaking on a panel. He was impressed by their knowledge of banking, and the explanation of the Invictus stress testing process.

Other firms also presented stress testing plans, but their processes seemed "like window dressing for regulators," Daily said. The Invictus stress testing "had a lot of merit," offering the bank "meaningful information" it could use, he added.

"I'd been in banking a long time, but we really hadn't done stress testing before. We always kept extra capital. We never quantified it. Examiners could never tell you that it was enough. They would say that it's good you're keeping extra."

Regulators Reward Bank

Flash forward a few years, and Daily couldn't be happier. Not only have regulators rewarded him for being proactive, but he and his board have confidence that Community First has enough capital to continue on its strategic growth plan, even if there is another financial crisis.

"The Invictus stress test model is a tool that has helped us evaluate our capital adequacy in conjunction with our strategic plan for future growth. We want to grow, but we want to keep an eye on

our capital to make sure we have enough to survive a severe economic downturn," he said.

He likes the fact that the Invictus model gives "absolute results" because it incorporates the bank's specific loan makeup, internal loan ratings, loss history and risk migration. Trends in stress testing over the past few years have also been revealing. "Analyzing a compilation of individual stress tests done over time has been important in validating the model as a tool in capital planning," he said. "The Invictus model also helps us look at the migration of risk in our ALLL model. We've gotten more insight into that process and it helps us do a better job of allowance for loan losses."

Management presents the stress test results to the board semi-annually. Graphics make it easy for the board to read and comprehend the results. "The board relies on them to understand our capital adequacy under a combination of growth and adverse scenarios," he said. "We tell them the bank's growth goals and what capital is needed and they can look at all that and see we would be able to have adequate capital, even in a crisis."

And he appreciates the individualized, flexible service he gets from Invictus, which includes conference calls and a willingness to tailor graphics to the bank's needs. "They are very accommodating. They take the time to learn about the uniqueness of our bank," Daily said. "Over the years, they have been very willing to change and customize various managerial reports when requested."

The bank incorporates the stress testing results into its overall enterprise risk management program. "Everything revolves around having capital. We're a small bank. Our ability to get new capital is limited. We have a strategic plan on the direction we want to take the bank without putting strain on our capital," he said. "The Invictus test results show that if we have a severe economic downturn, even worse than the last one, that we would have the reserves to survive it."

The process allows Daily to demonstrate to regulators that the bank understands what is happening with its capital. "At our most recent exam, the regulator mentioned that since our bank had been stress testing for several years, it helped demonstrate our bank's proactive management approach, which is what they want to see at community banks," he said. ■



How Invictus Helped A Troubled Bank Look To The Future *A Client's Perspective*



When MBank CEO Jef Baker took over the troubled bank in 2011, there was a 95 percent chance that the Oregon-based bank would fail. But Baker isn't your ordinary turnaround CEO – he is an accountant who had been the bank's CFO, and he likes to beat the odds.

Flash forward three years, and Baker is describing the \$173 million Portland bank as “the little engine that could.” Regulators just lifted the bank's PCA directive, and the bank closed out 2013 with \$2 million in earnings. Although still under a consent order, MBank is now diving into strategic planning for the future.

Baker heard Invictus Consulting Group chairman Kamal Mustafa speak at a conference and knew he had to hire the company to make sure the bank's capital plan and projections were supportable. The strategic plans contained actions to improve the bank's risk profile, but were they enough?

At its board of directors meeting in February, two Invictus executives presented the results to the six-member board and explained what they meant and the assumptions that were used. Invictus showed what would happen to the bank with the strategic actions, and what would happen without them.

“They did a nice job of educating us as a client in how this worked, in walking us through all the data,” Baker said. “They demystified the black box to help us better understand our risk profile, as well as helping us feel confident in talking about our stress testing with regulators.”

The board package included information about the bank's loan portfolio and what kind of losses the bank could expect if the current economic environment were to significantly worsen. The Invictus model is able to dig into the loan portfolio to give a snapshot of asset quality by vintage and by concentrations, and pinpoint exposures that

would lead to a potential loss of regulatory capital. In a comprehensive way the model also recognizes increasing overhead and reduced revenues, beyond just loan losses, in projecting results in a tougher economy.

“It was great to understanding our capital position better,” Baker says. “Looking at the portfolio mix and the vintage is critical in understanding our balance sheet. I think it gave our board a deeper understanding of our loan portfolio, and a better appreciation of the stress tests we were doing.”

Since the bank had never done a robust capital stress test before, the Invictus presentation was “brand new” to the board, Baker said. “I think they were very impressed. They recognized that this was a very high quality product and process. I think they felt comforted that we were 1) educating ourselves and understanding better our loan portfolio and potential impacts to capital and 2) being proactive in management, knowing that capital stress testing is not technically required. From a regulatory perspective, we believe it will be viewed as very positive.”

Baker said he loves the Invictus model because it provided him with a perspective on what happened to the bank's portfolio historically, and it allowed him to take that loss experience and apply it going forward. “I think it's great that this model can use our historical loss experience along with information from the banking industry to focus on the actual portfolio today.”

The bank submitted a capital plan to regulators about where it wanted to go, and the Invictus stress test indicated that the plan was acceptable. While the real benefit is a better understanding of a bank's risk profile, Baker admits he hopes that regulators reward the bank in its M rating for using stress testing as a risk assessment tool, even though it's not required for small banks. “If the regulators recognize our efforts, that will be the icing on the cake.”



Invictus Gave My Bank Board Confidence to Issue Dividend *A Client's Perspective*



University Bancorp included the results of the bank's capital stress tests in its **July press release** announcing the bank's second quarter profits. Stephen Lange Ranzini, President and CEO, noted that the Invictus tests showed that the bank would have 14.8 percent Tier 1 Capital in a two-year adverse case scenario, and 12.9 percent Tier1 Capital in a severely adverse case. Ranzini recently answered questions from *Bank Insights* about his experience with Invictus and capital stress testing.

Q: *The bank cited its Invictus stress test results in its press release. Can you explain how the stress testing process helped the bank and its board?*

A: By demonstrating through rigorous and defensible capital stress tests that the bank has excess regulatory capital, we convinced our primary regulator that our current capital was more than adequate. This gave the board of directors the courage to resume paying monthly dividends from our profits to our bank holding company. That has allowed our bank holding company to rapidly eliminate its double leverage and to position our bank holding company to begin to pay dividends to our shareholders.

Q: *Why did you decide to do capital stress testing?*

A: The FDIC would never commit to a specific targeted level of capital ratios we needed to achieve our goals of having adequate capital. They always wanted to assert that the answer "depends" on future developments. By telling them the answer, which they accepted after probing the assumptions underlying our capital stress

test, we eliminated the need to know their own views, since they accepted our view.

Q: *How critical has it been to integrate stress testing into the strategic planning process?*

A: Knowing that the bank has excess capital has allowed us to eliminate a need for capital raising from the strategic plan. While we currently have no plans to do so, it does give us the flexibility to add new lines of business or to expand capital intensive lines of business.

Q: *How have regulators reacted to your stress testing results?*

A: The regulators accepted the stress test results after probing the assumptions underlying our capital stress tests, and they agreed that the assumptions were reasonable.

Q: *How has the board reacted to the stress testing?*

A: It gives the board great confidence that the bank is well capitalized to sustain itself through a Depression-like environment. Having lived through the Recession, regaining this confidence is critical and helps us to retain talented directors.

Q: *What advice would you give other bank CEOs about the benefits of capital stress testing?*

A: It is money well spent. I like and respect the work that Invictus has done for us. Our bank is atypical in some ways and Invictus was able to customize and modify their model to accurately capture these unique variables in our own bank's capital stress tests. ■