

## Stress Test Results: Regional & Community Banks to See Harsher Exams, Investor Flight

FinCriAdvisor May 17, 2009

FinCriAdvisor Text

Banks nationwide should brace for a perfect storm of harsher exams, deposit flight, dry capital markets and share price declines due in large part to the results of the stress tests of 19 core banks.

Because the core banks - those with assets of \$100 billion or more - fared reasonably well (see test results), they are expected to attract renewed interest from investors and customers away from regional and community banks, explains Joe Harenza, CEO of Griffin Financial Group in Reading, Pa.

At the same time, the methodology of the stress tests, such as examiner scrutiny of tangible common equity (TCE) and highly customized, portfolio specific analysis of an institution's ability to withstand economic stress, is likely to be expanded to all institutions, adds former OCC Chief Counsel Brian Smith, now a partner with Latham & Watkins in Washington, D.C.

This already has manifested itself in the field with examiner application of optional guidelines as required rules. "Banks are being more rigorously pressured to comply with various guidelines as if they were regulations," Smith says. He cites heavy examiner scrutiny of commercial real estate and directives to comply with previously optional lending guidelines on it.

"The institution says, 'This is a business we really know, the guideline is not a fixed regulation and we are not too far off the norm,'" Smith relates. "The regulator says, 'We issued the guideline, so you will comply.' If they don't, it manifests itself [negatively] in bank exam results, board meetings and supervisory reviews. They are taking more of a rulebook approach, even though the rules are not issued as rules. They are supervisory guidelines, suggestions for examiners, instructive/educational guidelines and not a final regulation."

Harenza agrees. "I think there is a good chance they will incorporate some if not all of that methodology," particularly for TARP banks as they look to pay back Treasury, he says. Treasury "spent a lot of time developing [the stress test loss ratios and economic assumptions] and have a lot of intellectual investment in it. You can rationally expect some part of that stress test will find its way into regulatory examinations and regulatory reviews."

But the application of stress test methodology to non-core institutions is a mistake, says Robert Atwell, chairman/CEO of Nicolet National Bank (\$620 million) in Green Bay, Wis. It only will "ironically reinforce the market positions of the large organizations" by driving investors and depositors to the now "safe" core banks.

This is a two-part process:

**1. The core banks were able to lobby and negotiate terms unavailable to other institutions.** The customized loss estimates on various asset classes came from a negotiated consensus between the banks and stress test examiners, Harenza says. The same thing happened regarding pre-provision reserves. "The moral of the story is that it was tailor made to each of the 19 institutions," he says. "The banks contested and arm wrestled the government." As a result, Citigroup went from needing an additional \$35 billion in common equity to just \$5.5 billion, he says, citing a Wall Street Journal report.

But regional and community banks will not be able to offer input to examiners and will not receive tailored loss estimates, Harenza says. Yet several analytics firms - Barclays Capital, SNL Financial, Sterne Agee Research - already have released "bank of the envelope" estimates of TCE shortfalls by non-core banks. "Now what you have are buy and sell recommendations on small- and mid-cap organizations made on flawed

analyses. That's a killer," Harenza says. "This may not only impact valuation and ability to raise capital, but competitive position as well."

**2. The core banks received a government imprimatur with the stress test results.** Since the financial crisis emerged, many depositors and investors have abandoned core banks in favor of community banks in a flight to safety and easier loan terms, Harenza says. "Now, when the government stands up and says half these guys are healthy and it won't let any of them fail, it has to hurt community banks." In addition, by making the test results, earnings projections and capital plans of core banks transparent to the investment community, it leaves a "big question mark" about the relative safety of community banks that are not subject to such transparency and hurts their ability to raise capital.

"I'm not concerned that this will suck capital away from good community banks," Atwell says. But he agrees that the government's green light to the core banks does put the larger banking community at risk because it props up a centralized system of banks and will necessitate an "uber regulator."

Such a regulator is coming, Smith says, one that will rely on stress test methodology. "I read very carefully the release from the government. It never quite promised they wouldn't use some of the same techniques as part of examination of the vast majority of banks. It just said it wouldn't use this program," he says, also citing Fed Chairman Ben Bernanke's May 7 speech at the Bank of Chicago:

"The Federal Reserve has been intensively evaluating the lessons of the crisis, both with respect to the companies we supervise and to our own policies and procedures, and we are actively incorporating what we have learned into daily supervisory practice," Bernanke said. "The crisis has likewise underscored the need for heightened vigilance and forcefulness on the part of supervisors to make sure that standards are met" in the areas of capital adequacy, liquidity planning and risk management. "For instance, we have emphasized to banks the importance of stress testing to help detect risks not identified by more-typical statistical models."

Smith says stress testing is not new, but the emphasis represents a real "shift" to a more "holistic" approach to bank examinations and "decided emphasis" on TCE, in large part because investors demand it. "The stress test was in many ways field testing how these things work" for all institutions, he says, noting that such tests previously focused on discrete areas of an institution, not the entire company. He also suspects regulators had been jointly developing the approach before the crisis erupted, perhaps in reaction to Basel II. "We genuinely believe this signals more of an aggressive, holistic, comprehensive approach to bank supervision."

In addition, the focus on TCE is here to stay, Smith says. "It's like a big balloon - you blow it up and start to press it in from one side, the stress keeps pressing, pressing, pressing. Is there a way to prevent it from bursting?" if products sour, economic pressures build and capital becomes scarce, he asks. "What the Fed is saying is that in order to manage this properly you have to stress test them all" and use TCE as a buffer.

Regulators are not likely to land on a system-wide TCE ratio, such as the 4% cited in the stress tests, but to demand an institution-specific one, Smith says. Similarly, the stress test methodology is a strong indicator that all regulators are moving toward highly customized, portfolio specific analysis resulting in individualized capital requirements that includes analyses of past loan performance, portfolio composition, origination vintage, underwriting standards, borrower characteristics, geographic distribution, international operations and business mix.