Capital Plans Help to Sway Examiners, Calibrate Strategic Planning

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As all banks probably know by now, examiners consider PCA thresholds for capital adequacy as the bare minimum banks can hope to keep and still avoid regulatory censure. Examiners can and usually do push banks to meet higher capital standards. So, the question is: should banks wait until their next exam to find out if examiners will want more capital? Or should they prepare for and present their own magic number to the examiner the next time they swing through. The better strategy by far is the latter, experts say, and it's getting good results in exams. It may make the difference between a cordial, open conversation with examiners about capital needs and a blunt order: raise capital levels by X in 180 days or else.

The regulators want to know that banks are thinking about their risks and about how much capital they'll need to manage those risks. One relatively easy way to show them that you and your bank are doing this is to think through what an appropriate level of capital might be for your bank and to draft a capital plan that explains how you plan to get there (or, alternatively, why you're exactly where you need to be), says Jeff Reynolds, Managing Director for Darling Consulting Group, Newburyport, Mass.

One of the main reasons to consider a proactive capital plan – complete with a capital target – is to show the examiners you care about capital levels and examiner concerns, Reynolds says.

The practice makes the most sense for banks in that grey area between PCA triggers and the capital level most often pushed in consent orders: 8%, Reynolds says. "You have a number of banks in no man's land," he says. "They may be in the low 7% tier one capital. Those banks can probably expect an examiner to come in and say, how do you plan to get to 8%? If you had a document drafted up ahead of time, something that explains where the bank is, where it wants to go and how it plans to get there, something that discusses some scenarios that might impact that plan, it puts your bank in a position of strength. It can buy you so much goodwill with the regulators."

Bankers have been and may be reluctant to commit to a capital plan and a capital policy, but it's in their best interest to do so, Reynolds adds. In some cases bank management might be reluctant to put policies around capital levels but those executives and board members already have some idea what they would plan to do if bank capital levels started to erode – what they'd do if they became really concerned about capital.

"So what's the harm in putting it in print?" he asks. "What the regulators are really looking for is that banks put something down on paper - that there's a policy there. That everyone's on board with it."

Banks that are taking capital plans into exams are seeing favorable results, he adds. It can be especially helpful if the bank suspects that examiners will have reason to push for more capital. It's better to have the conversation sooner and on the bank's terms – rather than the examiners' terms. A capital plan, presented at the start of an exam, can do that.

"You may understand what the examiners are saying about your capital levels. Often times, the reason they want to see [your capital levels] move is because of asset quality. You have, for example, levels of nonaccruals higher than peer average," he says.

If you can get a capital plan together, you can demonstrate that you understand their concerns, that the bank is moving in that direction, and, by the way, is in better shape than the examiners might think, he says.

"What you don't want to risk is coming into an exam and hearing examiners say meet these new capital targets in 180 days."

What should a capital plan look like? For exam purposes, it doesn't need to be involved, Reynolds says. Start with a budget, add some stress testing results/analysis, write a policy around it and be finished, he suggests. That alone can "demonstrate the level of importance your bank places on maintaining appropriate levels of capital relative to your risk profile, which is a hot button issue right now."

Nevertheless, examiners are pushing it as a best practice, which means a bank's window for proactive action (and brownie points) may be small, says Orlando Hanselman, the education programs director for Fiserv Risk & Compliance.

"There has been an increased focus on enhanced capital planning by the regulators," he says. "Field examiners are bringing this issue to the forefront at much smaller banks than what the statutes explicitly require. I've seen banks in the $500 million asset range being asked to have more robust and comprehensive capital plans. [They were also] asked to stress test their capital and use the report to support activities such as dividend payments or new growth strategies."

Whether your bank has been asked for a capital plan or not, however, the benefits for drafting one go well beyond proactive examiner strategy (as beneficial as those may be), Hanselman adds. If banks don't understand if they're holding or targeting an appropriate level of capital, they're likely either taking too much risk with too little capital or holding too much to the shareholders' detriment.

"Any financial institution that has outside shareholders has a fiduciary duty to do capital planning," he says. "Banks owe that to their external shareholders. If a bank does so and finds that it's undercapitalized, it needs to clear a path forward with unambiguous accountability. It needs to set a timeframe to meet minimum capital standards and it needs to decide what actions it needs to take to meet that timeframe. If it's overcapitalized, it owes the shareholders a few answers. It will need to explain how it plans to use the capital in a safe and sound manner."

"I concur that having a capital plan that shows you'll continue to maintain your capital position according to regulatory ratios is really useful," he adds. "But that's the baseline, de minimis requirement. Banks of all sizes should go beyond that and calculate their own economic capital and risk-adjusted return on capital."

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