2013 IBA Mega Conference

Capital Planning Amid Evolving Regulations

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3:15 – 4:15 p.m.

Austin Associates LLC

Presenter

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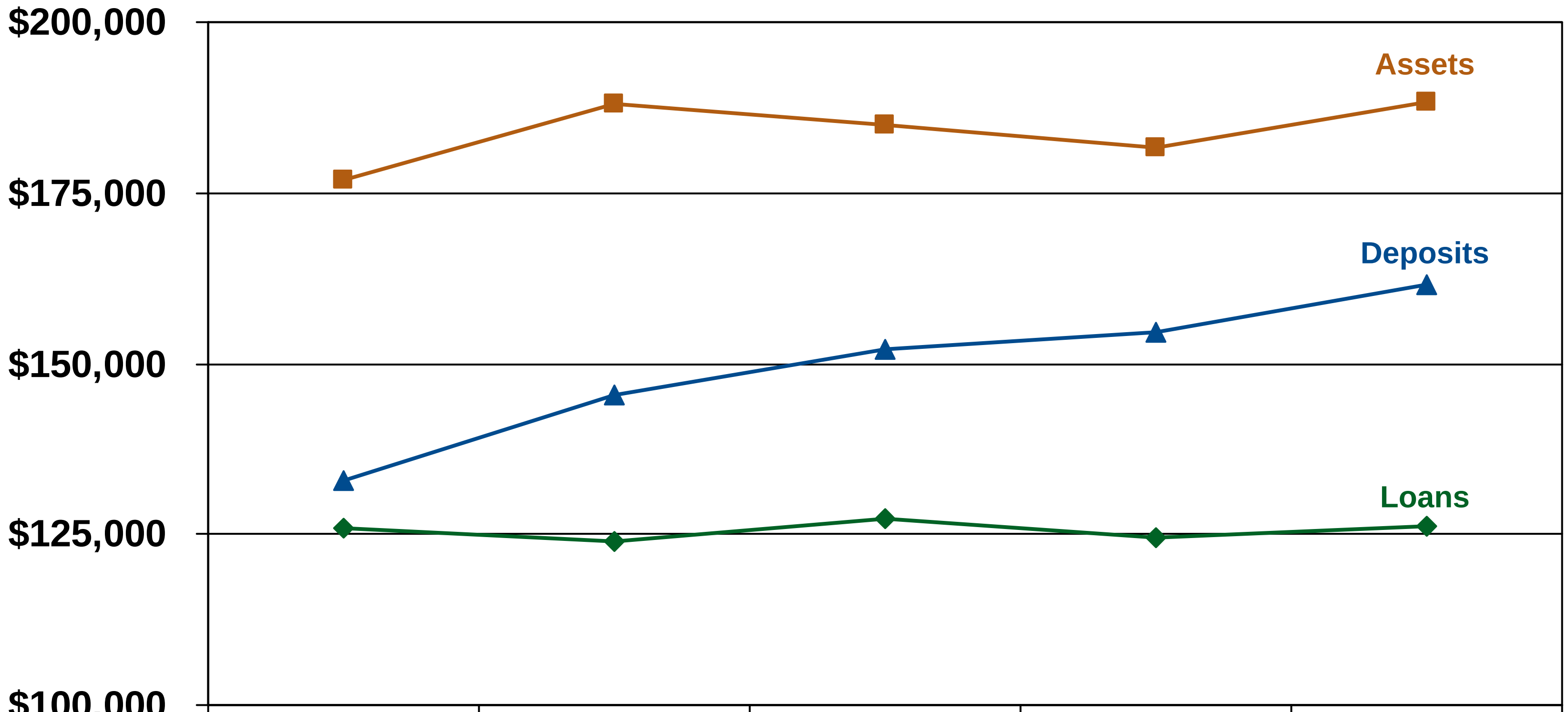
Capital Planning Amid Evolving Regulations

- Industry Update
- Regulatory Guidance
- Basel III
- Case Study
- Developing a Capital Plan
- Stress Testing

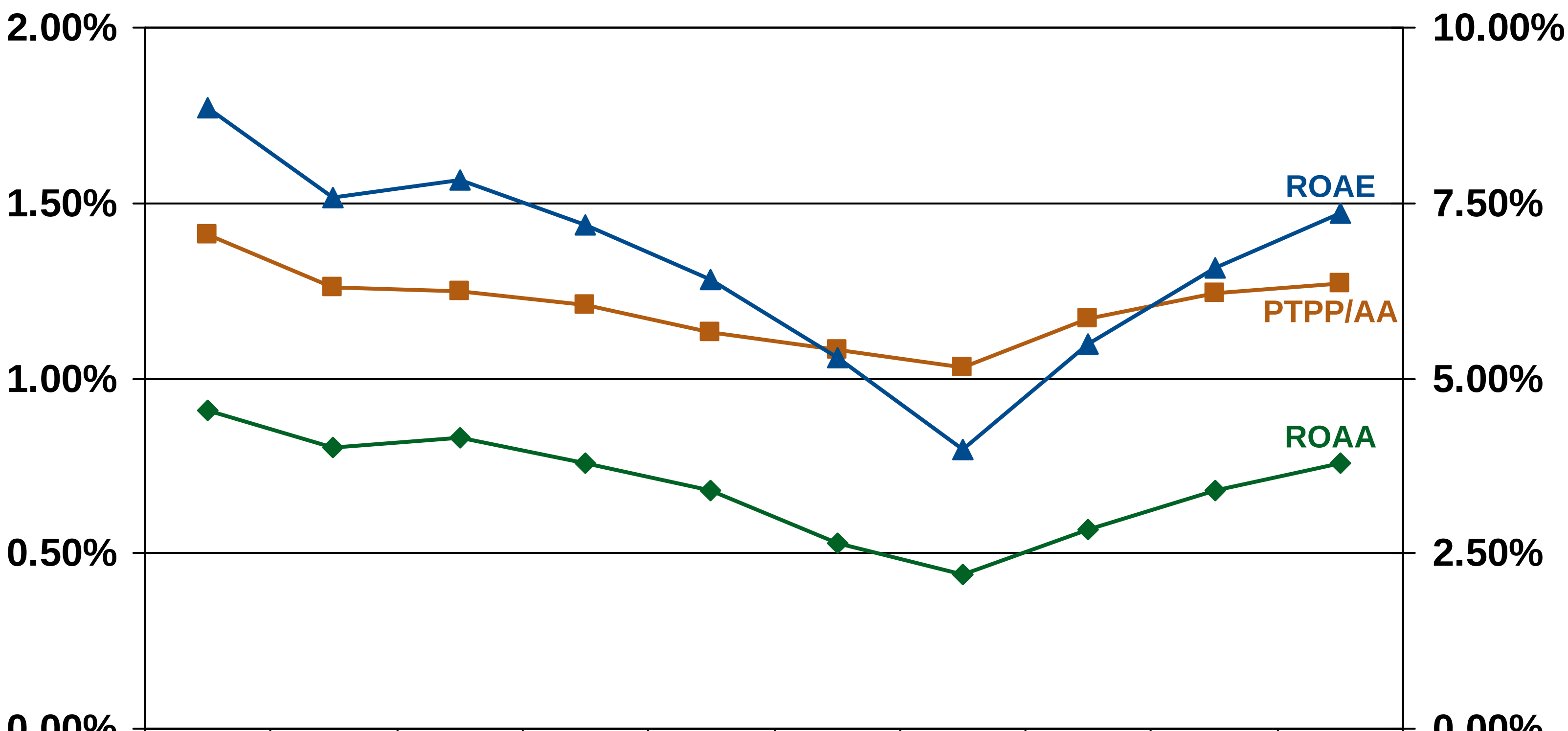
Balance Sheet Growth



	2008Y	2009Y	2010Y	2011Y	2012Y
Assets	$176,882	$188,058	$184,838	$181,609	$188,188
Loans	$125,819	$123,977	$127,166	$124,490	$126,169
Deposits	$132,995	$145,540	$151,952	$154,528	$161,580

Note: Median results of all Indiana-based commercial banks, savings banks, and savings institutions.
Includes acquired/defunct companies.
Source: SNL Financial

Earnings & Profitability



	2003Y	2004Y	2005Y	2006Y	2007Y	2008Y	2009Y	2010Y	2011Y	2012Y
PTPP/AA	1.41%	1.26%	1.25%	1.21%	1.13%	1.08%	1.03%	1.17%	1.24%	1.27%
ROAA	0.91%	0.80%	0.83%	0.76%	0.68%	0.53%	0.44%	0.57%	0.68%	0.76%
ROAE	8.85%	7.57%	7.83%	7.18%	6.41%	5.30%	3.98%	5.48%	6.56%	7.36%

Note: Median results of all Indiana-based commercial banks, savings banks, and savings institutions.
Includes acquired/defunct companies.
PTPP = Net Interest Income + Noninterest Income – Noninterest Expense.
ROAA and ROAE adjusted to C-Corporation status based on tax-exempt income and appropriate marginal tax rates.
Source: SNL Financial

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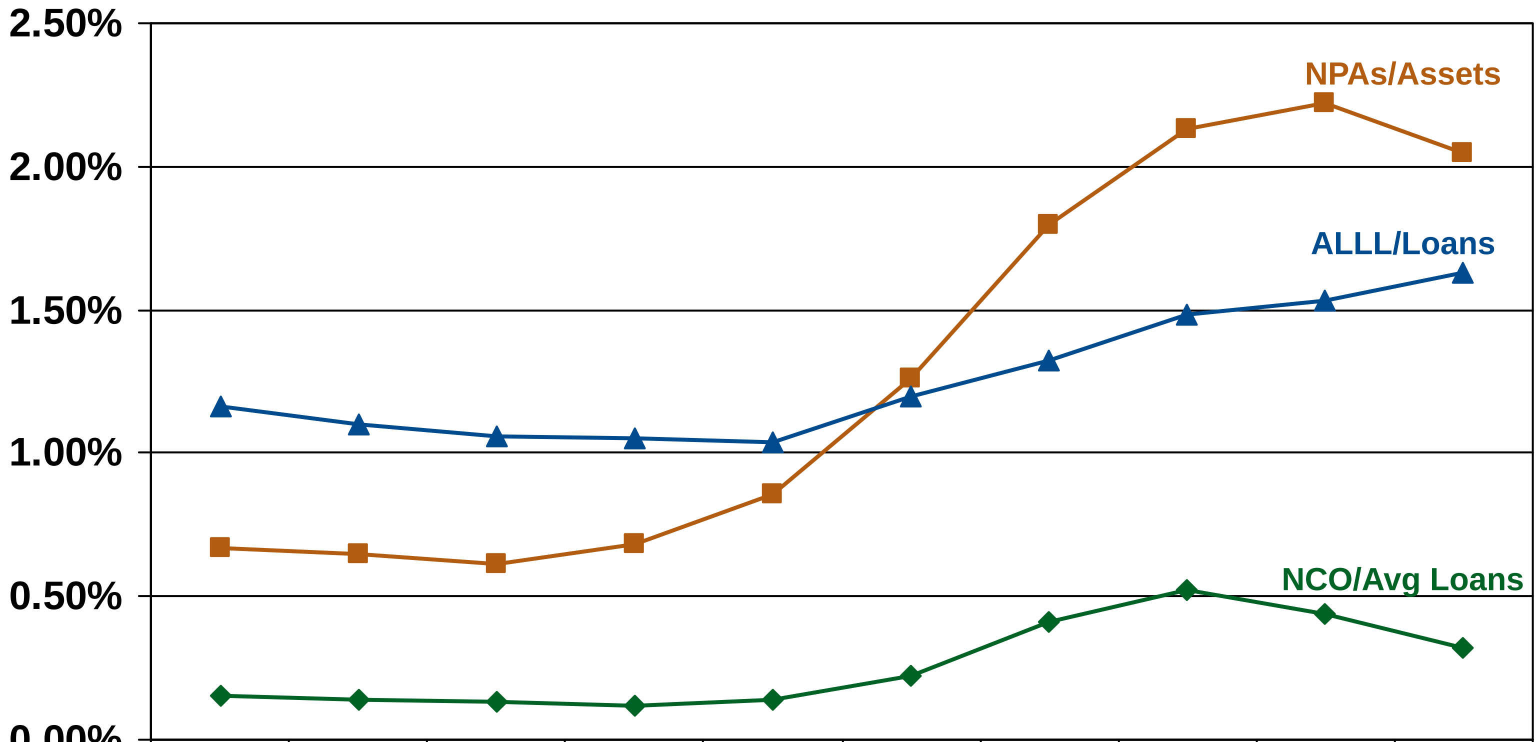
Asset Quality



	2003Y	2004Y	2005Y	2006Y	2007Y	2008Y	2009Y	2010Y	2011Y	2012Y
NPAs/Assets	0.67%	0.65%	0.61%	0.68%	0.86%	1.26%	1.80%	2.13%	2.22%	2.05%
NCO/Avg Loans	0.15%	0.14%	0.13%	0.12%	0.14%	0.22%	0.41%	0.52%	0.44%	0.32%
ALLL/Loans	1.16%	1.10%	1.06%	1.05%	1.04%	1.20%	1.32%	1.48%	1.53%	1.63%

Note: Median results of all Indiana-based commercial banks, savings banks, and savings institutions. Includes acquired/defunct companies. Nonperforming assets ("NPAs") equal to the sum of loans 90+ days past due, nonaccrual loans, other real estate owned (OREO), and debt securities & other assets. NPAs exclude the guaranteed portion of loans covered by the U.S. government and OREO covered by loss-sharing agreements with the FDIC. Performing restructured loans are included.

Source: SNL Financial

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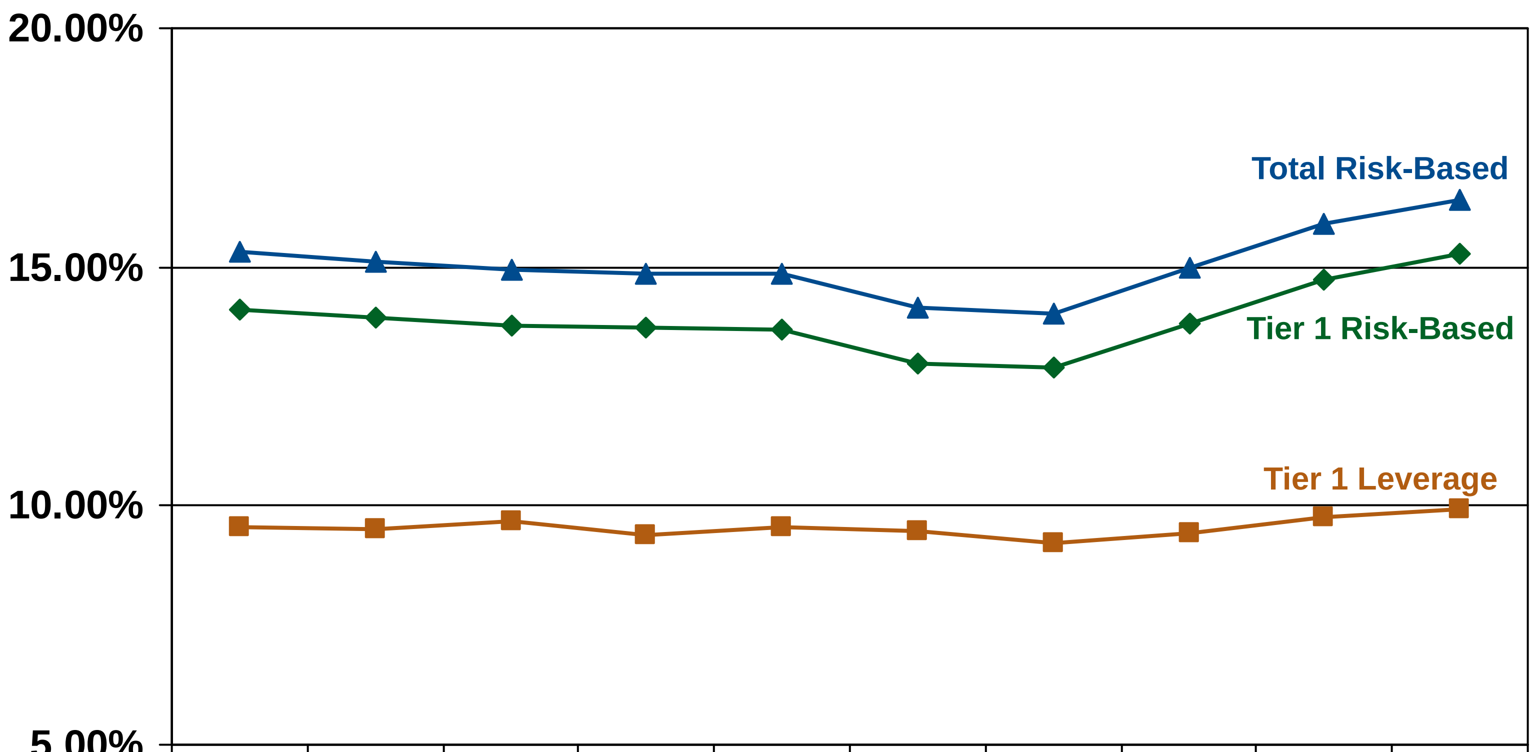
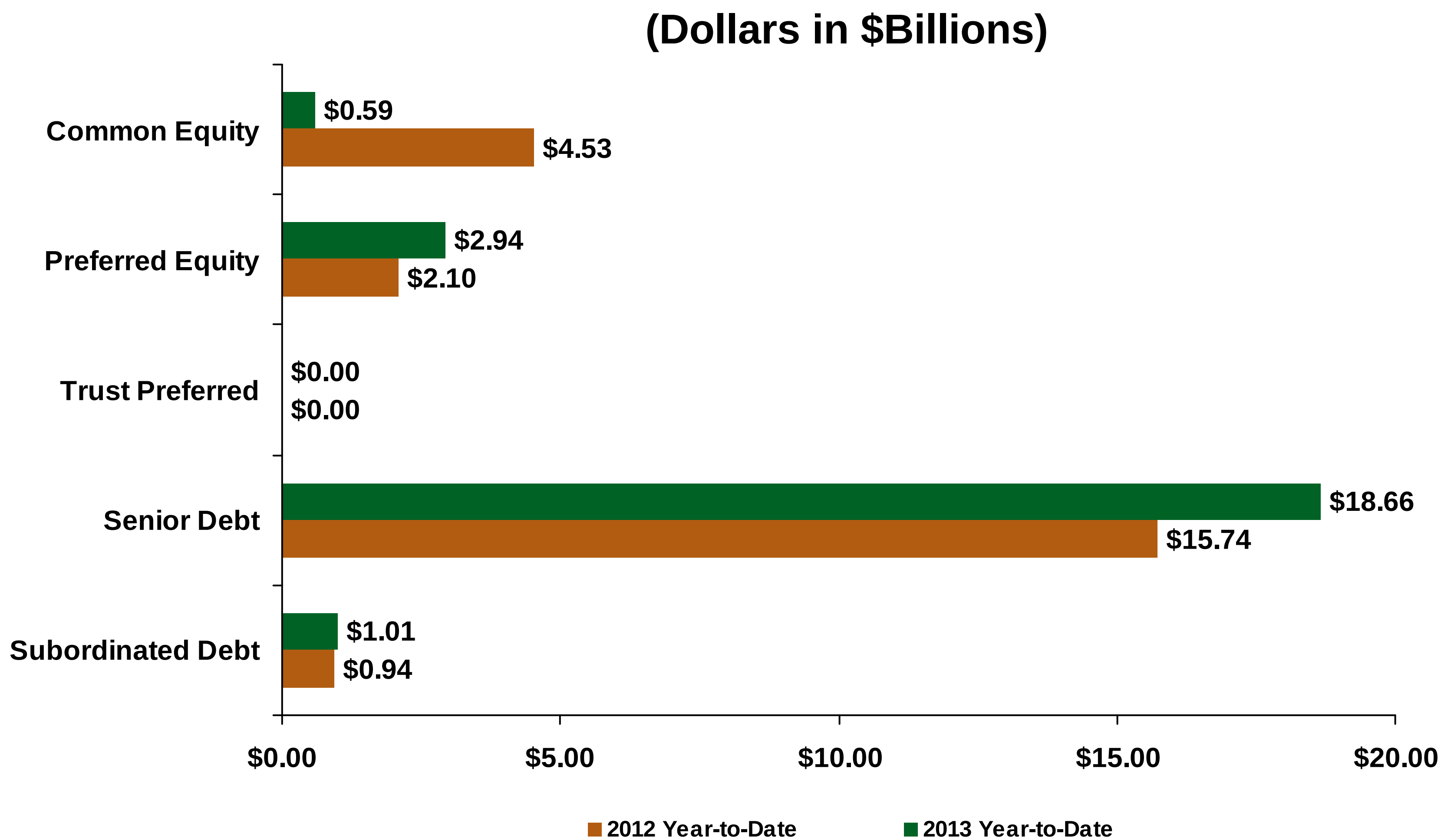
Capital Ratios



	2003Y	2004Y	2005Y	2006Y	2007Y	2008Y	2009Y	2010Y	2011Y	2012Y
Tier 1 Leverage	9.57%	9.51%	9.70%	9.39%	9.54%	9.45%	9.22%	9.41%	9.75%	9.95%
Tier 1 Risk-Based	14.11%	13.93%	13.79%	13.75%	13.69%	12.98%	12.89%	13.82%	14.72%	15.29%
Total Risk-Based	15.31%	15.12%	14.94%	14.88%	14.87%	14.14%	14.03%	14.98%	15.92%	16.41%

Note: Median results of all Indiana-based commercial banks, savings banks, and savings institutions.
Includes acquired/defunct companies.
Source: SNL Financial

Capital Raises



Source: SNL Financial

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Industry Update

- Uncertainty of Basel III
- Margin Compression
- Mixed Signals on Loan Demand
- “Irrational” pricing
- Improving asset quality
- Low or negative provisions
- Bank equity markets stabilizing
- M&A activity picking up

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Industry Update

- Dodd-Frank signed into law 7/21/10
- Implementation 2011
- Increased capital requirements and creation of CFPB, among extensive provisions
- “Tougher” regulatory exams
- Enhanced enterprise risk management (“ERM”)
- Increased compliance costs

Regulatory Guidance: Capital Planning

- **OCC 2012-16**: Guidance for Evaluating Capital Planning and Adequacy (July 2012)
  - Every bank must have effective process to: (i) assess capital adequacy in relation to overall risks; and (ii) plan for maintaining appropriate capital levels
- **OCC 2012-33**: Community Bank Stress Testing
  - To identify and quantify risk in the loan portfolio and help establish effective strategic and capital planning process

OCC 2012-16 - Elements

1. Identifying and Evaluating All Material Risks
2. Setting and Assessing Capital Adequacy Goals that Relate to Risk
3. Maintaining a Strategy to Ensure Capital Adequacy and Contingency Planning
4. Ensuring Integrity in the Internal Capital Planning Process and Capital Adequacy Assessments

Supervisory Review – included in assessment of ***C***apital and ***M***anagement component ratings

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OCC 2012-16 – Element #1

Identify and Evaluate All Material Risks

Risk Factor	Inherent Risk	Risk Management	Composite Risk Level	Trend
Credit				
Operational				
Liquidity				
Market				
Reputational				
Strategic				
Legal				

- Start with regulatory risk assessment
- Customize based on bank-specific issues

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OCC 2012-16 – Element #2

Set and Assess Capital Adequacy Goals that Relate to Risk

- Determine capital needs in relations to risks and strategic direction
- Short-term and long-term
- Higher risk + Growth plans + Acquisitions = Higher Capital Goals
- Concentration levels and limits
- Quality of risk management, internal controls and audit processes
- Quality, sustainability and level of earnings
- Pro forma modeling (at least 2 years)

OCC 2012-16 – Element #3

Determine a Strategy to Ensure Capital Adequacy and Contingency Planning

- Internal and external sources of capital
  - - Earnings
  - - Infusion of capital
- Contingency Planning
  - - Deleverage
  - - Asset Mix change
  - - Asset Sale
  - - Raise Capital
  - - Sell

OCC 2012-16 – Element #4

Ensure Integrity in the Internal Capital Planning Process and Capital Adequacy Assessments

- Capital planning must be documented
- Roles/Responsibilities of Board, Management and Audit
- Process for monitoring risk tolerance levels, capital adequacy, including board reporting and contingency plans
- Key planning assumptions and methods must be documented
- Risk exposures and concentrations
- Measures to take in response to changes in conditions
- Stress testing

OCC 2012-33: Stress Testing

- **Use OCC 2012-33 in conjunction with**:
  - (i) "Concentrations of Credit" booklet in the OCC's Comptroller's Handbook Series;
  - (ii) OCC Bulletin 2012-16; and
  - (iii) Interagency Final Guidance on "Concentrations in CRE Lending, Sound Risk Management Practices"

- Dodd-Frank requires annual stress testing for Banks > $10 Billion
  - (i) Community Banks not required to use same testing, but
  - (ii) Some form of annual stress testing is a key part of sound risk management for community banks

Stress Test Methodology

- No specific method is mandated; wide range of possible acceptable methods
- For most community banks, a "simple, stressed loss-rate analysis based on call report categories may provide an acceptable foundation"
  - \- historical loss experience during previous stressful periods
  - \- historical market experience
- Calculate impact to earnings, ALLL and Capital ratios
- Mitigation Strategies: modify loan growth, revise risk tolerances, adjust loan mix, strengthen underwriting criteria

Basel III

- June 2012, FRB, OCC, FDIC proposed rules to conform U.S. capital rules to international capital rules agreed to by Basel Committee (Basel III)
- Narrower definition of capital (lower numerator)
- Increased risk-weighting of certain assets (higher denominator)
- New capital ratio – Common Equity Tier 1 Capital
- Higher capital ratio requirements
- Capital buffer requirement/Operating restrictions if not met (dividends, repurchases, executive bonuses)
- Applies to all Banks, S&Ls, SLHCs and BHCs>$500 million in assets

Basel III

Capital Ratio	Fully-Phased in Minimum	Comments
Tier 1 Leverage	5.0%	Tier 1 excludes TruPS
Tier 1 Risk-Based	6.0% + 2.5% = 8.5%	Tier 1 includes NCPPS
Total Risk-Based	8.0% + 2.5% = 10.5%	TruPS are included in Tier 2
Common Equity Tier 1 Capital (Risk-Based)	4.5% + 2.5% = 7.0	Common equity only, and includes AOCI adjustment

- Full implementation phase-in by 2019
- Extremely complex – risk weightings and exclusions
- Strong opposition from community bankers
- Final implementation remains on HOLD

Case Study

- Midwestern-based Bank
- $700 million in assets
- Written Agreement with OCC
  - Credit risk management focus
  - No explicit “Capital Plan” requirement
  - IMCR of 8% Tier 1 Leverage/12% TRBC
- Bank presently exceeds IMCR requirements
- Board determined to develop a formal, written Capital Plan

Case Study: Capital Plan

Table of Contents

Case Study: Capital Plan

Executive Summary

- Manage capital consistent with regulatory guidance
- Summarized Formal Agreement
- Referenced IMCRs and current capital ratios
- Listed core strategic objectives
- Summarized oversight responsibilities and process

Case Study: Capital Plan

Financial Performance Review

- Historical and current performance and condition
- Core earnings analysis – the resource to absorb credit losses (pre-tax pre-provision earnings/PTPP)
- Asset quality metrics and trends
- Capital position
- Demonstrate objective, quantitative understanding of the bank's current position
- ***"Peer Group Analysis"*** augments this analysis

Case Study: Capital Plan

Key Risk Assessment

- Used Regulatory Exam Risk Matrix as starting point
- No formal ERM process; Risk assessments prepared by managers; reviewed by Internal Audit or Compliance
- Credit Risk (classified asset totals, NCO's, specific exam criticisms related to credit risk management)
- Interest Rate Risk (increasing rates = NIM pressure)
- Liquidity Risk (high NPAs, erratic earnings)
- Price Risk (high % of capital in TruPS, non-agency CMOs, CMBS and high REO level)
- Strategic Risk and Reputation Risk also cited due to problems
- "Mitigating Factors" discussion followed each key risk assessment

Case Study: Capital Plan

Core Strategic Objectives

- Internally-focused operating strategy
- Compliance with Written Agreement
- NPA reduction, including specific remediation efforts
- Capital management
- Revenue enhancement initiatives
- Cost reduction initiatives
- Focus on C&I and CRE-owner occupied loans, and de-emphasize commercial participations, construction and development lending
- Focus on Business Relationships
- High performance, “Best Practices” culture

Case Study: Capital Plan

Quarterly Financial Projections

- Baseline forecast for 2013-2014, quarterly and annual
- Description of all key assumptions
- Narrative summary of results
- Key Drivers: Growth; NCOs, PTPP earnings
- Projected capital ratios

Capital Stress Test

- Impact of potential future NCOs to “stress test” regulatory capital ratios
- Actual NCO history by Call Report category (2008-12)
- Local market NCO history (2008-12) for reference purposes
- Applied actual loss rates during highest 2-year NCO period against current portfolio balances to establish “More Adverse” scenario (or worst case scenario)
- Established “Base Case” scenario on management’s 2013 budget forecast; “Moderate Case” based on 2011-12 average loss rates.
- Justified lower “Base Case” NCO assumption on actions taken to mitigate credit risk

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Capital Stress Test

	Description
Start with:	2013-14 PTPP Earnings Projection
Plus	Actual ALLL at 12/31/12
Less	Required ALLL at 12/31/14
Equals	Total Resources to Absorb Credit Losses
Less	“Base Case” NCO assumption 2013-14
Equals	Pre-tax Resources after assumed credit losses
	Calculate net after-tax Resources
	Adjust for Capital Transactions (Dividends, etc.)
Add to:	Tangible Equity

- Calculate pro forma tangible equity and capital ratios
- Consider effect of any forecasted growth or decline in assets

Case Study: Capital Plan

Contingency Plan

- Parent holding company cash balances
- Deleverage (shrink) balance sheet by reducing rates paid on deposits
- Sell assets to generate gains
- Reduce volume of new loans originated
- Replace investments with lower risk-weighted investments
- Replace loans with lower risk-weighted loans
- Close or sell branch offices
- After exhausting balance sheet management strategies, consider sale of capital instruments (common stock, preferred stock, debt, etc.)
- Did not include sale of bank as an alternative (at this time)

Case Study: Capital Plan

Regulatory Comments on Draft Capital Plan

- Vary factors other than NCOs, including appropriate ending ALLL
- Validate PTPP assumptions; 5% reduction in “Moderate” and 10% reduction in “More Adverse” scenarios need to be supported – use IRR and Liquidity stress tests to estimate potential decline in revenue
- Capital Triggers – “The Board should set capital triggers above the 8% and 12% minimums to prompt Board and management action before capital deteriorates below the minimum levels
- Management should establish a Capital Policy in addition to the Capital Plan. The Policy should document the:
    - Capital planning process and the Board’s expectations and goals
    - Type and frequency of reporting to monitor the capital plan
    - Roles and responsibilities of key parties to the process
    - Key planning assumptions, methodologies and limitations

Q & A

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