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BUSINESS VALUATION &
FINANCIAL ADVISORY SERVICES

Bank Watch

March 2017

New Book for Community Bankers
Coming Spring 2017

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Strategic Benefits of Stress Testing

"Every decade or so, dark clouds will fill the economic skies, and they will briefly rain gold. When downpours of that sort occur, it's imperative that we rush outdoors carrying washtubs, not teaspoons. And that we will do."

– Warren Buffett, **Berkshire 2017 Annual Shareholder Letter**

While the potential regulatory benefits are notable, stress testing should be viewed as more than just a regulatory check-the-box exercise. The process of stress testing can help bankers find silver (or gold in Warren's case) linings during the next downturn.

What Stress Testing Can Do For Your Bank

As we have noted before, a bank stress test can be seen as analogous to stress tests performed by cardiologists to determine the health of a patient's heart. Bank stress tests provide a variety of benefits that could serve to ultimately improve the health of the bank and avoid fatal consequences. Strategic benefits of a robust stress test are not confined merely to the results and structure of the test. A robust stress test can help bank management make better decisions in order to enhance performance during downturns. A bank that has a sound understanding of its potential risks in different market environments can improve its decision making, manage risk appropriately, and have a plan of action ready for when economic winds shift from tailwinds to headwinds.

By improving risk management and capital planning through more robust stress testing, management can enhance performance of the bank, improve valuation, and provide better returns to shareholders. For example, a stronger bank may determine that it has sufficient capital to withstand extremely stressed scenarios and thus can have a game plan for taking market share and pursuing acquisitions or buybacks during dips in the economic, valuation, and credit cycle. Alternatively, a weaker bank may determine that considering a sale or capital raise during a peak in the cycle is the optimal path forward. If the weaker bank elects to raise capital, a stress test will help to assess how much capital may be needed to survive and thrive during a severe economic environment. Beyond the strategic benefits, estimating loan losses embedded within a sound stress test can also provide a bank with a head start on the pending shift in loan loss reserve accounting from the current "incurred loss" model to the more forward-looking approach proposed in FASB's CECL (Current Expected Credit Loss) model.

Top Down Stress Testing

In order to have a better understanding of the stress testing process, consider a hypothetical "top-down" portfolio-level stress test. While not prescriptive in regards to the particular stress testing methods, **OCC Supervisory Guidance** noted, "For most community banks, a simple, stressed loss-rate analysis based on call report categories may provide an acceptable foundation to determine if additional analysis is necessary." The basic steps of a top-down stress test include determining the appropriate economic scenarios, segmenting the loan portfolio and estimating losses, estimating the impact of stress on earnings, and estimating the stress on capital.

While the first step of determining a stressed scenario to consider varies depending upon a variety of factors, one way to determine your bank's stressed economic scenario could be to consider the **supervisory scenarios announced by the Federal Reserve** in February 2017. While the more global economic conditions detailed in the supervisory scenarios may not be applicable to community banks, certain detail related to domestic variables within the scenarios could be useful when determining the economic scenarios to model at your bank. The domestic variables include six measures of real economic activity and inflation, six measures of interest rates, and four measures of asset prices.

The 2017 severely adverse scenario includes a severe global recession, accompanied by heightened corporate financial stress (real GDP contraction, rising unemployment, and declining asset values). Some have characterized the 2017 "severe" scenario as less severe than the 2016 scenario (given a relatively higher disposable income growth forecast and a lack of negative short-term yields, which were included in the 2016 economic scenarios). However, CRE prices were forecast to decline more in the 2017 scenario, and those banks more focused on CRE or corporate lending may find the 2017 scenarios more negatively impact their capital and earnings forecasts.

For community banks facing more unique risks that are under greater regulatory scrutiny, such as those with significant concentrations in commercial real estate lending or a business model concentrated in particular niche segments, a top-down stress test can serve as a starting point to build their stress testing process. The current environment may be an opportune time for these banks to plan ahead.

While credit concerns in recent quarters have been minimal and provisions and non-performing asset levels have trended lower for the banking sector as a whole, certain loan segments have shown some signs that the credit pendulum may have reached its apex and reversed course by swinging back in the other direction. REITs were net sellers of property in 2016 for the first time since 2009, and a rising rate environment could pressure capitalization rates higher and underlying commercial real estate asset values lower. Furthermore, banks with longer duration fixed rate loans could face a combination of margin pressure and credit quality concerns as rates rise.

Conclusion

Regulatory guidance suggests a wide range of effective stress testing methods depending on the bank's complexity and portfolio risk–ranging from "top-down" to "bottom-up" stress testing. The guidance also notes that stress testing can be applied at various levels of the organization including transactional level stress testing, portfolio level stress testing, enterprise-wide level stress testing, and reverse stress testing.

We acknowledge that community bank stress testing can be a complex exercise as it requires the bank to essentially perform the role of both doctor and patient. For example, the bank must administer the test, determine and analyze the outputs of its performance, and provide support for key assumptions/results. There is also a variety of potential stress testing methods and economic scenarios for a bank to consider when setting up their test. In addition, the qualitative, written support for the test and its results is often as important as the results themselves. For all of these reasons, it is important that bank management begin building their stress testing expertise sooner rather than later.

In order to assist community bankers with this complex and often time-consuming exercise, we offer several solutions, including preparing custom stress tests or reviewing ones prepared by banks internally, to make the process as efficient and valuable for the bank as possible.

To discuss your stress testing needs in confidence, please do not hesitate to contact us. For more information about stress testing, **visit our website**.

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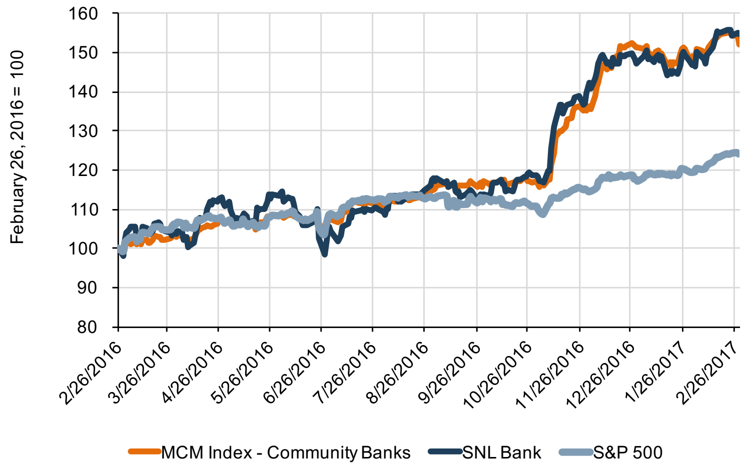
What We're Reading

Silicon Valley Tried to Upend Banks. Now It Works With Them.
NY Times | Nathaniel Popper

Safeguarding Top Talent Is Key for Making Mergers Succeed
Bank Director | Mark Walztoni

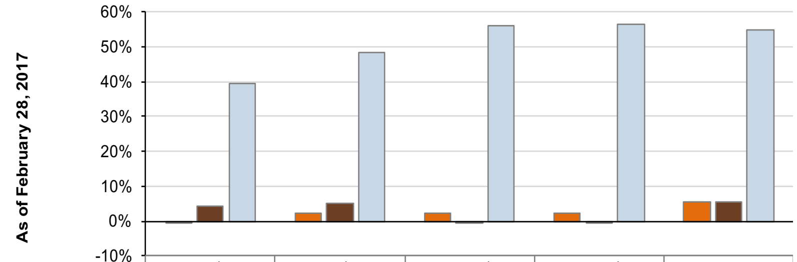
Reading the Tea Leaves at Ruth's Chris Steak House in Lafayette
Mercer Capital | Jeff Davis

Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



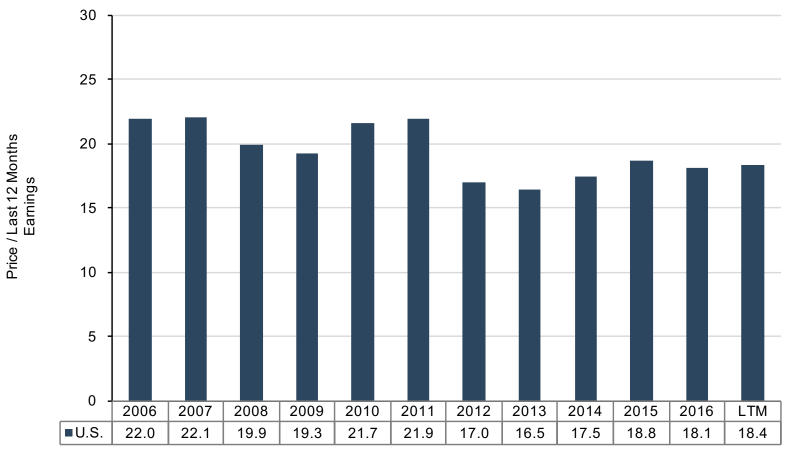
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	-0.53%	2.23%	2.05%	2.35%	5.62%
Quarter-to-Date	4.26%	5.09%	-0.76%	-0.76%	5.39%
Last 12 Months	39.48%	48.41%	55.84%	56.54%	54.61%

Median Valuation Multiples

	Median Total Return as of February 28, 2017			Median Valuation Multiples as of February 28, 2017					
Indices	Month-to-Date	Quarter-to-Date	Last 12 Months	Price/ LTM EPS	Price / 17(E) EPS	Price / 18(E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	2.26%	3.51%	52.15%	20.3x	18.0x	15.4x	143%	154%	1.6%
Midwest Index	2.15%	-1.17%	53.86%	18.2x	16.9x	15.1x	149%	171%	1.9%
Northeast Index	2.75%	-2.17%	49.43%	17.3x	17.3x	14.6x	153%	174%	2.1%
Southeast Index	0.62%	-0.86%	47.65%	18.4x	18.4x	15.4x	148%	152%	1.2%
West Index	2.32%	4.75%	56.66%	17.2x	19.3x	16.8x	152%	161%	1.6%
Community Bank Index	2.00%	0.32%	51.91%	18.5x	17.7x	15.3x	148%	162%	1.7%
SNL Bank Index	**5.34%**	**4.90%**	**54.73%**						

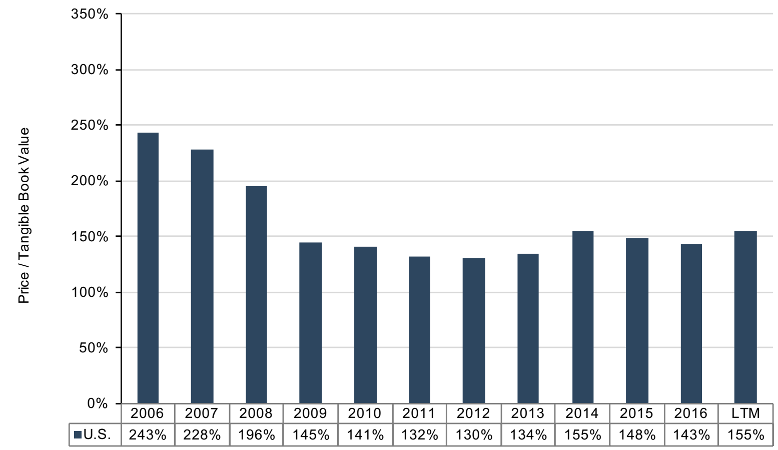
Median Price/Earnings Multiples

Target Banks' Assets <$5B and LTM ROE >5%



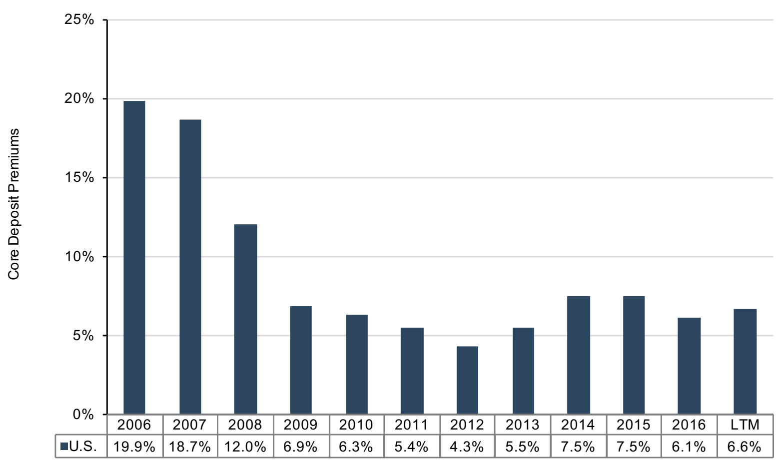
Median Price/Tangible Book Value Multiples

Target Banks' Assets <$5B and LTM ROE >5%



Median Core Deposit Multiples

Target Banks' Assets <$5B and LTM ROE >5%



Median Valuation Multiples for M&A Deals

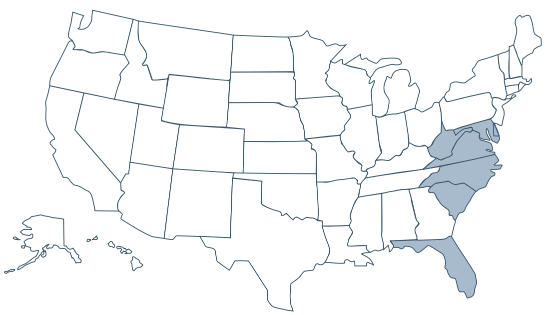
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended February 2017

Regions	Price / LTM Earnings	Price/ Tang. BV	Price / Core Dep Premium	No. of Deals	Median Deal Value	Target's Median Assets	Target's Median LTM ROAE
Atlantic Coast	20.5x	155%	6.6%	19	41.58	380,829	7.28%
Midwest	17.3x	142%	6.3%	67	33.29	128,102	8.23%
Northeast	21.0x	196%	11.5%	5	127.67	811,368	9.50%
Southeast	18.1x	139%	5.7%	27	36.13	184,113	7.92%
West	18.5x	159%	7.9%	16	56.91	242,827	9.79%
National Community Banks	**18.4x**	**155%**	**6.6%**	**134**	**41.74**	**192,885**	**8.22%**

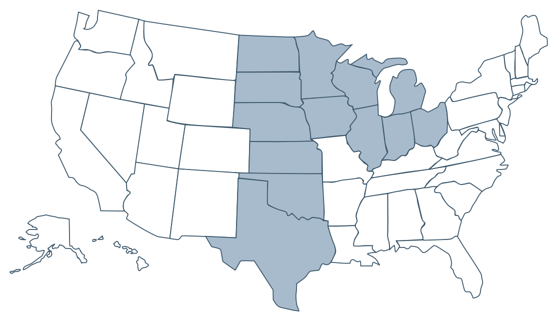
Source: S&P Global Market Intelligence

Mercer Capital's Regional Public Bank Peer Reports

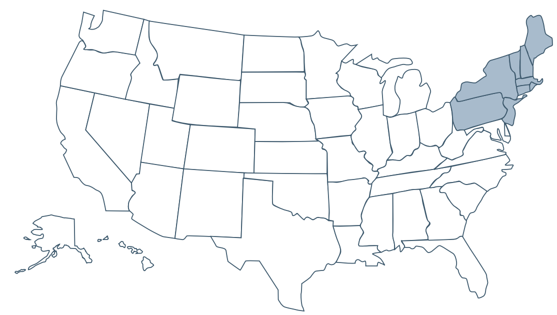
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



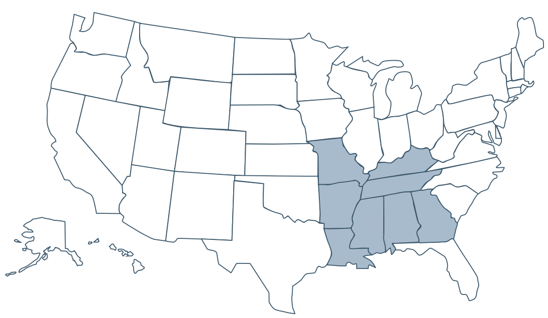
Atlantic Coast



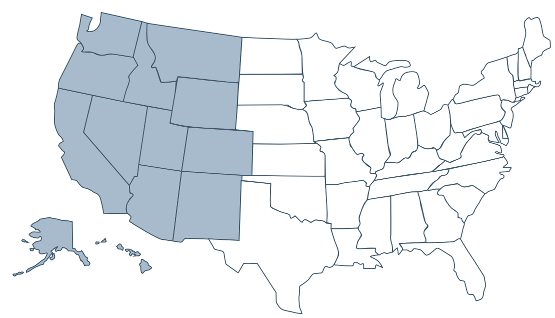
Midwest



Northeast



Southeast



West

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- Financial reporting for banks
- Goodwill impairment
- Litigation support
- Stress Testing
- Loan portfolio valuation
- Tax compliance
- Transaction advisory
- Strategic planning

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For more information about Mercer Capital, visit **www.mercercapital.com**.

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