Consider Adding Stress Testing to Your Community Bank’s New Year’s Resolution

As we all prepare to turn the page from 2015 and set resolutions and goals for 2016, consider adding stress testing to your community bank’s New Year’s Resolutions.

Regulatory Commentary

While there is no legal requirement for community banks to perform stress tests, recent regulatory commentary suggests that community banks should be developing and implementing some form of stress testing on at least an annual basis.

For additional perspective, consider the following excerpts:

» A 2015 Sageworks Exam Survey found that over 75% of bank and credit union respondents (99% of which were below $10 billion in assets) are either already implementing stress tests, have been asked to expand their stress testing, or have been asked to start stress testing by examiners. ¹

» FDIC Governor Daniel K. Tarullo stated the following in June 2014: “Supervisory stress testing has fundamentally changed the way we think about capital adequacy. The need to specify scenarios, loss estimates, and revenue assumptions—and to apply these specifications on a dynamic basis—has immeasurably advanced the regulation of capital adequacy and, thus, the safety and soundness of our financial system. The opportunities it provides to incorporate macroprudential elements make it, in my judgment, the single most important advance in prudential regulation since the crisis.” ²

The OCC noted in October of 2012 that “some form of stress testing or sensitivity analysis of loan portfolios on at least an annual basis to be a key part of sound risk management for community banks.”

Benefits of Stress Testing

While the potential regulatory benefits are notable, stress testing should be viewed as more than just a regulatory check-the-box exercise. Similar to stress tests performed by cardiologists to determine the health of a patient’s heart, bank stress tests can provide a variety of benefits that could serve to ultimately improve the health of the bank. Stress testing benefits include:

- Enhancing strategic decisions.
- Improving risk management and capital planning.
- Enhancing the value of the bank.

For example, a stronger bank may determine that it has sufficient capital to withstand extremely stressed scenarios and thus can consider acquisitions, special dividends, or buybacks. Alternatively, a weaker bank may determine that considering a sale or capital raise is the optimal path forward. Additionally, estimating loan losses embedded within a sound stress test can provide the 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.

Stress Testing Resources

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 are also a variety of potential stress testing methods and economic scenarios for the 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 banks begin building their stress testing expertise sooner rather than later.

**2016 Stress Testing Timeline**

1Q16
- Discuss internally who at the bank should be on your stress testing team
- Identify what (if any) external support/service providers should be part of the team and begin discussions with them as appropriate

2Q16
- Attend Mercer Capital’s webinar on stress testing in February 2016
  - This webinar will cover the basics of community bank stress testing in greater detail, review the economic scenarios published by the Federal Reserve, provide greater detail on the key steps to developing a sound community bank stress test, and discuss how to analyze and act upon the outputs of your stress tests.
  - Watch for more information in the January issue of Bank Watch.
- Implement/design the stress testing framework/process at your institution
- Perform the stress test and provide quantitative and qualitative support for the results

3Q16
- Complete the stress testing process and share the results with your Board/senior management
- Determine additional areas/tests for consideration in future stress tests

4Q16
- Prepare for 2017 Stress Testing Process – What worked? What didn’t? What can be improved?
- Compare results of 2016 Stress Test projected performance versus actual
- Identify ways to further implement stress testing into your strategic planning/value creation process
In order to assist community bankers with this complex and often time-consuming exercise, we developed three potential solutions to make the process as efficient and valuable as possible.

- Provide your bank with the appropriate tools and analytical/modeling support such that you can prepare your own stress test as quickly and efficiently as possible.
- Evaluate your bank’s existing stress test process/model/outputs to either validate or enhance your stress test.
- Design and prepare your bank’s stress test entirely should you desire to outsource more of the process and perform a test more quickly.

If you do elect to focus on stress testing in 2016, we know that New Year’s resolutions are often broken and particularly tough to keep. Studies have shown that setting specific goals with deadlines is more effective than vague vows and good intentions.

**Conclusion**

We developed a timeline that can help your bank stick to your New Year’s Resolutions and develop a stress testing process and framework appropriate for the size and complexity of your institution (see page 2).

For more information about stress testing or to discuss your bank’s specific situation and stress testing goals in greater detail, do not hesitate to contact us.

Jay D. Wilson, Jr. CFA, ASA, CBA
wilsonj@mercercapital.com
901.685.2120
There is no shortage of commentary about KeyCorp’s $4.1 billion agreement to acquire First Niagara Financial Group Inc. and New York Community Bancorp Inc.’s $2.0 billion agreement to acquire Astoria Financial Corp. I am adding my two cents, though maybe with a somewhat different perspective from what I have read so far.

Bank M&A is almost always about creating operating leverage from expense savings and secondarily expansion into better growing markets. Occasionally transactions are transformative like Mellon Bank Corp.’s 1994 acquisition of Dreyfus Corp. The deals for First Niagara and Astoria are expense stories. As such, I think the deals make sense strategically.

Astoria is an in-market deal for New York Community. Management is targeting 50% expense savings. First Niagara represents a combination of an in-market deal and expansion into Pennsylvania, Massachusetts and Connecticut. KeyCorp is publicly targeting 40% expense savings. I suspect both management teams hope to do better. After all, much of the cost base is in the branch network, and branch banking is going to be radically scaled back in the coming years given the digitization of money and migration of transactions to the Internet. ZIRP only increases the urgency to do so because it devalues core deposits and the expensive branch networks that were necessary in the 20th century to gather the deposits.

There are a few other benefits too. Both companies will benefit from diversification of their loan portfolios. Core deposit funding will increase. Revenue synergies are always questionable. In the case of KeyCorp, there is the potential to overlay what I believe has been a decadelong successful corporate-investment banking effort. Will that be enough to offset the loss of top-notch lenders who will be bid away by competitors with a checkbook? I don’t know.

And neither transaction will be dilutive to growth because none of the buyers and sellers has exhibited much growth. KeyCorp’s pre-tax, pre-provision net revenues were $1.36 billion for the LTM period ended Sept. 30, compared to $1.22 billion in 2011, according to SNL Financial data. New York Community’s LTM metric was $749.3 million compared to $806.7 million in 2011. The targets’ trends are worse, but they are selling for a reason. First Niagara saw a reduction in its pre-tax LTM PPNR to $418.9 million from $451.9 million in 2011, while Astoria’s pre-tax PPNR fell to $109.3 million from $143.2 million.

Perhaps the PPNR histories point to why there is some skepticism that I have heard among investors about 2017 EPS accretion. In fairness to the companies, pro forma EPS after expense savings is based upon the analysts’ consensus forecasts for buyer and seller. I think all of the management teams could be modeling lower stand-alone earnings than the analysts for 2017.

If I am right that the deals make strategic sense, the market’s bloodless verdict was not so optimistic. KeyCorp’s shares fell more than 7% on the day of the announcement to close at $12.42 per share. The drop was even sharper if the decline is measured from the close on Oct. 28 because media reports on the 29th indicated KeyCorp would be the suitor. New York Community

What We’re Reading

Emily McCormick of BankDirector has some interesting survey data from bank executives and directors regarding their views on fintech in a piece entitled “Finding Opportunities in the Fintech Boom.”
http://mer.cr/1lPKcPi

Ken McCarthy and Razi Haider of SNL Financial take a look at community bank loan growth trends in the article “Loan Growth Remains a Challenge for Nation’s Community Banks.”
http://mer.cr/1SOHTXL

Andrew Strimaitis and Donald Norman of Barack Ferrazzano have an interesting piece on Section 280G compliance in M&A deals (a topic that we have also written on recently) entitled “Avoiding the Excess Parachute Payments Trap in M&A Deals.”
http://mer.cr/1YZsOpP
Mercer Capital's Bank Watch

December 2015

fell 12% on the announcement. The one deal that comes to mind that was comparable was Comerica Inc.'s Jan. 18, 2011, announcement that it would acquire Houston-based Sterling Bancshares Inc. Comerica was pushed in the bidding process; its shares fell more than 8% on the day of the announcement. These deals are atypical. Post-crisis, the propensity of many buyers' shares has been to rise (or not fall) on announcement.

The market was clear: both companies overpaid. I think the better technical description would be to say the exchange ratios for both First Niagara (0.68 of a KeyCorp share plus $2.30 of cash per share) and Astoria (1 NYCB share, plus 50 cents cash per share) were too generous.

This was particularly true with KeyCorp, which at the time of the announcement was trading for about 13x LTM EPS compared to an announced deal value that equated to about 19x earnings for First Niagara and included 12% dilution to tangible book value per share. The effective multiple to KeyCorp shareholders is lower including the 40% expense savings, but the question is, who is being paid vs. who is taking the execution risk? KeyCorp's slide deck included an NPV calculation for net expense synergies, which at about $3.1 billion equated to 67% of the transaction value.

In the case of Astoria, the math was not as daunting. New York Community was trading around 17x LTM EPS immediately prior to the announcement. The announced deal value equated to about 23x LTM earnings for Astoria. The effective multiple is much lower with the 50% targeted expense savings, plus TBVPS accretion of 6% is expected.

What was unexpected was a $650 million common raise to offset a $614 million after-tax charge to restructure fixed-rate borrowings. A 32% cut in the quarterly dividend to 17 cents per share had a pile-on effect, although investors should not have been surprised by the cut. The company raised the quarterly dividend to 25 cents per share in 2004, failed to earn it on an annualized basis from 2006 to 2008, and has only modestly covered it since then. Sustainability of the dividend has been part of the New York Community investor lexicon for years.

It is easier said than done, but one of the nuances of M&A involving share exchanges entails buy-in from the seller to create “shared upside” rather than “shared downside” as First Niagara and Astoria have experienced. This requires a seller that is willing to back off just a bit in terms of the exchange ratio to help create a favorable market reaction. It is a tough argument for an investment banker to make to a seller's board even though it may be sound. For the buyer and investor, it is a variation of the most important factor in terms of determining the return from an investment: the price paid. It is the one variable all can control. For acquirers of businesses, the second variable is execution.

So, did KeyCorp and New York Community management cut bad deals? Probably not. New York Community used the announcement to take care of other business that the market had ignored. KeyCorp was pushed, I think, by Huntington Bancshares Inc. — something I suspect CEO Steve Steinour took great pleasure in doing. Nevertheless, I think both should work out in time, although that does not help investors who held shares of the buyers prior to announcement.

Jeff K. Davis, CFA,
jeffdavis@mercercapital.com
615.345.0350
Mercer Capital's Public Market Indicators

Mercer Capital's Bank Group Index Overview

![Chart showing Mercer Capital's Bank Group Index Overview from November 28, 2014 to December 31, 2015]

Return Stratification of U.S. Banks by Asset Size

![Chart showing return stratification of U.S. banks by asset size]

Median Valuation Multiples

<table>
<thead>
<tr>
<th>Indices</th>
<th>Month-to-Date</th>
<th>Quarter-to-Date</th>
<th>Year-to-Date</th>
<th>Last 12 Months</th>
</tr>
</thead>
<tbody>
<tr>
<td>Atlantic Coast Index</td>
<td>6.53%</td>
<td>11.93%</td>
<td>19.05%</td>
<td>22.65%</td>
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<tr>
<td>Midwest Index</td>
<td>6.95%</td>
<td>10.46%</td>
<td>15.61%</td>
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<td>Northeast Index</td>
<td>4.84%</td>
<td>9.21%</td>
<td>11.13%</td>
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<tr>
<td>Southeast Index</td>
<td>5.77%</td>
<td>8.82%</td>
<td>15.21%</td>
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<tr>
<td>West Index</td>
<td>5.89%</td>
<td>9.82%</td>
<td>19.15%</td>
<td>23.42%</td>
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<tr>
<td>Community Bank Index</td>
<td>5.94%</td>
<td>10.17%</td>
<td>15.38%</td>
<td>20.04%</td>
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<tr>
<td>SNL Bank Index</td>
<td>4.12%</td>
<td>9.69%</td>
<td>5.33%</td>
<td>7.96%</td>
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| Median Total Return      |              |                |              |              |
|--------------------------|--------------|----------------|--------------|
| Price/ LTM EPS           | Price/ 2015 (E) | Price/ 2016 (E) | Price/ Book Value |
| Atlantic Coast Index     | 17.00        | 17.07          | 14.77        |
| Midwest Index            | 15.31        | 15.52          | 13.17        |
| Northeast Index          | 14.99        | 15.87          | 13.98        |
| Southeast Index          | 13.41        | 16.30          | 15.48        |
| West Index               | 17.35        | 18.14          | 15.04        |
| Community Bank Index     | 15.47        | 15.97          | 14.42        |
| SNL Bank Index           | 15.47        | 15.97          | 14.42        |

<table>
<thead>
<tr>
<th>Median Valuation Multiples as of November 30, 2015</th>
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<tbody>
<tr>
<td>Assets $250 - $500M</td>
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<tr>
<td>-------------------------------</td>
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<tr>
<td>Month-to-Date</td>
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Mercer Capital’s M&A Market Indicators

December 2015

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 November 2015

Regions | Price / LTM Earnings | Price / Tang. BV | Price / Core Dep Premium | No. of Deals | Median Deal Value | Target’s Median Assets | Target’s Median ROAE (%)
--- | --- | --- | --- | --- | --- | --- | ---
Atlantic Coast | 22.16 | 1.51 | 8.4% | 21 | 95.48 | 505,647 | 7.44%
Midwest | 18.60 | 1.57 | 8.3% | 73 | 41.70 | 120,864 | 8.81%
Northeast | 22.72 | 1.48 | 9.4% | 10 | 55.29 | 443,643 | 6.63%
Southeast | 19.71 | 1.41 | 7.0% | 24 | 32.20 | 213,350 | 8.09%
West | 16.58 | 1.44 | 6.9% | 14 | 48.75 | 200,724 | 9.68%
National Community Banks | 19.71 | 1.48 | 7.5% | 142 | 50.00 | 201,665 | 8.21%

Source: Per SNL Financial

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Contact Us

Jeff K. Davis, CFA
615.345.0350
jeffdavis@mercercapital.com

Andrew K. Gibbs, CFA, CPA/ABV
901.322.9726
gibbsa@mercercapital.com

Jay D. Wilson, Jr., CFA, ASA, CBA
901.322.9725
wilsonj@mercercapital.com

MERCER CAPITAL

Memphis
5100 Poplar Avenue, Suite 2600
Memphis, Tennessee 38137
901.685.2120

Dallas
12201 Merit Drive, Suite 480
Dallas, Texas 75251
214.468.8400

Nashville
102 Woodmont Blvd., Suite 231
Nashville, Tennessee 37205
615.345.0350

www.mercercapital.com

Contact Us

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