April 27, 2012

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington, D.C. 20429
comments@FDIC.gov

Comments on: Proposed Rule That Implements the Requirements in Section 165(i) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (RIN 3064-AD91)

Dear Mr. Feldman:

Invictus Consulting Group LLC ("Invictus") welcomes the opportunity to comment on the aforementioned "Proposed Rule That Implements the Requirements in Section 165(i) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (RIN 3064-AD91)." Invictus is a boutique advisory firm specializing in the development and implementation of bank stress testing for bank regulators, banks, director and officer liability underwriters for banks, and bank investors.

Invictus Comments on Dodd-Frank

Our comments below are based on real-world experience in stress testing banks and helping them present and communicate the results of their stress tests to their regulators.

Invictus has been working with regulators and bank clients since the start of the recession. We have run quarterly stress tests on every single bank in the country since 2008. These stress tests have relied on FDIC call report data supplemented by additional external sources of public information. In this process we have compiled considerable statistics and appropriately re-collated data that is used to reinforce

INVICTUS
CONSULTING GROUP LLC

and support the driving assumptions behind our client banks' stress tests. Using public data and applying our unique methodology across all banks allows for direct comparison, rating and ranking of all banks in the country. We have bank regulatory clients who use our reports to both triage and provide insights for banks under their regulatory supervision.

Clarity and Consistency.

There is considerable confusion in the marketplace regarding stress testing. The final report produced by the FDIC must provide maximum clarity to the marketplace to ensure efficiency and effectiveness on behalf of both the banks and their regulators.

To provide this clarity the final report must have consistency across the three most important parameters involved in the stress testing process.

- Practical and realistic definition of stress testing environmental criteria - Baseline, Adverse and Severely Adverse scenarios.
- Consistent and relevant financial reporting data - Restructuring of call report information requirements.
- Basic acceptable stress testing methodology.

The challenge is not only clarity within each of the above parameters, but more importantly in their interrelationships and practical implementation. Unfortunately, each of these parameters has serious issues that need to be addressed to prevent increased confusion and inefficiency.

1. Stress Testing Scenarios (Baseline, Adverse and Severely Adverse)

Applicability of macroeconomic data to Dodd Frank Banks. We believe that this is a potential area where a fairly serious mistake can be made by regulators if they attempt to define macroeconomic criteria in a similar format to the criteria provided to participants in the CCAR and CapPR program. Macroeconomic criteria can be reasonably applied to national institutions with broad geographic footprints. Using this

format for regional and community banks is not only illogical, but also defeats the purpose of the stress testing requirements required under the Dodd-Frank legislation.

- Stress defined by macroeconomic data does not directly affect bank assets. It affects their unique customer base whose performance under stress conditions affects customers' credit worthiness. This in turn affects the banks operating performance and capital adequacy.

- The economies of each region or state in the US vary greatly, and thus "one size" does not fit all. Industry concentrations by type, population density and economic income are completely different across US regions. The reaction and performance of these customer bases of the Dodd Frank bank are considerably different within the same national macroeconomic criteria. Seattle's dependence on aviation, Detroit's dependence on the automotive industry and the heavy agricultural concentrations in Iowa are more than obvious examples.

Thus any macroeconomic data applied to banks falling under 165(i) of Dodd-Frank or community banks should be at the lowest level available that corresponds to the bank's footprint -- at least state-by-state, but preferably by region within state. Although this approach will create additional work for regulators, applying national macroeconomic factors to more geographically restricted banks is fallacious, potentially contributing to questioning credibility of the results and increased confusion and inefficiency of the process.

Practical application of economic stress descriptors. Most banks do not have access to economic advisers. The quantification of this data, even if provided on a regional basis, will be subject to a myriad of different interpretations across the different loan portfolios. There are several complex issues where the application of these economic stress factors can further confuse the issue. For example unemployment rates (national or regional) have a relatively more direct application to consumer credit cards and home mortgages. However, they also will affect the performance of bank corporate customers with retail exposure. The time lags and relative magnitude of just this single economic factor is open to considerable interpretation by individual banks. Thus, without proper guidance the results of individual bank stress tests will vary greatly, producing totally inconsistent results without proper guidance.

Recommended Approach. Both of these issues can be effectively solved if the regulators break from the pattern established in the CCAR and CapPR program. It is a fairly simple matter to create consolidated bank financials within each state and or region. These consolidated banks would treat each state/region as a single consolidated banking entity comprised of all regional banking activity within that state/region. The regulators could then apply the economic criteria to this consolidated banking entity with focus on specific loan categories covering the appropriate scenarios. This template would not only provide clarity to the individual banks, but also define interrelationships between economic criteria and loan performance on a consistent and relevant basis. This would still allow individual banks to differentiate and substantiate their performance against the scenarios for the appropriate consolidated entity. The educational value of this exercise for Dodd Frank banks should not be underestimated. (Attachment A1 shows the example of the loan category CRE-Investor Owned between Florida and Michigan, and then compared to all banks in the country—Bank USA)

2. <u>Consistent and Relevant Financial Reporting Data.</u>

Financial accounting reports and the FDIC call report data requirements were more than adequate in the pre-recession environment. Implicit in the information requirements were two basic assumptions:

- Loan portfolios within broad categories behaved fairly homogeneously. The credit characteristics of the different loans that comprised a particular loan category were similar enough that historical experience within that loan category was a reasonable basis for evaluating the behavior of that portfolio. As such a total reporting aggregate number for each loan category was sufficient for reporting purposes.
- Required earnings and interest-rate-spread information was sufficient to provide easy extrapolation of future earnings under normal operating conditions.

Unfortunately the recession has drastically changed the type of information required and brought to the forefront key parameters that had only minor relevance in the past decade prior to the recession.

Consolidated Loan Portfolio Reporting. Loan portfolios today are comprised of varying percentages of different vintages (origination dates). These vintages that include pre-

recession loans have very different stress characteristics, pricing structures, loan to asset values and debt service coverage capacity. The relative and absolute magnitude of these vintages and their distribution over time will in turn have substantial impact on the bank's capital adequacy under stress, its *pro forma* profitability and its asset turnover rates. Present loan information requirements—simply a snapshot balance--create opacity over this vital loan vintage information.

Validation. A bank generated stress test for regulatory purposes has by its very nature two primary requirements:

- The generation of realistic and practical stress tests under the prescribed scenarios.
- A justification/verification of the assumptions that drive the stress test.

Regulators reviewing the stress test also need a realistic and practical basis for verifying consistency and accuracy. The requirement to submit loan category data as a single number no longer provides the key information necessary for effective stress testing or validation of stress testing results. While banks can re-collate their existing data by vintage and perform the vintage segregated stress tests on these portfolios, they still lack access to broad market data within their geographical footprint to substantiate and verify their direct experience. This exposes them to regulatory second guessing as other banks within their geographical footprint submit different driving assumptions. It also prevents them from gaining insights into their own analysis, insights that can only be generated when comparing their assumptions and performance with their peers. (Attachment A2—Depiction of the similar pattern of a Florida bank versus all banks in Florida)

***Pro Forma* Earnings.** The present banking environment, characterized by declining loan demand, compressing spreads and increasing capital adequacy requirements, further reinforces the need for additional reporting details such as pricing, spread information and amortization schedules. Declining spreads, the runoff/maturity of existing portfolios each with different yields and spreads, and the slower redeployment/reinvestment in new loans all combine to have a dramatic impact on banks' profitability during the stress horizon. In each quarter of the projected stress horizon the composition by vintage of each loan category will result in very different stress criteria, overall yield and susceptibility to interest rate stress. Redeployment of liquidity generated by maturities into different portfolio mixes and investments will further complicate the process. The importance of accurate earnings estimates during the stress horizon cannot be understated. (Attachment A3—*Pro forma* income from

loans using LoanLayering™ with yields inherent to each layer consistent with its vintage)

Quarterly Vintages. With Call Report data provided quarterly, we strongly advocate changing the reporting requirements to include quarterly vintage information on new loans generated during that quarter. Over time this process will build an appropriate and more relevant database for the banks and the regulators. By making this a quarterly requirement the regulators would not put an excessive burden on the already stretched bank resources.

While this database will take some time to build to become effective as a tool, an early start will provide dividends for both banks and regulators in the very near future. It will also considerably improve market bank analysis presently dominated by organizations using antiquated methodologies based on opaque data.

3. Bank Stress Testing Methodology.

Background: *It is universally recognized that historical pre-recession bank analytic methodologies failed miserably in the face of the recession. A common misconception is to blame these methodologies for failing to predict the existing recession. A far more serious issue was and still is their inability to quantify the impact of the recession on the banks' operating performance and capital adequacy. These methodologies evolved into highly theoretical quantitative oriented analyses designed to fine-tune bank operations within limited reality boundaries. Over time they lost the connection with the practical and logical approaches to analyzing bank assets. Highly quantitative oriented, econometric models are not only alien to most bank strategic planning processes but will yield impractical and erroneous results.*

Unlike the CCAR and CapPR programs where the banks were apparently free to choose their stress testing methodology the next level of stress tested banks will need guidance on appropriate methodologies. Some of the issues to be considered are: -

- A large number of different approaches with varying results will make the regulatory oversight extremely difficult. Banks forced to retest based on regulatory feedback would be consuming precious resources, potentially placing themselves in a position to not be able to adequately communicate a defense to

regulators with a subsequent result of undeserved higher capital adequacy requirements.

- The recommended approaches should be practical and logical so that they can be instinctively understood and effectively integrated into the banks internal strategic planning and operational management processes. Stress testing can then truly become the implementation of specific scenarios required by regulators to define capital adequacy.

- Unlike the senior management of large banks (CCAR and CapPR) who are distant from their client marketplaces, the relatively smaller regional and community banks have a much greater awareness of the behavior and vagaries of their local marketplace. The methodology has to be designed to take advantage of this unique knowledge. This is not a particularly difficult task provided it is given the appropriate attention and focus.

- The stress testing process and its validation should not become an accounting exercise nor should it contain "black box" components. Massive output without complete transparency and active senior management involvement and understanding of the results will only encourage the separation between Stress Testing Reports and effective integration of stress testing as a management tool.

- Adaptation of pre-recession methodologies to modern stress testing will result in unacceptable compromises. Most of these methodologies focused on liability management in response to market needs over the decades prior to the recession. Stress testing of assets is a completely different proposition and needs a fresh and clean approach. The asset stress testing process defines and leads practically all other specific stress testing activities with particular focus on liquidity and interest rate sensitivity. The structure, vintage and maturity of loans that comprise the portfolios have a direct and leading impact on bank liquidity as well as its susceptibility to vagaries in the interest rate markets. These assets must be stressed first before the implications on liquidity and interest rate sensitivity can be properly evaluated. (Attachment A4--Aggregate Regulatory Capital impact from stresses applied to all loan categories and stress characteristics)

INVICTUS
CONSULTING GROUP LLC

Conclusion

As mentioned earlier, Invictus has developed methodologies using re-collated public information to create regional and national databases. We have used these methodologies and data bases to perform stress tests on a variety of banks. In practically all cases the stress tests have been successfully incorporated into the banks strategic planning process. All of the aforementioned suggestions are derived from actual hands-on experience, and solutions have been developed to address each of the comments in this document. We are prepared to share this information with the regulators.

Please feel free to contact us directly if you have any additional comments.

Sincerely,

Kamal Mustafa
Chairman

Leonard J. DeRoma
President

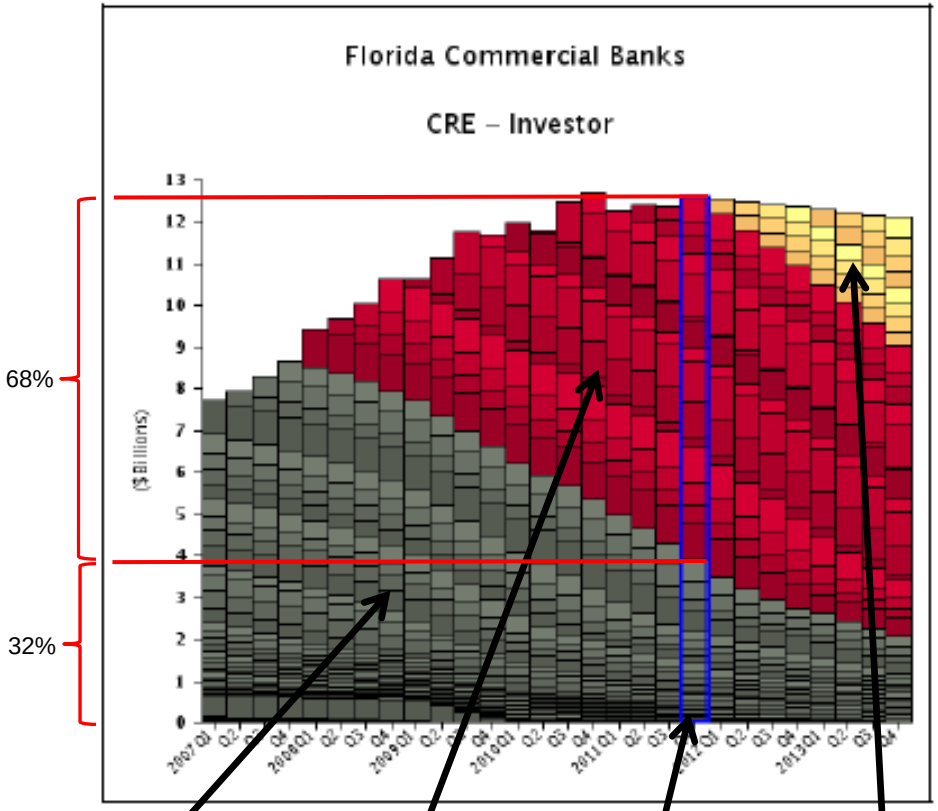
Attachment A1 *(page 1 of 2)*

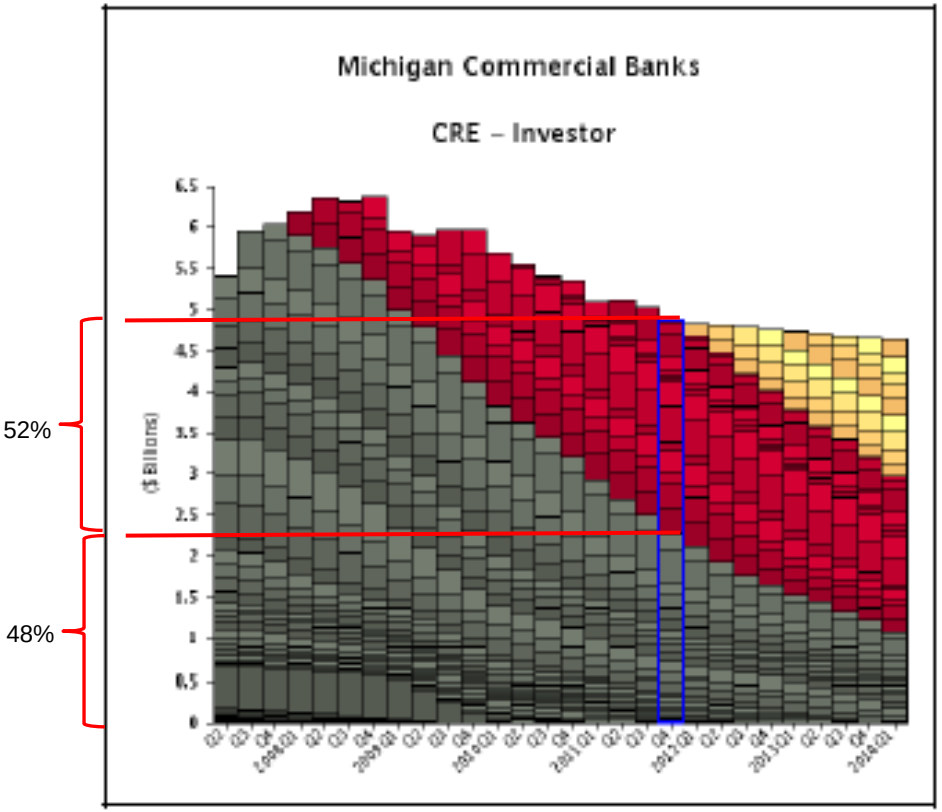
INVICTUS
CONSULTING GROUP LLC

LoanLayering™*

Total Volume of Loan Patterns in Florida vs. Michigan (CRE-Investor)

* **Patent Pending**





Pre-recession loans are in **gray**

Post-recession loans are in **red**

Current Period is in **blue box**

Future loans are in **gold**

The LoanLayering™ shows the volume of CRE - Investor loans originated pre-recession vs. post-recession, which have different underwriting standards and impact on earnings. It also shows the pattern of the vintages and the expected runoff rates. In the current quarter

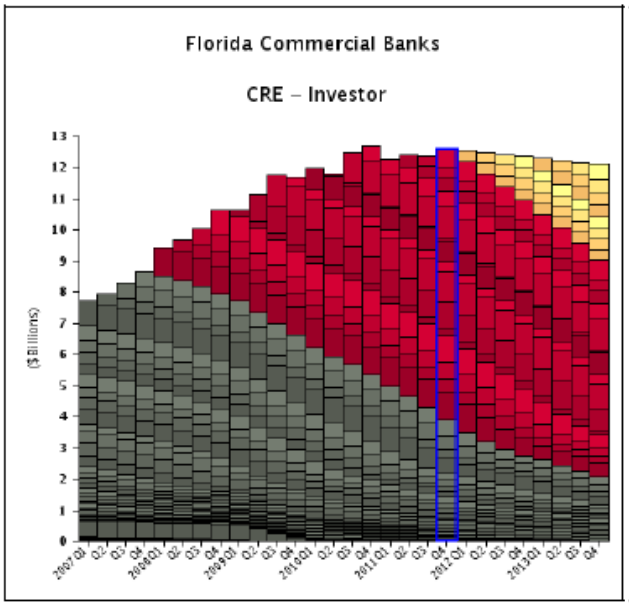
- Florida banks currently have approximately **68%** post-recession (red) and **32%** pre-recession loans (gray)
- Michigan banks currently have approximately **52%** post-recession (red) and **48%** pre-recession loans (gray)

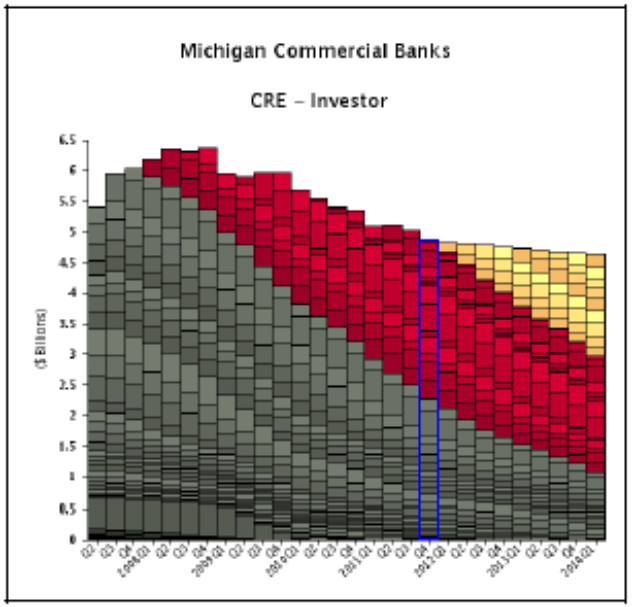
INVICTUS
CONSULTING GROUP LLC

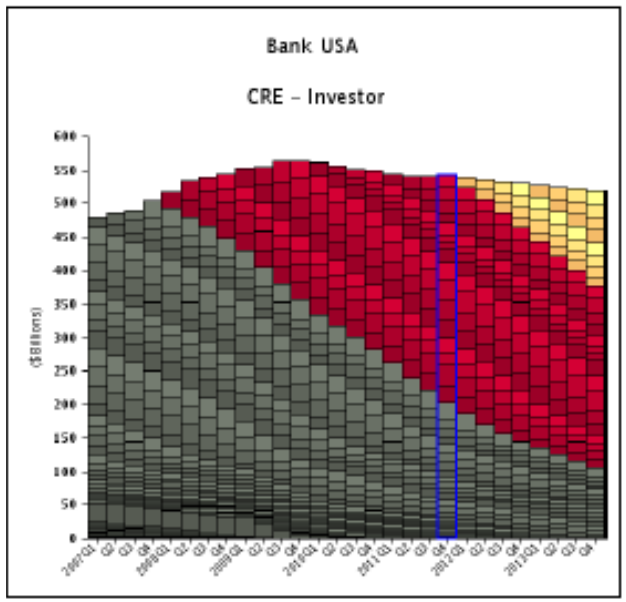
LoanLayering™*

Total Volume of Loan Patterns in Florida vs. Michigan vs. Bank USA

* **Patent Pending**







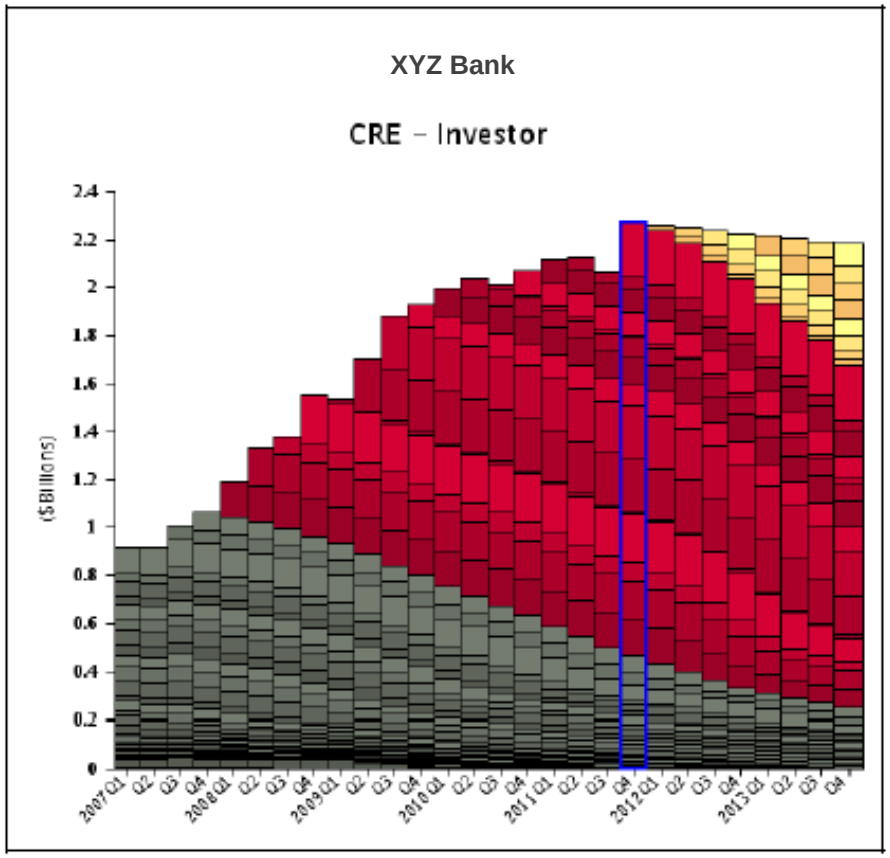
LoanLayering™ patterns can also be compared to all banks in the country (Bank USA on the right above), reflecting both regional variations in loan trends and how they compare to trends for all banks in the U.S.

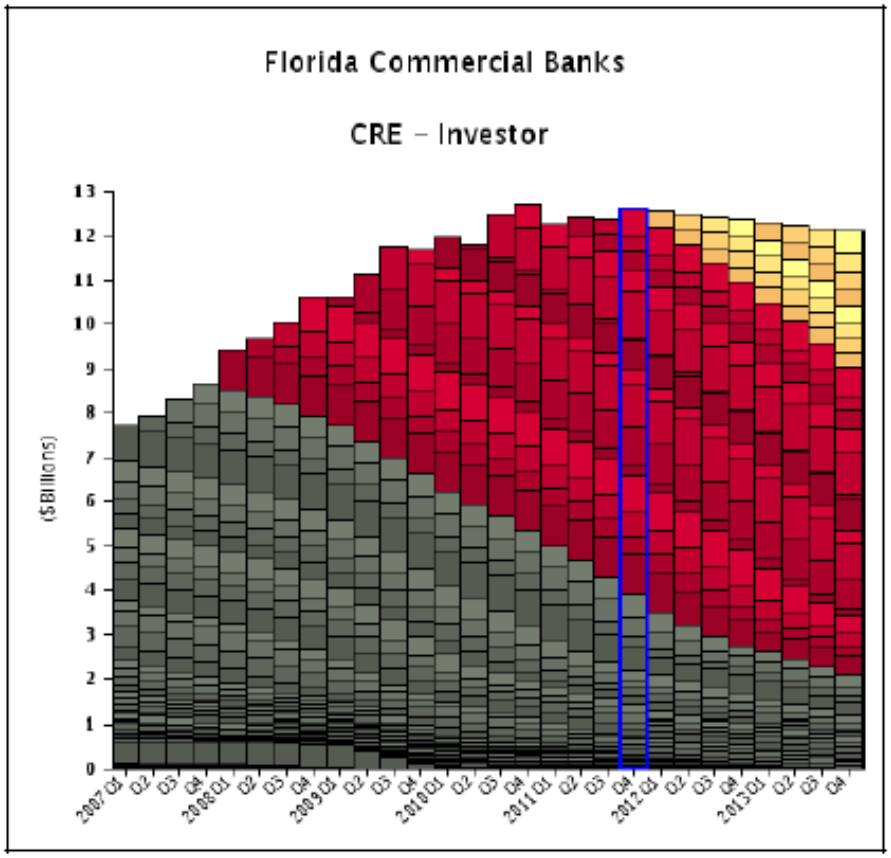
Attachment A2

LoanLayering™*

Actual Florida Bank vs. Florida

* Patent Pending





LoanLayering™ patterns tend to be relatively similar within a state/region, but as the previous graphs show, can be very different from region to region.

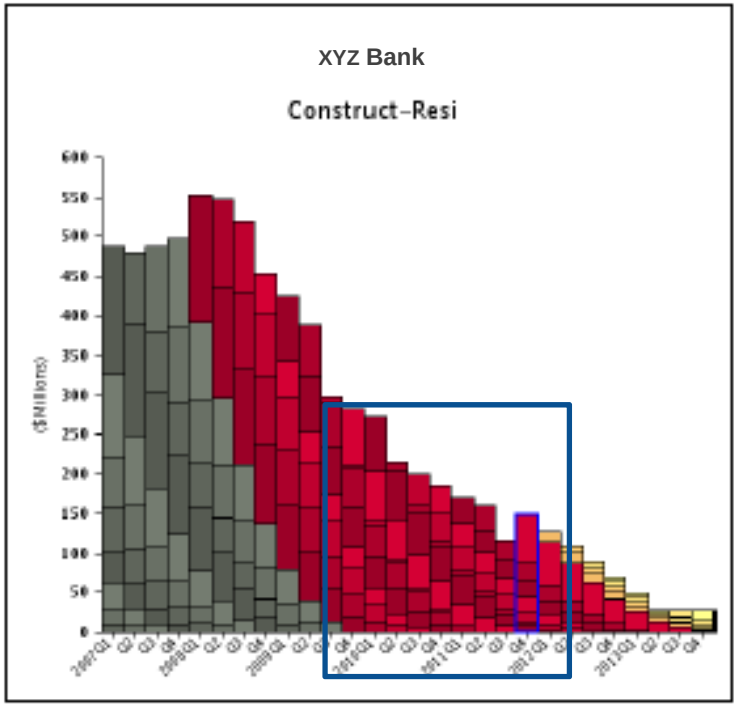
Attachment A3

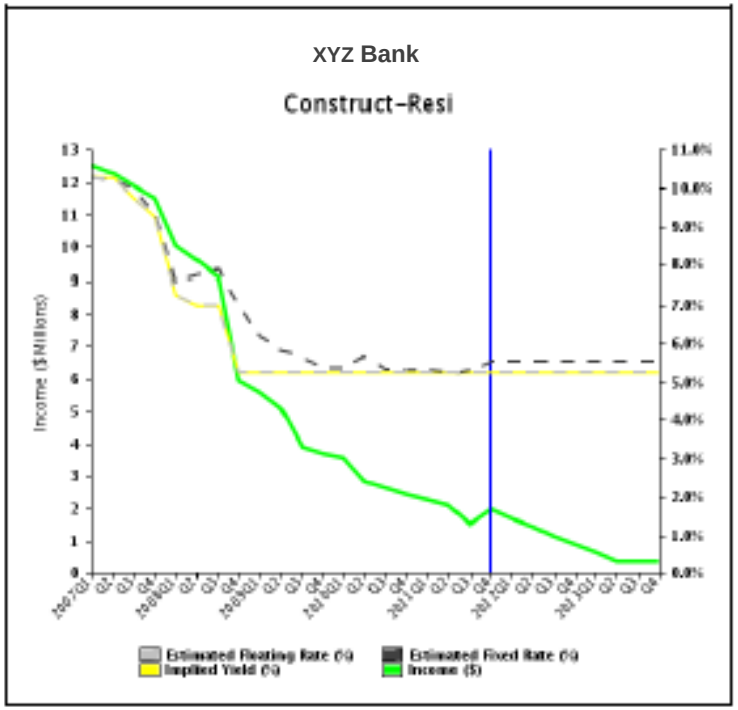
INVICTUS CONSULTING GROUP LLC

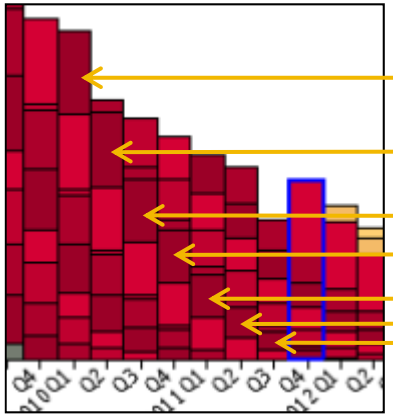
LoanLayering™*

Impact of Quarterly LoanLayering on Income

* Patent Pending







- The stack of layers for each quarterly period reflects the bank's total loans in the category.
- Each of the loan layer "boxes" reflect the balance of loans outstanding originated in a prior quarter.

- The Income Analysis on the right shows the yields inherent to each layer consistent with its vintage. (green line).
- The income is derived from the cumulative earnings for each of the layers by period.
- The blue line shows the current period.

Attachment A4

Invictus Dowel Chart™*

Represents the contribution to total stress by loan category and stress factors

* Patent Pending

Dowel Chart: The height of each dowel is associated with a distinct loan category and represents that category's contribution to the decline of Tier 1 capital over the stress horizon. The decline in capital is then distributed based on various stress factors. The sum of all the heights of the dowel represents the net cumulative impact to the decline of Tier 1 capital.

Thermometer: Represents the total impact of the decline of Tier 1 capital. The top of the white section is the beginning Tier 1 capital. The top of the red shows the impact without earnings (the sum of the decline portrayed by the individual dowels), and the yellow represents the impact of earnings over the stress horizon adjusted for a wide range of factors including maturity of assets, reallocation of assets, and changing liability structure.