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Frenemies of the Future

"Coopetition" with fintechs may be the key to thriving in tomorrow's financial services industry

By Amber Seitz

» *Cooperation + Competition = Coopetition.*

For several years now, the banking industry has been inundated with warnings about how financial technology (fintech) startup companies will disrupt the industry to the point where traditional depository banks—especially smaller community banks—become irrelevant. As it turns out, the rumors of banking's imminent demise were greatly exaggerated, according to **Lee Wetherington**, director of strategic insight at Jack Henry & Associates. "We're beyond the point where everyone thinks fintechs will destroy banks," he said, explaining that fintechs discovered they couldn't establish user bases large enough and quickly enough to sustain their business models and compete directly with banks. In addition, efforts by some of the nation's largest banks to emulate fintechs (or outright acquire them) helped to neutralize the competitive threat.

Rather than direct competition, banks and fintechs find themselves in a competitive, yet co-dependent standoff; each has something the other needs, but since the other is a competitor, partnerships between the two are far from routine. A recent *Forbes* article described this dynamic as "coopetition," "a term used to describe unconventional collaboration and cooperation within an otherwise competitive field of players." **Stacy Grafenauer**, vice president/director of deposit operations and electronic solutions at First Bank Financial Centre, Oconomowoc and a member of the 2017-2018 WBA Technology and Operations Committee described the process of banks partnering with fintechs as "building an alliance without compromising sound practices."

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Staying ON TRACK

Five key factors to consider when calibrating your capital plan today

By Amber Seitz

Tactical allocation of capital is an integral component of success for every financial institution, so capital planning and strategic planning should be closely tied. Just as bank management and the board must regularly review their institution's strategic plan and make adjustments, an effective capital plan should be reviewed and recalibrated at least annually. That assessment has never been more critical, as the financial services industry approaches what could be a tumultuous period.

"The full rollout of the capital conservation buffer under Basel III, CECL, and a potentially completely different economic cycle will be hitting at about the same time, so banks need to be considering and planning for that now," said **Nick Hahn**, director of risk advisory services at RSM US LLP. "It's a bit of a perfect storm." To adequately prepare, bank management and directors should consider the following five key factors as they look back at 2017 and forward to 2018 during the capital planning process:

1: Strategy

The bank's strategic plan is the most significant influence on the capital plan, since different strategic goals require different capital strategies. According to **Jon Bruss**, managing principal and CEO of Fortress Partners Capital Management, there are several situations common to our industry that drive the need for capital: growth in assets exceeding the ability of the bank to retain earnings to support the growth, asset quality problems wiping out a

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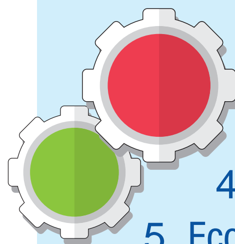
large block of capital, or preparation for an acquisition as a buyer are among them. "There is no one solution that works for all banks in all situations," he said. Banks dealing with rapid growth in assets driven primarily by loan growth can fund a capital shortfall with common equity or with debt issued by a bank's holding company. "Any bank that's in the market for an acquisition and doesn't have a quote symbol for its stock is going to need to make that purchase for cash," Bruss explained. There are several options bank leadership should consider for sourcing those funds. "Cash at the holding company level can be sourced with debt raised via an investment banking firm, lent by a correspondent bank or by an offering in the communities served by the bank, each approach carrying a different cost," Bruss advised. Common equity can be used to raise cash to fund that purchase, "by selling shares to members of the community or via an investment banker-assisted community offering," he continued. "That requires thoughtful planning today, because tomorrow you may be an acquirer."

2: Unexpected Occurrences

In addition to a yearly review, sudden, unplanned-for incidences should trigger a reassessment of the bank's capital plan. "If there's an unexpected loan charge-off that impacts your capital, for example, review your plan again then," said **Lee Christensen**, partner, financial institutions practice at Wipfli. "That way you know if you're on track or if you need to change the way you operate in order to get back on track." A cybersecurity breach or unanticipated findings during ALM routines and/or liquidity forecasting should also trigger a review.

Five key factors to consider when calibrating your capital plan today:



1. Strategy
2. Unexpected occurrences
3. Competition
4. Legislation and regulation
5. Economic cycle

3: Competition

Today's financial services industry is highly competitive, and banks need to win against more than just their peers—credit unions, farm credit lenders, and even financial technology companies are all vying for the same customers. That can lead to dangerous choices. "You can sacrifice on term, price, or structure, and for many institutions pricing has reached the bottom, so now they're making decisions to sacrifice on term or credit risk monitoring controls, which ultimately increases credit risk," Hahn explained. "Financial institutions need to be very aware of the role competition in the market has played and how that could impact credit losses going forward and, ultimately, capital." To address this risk, Hahn recommends bank leadership maintain a thorough understanding of how potential losses could impact the balance sheet. "If we see any upticks in losses, you need to understand what's driving it and know if you need to extrapolate or do broader analysis of the portfolio in general to see if it will spread," he advised.

4: Legislation and Regulation

Looking forward to 2018 and beyond, there are several legislative and/or regulatory factors to consider when doing capital planning. First is tax reform, which Christensen says will be a big event for banks if it comes to fruition because many banks currently hold a large amount of tax-deferred assets on their books. If Congress follows through on the plan to drop the tax rate from 34 percent to 20 percent, those assets will need to be revalued. "That will be a good thing in the long run, but it may have a negative impact in year one because the offset goes into expense, which ultimately flows into capital," Christensen explained.

Another factor to consider is Basel III's phase-in. In mid-October, the Basel Committee on Banking Supervision announced a plan to break the year-long deadlock that has delayed the capital standards' implementation: setting capital floors at 72.5 percent. The measure has yet to be approved by the central bank governors and supervisors on the Basel Committee's oversight body.

Finally, the regulatory factor looming largest over the industry: CECL. "In the year of adoption, banks will be allowed to look at their allowance as it's calculated under the old and new methods and the difference will be a one-time charge to equity," said Christensen. "We'd recommend banks preserve capital for that hit, rather than maintaining excessive allowance." However, there is still some uncertainty, as banks seem to be waiting for guidance from regulators on how to build their new models, but the regulators seem to be waiting to offer guidance until they see the models.

5: Economic Cycle

Banks should review their capital plan more frequently during times of economic turbulence or market instability, and the next period of such agitation is on the horizon. "We're likely closer to the next recession than we are to the last one," Hahn declared. "Many institutions are making the loans that will be their next losses right now." One sector in particular where the coming downturn is apparent is in the highly cyclical agri-business arena; while not yet as severe as some previous dips, ag credits are becoming more stressed. "If and when charge-offs become necessary, the banks need to have the capital available," said Christensen. "We've gone five or six years with very minimal charge-offs. The economy has been on a relatively long upturn during that period, but it doesn't feel like it because we haven't seen the sharp incline that we had in the early 2000s."

Take Action

With these factors in mind, bank management and directors should consider the following action steps (all suggested by one or more of the experts interviewed for this article) to ensure a comprehensive, effective review of their capital plan:

» Refer back to your original capital plan and your projections. Compare that data with what your current reports tell you.

» Closely evaluate the 30- and 60-day reports to see if there is potential for those to extend into the 90-day past due report.

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Midwest Bankers Insurance Services (MBIS):

Cybercrime 101: Some Basics

By Jeff Otteson

On average, 4,000 ransomware attacks occurred per day in 2016, according to an FBI report. Many industry experts now project cybercrime damage costs will reach $6 trillion annually by 2021. Banks need to be aware of the tactics criminals may use to attack their customers or the bank itself.

Popular cybercrime techniques:

» *Account Hijacking/Social Engineering*: Pretending to be someone else in order to take over/gain access to an account.

» *Denial of Service Attack (DoS)*: Overwhelming a system/website to the point that it stops functioning.

» *Graffiti*: Defacing a website, page, or online property.

» *Ransomware*: Using a malware or virus to hijack and block the victim's data or system until payment is made, typically in untraceable bitcoin currency.

Insurance Insights

Jeff Otteson
MBIS

» *SQL Injection Attack*: Taking advantage of vulnerabilities in a web application to "trick" the program code into changing data or executing commands when faulty user data is supplied.

» *Strategic Web Compromise*: Hacking into web servers just to set up an attack on a different target.

» *Targeted Attack*: Extracting data from a specified target through any channel possible.

Keep these tactics in mind as you consider how your bank is protected against fallout from a cybersecurity breach. Technically, an organization owns and is responsible for data stored in its systems, as well as data stored by a third-party vendor or "in the cloud" on its behalf.

Otteson is vice president – sales at MBIS. Please contact Jeff at 608/217-5219 or jeffo@mbisllc.com for more information about solutions from MBIS that may help protect your institution in the event of a cybersecurity incident.

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» Adjust your approach to stress testing. Relying on probability of default—looking at what causes borrowers to default—isn't as valuable from a capital planning perspective as using loss-given testing to anticipate the bank's exposure if certain loans go bad.

» Understand the capital sources available to your bank in its current state and also in anticipated future states. In other words, verify that your capital plan is realistic. If your institution isn't attractive to capital markets at the time when you need capital the most, know what your alternative source of funding will be. Leveraging your third-party relationships is an important component in maintaining an accurate understanding of today's capital markets.

» Avoid a siloed approach to reviewing capital. Other risk management exercises and models, including interest rate risk and liquidity, should all impact your capital planning process.

» Adhere to your loan policies. Amid fierce competition and an economic expansion, it is essential for bank leadership to enforce loyalty to the bank's policies in order to prevent taking on excessive risk.

Capital planning is one of the executive team and board's most important duties, so frequent assessment and adjustment of the plan is not only a good practice from a risk management perspective, but also from a strategic perspective.

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