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SafeTalk®

Preparing for the New Cycle: Capital Planning and Allocation

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Founded in 2008, Invictus Group joined ABA Insurance Services Inc. as a subsidiary in 2024. They are recognized for their expertise in helping banks navigate the complexities of capital allocation. Led by Adam Mustafa, the Invictus team employs a data-driven approach, providing customized stress testing models, scenario analysis, and strategic capital planning to help banks maximize returns while maintaining safety and soundness in an ever-evolving economic landscape. Through their proprietary analytics, Invictus helps enable banks to deploy capital and stay prepared for economic shifts, making them a pivotal ally in the banking industry.

We have officially kicked off a new banking and economic cycle. It's the top of the first inning, and the next several years are uncertain. This cycle may differ significantly from any we've seen, especially in contrast with the period following the 2008 Financial Crisis. The Trump 2.0 administration is making significant changes to fiscal policies and trade relations, potentially catalyzing an economic revolution, and creating exciting new lending and growth opportunities for banks.

However, the dramatic changes also bring uncertainty. Tariff policies might be structural, driven by objectives to repatriate manufacturing and create a new revenue stream. Structural tariffs increase the risk of a trade war and global economic slowdown, potentially triggering a recession or stagflation.

The economy today has both a higher ceiling and lower floor than seen in some time.

Community banks need to operate without being overly optimistic or paralyzed by fear. One critical step is that management needs to divide the bank's capital into offense and defense.

- **Offensive capital** can be used for loan growth, expanding new business lines, investments in technology, and M&A, as well as funding actions like dividends and stock repurchases.
- **Defensive capital** serves as a rainy-day fund for unexpected risks.

Old approaches, such as assuming defensive capital equals PCA guidelines or using arbitrary rules of thumb (e.g., a 9% Leverage Ratio), may be insufficient. These methods may risk allocating too much capital to defense, resulting in unnecessary capital earning a 0 percent return on investment and draining ROE in an environment where banks have to consistently justify their independence.

Conversely, too much offensive capital may jeopardize safety and soundness.

Each bank is unique, and capital division should reflect that. Banks should use quantitative methods like stress testing, capturing their unique risk profiles to optimize capital allocation. Internal capital limits from this exercise should be codified in ***a written capital plan***, ratified by the board of directors.

- **A properly written capital plan should include internal capital limits, early warning triggers, and target operating levels for each regulatory capital ratio.** It should also have key risk indicators, such as concentration and classified asset ratios, to serve as an early warning system. Capital plans should also include a dividend policy, contingency plans, and guidelines for breaches.
- **Capital plans and their quantitative mechanisms should be updated annually** to reflect economic and industry changes.
- **With the right capital plan, management can focus on deploying offensive capital**, while providing the board with the necessary tools and oversight, even amid rising uncertainty.

When was the last time you updated your capital plan? Invictus *provides groundbreaking analytics and strategic insights to help banks make data-driven capital decisions with confidence. Whether you need to refine your capital plan, optimize capital allocation, or leverage stress testing to support growth, our team is here to help. Learn more at invictusgrp.com or schedule a discussion with our experts by contacting Patti Casaleggio at pcasaleggio@invictusgrp.com.*