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Financial Reform Legislation and Regulation and Other Hot Topics – What's in it for Community Banks?

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Who We Are

- Top 10 law firm in M&A every year since 2001
  - No. 1 in 2009, 2011, 2012, 2015, 2016 and 2017
- No. 1 law firm nationally in community bank capital raising transactions and mutual-to-stock conversions since 2000
- Largest practice group nationally dedicated exclusively to representing financial institutions
  - 25 Attorneys
  - Represent 275+ financial institutions, 100+ mutual institutions, 80+ SEC reporting companies; 35+ NY banks.

Agenda for Discussion

1. Regulatory Reform – Is the Pendulum Swinging Back?

2. Overview of Regulatory Reform Legislation (S.2155)

3. Mergers and Acquisitions in Current Regulatory Environment

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Regulatory Environment – Post 2008 Crisis

Dodd-Frank is really more of the "symptom than the cause" to the regulatory environment.

1. In addition to Dodd-Frank - courts, investors, legislators and regulators are more focused and engaged on risk/management governance issues.

2. Regulators, burned by market failures, have pro-actively responded, particularly in M&A, cybersecurity, vendor management and compensation.

3. Rise of "risk management culture."

Regulatory Environment – Post 2008 Crisis

- Regulators have exerted more control over community banks in three primary areas (<u>none</u> based on Dodd-Frank):

- <u>First</u> – By downgrading the supervisory ratings for banks
  - ➢ Banks receive confidential CAMELs ratings, which are effectively non-appealable.
  - ➢ 1-ratings are extremely rare.
  - ➢ Implications of a 3 rating could effectively put the bank in the penalty box – limits M&A/branch acquisitions/could lead to enforcement actions.

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Regulatory Environment – Post 2008 Crisis

- Second – More regulation by enforcement action of the regulators.

  - Regulators issue enforcement actions on wide range of topics, including (1) strengthening capital; (2) succession planning; (3) BSA/AML compliance; and (4) risk management, which could remain in place for many years.

  - Until the enforcement actions are lifted, M&A and other corporate activities are extremely difficult.

Regulatory Environment – Post 2008 Crisis

- Third – Corporate governance/risk management has been turned into a supervisory tool.

  - Corporate governance has received intense focus from Congress, activist shareholders and proxy advisory firms, which led to the adoption of substantial reforms.

  - Adding a heavy layer of regulation of corporate governance indirectly leads to the micro-managing/second-guessing of board members, particularly in areas of strategic decisions that should be a board function.

Overview of 2155 – The Dodd-Frank Rollback

The Pendulum is Swinging Back!

- Economic Growth, Regulatory Relief, and Consumer Protection Act ("2155") enacted in May 2018, which was enacted to relieve the regulatory burdens imposed on community banks.
- Additionally, starting to see a "change in tone" at the leadership levels of the regulatory agencies.
- Examples include: (1) efforts to modernize CRA; (2) joint policy statement from the federal regulators downplaying the role of supervisory guidance in enforcement; and (3) Fed's policy governing directors.

Overview of 2155 – The Dodd-Frank Rollback

2155 – What's in it for Community Banks?

1. Expansion of Capital Options for Community Banks.

2. Loan Growth Acceleration – Certain provisions are designed to remove administrative burdens to spur loan growth.

3. Other Highlights for Community Banks.

4. Increased M&A Activity – Increases in various thresholds for which certain Dodd-Frank/regulatory restrictions apply will likely result in the emergence of new acquirers.

Expansion of Capital Options

1. New Community Bank Leverage Ratio

- 2155 requires the banking agencies to establish a Community Bank Leverage Ratio (tangible equity to average total assets) of not less than 8% and not more than 10% for "Qualified Community Banks."
- "Qualified Community Banks" are generally defined as banks and their holding companies with consolidated assets of less than $10B (unless otherwise determined by the regulatory agency based on risk profile).
- A Qualified Community Bank would be deemed to satisfy all generally applicable Basel III leverage and risk-based capital requirements, and the bank would be deemed "well-capitalized."

Expansion of Capital Options

1. New Community Bank Leverage Ratio (cont'd)

- Regulators are mandated to establish procedures for treatment of a "Qualified Community Bank" when the Community Bank Leverage Ratio falls below the minimum required percentage.
- Pros:
  - ➢ Avoids the complexity in calculating risk-based capital ratios.
  - ➢ Avoids the problem/"punishment" of subjective risk-weighting of assets (e.g., bank may avoid a small business loan because of the risk-weighting of such loan and its impact on capital).
  - ➢ Macro-level – arguably the leverage ratio is a better indicator of financial health than the risk-based capital ratios.

Expansion of Capital Options

New Community Bank Leverage Ratio (cont'd)

- Considerations:
  - Depending on stockholder base, banks may not want to supplement their capital with common stock or other tangible equity to satisfy the new Community Bank Leverage Ratio.

  - Not as advantageous for banks that do not have a large amount of high risk-weighted assets or for BHCs/SLHCs with less than $3.0 billion in assets who are exempt from the risk-based capital requirements at the holding company level.

Expansion of Capital Options

2. Small Bank Holding Company Policy

- 2155 requires the FRB to increase the consolidated asset threshold for applicability of its Small Bank Holding Company Policy Statement from $1 billion to $3 billion, which currently is in effect.
- FRB Small Bank Holding Company Policy Statement – originally implemented in 1980s, allows banks to leverage debt at the holding company level to finance acquisitions and to increase capital at the bank level. Asset threshold to qualify for BHCs was originally $150 million, which was increased to $1.0 billion per Dodd-Frank.
- As amended by 2155, <u>now</u> BHCs and SLHCs with less than <u>$3.0 billion</u> in assets are generally considered "small holding companies" for purposes of the statement.

Expansion of Capital Options

Small Bank Holding Company Policy (cont'd)

- Pros/Significance:
  - BHCs and SLHCs that qualify as "small bank holding companies" are not subject to the FRB's risk-based/leverage capital requirements. Such requirements would only apply to the subsidiary bank (i.e., BHC/SLHC is deconsolidated from the bank in determining minimum capital ratios).
  - As a result, holding company level debt can be used to increase capital at the bank level (which would be treated as Tier 1 capital), without diluting the ownership interests of stockholders.
  - Interest paid on debt is tax deductible, which reduces cost of capital.

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Expansion of Capital Options

Small Bank Holding Company Policy (cont'd)

- Considerations:
  - Debt-to-Equity Ratio should be no more than 1:1 so that BHC/SLHC are not restricted from paying dividends and doing stock buy-backs.
  - Debt at the holding company level may adversely affect the bank's Community Bank Leverage Ratio or Basel III minimum risk-weighted and leverage capital requirements (which would apply on a consolidated basis if the BHC/SLHC's asset threshold is $3.0 billion or more).

Expansion of Capital Options

3. Capital Treatment of Certain Commercial Real Estate Loans

- Background: Dodd-Frank added a new category of CRE loans called High Volatility Commercial Real Estate ("HVCRE"). These loans are assigned a 150% risk weight, instead of 100% risk weight, for risk-based capital purposes (which means banks would have to hold additional capital for such loans)
- 2155 prohibits regulators from assigning a heightened 150% risk weight to a HVCRE, unless the HVCRE meets a narrower definition of "HVCRE ADC loan" per 2155.

Loan Growth Acceleration

1. Expansion of Qualified Mortgage Safe Harbor

- Background: Dodd Frank amended Section 129C(a) of Truth in Lending Act ("TILA") by adding the "ability to repay rule" for mortgage loans (i.e., creditors must make a reasonable determination of a borrower's "ability to repay" before making a mortgage loan).
- To comply with the "ability to repay" rule, must either: (1) satisfy burdensome requirements in determining the borrower's "ability to repay," (i.e., credit history, income, employment status, debt-to-equity ratio, which must be verified by third party docs) or (2) show that the mortgage qualifies as a "Qualified Mortgage" (e.g., mortgage loan qualifies for purchase by Fannie Mae/Freddie Mac).
- Critics of this rule believed that the rule resulted in the exclusion of lower income borrowers from the mortgage market.

Loan Growth Acceleration

Expansion of Qualified Mortgage Safe Harbor (cont'd)

- 2155 amends TILA by adding a safe harbor for banks with less than \$10 billion in assets that provides that as long as the mortgage loan is <u>originated and retained in portfolio</u> by the bank, the mortgage loan would be treated as a Qualified Mortgage for purposes of TILA (and the "ability to repay" rule would be deemed satisfied).
- Amendment allows community bank's to exercise greater discretion/professional judgment in assessing a borrower's ability to repay, without having to satisfy the burdensome underwriting standards of the "ability to repay" rule.

Loan Growth Acceleration

2. Relief from HMDA Reporting

- Background: Dodd Frank amended HMDA to include additional reporting requirements that banks would have to disclose to the CFPB, including credit scores, total points/fees payable, ethnicity, race and gender.

- Enhanced Dodd-Frank HMDA disclosures were designed so that the CFPB can more easily identify discriminatory lending practices.

Loan Growth Acceleration

Relief from HMDA Reporting (cont'd)

- 2155 would exempt banks from the enhanced HMDA disclosure requirements adopted by the CFPB so long as:

  (1) the bank originates fewer than 500 closed-end mortgage loans and fewer than 500 open-end lines of credit secured by residential real estate (in each of the prior two years); and

  (2) the bank's CRA rating is satisfactory.

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Other Highlights - 2155

1. Reciprocal Deposits

- 2155 amends the FDIA to clarify that reciprocal deposits of another bank obtained using a deposit broker (e.g., CDARS) would not be considered “brokered deposits” subject to the FDIC’s brokered-deposit regulations, so long as the reciprocal deposits do not <u>exceed the lesser of</u> $5 billion or 20% of liabilities.

- Enables banks to engage in reciprocal deposit networks with other banks, even if not well-capitalized.

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Other Highlights -2155

2. **Short Form Call Reports -** 2155 requires the banking agencies to adopt regulations that would allow banks with less than $5 billion in total consolidated assets to submit a short-form call report for the first and third quarters.

3. **18 Month Examination Cycle –** FDIA currently provides that well-managed/well-capitalized banks with $1 billion in assets or less are eligible for an extended 18 month examination cycle. 2155 raises the asset threshold from $1 billion to $3 billion.

Other Highlights - 2155

4. Savings Association Election to Operate as National Bank

- Allows a federal savings association with $20B or less in assets to elect to operate as a "covered savings association", which would have the same powers as a national bank – the QTL and other investment and asset limitations would no longer apply.
- A covered savings association would have to conform its activities to those permissible for a national bank, but will continue to be treated as a savings association for governance and corporate transaction purposes.
- Election would not help a federal savings bank with respect to NY municipal deposit restriction.

Increased M&A Activity- 2155

Increased asset thresholds (along with change in regulatory tone and good economy) may lead to more consolidation/M&A activity due to increased potential acquirers.

- Increase of SIFI (systemically important financial institution) threshold from $50 billion to $250 billion in assets (SIFIs are subject to enhanced prudential standards under Dodd-Frank)
- Increase of DFAST stress testing threshold from $10 billion to $100 billion.
- Increase of threshold to qualify for the FRB's Small Holding Company Policy Statement from $1.0 billion to $3.0 billion.

The Banking Landscape/Current M&A Activity

- The numbers (according to SP Global) demonstrate the increased trend in M&A transactions for banks:
  - 1/1/2018 – 8/31/2018 - 187 Bank M&A Deals; $23.3 billion aggregate deal value.
  - 1/1/2017 – 8/31/2017 – 166 Bank M&A Deals; $21.8 billion aggregate deal value.

The Banking Landscape/Current M&A Activity

- Pricing is more disciplined, with price to book value ratios strengthening, but still significantly below pre-Great Recession levels
  - Selective transactions/markets can still attract high multiples
- The stronger the Buyer’s trading multiples, the better it can compete in the M&A arena.
- Tangible book value dilution/earn back period are key factors in pricing for buyers.

The Drivers of Consolidation

- Increased regulatory and compliance costs.
- Management/Board/Shareholder succession issues.
- Competition for low cost deposits due to rising interest rates.
- Demonstrated preference by millennials for banks with sophisticated digital platforms.
- Interest Rate Environment – Continued Margin Compression

All of these have increased pressure to consolidate and improve economies of scale.

Regulatory Approvals and Environment

- Dodd-Frank, financial crisis and regulatory aversion to risk have had impact on bank M&A
  - ➢ Post-crisis -Deals can take longer and get more scrutiny.
  - ➢ However – growing confidence that M&A deals will receive regulatory approval and in a shorter time-frame.
- Regulatory risk remains greatest obstacle to completing an M&A deal
  - ➢ Buyer - has to have sound working relationship with federal and state regulators
- Pre-merger regulatory communication now more critical than ever.
- Generally, only approval of regulator(s) of Buyer required; Seller bank regulator is largely irrelevant.
- 4-7 month approval process.

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Regulatory Approvals and Environment

Key Regulatory Issues or Potential Obstacles:

- Buyer has MRAs or compliance issues (such as BSA)
- Buyer has a "3" rating overall or in certain CAMELs components (management, compliance or asset quality)
- Less than adequate pro forma capital levels
- Below "Satisfactory" CRA rating
- Post-closing concentration issues, e.g., CRE/capital
- Need to show how deal "fixes" Seller regulatory problems (if any)
- Protests filed by activist groups

A Successful M&A Transaction

- Review with counsel the key players and steps involved in a merger
- Review the key provisions of a typical merger agreement
  - How price is determined – Fixed vs. Floating exchange ratio
  - "Walk" provisions
  - Social issues – board of directors; senior management; employee benefits; severance payments; etc.
  - Dividends post deal announcement
  - Fairness opinion
  - Due diligence – representations and warranties; material adverse effect
  - Restrictive covenants
  - Termination fees and "no-shop" provisions
- Understand the regulatory/shareholder approval requirements of the transaction.

M&A – Take-Aways

- Current banking landscape offers Buyers, particularly those with a strong stock currency, opportunities to expand their franchise and enhance value through acquisitions
- Earnings, pressures, regulatory/compliance costs, and the impact of technology will continue to make it more difficult for banks to compete and be profitable (which will affect smaller banks disproportionally), which will continue to generate consolidation
- Both Buyers and Sellers need to have their “regulatory houses” in order before beginning the deal process
- Planning is essential for both Buyers and Sellers

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