A Washington Perspective on Regulatory and Legislative Developments

Eric M. Marion

Silver, Freedman, Taff & Tiernan LLP

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sftt Silver, Freedman Taff & Tiernan LLP

Topics of Discussion

Regulations in Perspective	➢ Renewed focus on community banks ➢ Basel III ➢ Effects of QM Rules ➢ BSA/AML ➢ FDIC Guidance on S Corp Dividends
Developments on Capitol Hill	➢ Bills likely to Pass this Term ➢ Prospects for GSE reform and the Future Senate ➢ Mutual Capital Certificates
Future of Community Banks	➢ Resilience of Community Banks ➢ Economies of Scale ➢ Prospects For De Novos

Renewed Focus on Community Banks

The supervisory and regulatory environment remains challenging, but there are hopeful signs that both regulators and legislators are attempting to address issues important to community banks. Initiatives have been undertaken by the FDIC, FRB, FFIEC, CFPB and OCC to provide guidance and attempt to tailor regulations.

- The **Federal Deposit Insurance Corp**. expanded its quarterly banking profile for the first quarter of 2014 to include a new section on the performance of community banks - https://www2.fdic.gov/qbp/2014mar/qbp.pdf. In the first quarter of 2014, the FDIC produced a report on community bank consolidation - https://www.fdic.gov/bank/analytical/quarterly/2014_vol8_2/article.pdf following on its Community Banking Study released in December 2012 - https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf. In 2009, the FDIC created the FDIC Advisory Committee on Community Banking. The Committee has held regular meetings three times per year.

- The **Federal Reserve Bank** ("FRB") **of Kansas City** released a bulletin in May with details on the new capital rule for community banks, which takes effect on January 1, 2015, including key changes and areas of supervisory focus. http://www.communitybankingconnections.org/fedlinks/2014/May2014.pdf

- The **FRB of Minneapolis** has undertaken to study the effects of increased banking supervision and regulation on consolidation among community banks and quantifying the costs of the additional regulation. https://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=5102&&

- The **Consumer Financial Protection Bureau** created the Community Bank Advisory Council ("CBAC"). The CBAC's Charter estimates four meetings per year. The last meeting was held in October 2013. http://www.consumerfinance.gov/advisory-groups/advisory-groups-meeting-details/

- The **Federal Financial Institutions Examination Council** ("FFIEC") held a webinar in May, which is available on the FFIEC's web site, on cyber security preparedness for community financial institutions. http://www.ffiec.gov/press/PDF/CCIWG_Cybersecurity_Draft18forIndustry_May7webinar.pdf

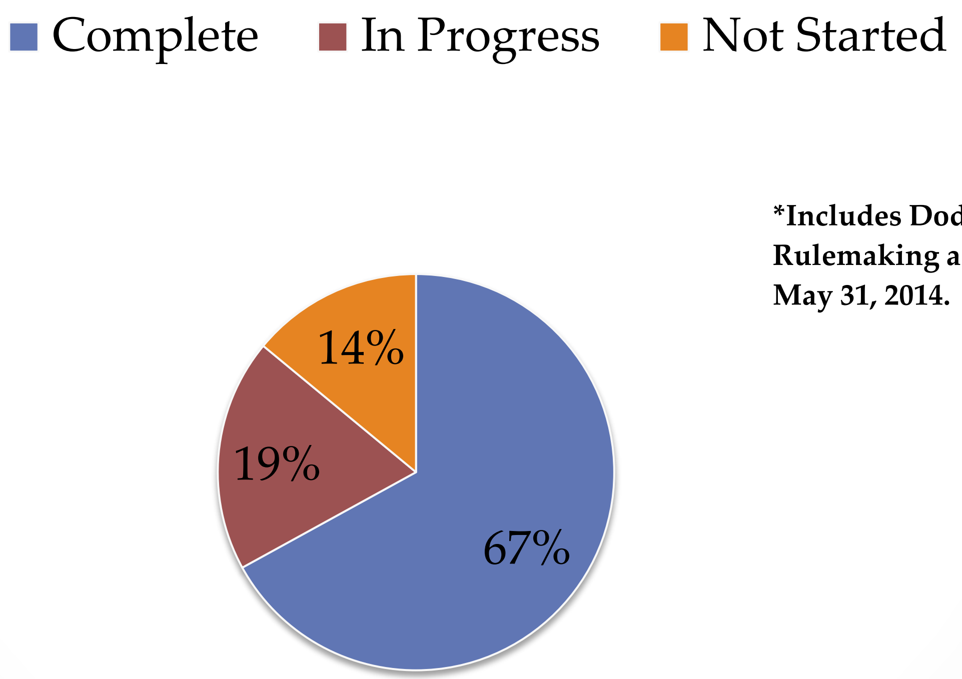
Regulatory Relief

- In the current environment, it is likely that legislative relief may still prove to be quite modest.

- Prospects for regulatory relief remain constrained by the requirements of the Dodd-Frank Act and the concerns of banking agency policymakers that they need to be reasonably vigilant in preventing another financial crisis.

Status of Dodd-Frank Rulemaking

Almost one-third of Dodd-Frank rules are incomplete after four years.



***Includes Dodd-Frank Rulemaking as of May 31, 2014.**

Sources : Federal Register, BGOV analysis

Bloomberg Brief, Financial Regulation Community Banking & Credit Unions, Special Edition June 2014.

Basel III

Comments from community banks resulted in three major changes from the proposed capital rule. These changes include:

- **Residential Mortgage Exposure**: The proposed rule called for higher risk weights applied to certain residential mortgage exposures. None of the proposed increases in weights are found in the final rule. Thus, remaining unchanged is the 50 percent risk weight for "prudently underwritten" first-lien mortgage loans that are not past due, reported as nonaccrual or restructured, and a 100 percent risk weight for all other residential mortgages.

- **Grandfathered Capital Instruments and Tier 1 Capital**: The initial proposal would have required trust preferred securities and cumulative perpetual preferred stock to be phased out of tier 1 capital. The final rule exempts depository institution holding companies with less than $15 billion in total consolidated assets as of December 31, 2009, or organized in mutual form as of May 19, 2010, from this requirement. Grandfathered capital instruments, consistent with current treatment, are limited to 25 percent of adjusted tier 1 capital elements.

- **Accumulated Other Comprehensive Income (AOCI) Filter**: The initial proposal would have included most AOCI components in regulatory capital. In the final rule, community banking organizations are given a one-time election to filter certain AOCI components, similar to current treatment. The AOCI opt-out election must be made on the first regulatory report filed after January 1, 2015.

Held to Maturity Portfolios Increase

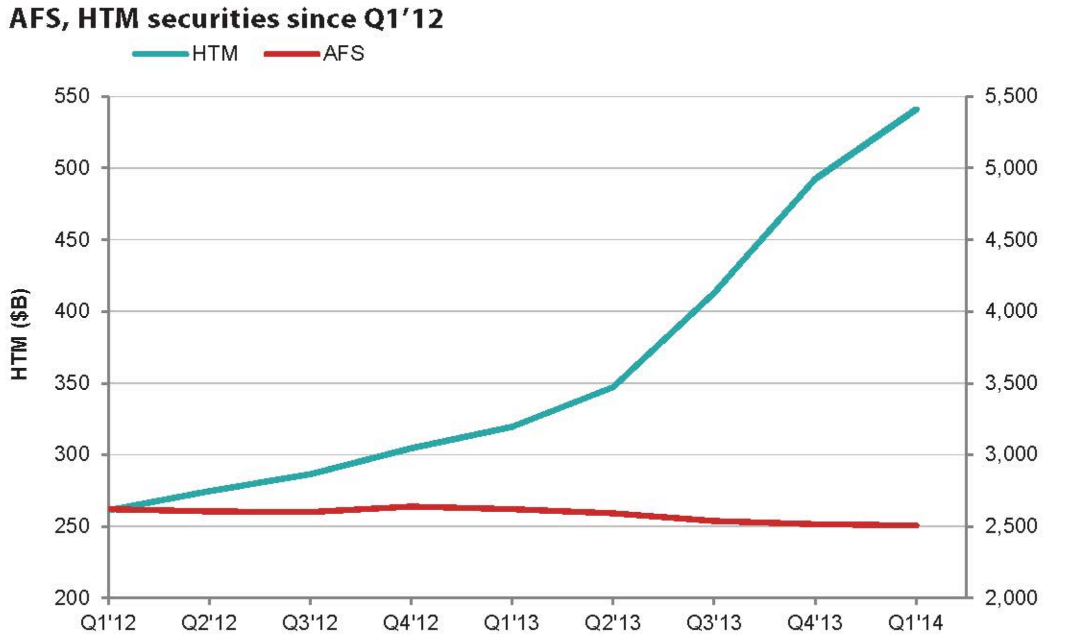
- Under the Basel III rules, changes in the value of AFS portfolios would flow through regulatory capital at institutions with more than $250 billion in assets.

- HTM portfolios grew to nearly 18% of securities portfolios at the end of the first quarter of 2014 from just under 10% two years ago.

- Primarily larger banks have increased their HTM portfolios. Larger banks are not only trying to protect those liquid securities from mark-to-market adjustments that could negatively impact tangible common equity but also classifying as HTM many of the liquid securities they have acquired to prepare for new provisions such as the "liquidity coverage ratio," or LCR.

- Still, smaller institutions have built their HTM portfolios as well, with banks under $1.0 billion in assets building those portfolios to $38.96 billion at the end of the first quarter, up 13.3% from one year earlier.

Held to Maturity Portfolios Increase



As of June 4, 2014.
Represents aggregates for commercial banks and savings banks since the first quarter of 2012.
Available-for-sale securities and held-to-maturity securities are shown on a cost basis.
Data based on regulatory filings.
Source: SNL Financial

SNL

FDIC Guidance on S Corp. Dividends

- On July 21, 2014, the FDIC issued guidance on how it will evaluate requests by S Corporations to make dividend payments that would otherwise be prohibited under the Basel III capital conservation buffer.

- The capital conservation buffer will be phased in during 2016-2018 and fully effective in 2019.

- The FDIC guidance permits banks that have made an S Corp. election to apply to the FDIC for a dividend waiver if they are not otherwise permitted to pay dividends.

- There is concern about the uncertainty of whether a dividend waiver will be granted.

QM Rules Expected to Cause Higher Operational Costs

According to Fannie Mae's June Mortgage Lender Sentiment Survey, the QM rules are expected to result in higher costs. In the quarterly survey conducted by Fannie Mae's Economic and Strategic Research Group and with senior mortgage executives as participants:

- 85% of the lenders reported that costs for quality-control-related activities have increased over the past 12 months.
- 74% expect operational costs to increase as a result of the QM rules.
- 80% of the lenders have no plan to pursue non-QM loans, with larger lenders more likely to report that they plan to actively pursue such loans.
- 84% reported that they expect at least 90% of their single-family mortgage origination dollar volume to be considered qualified mortgages under the new QM rules.
- 74% of all lenders surveyed agree that "the quality control investments will reduce their repurchase risk," with smaller lenders less likely to agree.
- An estimated 95% of the mortgage loans being made in the current market fit the QM criteria, according to Richard Cordray, director of the CFPB.

Bank Secrecy Act and Anti-Money Laundering

- Regulators have been ramping up scrutiny of compliance with Bank Secrecy Act and Anti-Money Laundering provisions for some time during the exam process. The bar keeps getting raised higher, particularly when a bank is looking to expand.

- Banks such as BancorpSouth Inc., Tupelo, MS, Fulton Financial Corp., Lancaster, PA, Bancorp Inc., Wilmington, DE, and others have recently been flagged for BSA/AML issues.

- BancorpSouth recently withdrew two merger applications as a result of BSA compliance issues.

Legislative Developments

Between now and the mid-term elections three items of banking legislation are expected to pass:

- Ex-Im Bank Reauthorization
- Terrorism Risk Insurance Act (“TRIA”)
- Collins Amendment Correction

Ex-Im Bank Reauthorization

On July 30 2014, U.S. Senators Joe Manchin (D-W.Va.), Mark Kirk (R-IL), Roy Blunt (R-MO), Joe Donnelly (D-IN), Mark Warner (D-VA), Maria Cantwell (D-WA), Banking Chairman Tim Johnson (D-SD), and Tim Kaine (D-VA) introduced legislation to reauthorize the Export-Import Bank, which is set to expire on September 30, 2014.

The five-year reauthorization package would:

- Incrementally increase the Bank's spending authority to $160 billion from $140 billion over a four-year period,
- Require the Bank to submit reports to Congress detailing its business plan and risk exposure, and
- Ensure the Bank's loan loss ratio is less than two percent for any quarter in that fiscal year.
- The bill would also require a Government Accountability Office (GAO) study to be completed within one year to identify the risk to taxpayers of the Bank's Medium-Term Program.

In the House, Representative Hensarling, Chairman of the House Financial Services Committee, has publicly stated his concerns over the Ex-Im Bank. One possibility is the House could pass a six-month extension and revisit the issue next year in the event Republicans take over the Senate in November's election.

Terrorism Risk Insurance Act

The Terrorism Risk Insurance Act (TRIA) is part of a Federal plan for economic continuity and recovery after a severe terrorist attack on the United States. Enacted following the September 11th attacks, the plan stabilized the commercial insurance market. TRIA requires insurers to offer coverage for terrorism to policyholders in certain commercial insurance lines.

- On July 17, 2014, the U.S. Senate passed the Terrorism Risk Insurance Act renewal bill, S. 2244 reauthorizing TRIA for additional seven years and increasing the deductible and the recoupment threshold.

- The House bill, TRIA Reform Act of 2014, H.R. 4871, has been voted out of the Financial Services Committee but not yet voted on by the full House. The bill would extend TRIA for five years through calendar year **2019** and would bifurcate terrorism related damages into those caused by conventional means (a $500 million trigger) and those caused by NBCR – nuclear, biological, chemical and radiological sources ($100 million trigger), as well as other changes to the existing program: increasing the insurer deductible; the industry aggregate deductible; the threshold above which damages are paid; and allowing small insurers to “opt-out” of the program.

Collins Amendment

Collins fix: S. 2270, the Insurance Capital Standards Clarification Act of 2014 and the companion House bill, H.R. 4510, clarifies that the Fed can apply insurance-based capital standards to the insurance portion of a business, while still keeping banking capital standards for the banking portion of the business. It would revise Sec. 171 of the Dodd-Frank Act, the so-called "Collins Amendment."

- The Senate Banking Committee decided not to include the Collins Amendment in its TRIA-extension bill, opting instead to "hotline" S. 2270, to get Senate approval under expedited procedures.

- It would impact insurers such as American International Group and Prudential Financial that have been designated as systemically important financial institutions (SIFI), and eventually MetLife, which is being evaluated as a potential SIFI, from bank-like capital regulation by the FRB.

- It would also impact insurers such as State Farm and USAA, which the FRB oversees as their consolidated regulator because they operate savings and loan holding companies. The FRB has not disclosed a list of other insurers it oversees in this capacity.

Prospects for GSE reform and the Future Senate

- The two Senate GSE reform bills and one in the House are likely not to go forward this term.

- While the composition of the Senate is yet to be determined, if Republicans were to win a majority it would impact the banking committee.

- Senator Richard Shelby, an Alabama Republican who previously chaired the Senate Banking Committee, is favored to lead the committee. Representative Capito, a member of House Financial Services Committee, is favored to win a West Virginia Senate seat.

- The change in House leadership may also have an impact on the future of GSE reform.

Mutual Capital Certificates

- H.R. 4252: Mutual Bank Choice and Continuity Act of 2014, amends the FDIA to authorize a mutual depository to issue mutual capital certificates that qualify as common equity Tier 1 capital.

- Authorizes the OCC to charter mutual national banks either de novo or through conversion of an insured depository institution or insured credit union.

- This is the second time such bills were introduced and they have a strong lobby (See H.R. 4217 (112th Congress)).

- Mutual capital certificates would provide a means for raising capital without conveying shareholder rights, however, the costs of such capital may deter their use.

Resilience of Community Banks

Changing definition of "Community Bank"

- Common practice had been to define community banks in terms of asset size, usually below $1.0 billion.

- The FRB of Minneapolis studies focused on institutions under $10 billion, a substantial increase over the $1.0 billion threshold.

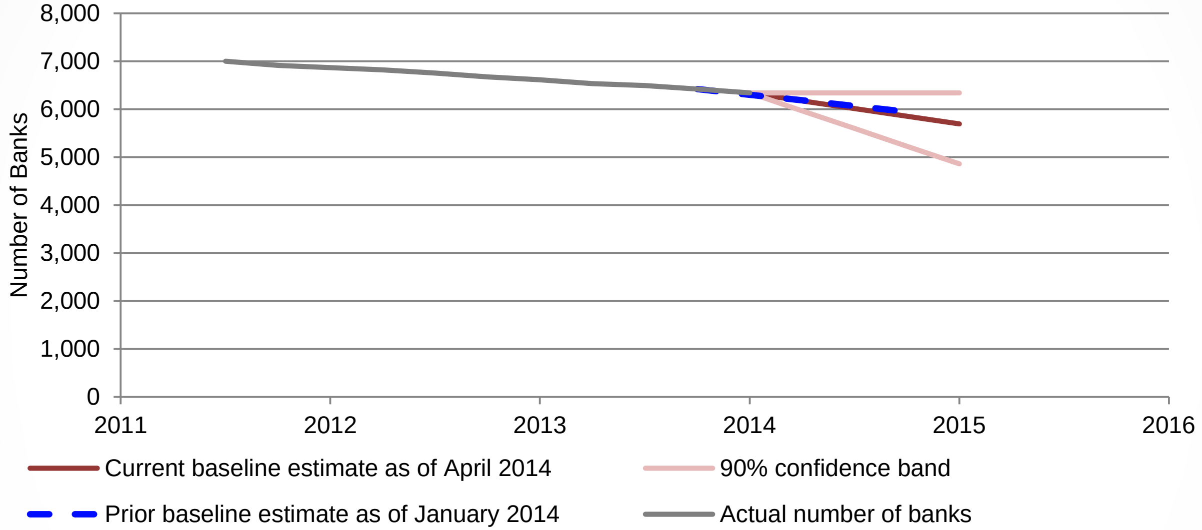
- The FDIC has taken a more nuanced approach and defined community banks based on a bank's business model with a focus on lending and deposit gathering and a limited geographic scope of operations.

- At year end 2013, under the FDIC's definition of "community bank" 330 banks exceeded the $1.0 billion size limit but met the definition of a community bank.

Assessing Community Bank Consolidation

Number of United States Community Banks: 2011 to 2015

(Baseline Estimates Using Bank Survival Model)



For details on this baseline estimate, see "Assessing Community Bank Consolidation" (Minneapolis Fed Economic Policy Paper 14-1)

	Actual Data	Bank Survival Prior Forecast	Current Forecast	90% Confidence Band Upper	90% Confidence Band Lower
2014Q3	6,337	6,302			
2014Q4		6,185	6,337	6,337	6,337
2015Q1		6,067	6,175	6,338	5,968
2015Q2		5,950	6,014	6,339	5,598
2015Q3			5,852	6,339	5,229

In a Consolidating Industry, Community Banks Remain Significant

- However you define a community bank, the number of community bank charters has declined dramatically since its peak in 1985.

- Although, the FDIC finds that community banks as a percentage of all banks have increased.

- As of year-end 2013, under the FDIC definition 93% of all FDIC-insured banking charters met the definition of a community bank.

Share of Industry Assets in Decline

- Notwithstanding the increase in the proportion of bank charters held by community banks, their share of industry assets has continued to decline.

- In 1985, community banks held 37% of industry assets but by 2013 that share had declined to 14%.

- The decrease in share of industry assets mirrors the decline in share of banking offices which decreased from 53% of total banking offices in 1985 to 35% in 2013.

- Community banks are also most concentrated in rural areas. While noncommunity banks have sought out faster growing urban areas, community banks have retained their historical presence in rural non-metropolitan areas. More than 70% of the offices and deposits in rural areas are held by community banks.

Economies of Scale

- The FRB studies have shown that it is increasingly difficult for smaller financial institutions to operate profitably.

- Data suggests that financial institutions with more than $100 million in assets have reached a level of economies of scale at which they can more effectively address the additional costs of regulations.

- As evidence for this, the number of banks with assets between $100 million to $1.0 billion increased 7% from 1985 to 2013. Over the same period, the number of institutions with assets less than $100 million decreased by 85%.

Costs of Regulation

- As further evidence that size matters, the FRB of Minneapolis analyzed the potential costs of increased regulation on banks of various asset sizes with a focus on banks with assets under $50 million.
- The analysis assumed that hiring additional employees is a proxy for the additional costs of regulation.
- In the case of banks with less than $50 million in assets, return on assets would decrease by 23 basis points and 13% of the banks would become unprofitable.
- The assessment did not place a value on additional technology expense.
- The FDIC study, "Community Banks Remain Resilient Amid Industry Consolidation“ noted the difficulty of separating regulatory and non-regulatory expense as a proxy for additional costs of regulation.

Regulatory Costs Calculator

The FRB of Minneapolis posted a regulatory cost calculator on its website.
https://www.minneapolisfed.org/banking/data/regcostcalc/index.cfm

Quantifying the Cost of Additional Regulation

DISPLAY INSTRUCTIONS

PERFORM CALCULATIONS

Input Parameters

	Asset Size Cutoff (millions of $)	Number of FTEs
Cohort 1	50	1
Cohort 2	100	1
Cohort 3	250	2
Cohort 4	500	2
Cohort 5	1000	3

Compensation
(thousands of $ per FTE -- amounts are measured in 2013 $)

Rural Banks	Urban Banks
	75

Year on which the Analysis Is Performed

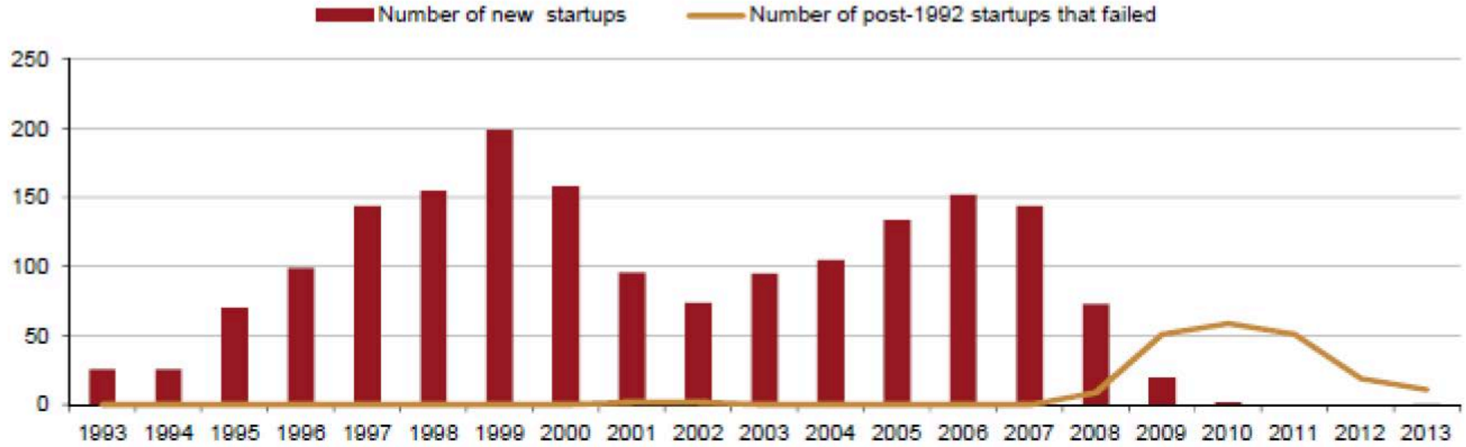
2013

Profitability Stats After the Change

Percentiles of the Distribution of Changes in ROA (bps)					
25th	50th	75th	Number of Firms in the Cohort	Additional Unprofitable Firms	Additional Firms with ROA < 40 bps
-16.8	0	0	706	36	41
-9.4	0	0	1098	13	29
-9.2	0	0	1947	28	53
-4.6	-3.4	0	1019	4	17
-3.6	-2.8	0	540	3	2

De Novo Activity

Bank & thrift startup statistics from 1993 to 2013



Data as of Jan. 7, 2014.
Excludes banks and thrifts formed under a holding company that existed at least six months prior to filing and/or were formed with a holding company that had one or more pre-existing subsidiaries. Specialty banks and companies adopting new charters are also excluded.
Source: SNL Financial

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Startup banks & thrifts established and failures by year

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total
Startups established	158	96	74	95	105	134	152	144	73	20	2	0	0	1	1,054
Startups that eventually failed	26	15	13	17	17	20	20	3	0	0	0	0	0	0	131
Startups that eventually failed (%)	16.46	15.63	17.57	17.89	16.19	14.93	13.16	2.08	0.00	0.00	0.00	NM	NM	0.00	12.43

As of Jan. 8, 2014
Limited to startups established since Jan. 1, 2000.
Source: SNL Financial

SNL

De Novo Chartering

- Bank of Bird-in-Hand, which opened in November, 2013, is the only new bank established in the U.S. since 2010.
- The organizers raised about $17 million in initial capital from about 200 shareholders.
- Data shows that asset size matters. Somewhere over $100 million you begin to get enough scale to absorb costs.

Future of Community Banking

- It goes without saying that community banks serve an important role by providing credit to small businesses and serving communities that are underserved by large financial institutions.

- It seems fairly safe to predict that in the future community banks will be larger and fewer in number.

- The community banks that learn to adapt to the new normal will be able to thrive in the areas in which they specialize. Undoubtedly more robust operations and staffing will be a prerequisite for future success.

Questions

For further information contact:

Eric M. Marion, Esq.
Silver, Freedman, Taff & Tiernan LLP
3299 K Street, N.W., Suite 100
Washington, DC 20007-4444
Phone: (202) 295-4500
Fax: (202) 337-5502
Email: emarion@sfttlaw.com
Website: http://www.sfttlaw.com