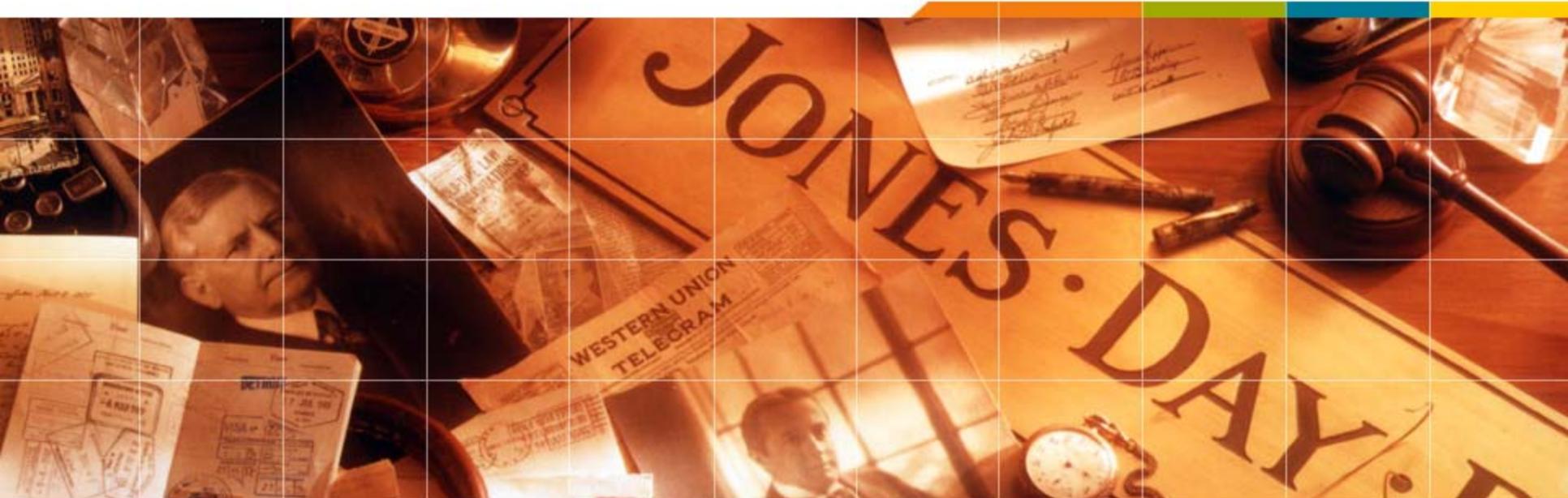




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## Succeeding in the Current Regulatory Environment



## Bank Management Conference

July 7-10, 2011

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# I. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

- 15 chapters and 848 pages.
- The Sarbanes-Oxley Act was 11 titles and 66 pages.
- Enacted July 21, 2010 with various effective dates.
- Requires over 300 rulemakings and 130 studies. See Congressional Research Service Report R41611, [www.crs.gov/pages/Reports.aspx?PRODCODE = R41611 & Source = search](http://www.crs.gov/pages/Reports.aspx?PRODCODE=R41611&Source=search).
- Jones Day White Paper, *More than Just Financial Reform: Analysis and Observations on the Dodd-Frank Act* (August 2010).

## II. Rulemaking

- Many rules are required within one year of enactment. For example, the CFTC must issue 100 new rules, including 60 by July 2011, but will miss its deadlines.
- Many rulemakings require consultation among not just the bank regulatory agencies, but also the SEC, CFTC and Treasury, but other deadlines are being missed or delayed.
- Executive Order 13,563 (74 F.R. 3821) (Jan. 18, 2011) – a comment period should generally be at least 60 days.
- The average comment period for many Dodd-Frank Act proposed rules arguably has been shorter at 30 – 45 days. House Financial Services Letter (March 9, 2011).

## II. Rulemaking (cont'd)

- “20X taller than the Statue of Liberty” and 3,500 Federal Register pages of proposed and final rules through April.” “Overhaul Grows and Slows”, *WSJ* (May 2, 2011).
- 21 rules finished.
- A majority of the 387 required rules have not been proposed yet.
- Agency budget requests and hiring are increasing as the agencies try to deal with the workload.
- GAO reported that the “Federal agencies implementing the Dodd-Frank Act will need to hire or employ by transfer, 2,000 new persons and spend as much as \$973 million on Dodd-Frank regulation. The spending is likely to be ongoing, with CFPB accounting for \$329 million in FY2012. *Bloomberg News* (Mar. 29, 2011).

### III. Studies

- Many studies are directed to analyze how to further implement the Dodd-Frank Act's intent and specific requirements and are not directed to correcting flaws or analyzing the practicality or market or other effects of the Act.
- Like the Act, the rulemaking is unlikely to have the benefit of analytical, empirical studies.
- Only a few studies have been issued so far.

## IV. Capital Effects of the Dodd-Frank Act and International Supervision on Banking

### A. The Collins Amendment (Section 171)

- Trust preferred securities can no longer be issued as Tier 1 capital.
- The applicable “prompt corrective action” or “PCA” leverage and risk-based capital requirements are applied on a consolidated basis to depository institution holding companies and “nonbank financial companies” supervised by the Federal Reserve (“supervised financial companies”).
- Phase-in – incrementally over 3 years, generally beginning January 1, 2013.

## IV. Capital Effects of the Dodd-Frank Act and International Supervision on Banking (cont'd)

- The federal bank regulators are required, with recommendations from the new Financial Stability Oversight Council (“FSOC”) chaired by the Treasury Secretary, to develop additional capital standards to address the following risks to the institution and to “public and private stakeholders in the event of adverse performance, disruption or failure of the financial institution or activity”:
  - Significant volumes of derivatives, securitized products purchased or sold, financial guarantees purchased and sold, securities borrowing and lending, and repurchase and reverse repurchase agreements;

## IV. Capital Effects of the Dodd-Frank Act and International Supervision on Banking (cont'd)

- Concentrations in assets for which financial reports provide values based on models rather than deep and liquid two-way markets; and
- Concentration in market share for any activity that would substantially disrupt financial markets if the institution was forced unexpectedly to cease the activity.
- Capital events under trust preferred securities allowing issuer calls subject to regulatory approval.
- The intermediate holding company capital issue and the Barclay's Deutsche Bank solutions.

## IV. Capital Effects of the Dodd-Frank Act and International Supervision on Banking (cont'd)

### B. Other Capital Changes

- The Federal Reserve seeks to apply its BHC supervision to thrift holding companies controlled by commercial entities through intermediate holding companies for all financial activities conducted by grandfathered unitary thrift holding companies. Federal Reserve, “Notice of Intent to Apply Certain Supervisory Guidance to SLHCs,” 76 F.R. 22662 (Apr. 22, 2011).
- FSOC is required to study “contingent capital” that is derived from debt or hybrid instruments that would become capital upon a financial company, including a bank or thrift holding company, becoming distressed. Barclays and others reportedly have considered contingent convertible instruments (“CoCos”) as deferred compensation.

## IV. Capital Effects of the Dodd-Frank Act and International Supervision on Banking (cont'd)

### C. Basel III

- Independently of the Dodd-Frank Act, the Bank for International Settlements' ("BIS") Basel Committee on Banking Supervision ("Basel Committee") has adopted new capital and liquidity requirements.
  - Basel III: A global regulatory framework for more resilient banks and banking systems (Dec. 16, 2010, as revised June 1, 2011)
  - Basel III: International framework for liquidity risk measurement standards and monitoring (Dec. 16, 2010).

## IV. Capital Effects of the Dodd-Frank Act and International Supervision on Banking (cont'd)

- **Fully phased-in Basel III target capital levels:**

	<b>Common Equity Tier 1</b>	<b>Tier 1 Capital</b>	<b>Total Capital</b>
Minimum	4.5%	6.0%	8.0%
Conservation Buffer	<u>2.5</u>	<u>2.5</u>	<u>2.5</u>
Totals	4.5%	8.5%	10.5%
Countercyclical buffer range 0–2.5%			

### ***Minimum Requirements for Capital Instruments, Basel Committee (Jan. 10, 2010)***

- **Basel Committee’s Group of Governors and Heads of Supervision (“GHOS”) adopted a consultative document on June 25, 2011 on buffer capital to be considered in July for globally systemically important banks (“G-SIBs”).**

## IV. Capital Effects of the Dodd-Frank Act and International Supervision on Banking (cont'd)

- Methodology for assessing systemic importance including size, interconnectedness, lack of substitutability, global activity and complexity.
  - Additional Tier I common equity of 1.0% to 2.5% depending on the bank's systemic importance; *plus* a
  - Surcharge of 1% to discourage an institution from becoming materially more important as globally systemic.
  - Phase-in with conservation and countercyclical buffers between January 1, 2016 and January 1, 2019.
- 
- U.S. bank regulators' proposals to implement Basel III capital guidelines expected in late July 2011 (perhaps delayed by latest Basel consultative agreement?).
  - Basel III is designed for "internationally active" large institutions. How will these rules be applied to community and mid-size U.S. organizations?

## IV. Capital Effects of the Dodd-Frank Act and International Supervision on Banking (cont'd)

- Currently, Reg. Y, App. A., fn. 6 defines an “international active banking organization” as having at least \$250 billion in assets or foreign exposures of \$10 billion or more.”
- Federal Reserve Governor Tarullo, Testimony on Capital and Liquidity Standards to the House Financial Services Committee (June 16, 2011). Cf. testimony of FDIC Chairman Bair and Acting Comptroller Walsh provided on June 16, 2011 to this Committee.

## IV. Capital Effects of the Dodd-Frank Act and International Supervision on Banking (cont'd)

### D. Federal Reserve Stress Tests and Capital Planning

- Stress Test I: “Forward Looking Economic Assessments “ (Feb. 25, 2009) announced the Supervisory Capital Assessment Program (“SCAP”).
- Federal Reserve, “The Supervisory Capital Assessment Program: Design and Implementation (Apr. 24, 2009)
- Federal Reserve SR09-4: “Applying Supervisory Guidance and Regulation on the Payment of Dividends, Stock Redemptions and Repurchases at Bank Holding Companies, revised, with Attachments and FAQs and addendum (Feb. 24, 2009
- Stress Test II: “Comprehensive Capital Analysis and Review: Objectives and Overview” (Mar. 18, 2011) (“CCAR”)
- The Federal Reserve expects large, complex bank holding companies to hold sufficient capital, even in adverse environments, to:
  - maintain access to funding;
  - continue to serve as credit intermediaries;
  - meet obligations to creditors and counterparties; and
  - continue operations.

## IV. Capital Effects of the Dodd-Frank Act and International Supervision on Banking (cont'd)

- Large bank holding companies will provide the Federal Reserve annual comprehensive capital plans, including:
  - The firm's current regulatory capital base, key contractual terms of its capital instruments, and any management plans to retire, refinance, or replace the instruments over the planning horizon.
  - All planned capital actions (e.g., dividends, share purchases and issuances), as well as anticipated changes in the company's risk profile, business strategy, or corporate structure over the planning horizon.

## IV. Capital Effects of the Dodd-Frank Act and International Supervision on Banking (cont'd)

- The processes and policies for determining the size of dividend and common stock repurchase programs under different operating conditions.
- The firm's assessment of potential losses, earnings, and other resources available to absorb such losses under stressed economic and financial market environments, and the resulting effects on the firm's capital adequacy and capital needs over the planning horizon.
- The firm's assessment, accompanied by supporting analysis, of the capital needed on a post-stress basis to continue operations, meet its obligations, and function as a credit intermediary.

## IV. Capital Effects of the Dodd-Frank Act and International Supervision on Banking (cont'd)

- “The CCAR is one of the key methods through which the Federal Reserve will hold bank holding companies -- and their boards -- to high standards in the critically important areas of assessing capital needs based on all of the firms activities and firm-wide risk exposure . . . .”
- CCAR builds upon Federal Reserve SR 09-4 (Rev'd. Mar. 27, 2009) and the related Revised Temporary Addendum to SR 09-4 (Nov. 17, 2010).
- Interagency “Proposed Guidance on Stress Testing for Banking Organizations with More than \$10 Billion in Total Consolidated Assets,” 76 F.R. 35072 (June 15, 2011).
- Section 165(i) of the Dodd-Frank Act separately requires stress testing of the largest non-bank financial companies.
- See also Basel Committee, “Principles for Sound Stress Testing Practices and Supervision” (May 2009).

## IV. Capital Effects of the Dodd-Frank Act and International Supervision on Banking (cont'd)

### E. Increased Liquidity

- Basel III, Part B “Introducing a global liquidity standard” (Dec. 16, 2010).
- “Interagency Statement on Funding and Liquidity Risk Management”, FDIC FIL 84-2008 (Aug. 26, 2008).
- *FDIC Supervisory Insights*, “Liquidity Analysis: Decades of Change” (Winter 2007).

# V. Major Effects of the Dodd-Frank Act on Banks

## A. The Dodd-Frank Act affects:

- FDIC insurance costs;
- Permissible bank and BHC activities;
- Hedging;
- Permissible fees and charges;
- Balance sheet structure, including securitizations;
- Mergers and acquisitions;
- Reporting;
- Examinations and supervision;
- Governance;
- Compensation;
- Consumer protection; and
- Costs of doing business and personnel needed.

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

### B. FDIC Insurance and Assessment Revisions

- FDIC insurance permanently increased to \$250,000 per depositor.
- Section 331(b) of the Dodd-Frank Act requires the FDIC to expand the assessment base from domestic insured deposits to average consolidated total assets minus average tangible Tier 1 capital.
- The FDIC's Deposit Insurance Fund's ("DIF") designated reserve ratio as a percentage of insured deposits is required to be increased by Section 334(a) of the Act to 1.35% by September 30, 2020, rather than 1.15% by December 31, 2016, as previously required. "Small" (under \$10 billion in assets) banks are exempt from this increase in the DIF reserve ratio.

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

- The FDIC adopted a revised deposit insurance risk based assessment in 76 F.R. 10672-10733 (Feb 25, 2011).
- The FDIC's minimum designated reserve ratio for DIF was increased to 2.00% of insured deposits, which will require an increase in the DIF estimated at \$116 billion.
- Annualized deposit insurance premium assessments will now range from \$.025 to \$.45 for each \$100 of the new assessment base, depending on the FDIC's four new risk categories for small institutions.

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

- A special risk-based assessment system for large (over \$10 billion of assets) insured institutions and complex institutions is implemented that does not use the risk categories or issuers' L-T debt ratings.
- Large institutions will be assessed based on their CAMELS ratings and predictive scorecards for large and complex institutions (\$50 billion or more of assets), respectively.

# V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

## C. The Volcker Rule

- New Section 13 of the BHC Act.
- Generally any “banking entity” is prohibited from:
  - Engaging in proprietary trading; or
  - Acquiring or retaining any equity, partnership, or other ownership interest in or controlling relationship over, or sponsorship of a hedge fund or a private equity fund.
- Section 13(h)(2) defines hedge funds and private equity funds as issuers that would be an investment company, except for the exemptions provided by Sections 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940.
- Limitations also are imposed on these activities conducted by supervised financial companies.

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

- Generally, Section 13 becomes effective on the earlier of 12 months after the date of issuance of final rules under Section 13(b) and two years after the date of enactment.
- Banking entities and supervised nonbank financial companies must bring their activities and investments into compliance with Section 13 not later than two years after the effective date, subject to possible extension by the Federal Reserve.
- Section 13(d)(3) provides that the appropriate federal banking agencies, the SEC, and the CFTC shall adopt rules imposing additional capital requirements and quantitative limitations, including diversification requirements with respect to activities permitted under Section 13.

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

- The Federal Reserve issued final rules on the time for conformance with the Volcker Rule in 76 F.R. 8265-8278 (Feb. 14, 2011).
- FSOC *Study & Recommendations On Prohibitions On Proprietary Trading & Certain Relationships With Hedge Funds & Private Equity Funds* (Jan. 2011).

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

### D. Interchange and the Durbin Amendment (Section 1075 of the Act)

- Amends the Electronic Funds Act (“EFTA”) by adding a new Section 920.
- Requires the Federal Reserve to adopt rules to establish debit card interchange fee standards and prohibit network exclusivity arrangements and routing restrictions.
- A 2010 Federal Reserve study shows that debit card use in the U.S. exceeds all other forms of noncash payments and, by number of payments, represents approximately 35% of total noncash payments.
- The Fed proposed rules in 75 F.R. 81722-81763 (Dec. 28, 2010).

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

- Comment was requested on comment on two alternative interchange fee standards that would apply to all covered issuers:
  - based on each issuer's costs, with a safe harbor (initially set at 7 cents per transaction) and a cap (initially set at 12 cents per transaction); or
  - a stand-alone cap (initially set at 12 cents per transaction).
- Some estimate that the industry will lose \$15-20 billion of annual revenue under the Federal Reserve's proposal.
- TCF brought suit against the proposed regulations in *TCF National Bank v Bernanke*, No. 4:10-cv-04149-LLP (D. SD).

# V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

## E. Derivatives

- Title VII of the Dodd-Frank Act.
- The SEC will regulate transactions defined as “security-based swaps” and entities engaging in or related to such security-based swaps, and the CFTC will regulate transactions defined as “swaps” and entities engaging in or related to such transactions. Mixed swaps will be regulated jointly by the CFTC and SEC.
- Clearing and trading on or through designated contract markets, national securities exchanges, or swap execution facilities is mandated for swaps designated for clearing by the SEC or the CFTC.

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

- New requirements have been imposed on swap dealers as well as on a new category of non-dealer participants in derivatives markets—"major swap participants". In addition to mandatory clearing, these new requirements include position limits for certain trades, mandatory registration with either the CFTC or SEC (and sometimes both), real-time reporting of trades, enhanced recordkeeping requirements, and margin and capital requirements.
- Capital requirements apply to all trades executed by swap dealers and major swap participants, and margin requirements apply to all uncleared trades executed by these entities.
- Effects may include greater costs and collateral, as well as less activity and market liquidity for both the derivatives and the underlying instruments or commodities.

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

### F. Banking Acquisitions

- Prior Federal Reserve approval is now required for BHC acquisitions of nonbank companies where more than \$10 billion of assets will be acquired.
- Hart-Scott-Rodino Act notices will be required regardless of Federal Reserve approval.
- BHC Act and Bank Merger Act transactions will now be subject to an additional statutory factor that the approving agency must consider the “risks posed to the stability of the U.S. banking or financial system” by any potential merger or acquisition of a bank or nonbank.

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

- FSOC's *Study & Recommendations Regarding Concentration Limits On Large Financial Companies* (Jan. 2011) was required by Section 622 of the Dodd-Frank Act. It considers the extent to which the concentration limits under new Section 14 of the BHC Act would affect the following:
  - Financial stability;
  - Moral hazard in the financial system;
  - The efficiency and competitiveness of U.S. financial firms and financial markets; and
  - The cost and availability of credit and other financial services to households and businesses in the U.S.

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

- The Federal Reserve must adopt regulations by September 2011 to implement FSOC's recommendations. Banks, depository institution holding companies and supervised financial companies would be prohibited from merging with or acquiring any other financial company if the total resulting liabilities of the bank exceed 10% of the aggregate consolidated liabilities of all financial institutions in the U.S. as of the end of the preceding calendar year.

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

- Exceptions are provided for acquisitions of defaulting banks, FDIC-assisted transactions, and acquiring companies that experience only a *de minimis* increase in their individual liabilities as a result of the transaction.
- Section 607(b) of the Act requires the acquiring BHC in interstate acquisitions to be “well capitalized and well managed”.

# V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

## G. Governance and Compensation

- Shareholder access.
- Say on pay, including golden parachutes.
- Clawbacks.
- Section 165(h) of the Act requires the Federal Reserve to issue regulations requiring each bank holding company that is publicly traded and has total consolidated assets of not less than \$10 billion to establish a risk committee. This also applies to supervised financial companies.
- The risk committee must be composed of independent directors as specified by the Fed and at least one risk management expert, and is responsible for enterprise risk management.

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

- Proposed Interagency (federal bank regulators, SEC and FHFA) Rule on Incentive-Based Compensation under Section 956 of the Dodd-Frank Act is applicable to banks with \$1 billion or more in assets, with heightened standards for banks with over \$50 billion or more in assets to avoid inappropriate risk-taking. (FDIC Press Release Feb 7, 2011).
- *Interagency Guidance on Sound Incentive Compensation Policies* (June 21, 2010).
- Dodd-Frank Act, Section 953(b) directs the SEC to adopt rules requiring disclosure of the median compensation of all issuer employees and the ratio between this median annual total compensation and the annual total compensation of the issuer's chief executive officer.

# V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

## H. Securitization

- Dodd-Frank Act, Section 941 adds provisions to be implemented by joint rulemaking by the federal bank regulators and the SEC regarding “credit risk retention” in securitizations 270 days after July 21, 2011.
- Federal Reserve *Report to the Congress on Risk Retention* (Oct 2010).
- Proposed Interagency Credit Risk Retention Rule, 76 F.R. 24090 (Apr. 29, 2011). Public comment has been extended to Aug. 1, 2011. 76 F.R. 34010 (June 10, 2011)
- FDIC’s new Securitization Rule (12 C.F.R. Part 360) and treatment of securitized assets by the FDIC as a conservator or receiver in light of SFAS Nos. 166 and 167. 75 F.R. 60287 (Sept 30, 2010).

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

- Originators/securitizers of asset-backed securities to maintain a minimum of 5% percent of the credit risk of the underlying assets supporting the issuance of asset-backed securities, except in the case of “qualifying residential mortgages”, and any other designated assets.
- According to the FDIC, private mortgage securitizations amounted to \$60 billion in 2010, the same level as in 2009 and only 5% of the peak volumes in 2005 and 2006. FDIC Chairman’s speech to the ABA Government Relations Summit (Mar. 16, 2011).

# V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

## I. Consumer Protection

- Title X of the Act establishes the Bureau of Consumer Financial Protection (the “CFPB”) by July 21, 2011.
- The CFPB is an independent agency within the Federal Reserve for funding purposes, since the CFPB can spend 10% of the Fed’s total 2009 operating expenses in 2011, and which increases to 12% in 2013 and later years, plus adjustment for inflation. The CFPB is estimated to be hiring 4,000 people and have an initial annual budget of approximately \$500 million.
- The CPB will be responsible for administering 18 consumer financial laws and issuing regulations and interpretations.

## V. Major Effects of the Dodd-Frank Act on Banks (cont'd)

- The CFPB will examine banks with more than \$10 billion of assets, and existing federal bank regulators will examine smaller institutions.
- Federal preemption of state laws regarding financial products and accounts is limited, and states may enforce federal law and CFPB rules.
- An emphasis on enforcement rather than rulemaking?
- The Bank agencies are taking a more activist role in consumer matters:
  - Joint Guidance on Overdraft protection Programs, “Office of Thrift Supervision Integration; Dodd-Frank Implementation,” 76 F.R. 30557 (May 26, 2011).
  - OCC “Guidance on Deposit-Related Consumer Credit Products,” 76 F.R. 33409 (June 8, 2011)

## VI. Effects on Profitability – How to Succeed

- The sheer volume of statutory and regulatory change is and will continue to take significant time and attention at all levels of management and operations at banks, as well as outside lawyers, accountants and consultants.
- The ABA estimates that more than 3,000 banks (about 41% of all banks) have fewer than 30 employees.
- Are small banks capable of meeting the new regulatory requirements profitably?
- Increased capital and liquidity requirements may reduce returns on equity and limit more profitable uses of funds.
- Credit risk retention will increase capital requirements.

## VI. Effects on Profitability (cont'd)

- Will innovation and the profits associated with innovation be stunted by regulatory strictures reflecting credit crisis headlines?
- Deposit insurance costs will remain high, with dividends and share repurchases subject to greater regulatory scrutiny.
- Will the Volcker Rule and other provisions, including the Durbin Amendment, reduce revenues and the diversification of revenues and create different risks of instability?
- Will banks seek efficiencies through mergers to (i) absorb their greater regulatory costs and (ii) have sufficient assets to support larger staffs needed for compliance?
- Interest and other charges on loans and credit will increase, at least to reflect increased FDIC insurance costs.
- Fees on services will be imposed or increased.
- Customer profitability and risk will be analyzed more closely with a view to fuller relationships.

## VII. Strategic Elements of Success

- A. Key Factors include the following:
- Management.
  - Capital.
  - Compliance.
  - Consolidation and acquisitions.

## VII. Strategic Elements of Success (cont'd)

### B. Management

- Perhaps the most important element.
- Compensation needs to be sufficient to attract the needed talent.
- Compensation needs to comply with new Dodd-Frank Act and regulatory requirements.
- Talented management is essential to all the elements of success.
- Hiring advisors to meet talent gaps.
- Remain well above “well-capitalized” for regulatory, competitive and acquisition purposes.

## VII. Strategic Elements of Success (cont'd)

### c. Capital

- Access to capital
  - Earnings, dividends and growth
  - Securities law compliance
  - Shelf Registration Statements
    - \$75 million or more market float
    - Less than \$75 million of market float
  - Availability of private offerings
  - How to repay TARP?
  - Is SBLF a good alternative?

## VII. Strategic Elements of Success (cont'd)

- SEC Reg. D provides a safe harbor for private offerings from registration under the Securities Act of 1933 (the “Securities Act”)
  - Dodd-Frank Act, Section 962 requires the SEC to adopt a bar of any securities offering or sale under § 506 of SEC Reg. D within 10 years of an industry bar or a “final order” of a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct.
  - Effects of UDAP findings on Reg. D availability?
  - See, SEC Rel. 33-9211 Proposed Rule “Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings” (May 25, 2011).

## VII. Strategic Elements of Success (cont'd)

- Meeting U.S. Capital Requirements following Basel III implementation.
- Federal Reserve expectations under Reg. Y, Appendix A for acquirers of other banks:
  - Banks generally are expected to operate well above the minimum risk-based ratios.
  - In particular, banks contemplating significant expansion proposals are expected to maintain strong capital levels substantially above the minimum ratios and should not allow significant diminution of financial strength below these strong levels to fund their expansion plans.
  - Institutions with high or inordinate levels of risk are also expected to operate well above minimum capital standards.

## VII. Strategic Elements of Success (cont'd)

### D. Compliance

- Compliance with regulations and laws, including the Dodd-Frank Act changes, is essential to:
  - Regulatory relations.
  - Access to capital.
  - Enforcement and other actions whose costs can materially adversely affect earnings and reputation.
  - Ability to grow and acquire others.
- Increased emphasis on compliance, especially consumer compliance in repaps and M&A proposals (NexTier/New Alliance; FDIC-assisted transactions).

## VII. Strategic Elements of Success (cont'd)

### E. Consolidation and Acquisition

- Perhaps the most important way to succeed post Dodd-Frank Act
- Depends upon management, capital and compliance.

## VIII. Dodd-Frank Act –A Catalyst for M&A

- Revenue restrictions - Volcker Rule, Durbin Amendment, Overdraft Rules/CFPB/Consumer Disclosure/Compliance.
- Capital – The Collins Amendment (DFA § 171) and Basel III.
- Basel III and Interagency Liquidity Requirements.
- FDIC insurance costs and assessments based on assets less tangible equity.
- Incentive Compensation.
  - SEC’s say on pay rules, including golden parachutes in mergers.
  - SEC’s proxy access rules.
- Heightened compliance and other costs.
- Uncertain, but far reaching, scope of the CFPB.
- Annual Federal Reserve stress test and capital plans for BHCs and financial companies with \$10 billion or more in assets.
  - It will trickle down on best practices.

## VIII. Dodd-Frank Act –A Catalyst for M&A (cont.)

- An increasing imperative to improve returns through revenue growth and cost savings.
- Banks that have limited options.
- Regulatory enforcement actions.
- Limited or no dividends under Federal Reserve SR 09-4, CCAR and the pending stress tests for banks with over \$10 billion in Assets.
- Little or no ability to expand organically or by acquisition.
- Deferrals or omitted distributions on trust preferred securities and preferred stock.
- Banks in geographic markets that are under economic stress, are overbanked and/or have poor prospects.
- The need for geographic and product diversification consistent with the Dodd-Frank Act.
- Regulatory pressures to rely more on credit spread products.
- Management and board fatigue.
- Inability to access the capital markets.
- Thrifts and the demise of the OTS on July 21, 2011.

## IX. Other Current Drivers of M&A

- Recapitalized banks where the PE and other investors seek a liquidity event.
- Divestitures
  - Branches/Banks
    - Hartford sale of Federal Trust to Center State
    - Royal Bank of Canada Sale of Retail Bank to PNC
    - ING Direct sale to Capital One pursuant to EU Directive
    - HSBC Announced Sale of Credit Cards and Branches
  - Lines of businesses
    - Proprietary trading
    - Hedge funds
    - PE funds
  - Wealth managements due to conflicts with investment banking
    - Other non-core businesses and locations

## IX. Other Current Drivers of M&A (cont'd)

- Impediments
  - Low stock prices.
  - Unrealistic seller price expectations.
  - Balance sheet risks, especially credit risks.
  - Uncertainty
    - Economic
    - Fiscal
    - Regulation
  - Unfilled regulatory positions (OCC, FDIC, etc.).
  - Regulatory staff workloads.
  - Consolidated entity must be in “safe and sound condition” at merger closing.
  - Antitrust
    - What are attractive markets.
    - The first to consolidate wins!

## IX. Other Current Drivers of M&A (cont'd)

- Industry Demographics (May 31, 2010)

Commercial Banks	6,453
Savings Institutions	<u>1,121</u>
Total FDIC-insured institutions	7,574
Institutions down 1,259 (14.3%) from 12/31/2005	

- The Industry by Size

Asset Size	No. of Institutions	% of Total
≤ \$100 mil.	2,574	34.0%
\$100 mil. - \$1 bil.	4,330	57.2
\$1 bil. - \$10 bil.	563	7.4
≥ \$10 bil.	107	1.4



## IX. Other Current Drivers of M&A (cont'd)

- Commercial Banks (March 31, 2011)

Asset Size	No. of Institutions	% of Total
≤ \$100 mil.	2,277	35.3%
\$100 mil. - \$1 bil.	3,659	56.7
\$1 bil. - \$10 bil.	431	6.7
≥ \$10 bil.	86	1.3

- Thrifts (March 31, 2011)

Asset Size	No. of Institutions	% of Total
≤ \$100 mil.	297	26.4%
\$100 mil. - \$1 bil.	671	59.9
\$1 bil. - \$10 bil.	132	11.8
≥ \$10 bil.	21	1.9



## IX. Other Current Drivers of M&A (cont'd)

- The industry had:

	<u>2010</u>	<u>Q1 2011</u>
• ROA	0.66	0.87 (annualized)
• ROE	5.99	7.75 (annualized)
• 197 mergers		56 mergers
• 157 failed banks		26 failed banks
• 11 new charters		1 new charter

Source: *FDIC Quarterly Banking Profile* (March 31, 2011)

## IX. Other Current Drivers of M&A (cont'd)

- Estimated 2,700 and 4,000 regulatory enforcement actions against banks and their holding companies.
- 888 problem banks (CAMELS 4 or 5) with \$390 billion of assets at March 31, 2011, compared to 252 with \$159 billion of assets at December 31, 2008.
- Institutions with TARP and deferred trust preferred dividends.
- Aging shareholder bases.

# X. Types of M&A Transactions

The following outlines the types of transactions that meet the needs of buyers and sellers and present opportunities today.

## A. TARP Conversion or Repayment

- Examples
  - TIB Financial Corp. / North American Financial Holdings Inc.
  - Hampton Roads Bancshares, Inc. / Carlyle Group, Anchorage Capital Group and CapGen Financial.
  - Pacific Capital Bancorp. / Ford Financial Fund.
  - Sterling Financial Corporation / Thomas H. Lee Partners and Warburg Pincus.
  - Central Pacific Financial Corporation / Carlyle Group and Anchorage Capital Group.
  - M&T Corp. and Wilmington Trust Company.

## X. Types of M&A Transactions (cont'd)

### B. New Management.

- SKBHC Holdings LLC / Starbucks Bancshares, Inc.
- Northeast Bancorp / FNB Formation LLC.
- Brand Banking Company.

### C. Direct Investment in Bank Subsidiary.

- First State Bank, Taos, New Mexico

### D. Bankruptcy.

- SKBHC Holdings LLC / America West Bancorp.
- Nexity Financial Corp. (Reorg and Bank failed).
- CIB Marine.
- Advanta.
- CIT.
- MidSouth Bancorp / Jefferson Bank and Outsource Holdings, Inc. – Section 363 Bankruptcy Sale.

## X. Types of M&A Transactions (cont'd)

### E. Bank liquidations.

- Bank of Currituck.

### F. Sale of Bank by BHC Parent.

- First Community Bank Corporation of America sale of First Community Bank by merger with Community Bank & Company.

### G. Buyouts

- Management

- First Republic Bank / ColFin FRB Investor, LLC, General Atlantic, LLC, and other private equity, institutional and management investors.
- Purchases of Divisions or Subsidiaries.
  - First Republic Bank.
  - Spinoffs, including sponsored spinoffs such as M&I/Metavante, are expected in the future.
  - Cross-guaranty protection.

- Purchases from other principal shareholders.

- PE exits must be consistent with Federal Reserve Policy.

### H. Simultaneous sales of banks and distressed assets.



# X. Types of M&A Transactions (cont'd)

## I. Failed Bank Acquisitions

- Capitalization of existing banks, including “contingent capital”, to buy failed institutions from the FDIC, as receiver (East West Bancorp / United Commercial Bank; various others)
- Blind pools and “shelf charters”
  - Bond Street Holdings LLC
  - NBH Holdings Corp.
  - North American Financial Holdings, Inc.
  - Blue Ridge Holdings, Inc.
- Other new companies formed to purchase failed banks
  - OneWest
  - BankUnited

## J. Failed Bank Acquirers

- IPOs for Further Growth
  - Bank United; Bond Street Holdings; North American Financial Holdings

## X. Types of M&A Transactions (cont'd)

### K. Growth

- Inflatable charters (Flowers National Bank, Cainesville, Missouri).
- Roll-ups (GrandPoint Capital, State Bank & Trust).
- Organic growth (EverBank Financial Corp. / Sageview Partners LP, New Mountain Partners II, L.P. and TPG Funds; Private Bancorp / GTCR).
- Branch purchases (NBH Holdings / Bank Midwest, Ovation Holdings, Inc. / National Bank of Southwest Florida; PNC/RBC Centura; Capital One/ING Direct).
- Concurrent private / public capital raises
  - (Seacoast / CapGen Financial).

## X. Types of M&A Transactions (cont'd)

- Initial Buyouts (First Republic, Flowers National Bank).
- Failed bank acquisitions (BankUnited, OneWest).
- Distressed debt transactions (Interinvest / Varde / First City).
- Roll-ups (State Bank & Trust Company, Grandpoint).
- Offensive transactions (Everbank, NBH Holdings).
- Private Equity Exits
  - IPO (First Republic Bank, BankUnited and EverBank IPOs).
  - Sale in a M&A transaction.
- Branch Sales and Purchases (Bank Atlantic and others).

## X. Types of M&A Transactions (cont'd)

### L. Recapitalized Banks – Buyers or Sellers?

- Many banks that have been recapitalized have enforcement actions and CAMELS ratings that will delay them from becoming buyers.
- Fixing is first priority; Earnings are becoming more important.
- Sales of non-performing and underperforming assets are usual.
- “Shrink to Grow.”
- Improving regulatory confidence.
- Going public – currency for acquisitions and a return to investors.
- Others may seek to sell the bank to realize their return.

## X. Types of M&A Transactions (cont'd)

### M. Other Market and Target Considerations

- Best demographics = more risk?
- Less risky, less growth markets?
- Complementary balance sheets and management.
- Management exits
  - Approach to people.
  - Building talent.
- Lines of businesses and competitive strengths
- Growth through branding or electronics – What is convenience today?
- Acquirers need a consistent strategy that is marketed well to investors and targets.

# XI. Questions and Answers

