The NEW Frontier of COMMUNITY BANKING
Legal Update 2015

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Presentation Overview

1. Industry Outlook and Overview
2. Current Regulatory Environment
3. Capital Markets Update
4. Current M&A Themes and Drivers
5. Board Considerations for 2015
Review of 2015

**Economic Impact**
- Texas economy continues to outpace other parts of US but still slow economic recovery
- Protracted low interest rate environment and continued NIM pressure on bank earnings
- Lower crude oil prices, prompting outsized scrutiny on banks with high energy exposure and general exposes to economies with heavy energy reliance

**Capital Markets**
- 2014 was the year of the bank IPO. 14 banks went public in 2014, with three in Texas
- 2015 is the year of subordinated debt
- Capital markets improved for privately-held banks

**Regulatory Landscape**
- Regulatory compliance remained pervasive
- Cybersecurity replaced vendor management as the new hot button
- CFPB Continues to set agenda on compliance

**M&A Activity**
- 217 bank mergers were announced year-to-date and 285 mergers in 2014
- Longer and more protracted regulatory approval process
- In Texas, 20 mergers were announced year to date in 2015

**Technology**
- Primary way community banks interact with customers in rapidly evolving causing many banks to rethink their branch footprint and strategies
- Cyber security and cyber fraud increasing and requiring increasing expenditures by banks on anti-fraud protections
Consolidation Trends

Bottoms-up consolidation is happening, with the most significant impact on the very smallest and the largest banks.

Another factor is the lack of de novo activity. Between 2000 and 2008, 1,042 de novo banks were chartered – an average of approximately 130 charters per year. Since 2011, a total of 6 de novo charters have been approved.

Source: FDIC as of September 30, 2014
Recent M&A Volume is Historically Consistent

Bank M&A deals per year (as a % of total banks) are at historically normal levels

Source: FDIC, KBW Research, SNL Financial.
Banks by Asset Size

- Less than $1 billion: 90% (5,982 banks)
- $1 to $10 billion: 8.5% (565 banks)
- Over $10 billion: 1.5% (109 banks)

6,348 total banks in the US

Source: FDIC as of June 30, 2014
Larger banks continue to deemphasize bank branches. While branches will not soon vanish as a transaction and business channel, they will definitely continue to evolve.

Customer behavior is changing. Customers used to transact business at the branch office. Now, branches are becoming advice centers, with transactions often occurring remotely.

Source: FDIC as of June 30, 2014
Bankers’ Greatest Concerns

- Regulatory compliance: 68%
- Growing loans: 33%
- Managing risks: 29%
- Cyber risks: 27%
- Competitive returns: 27%
- Weak economic growth: 25%
- Profitability: 23%
- Efficiency: 21%
- Growing deposits: 11%
- Accessing capital: 11%
- CEO succession: 11%
- Other: 7%

Source: Bank Directors’ 2014 Growth Strategy Survey
CURRENT
REGULATORY
ENVIRONMENT
Dodd-Frank Act State of Play

+ As of September 30, 2015, 271 rulemaking deadlines have passed. Of the 271 rulemaking requirements with deadlines that have passed, 193 (71.2%) have been met with finalized rules and rules have been proposed that would meet 45 (16.6%) more. Rules have not yet been proposed to meet 33 (12.2%) passed rulemaking requirements.

+ Of the 390 total rulemaking requirements, 249 (63.8%) have been met with finalized rules and rules have been proposed that would meet 58 (14.9%) more. Rules have not yet been proposed to meet 83 (21.3%) rulemaking requirements.
CFPB Update

"CFPB continues to set the agenda and tone for consumer compliance regulation and enforcement."

RECENT DEVELOPMENTS.

+ Rulemaking through enforcement actions
+ Continued focus on indirect auto lending. Cordray fielded questions about the bureau’s proxy methodology for measuring disparate impact in indirect auto lending. There have been reports that the method is leading to an overestimation of discrimination on the basis of race and national origin.
+ RESPA – Marketing agreements
+ Final HMDA data collection rules
+ Student loan servicing companies practices in focus
+ TRID compliance and mortgage tech vendors focus
Current Regulatory “Hot Button” Issues

“Regulators are focusing on strategic risk and operational risk.”

+ Interest rate risk
+ Asset quality – relaxation of credit underwriting standards
+ Capital planning and Basel III compliance
+ Third party and vendor risk management
+ Cyber Security and IT risks
+ Compliance risks
+ Governance and constituent involvement
+ Social Media Compliance
“Compliance issues are a deal killer – the elephant in the room every banker hopes to avoid.”

- FAIR LENDING
  - “Disparate impact” is the theory on which the Obama Administration has relied to enforce most fair lending actions
  - Supreme Court upheld “disparate impact” claims in 2015
- UDAAP
  - “Abusive” practices standard – CFPB’s position is “taking unreasonable advantage” of a consumer
  - Language and practices in marketing products
  - Debt collection practices
  - Third-party provider activities
  - Excess and unauthorized fees
- COMMUNITY REINVESTMENT ACT
- MORTGAGE LENDING and TRID
- BSA/AML
- RESPA – MARKETING SERVICING AGREEMENTS
- FLOOD INSURANCE
Third Party and Vendor Risk Management

“Mind your own business…and the business of your customers, vendors and business partners.”

+ **EXPANDING RESPONSIBILITY.** Risk management extends to service providers, customers, and third parties.

+ **ENFORCEMENT.** From BSA/AML to general principals of safety and soundness, there are broad avenues of enforcement.

+ **STAYING INFORMED.** Banks can no longer mind their own business – they must take an active oversight role in the business of others.

+ **POLICING.** Banks must actively police the business of service providers, customers, and business partners.

+ **MONDAY MORNING QUARTERBACK.** Compliance will be viewed in hindsight – if the bank does not “catch the bad guys,” the bank can be held liable.
Corporate Governance Practices

“There has been a deliberate shift in the regulatory focus on corporate governance practices driven by concerns over strategic risks.”

+ **LESSONS LEARNED FROM THE CRISIS.** The crisis demonstrated that one consequence of a bank having weak corporate governance could be significant losses or even bank failure. There is INTENSE regulatory focus on corporate governance practices.

+ **BOARD PRACTICES.** Good governance is a top down culture implemented by the board. It’s not just about having the right policies but the right practices and disciplines. DEFINE WHAT YOU RISK YOU WILL TAKE AND WHAT RISKS YOU WON’T TAKE.

+ **RISK MANAGEMENT FRAMEWORK.** Leading banks have robust risk identification and disciplined risk management practices implemented by the board. The regulatory bar for enterprise risk management has increased. There are expectations around establishing baseline assessments, where each risk is mapped to a number of indicators.

+ **INTERNAL CONTROLS.** Strong internal controls with defined relevant metrics to monitor risks.

+ **PROPER COMMITTEE STRUCTURES.** Banks must have appropriate and effective committee structures. This is not one size fits all but depends on the bank’s risk profiles.
Capital Markets Overview

+ Capital is still “king”
+ Advance capital planning is crucial
+ Basel III implications on bank and bank holding company capital levels
+ Investors are coming back to financial institutions
  + Private raises more successful
  + IPO markets have opened up
  + Private equity funds targeting community banks
  + Investors are expecting improved returns
+ JOBS Act eased restrictions on public offerings
+ Subordinated debt capital of choice for smaller banks
+ Capital more available for larger companies
Expansion of Small BHC Policy Statement

“Bank holding companies that are covered by the Small Bank Holding Company Policy Statement (but not their subsidiary banks) are exempt from the Basel III capital requirements and generally have more flexibility with the amount of debt they can issue.”

+ Raises threshold from $500 million in assets to $1 billion
+ Includes S&L Holding Companies
+ Changes Reporting Requirements
  + Eliminates quarterly consolidated financial reporting requirements (FR Y-9C)
  + Requires parent-only financial statements (FR Y-9SP)
+ Potential Signal for Additional Regulatory Relief
Capital Planning

PLAN IT. Regulators expect all banks to have a capital plan – Not just problem banks.

ADVANCED PLANNING. Advanced planning is critical. There is no such thing as “JUST IN TIME” capital. The application of the new Basel III standards will require heightened capital levels and penalize banks that fall below regulatory standards.

OPTIMIZE IT. Banks should OPTIMIZE their “capital stack” through the issuance of hybrid-capital instruments and debt.

“The power of dry powder!”
Sources of Funding

“Banks should OPTIMIZE their “capital stack” through the issuance of hybrid-capital instruments and debt. “

Common Stock
+ Common Equity Tier 1 Capital
+ Private placements
+ Rights offerings
+ Public offerings

Preferred Stock
+ Additional Tier 1 qualifying
+ Convertible
+ Non-dilutive
+ Not available for subchapter S banks

Debt
+ Subordinated debt offerings
+ Correspondent bank stock loans
+ Non-dilutive

Other
+ ESOP/KSOP
+ Retained earnings
+ Divestitures
+ Acquisition of over-capitalized institutions
CURRENT M&A THEMES AND DRIVERS
Why Today’s Deals are Different

“This M&A cycle is very different from the last post crisis period.”

- **Propellants**
  - New
- **Participants**
  - Fewer
- **Process**
  - Singular
- **Protection**
  - Creative
- **Pricing**
  - Conservative
- **Regulatory**
  - Expanded
Nationwide M&A Pricing Multiples Since 2003

Nationwide M&A Price / Tangible Book Value

Nationwide M&A Core Deposit Premiums

Source: SNL Financial as of 10/21/2015.
Texas M&A Post-Cycle

**Number of Transactions**

- 2010: 20
- 2011: 14
- 2012: 19
- 2013: 27
- 2014: 27
- 2015 YTD: 19

**Aggregate Deal Value ($mm)**

- 2010: $154
- 2011: $200
- 2012: $400
- 2013: $1,635
- 2014: $1,718
- 2015 YTD: $856

Source: SNL Financial.
Texas M&A Post-Cycle (Continued)

**Median Price / TBV**

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<th>Year</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015 YTD</th>
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<td>Price</td>
<td>1.32x</td>
<td>1.27x</td>
<td>1.46x</td>
<td>1.36x</td>
<td>1.63x</td>
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**Median Price / LTM EPS**

<table>
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<th>Year</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
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<tbody>
<tr>
<td>Price</td>
<td>23.7x</td>
<td>25.2x</td>
<td>17.7x</td>
<td>21.9x</td>
<td>16.9x</td>
<td>18.2x</td>
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Source: SNL Financial.
Drivers of Consolidation

“A majority of recent M&A activity is bottom-up consolidation. Changes to the economic and regulatory environment makes it difficult for smaller companies to remain independent.”

- Improvement in buyers stock prices
- Better seller fundamentals
- Ongoing revenue challenges
- Lack of organic growth prospects
- Regulatory compliance burden
- Management/director succession and fatigue
- Access to capital
- Lack of investment liquidity
Drivers of Valuation

“Growth is a significant driver in pricing. It’s not about what it costs, rather what is it worth.”
New M&A Regulatory Paradigm

Applications are subject to heightened regulatory scrutiny

+ Preview transaction with regulators in preliminary stages of negotiations
+ Approval threshold is higher for deals
+ Provide detailed analysis of due diligence findings and conclusions
+ Robust pro forma financial projections (including purchase accounting adjustments and capital projections)

Impact of new Basel III – Capital rules

+ Sources of funding

Address regulatory compliance issues

Avoid change in control “gun jumping” features in definitive agreements

+ Target board and committee observation rights
+ Low limits on loan approvals

Third-party protests and comments on applications is becoming increasingly more common

“Today, there is no such thing as a routine regulatory approval.”
2015 M&A Outlook

Activity
- Continued robust consolidation nationwide
- Some possible softening in Texas with low oil prices
- Continue to see more negotiated deals rather than auctions
- Most of the activity will likely involve smaller community banks

Pricing
- Pricing will likely remain flat with economic pending economic headwinds
- Buyers will remain disciplined
- Continued value gap between buyers and sellers
- Impact of Basel III rules on pricing

Structure
- More strategic and MOE transactions involving non-metropolitan area banks
- More deals with stock as a part of the consideration
- Social issues will continue to be important
- Parties will be creative in dealing potential post-closing risks

Regulatory
- Early consultation with regulators critical
- Buyers must have pristine compliance programs
- Longer and more protracted regulatory approval process
- Expect more CRA protest on applications by consumer groups
What Should Boards be Considering in 2015

“Boards should avoid the ABCs of business decay – Arrogance, Bureaucracy and Complacency.” - Warren Buffett

COMMUNITY BANKER’S DNA HAS NOT CHANGED BUT THE RULES OF ENGAGEMENT HAVE CHANGED. Stay true to traditional community banking values while understanding the understanding the “new normal” of community. While the business model has evolved your DNA has not changed.

+ “Change is the law of life and those who look only to the past or present are certain to miss the future.” – John F. Kennedy

DON’T DILUTE WHAT MAKES YOU STRONG. Community banks must protect their “DIFFERENTIATION ADVANTAGE”. Community banks can’t be everything to everyone. The one-stop shopping model is not always a successful strategy.

FOCUS ON WHAT MATTERS. Remember that “Culture” is more important than “Strategy”. Never loose sight of who the customer is. Make innovation a critical function of your business.

+ “Focus on matters small enough to change but big enough to matter.” – Kat Cole
LEADERSHIP AND INNOVATION ARE CRITICAL. Successful community banks must attract and invest in “best of class” talent and groom the next generation of leaders. Focus more on leadership and less on management.

+ “The highest calling of a leader is to unlock the potential in others” – Carly Fiorina

ACT WITH A SENSE OF URGENCY. Stay on the offensive and look for the opportunities in your market. Deepen the “Moat” with your core customers. There is a widening gap between the “haves” and “have nots” – don’t be left behind.

+ “Be quick but don’t hurry” – John Wooden

HAVE A PLAN. Implement a strategic plan. Study the characteristics of high performing banks in your peer group.

FOCUS ON EFFICIENCY AND SCALE. Banking is becoming more of an “economies of scale” business. Size is not a death sentence but smaller banks must stay relevant – to investors, to regulators and to customers.

“Even if you are on the right track you will get run over if you just sit there.” - Will Rogers
Mr. Fenimore is the co-founder and managing partner of one of the premiere community banking specialty law firms in the United States, Fenimore, Kay, Harrison & Ford. He brings more than 29 years of experience as a legal advisor to financial institutions and as a former federal and state banking regulator. Mr. Fenimore represents banks, thrifts and other financial institutions, as well as their investors, directors and executive officers in a full range of corporate, transactional, securities and regulatory matters confronting the financial services industry. His extensive experience in the fields of bank mergers and acquisitions, bank regulatory matters, securities law and corporate governance provides a solid foundation for his representation of financial institutions in a broad variety of transactions. Prior to founding his own law firm, Mr. Fenimore was the Managing Partner of the Austin office of a large international law firm.
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