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Bank Regulation Resizing

- Legislation Represents a Major Re-Balancing of Many Dodd-Frank Constraints
- Bank M&A Unleashed – A Likely New Consolidation Wave with "Top Down" Impetus
- Capital Options Expanded for Community Banks Below $10B – New Flexibility to Select Optimal Capital Structure
- Potential for Community Bank Lending Increased – Reduced Regulation Expands Residential and HVCRE Lending Opportunities

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Nudged forward by the Independent Community Bankers Association's last minute 10,000-signature petition, the House of Representatives approved the Senate's Economic Growth, Regulatory Relief, and Consumer Protections Act (EGRRCP or S.2155) with no changes on May 22nd and President Trump signed this bill into law on May 24th.

The road has now been cleared to rebalance banking regulation.

As we foreshadowed in our March 20th report "The Pendulum Swings", Congress and the Administration have returned to politics as the art-of-the-possible. At least in this case. If nothing else, this return to "regular" legislative order must be considered a major positive.

The elements of this legislation are certainly well-known by now. In this follow up report, we devote more effort clarifying the expansion of community and regional bank capital flexibility for banks under $10 billion in asset size and the three capital regime choices. As is often the case in regulatory relief, the options and implications become more complex. There is still much work to be done by the Federal Reserve Board (Fed), Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC) to define certain terms and integrate this legislation into the Basel III Simplification framework proposed by the regulatory agencies in September 2017. (Please see Sandler O'Neill's "Basel III Simplification of Capital Rules", dated October 10, 2017).

Without question, the most dramatic result of this legislative step in our view will be banking industry consolidation. This could trigger nothing short of a dam-break for banks above the $50 billion asset range – and those nearing that range that have been under SIFI or quasi-SIFI designation strategic restraints and impediments. This dam-break will be continuously fed by more banks approaching the $10 billion threshold that have found the tolerance, will, or means to cross into the larger merger stream by successfully managing the loss of Durbin revenues and increased supervision burdens such as higher FDIC risk premiums and CFPB review.

Put more quantitatively, with the new SIFI fencing there are 102 regional and community banks approaching $10 billion and ranging just shy of $250 billion in assets, representing $4.0 trillion in U.S. banking assets. This excludes a plethora of foreign domiciled banks, brokers and specialty finance companies. All of these are now in a sea about to undergo a sea change.

A transformational consolidation wave appears certain and early evidence is arguably visible now.

1. Greater M&A Activity:

The passage by the House of S.2155 will encourage medium-sized bank M&A activity by raising the threshold for Systemically Important Financial Institutions (SIFIs) from $50 billion to $250 billion in assets. Banks with $50 billion or more in assets have heretofore been designated SIFIs and subject to enhanced prudential standards for risk management. These include the most onerous stress testing referred to as the Comprehensive Capital Analysis and Review (CCAR) and enhanced liquidity measures.

With the passage of S.2155, all U.S. banking institutions with less than $250 billion in assets will be exempt from company-run stress tests (following an 18-month delay for banks between $100 and $250 billion in assets and excluding foreign banking organizations >$100 B). This will release approximately 102 banks (excluding foreign banking organizations > $100 B, brokers and specialty finance) from $10 billion up to $250 billion in assets from such stress testing and allow them to pursue alternative M&A or capital management strategies. New acquirers should emerge from this previously self-imposed dormant group, such as those below the $50 billion current threshold for CCAR or $10 billion threshold for company run stress tests that are compliant with CCAR.

As shown on the following page in Chart A, at the top of the waterfall, the remaining SIFI banks are limited in their ability to grow due to political headwinds and the 10% deposit cap for the largest banks. Below the SIFI threshold but above $250 billion, three have more room to grow but remain subject to the full prudential risk management and stress testing regime. Further down the waterfall, there are 12 banks representing about $1.8 trillion in assets below $250 billion in assets but more than $100 billion that will now we able to more aggressively pursue M&A. Next in line are seven banks with total assets of $50 billion but less than $100 billion who comprise about $0.5 trillion in assets followed by 83 banks with approximately $1.7 trillion in the range of $10 billion or more but less than $50 billion in assets.

Overall, there will now be 102 banks with total assets between $10 billion and $250 billion representing about $4.0 trillion of U.S. banking assets that will now have more motivation and flexibility to pursue M&A transactions. Among these banks, we may expect to see new super-regional banks formed over the next few years.

The bank M&A market has also suffered a chronic shortage of buyers for some time. Upon exploring partners or acquirers, many potential bank sellers have realized that the historical, more traditional interest from multiple bidders no longer exists. Often there are only two or three banks expressing interest and often only one emerges in a position to close. Our largest banks, the remaining GSIBs, have long been constrained by deposits caps and have otherwise been politically sidelined from expansion by acquisition. That era has been over for some time. Until now, few from the lower tiers have shown the willingness or conviction to replace or support “top-down” consolidation momentum. With this new legislation, we think this has changed.

Chart A

Bank M&A Waterfall After EGRRCP

(Excluding FBOs>$100B, Brokers and Specialty Finance) ($ in billions)

SIFIs (8 banks)	JPMorgan Chase & Co.			
	Bank of America Corporation			
	Citigroup Inc.			
	Wells Fargo & Company			
	Goldman Sachs Group, Inc.			
	Morgan Stanley			
	Bank of New York Mellon Corporation			
	State Street Corporation			
>=$250 but<SIFI (3 banks)	U.S. Bancorp			
	PNC Financial Services Group, Inc.			
	Capital One Financial Corporation			
>=$100 but<$250 (12 banks)	BB&T Corporation			
	SunTrust Banks, Inc.			
	American Express Company	Fifth Third Bancorporation		
	Ally Financial Inc.	Regions Financial Corporation		
	Citizens Financial Group, Inc.	Huntington Bancshares Incorporated		
	KeyCorp	Discover Financial Services		
	Northern Trust Corporation	M&T Bank Corporation		
>=$50 but<$100 (7 banks)	Synchrony Financial	Comerica Incorporated		
	First Republic Bank	Zions Bancorporation		
	BBVA Compass Bancshares, Inc.	SVB Financial Group	CIT Group Inc.	
>=$10 but<$50 (83 banks)	New York Community Bancorp, Inc.	Umpqua Holdings Corporation	BancorpSouth Bank	
	Popular, Inc.	Investors Bancorp, Inc.	Bank of Hawaii Corporation	First BanCorp.
	Signature Bank	Commerce Bancshares, Inc.	State Farm Bank, FSB	International Bancshares Corporation
	People's United Financial, Inc.	Texas Capital Bancshares, Inc.	Cathay General Bancorp	Great Western Bancorp, Inc.
	First Horizon National Corporation	PacWest Bancorp	Washington Federal, Inc.	Bremer Financial Corporation
	Mizuho Americas LLC	TCF Financial Corporation	Simmons First National Corporation	FCB Financial Holdings, Inc.
	CIBC Bancorp USA Inc.	Utrecht-America Holdings, Inc.	Midland Financial Co.	Glacier Bancorp, Inc.
	East West Bancorp, Inc.	Pinnacle Financial Partners, Inc.	South State Corporation	Berkshire Hills Bancorp, Inc.
	First Citizens BancShares, Inc.	Prosperity Bancshares, Inc.	Hope Bancorp, Inc.	Eastern Bank Corporation
	BOK Financial Corporation	Bank of the Ozarks	First Midwest Bancorp, Inc.	Cadence Bancorp, LLC
	Associated Banc-Corp	UMB Financial Corporation	Home BancShares, Inc.	Community Bank System, Inc.
	F.N.B. Corporation	Western Alliance Bancorporation	Comenity Bank	BCI Financial Group, Inc.
	Cullen/Frost Bankers, Inc.	MB Financial, Inc.	Third Federal Savings and Loan Assoc.	Customers Bancorp, Inc.
	Synovus Financial Corp.	First National of Nebraska, Inc.	Trustmark Corporation	TowneBank
	Sterling Bancorp	Fulton Financial Corporation	Hilltop Holdings Inc.	Pinnacle Bancorp, Inc.
	BankUnited, Inc.	Chemical Financial Corporation	Union Bankshares Corporation	CenterState Bank Corporation
	IBERIABANK Corporation	United Bankshares, Inc.	Central Bancompany, Inc.	Banc of California, Inc.
	Valley National Bancorp	FirstBank Holding Company	Hawaiian Electric Industries, Inc.	Banner Corporation
	Wintrust Financial Corporation	Flagstar Bancorp, Inc.	Columbia Banking System, Inc.	WesBanco, Inc.
	Hancock Holding Company	Old National Bancorp	First Interstate BancSystem, Inc.	Renasant Corporation
	Webster Financial Corporation	Arvest Bank Group, Inc.	United Community Banks, Inc.	Heartland Financial USA, Inc.

102 banks => $10 B and <$250 B with potential for M&A

Source: S&P Global Market Intelligence, excludes FBOs >$100B, brokers, and specialty finance

2. Capital Options Expanded for Community Banks (<$10 B)

The new legislation provides community banks with significant flexibility in their choice of capital structure between Basel III, the Small BHC Policy Statement (assets <$3 billion), or alternatively, opt out of Basel III, and comply with the new Community Bank Leverage Ratio with tangible equity/tangible assets of 8 to 10%.

This flexibility is highlighted in Chart B below where small banks with less than $10 billion in assets have the most capital structure alternatives to best match with their business plan, risk profile, growth rate and sources of available capital. This chart also highlights the fact that banks with less than $10 billion in assets comprise 98% of the total number of banks and about 13% of the total amount of assets. It also shows that smaller banks (<$3 billion) generally have much stronger levels of TE/TA with a median of 10.37% compared to 8.16% for the GSIBs.

Chart B

Summary of Capital Regimes by Asset Size Under EGRRCP

Institutions	Asset Size	Capital/Liquidity Framework	TE/TA (%) Median
Number 8 % 0.1% Total Assets 11.2 % 51.6%	• U.S. GSIB	• Basel III with LCR, NSFR and TLAC	8.16
Number 5 % 0.1% Total Assets 1.9 % 8.8%	• >= $250 B but < U.S. GSIB	• Basel III with LCR and NSFR	9.40
Number 119 % 2.2% Total Assets 5.9 % 27.2%	• >= $10 B but < $250 B	• Basel III	9.17
Number 172 % 3.2% Total Assets 0.9 % 4.1%	• >= $3 B but < $10 B	• TE/TA >= 8 to 10% OR • Basel III	9.34
Number 5,113 % 94.4% Total Assets 1.8 % 8.3%	• < $3 B	• Small BHC Policy Statement, TE/TA >=8 to 10% OR • Basel III	10.37

Number	5,417
Assets ($T)	21.7

Source: S&P Global Market Intelligence

(Includes foreign banking organizations, brokers, and specialty finance)

EGRRCP does not provide any capital relief to large banks. In fact, as shown in Appendix A, the 8 GSIB banks are required to not only comply with Basel III capital requirements, but also to meet Total Loss Absorbing Capital (TLAC) requirements that push their cumulative equity and long term debt requirements to 23% of risk weighted assets or higher depending on their risk and funding profile. All other banks will have to comply with either Basel III, the Small BHC Policy Statement or the new Community Bank Leverage Ratio. Appendix A shows that these capital frameworks require 10.0 to 10.5% total capital but the composition of such capital and the denominator of the capital calculation varies considerably. Basel III requires 82% equity with 19% debt, the Small BHC Policy Statement permits up to 75% debt with 25% equity, while the Community Bank Leverage Ratio requires 100% equity consisting of a majority of common stock. To select the optimal capital regime for the community bank to follow, a short overview of these three options is in order.

Basel III

All insured depository institutions operating in the U.S. are currently subject to the Basel III capital rules finalized in October 2013 and fully phased-in effective January 1, 2019 for non-advanced approaches banks. These requirements consist of a 4% tier 1 leverage ratio/average assets, a 7% common equity Tier 1 ratio/risk weighted assets, a 8.5% tier 1 leverage ratio/risk weighted assets, and a 10.5% total capital ratio/risk weighted assets. The numerator of all the Basel III ratios is subject to 13 regulatory adjustments to common equity tier 1. Among these, the bank's investment in deferred tax assets related to timing differences, mortgage service assets, and significant investments in unconsolidated financial institutions may not exceed 10% of adjusted common equity tier 1 and may not cumulatively exceed 15%. Any amount above these limits is deducted from common equity tier 1.

In September 2017, the regulatory agencies announced a notice of proposed rulemaking (NPR) related to simplifications to Basel III capital rules that would increase the threshold for deduction from 10% to 25% of common equity tier 1 and eliminate the 15% cumulative cap. In addition, the Basel III simplification NPR would lower the risk weighting on all high volatility acquisition and development lending from 150% to 130% but add more loans to this category if such loans are involved in the acquisition, development or construction of non-residential properties. The Basel III simplification NPR would also allow a substantial increase in includable minority interest. Once the final results of the Basel III simplification NPR are released by the regulatory agencies, banks can more accurately evaluate the merits of this capital regime versus the other alternatives.

Overall, the Basel III capital framework offers several benefits but carries many considerations that will affect the desirability of this capital framework for community banks with total assets less than $10 billion. As highlighted in the Chart C below, Basel III offers many benefits as a capital framework including lower risk weighting for lower risk assets. The framework is well understood by the investors and regulators. In addition, it has limited restrictions on off-balance sheet activities, it provides flexibility to include subordinated debt and preferred stock in total capital, has no limits on amounts of SEC registered debt or equity that can be issued, and potentially allows the use of synthetic securitization strategies to lower risk weighted assets. However, the capital deduction and higher risk weighting for HVCRE loans along with potentially higher administrative cost may make Basel III less attractive to community banks.

Chart C

Basel III Benefits and Considerations

Benefits	Considerations
o No transition based on asset size o Potentially lower weighted average cost of capital with use of tier 2 subordinated debt o Reduced risk weighting on lower risk assets o Well understood by the market and regulators o Already in complance so no changes to staff needed o Limited use of debt lowers default risk o No restrictions on amt. of SEC registered debt or equity o No limitations on significant off-BS activities through non-bank subs	o Subject to Basel III capital deductions o Subject to Basel III adverse risk weighting on certain types of loans and activities o Higher risk weighting for HVCRE lending o Higher administrative cost to track and report Basel III requirements

The Small BHC Policy Statement

The Federal Reserve Board implemented the Small Banking Holding Company Policy Statement (the "Policy Statement") in 1986. Since then, the initial qualifications and ongoing requirements of the Policy Statement have not changed other than (i) an increase in asset size from less than $150 million in 1986 to less than $3 billion under EGRRCP and (ii) the inclusion of savings and loan holding companies. A summary of the benefits and considerations to a community bank holding company with less than $3 billion in assets is provided below in Chart D. While this capital regime allows for substantially more debt with lower after-tax cost of capital, it comes with a maximum size limit of $3 billion in assets, limitations on non-bank and off balance sheet activities, as well as dividend restrictions above 1:1 leverage.

Chart D

Small BHC Policy Statement Benefits and Considerations

Benefits	Considerations
o Lowest ATX cost than preferred or common o Long term window for debt repayment o No regulatory filing requirement for senior debt o Debt can be used to faciliate financing for M&A	o Maximum permitted asset size ($3 Billion) o Ability to replace debt with common or preferred stock when reach $3 billion in assets o No significant non-bank activities (1) o No significant off-BS activities through non-bank subs (1) o No material amt of SEC registered debt or equity (ex. TPS) (2) o BHC debt must be repaid within 25 years o Max debt-to-equity ratio of 3.0 (75% debt) o Debt < .30:1 (25% debt) or less within 12 years o Each subs bank well capitalized under Basel III rules o No dividends until the D/E ratio reduced to 1.0:1 or less o Potentially exposes the bank to default risk during periods of financial distress

(1) The determination of whether a BHC engages in significant non-bank activities will continue to depend on a consideration of the size of the activities, and the condition of the BHC and the subsidiary depository institution.

(2) Determinations of materiality are made by the Fed on a case-by-case basis based on: the number and type of classes and series of stock issued; the holding companies market capitalization; the number of outstanding shares; the average trading volume; the holding company's history of issuing equity and debt securities, including whether the entity has issued any other securities that are not registered with the SEC (e.g., privately-placed securities); the nature and distribution of ownership; whether the securities are listed on a national exchange; whether the holding company qualifies as a "smaller reporting company" pursuant to the SEC's regulations and related interpretations; and the amount, type, and terms of any debt instruments issued by the entity.

The Federal Reserve will make a case-by-case determination on the qualifications of a BHC to use the Policy Statement. Those institutions that have off-balance sheet activities conducted through a non-bank subsidiary or have issued SEC registered debt or equity (excluding TPS) should check with their regulators to ensure they would qualify. The Federal Reserve clearly recognizes that ". . . a high level of debt at the parent holding company impairs the ability of a bank holding company to provide financial assistance to its subsidiary bank(s) and, in some cases; the servicing requirements on such debt may be a significant drain on the resources of the bank(s).

For these reasons, the Board has not favored the use of acquisition debt in the formation of bank holding companies or in the acquisition of additional banks. Nevertheless, the Board has recognized that the transfer of ownership of small banks often requires the use of acquisition debt. The Board, therefore, has permitted the formation and expansion of small bank holding companies with debt levels higher than would be permitted for larger holding companies."[1]

[1] Federal Register. Vol 80, No. 72/ Wednesday, April 15, 2015. Page 20154.

The additional leverage available to the BHC under the Policy Statement is significant as shown in Chart E below.

Chart E

Comparison Between Small BHC Policy Statement and Basel III

Small BHC Policy Statement

Assets < $3B

BHC

Maximum
75% Debt/
25% Equity

(50%/50% permitted without dividend restrictions)

Bank

	Basel III Well Capitalized (1)	FDIC PCA
Tier 1 Leverage / Avg. Assets Ratio	4.00%	5.00%
Common Equity / RWA Ratio	7.00%	6.50%
Tier 1 Leverage / RWA Ratio	8.50%	8.00%
Total Capital / RWA Ratio	10.50%	10.00%

Source: Federal Reserve, OCC and FDIC

(1) Includes 2.50% capital capital conservation buffer in calculation of fully phased in Basel III well capitalized ratios.

Basel III

Assets => $10B <$250B

BHC

Maximum
19% Debt/
81% Equity

(Assumes no double leverage with 2% sub debt out of 10.5% total capital)

Bank

	Basel III Well Capitalized (1)	FDIC PCA
Tier 1 Leverage / Avg. Assets Ratio	4.00%	5.00%
Common Equity / RWA Ratio	7.00%	6.50%
Tier 1 Leverage / RWA Ratio	8.50%	8.00%
Total Capital / RWA Ratio	10.50%	10.00%

Source: Federal Reserve, OCC and FDIC

(1) Includes 2.50% capital capital conservation buffer in calculation of fully phased in Basel III well capitalized ratios.

Banking institutions with less than $3 billion in assets comprise $1.8 trillion in assets among 5,113 banking institutions as of March 31, 2018. These banks represented about 94% of the 5,417 total U.S. banking institutions and approximately 8.4% of the $21.7 trillion in total assets. As such, assuming these institutions either had a BHC or could add a BHC structure if desired, the Policy Statement would provide capital structure flexibility for almost 94% of the 5,417 total banking institutions in the U.S. Nevertheless, the ongoing Policy Statement requirements and asset size limit at $3 billion threshold mean that an exit strategy from the Policy Statement to either Basel III or the TE/TA regime should also be considered.

Community Bank Leverage Ratio (TE/TA 8 to 10%)

With a focus on offering well-capitalized community banks a simple capital framework, a new community bank leverage ratio consisting of 8 to 10% tangible equity/tangible assets for banks and BHCs with less than $10 billion in assets was included in EGRRCP. If the BHC maintains capital in excess of the Community Bank Leverage Ratio, it would be deemed to comply with the leverage and risk-based capital requirements of Basel III and the bank would be considered well capitalized under the prompt corrective action regime (assuming an acceptable risk profile). As such, the community bank could "opt out" of other Basel III requirements. There are no guidelines currently available for the composition of the tangible equity, but it is reasonable to assume that common equity would be required to comprise a majority of tangible equity. This could create additional capital flexibility for community banks that want to supplement tangible equity with preferred stock.

Chart F

Community Bank Leverage Ratio Benefits and Considerations

Benefits	Considerations
o 10% capital ratio lower than 10.50% required for Basel III o Permanent capital with no default risk o Limited restrictions on activities to use Leverage Ratio o Not subject to Basel III capital penalties o Not subject to Basel III adverse risk weightings for certain lending and other activities o May be able to reduce administrative costs due to simpler regulatory filing and process	o Maximum permitted asset size ($10 Billion) o Ability to comply with Basel III requirements when reach $10 billion in assets o Higher ATX cost of capital than debt o No credit for tier 1 qualifying TPS on balance sheet o Limited need for tier 2 capital other than for CRE concentration o No benefit for lower risk weighting on single family loans and low LTV loans o Reduce return on average equity with potential implications for valuation o Less capital flexibility with fewer capital options

While the community bank leverage ratio may offer a very attractive, simple alternative for many community banks that have high risk weighted assets or substantial Basel III deductions from common equity tier 1, there is a trade-off on basing the capital ratio on average tangible assets compared to risk weighted assets.

Ultimately, the selection of the optimal capital framework for any particular bank is based on a number of factors including asset size, risk profile of the bank, growth rate, current capital levels and cost and availability of capital. The closer a bank is to one of the key asset thresholds of $3 billion or $10 billion, the more the bank has to anticipate the next asset threshold and conform the capital framework accordingly. We have highlighted these decision variables in several case studies shown below in Chart G.

The local lender in case study A has a high growth rate, lower credit risk but higher expense business model. With the current 15% growth rate, this bank has at least 5 years before reaching the $3 billion asset ceiling. By adding more debt to support growth, the bank can lower its cost of capital and improve returns on equity without undue default risk. The community lender in case study B has an expertise in CRE and HVADC lending with a higher risk weighted but higher yielding loan portfolio. With 12% tangible equity/tangible assets, it makes sense for lender B to select the community bank leverage ratio as its capital framework since the lender is already in compliance with this ratio and will not reach the $10 billion asset threshold in the near future. The diversified regional lender in case study C is rapidly approaching the $10 billion threshold when it will have to conform with Basel III. While it could potentially reach the 10% equity threshold to use the community bank leverage ratio, the short runway to $10 billion dictates that the focus should be on conforming with Basel III requirements.

Chart G

Optimal Capital Framework Case Studies for Banks < $10 billion in Assets

	A	B	C
Consideration	**Local Lender**	**Community Lender**	**Diversified Regional Lender**
Lending Focus	Residential and C&I	CREand HVADC	CRE, C&I, and SFR
Size ($,B)	0.8	2.5	8.0
Growth Rate	15%	8%	10%
RWA %	65.0%	95.0%	80.0%
Credit Profile	Lower Risk	Higher Risk	Moderate Risk
TE/TA	10.0%	12.0%	9.5%
ROA	0.85%	1.20%	1.10%
Capital Framework	Small BHC	CB Leverage Ratio	Basel III
Rationale	5+ years to reach $3 B Lower RWA % Lower asset risk Lower yielding assets Higher efficiency ratio	5+ yrs to reach $10 B High RWA % Higher yielding loans High level of equity	Close to $10 B threshold Meet current BIII ratios Moderate RWA %

Of course, the cost of capital will vary based on whether the bank is issuing common stock, preferred stock, subordinated debt or senior debt among other options. The cost of common stock will be impacted by many factors including asset size, stock liquidity, public or private ownership, risk profile and financial performance along with many other factors. Preferred stock generally has lower required returns than common stock but dividends on both are not tax deductible. The recent reduction in corporate tax rates from 35% to 21% has lowered the benefit of the tax deductibility of senior or subordinated debt payments. In substantially all cases, senior or subordinated debt will have a lower after-tax cost of capital than preferred stock due to the tax deductibility of payments.

In terms of capital availability, at the end of the first quarter of 2018, small banking institutions with less than $3 billion in assets reported very strong tangible equity/tangible assets ratios of 11.85% (mean) and 10.37% (median), respectively. This suggests that a majority of small banks already meet the 10% tangible equity/tangible assets requirement and could simply opt out of Basel III and into the Community Bank Leverage Ratio with no other capital action needed. A substantial number of institutions between $3 billion and $10 billion also meet or exceed the 10% tangible equity/tangible assets requirement with a mean ratio of 10.03% and median of 9.34%.

3. Potential for Community Bank Lending Increased

To encourage more single-family residential loan originations by community banks, EGRRCP provides a safe harbor for Qualified Mortgage (QM) originated and retained by an insured depository institution or credit union with less than $10 billion in total assets. Loans that meet certain conditions including limits on prepayment penalties, points and fees, negative amortization, interest-only features, and documentation will be deemed in compliance with the "ability to repay" (ATR) requirement under the Truth in Lending Act (TILA).

SFR mortgage loan origination by community banks will also be encouraged by changes to the Home Mortgage Disclosure Act (HMDA) to increase the minimum number of loans originated by community banks before being subject to HMDA disclosure requirements. In 2017, bank lenders that originated at least 25 closed-end mortgages or 500 open-end lines of credit in each of the last two years were required to collect and report at least 22 fields of information from each borrower.[2] Effective January 1, 2018, the number of HMDA required data fields increased to 59.

Based on numerous discussions with small bank CEOs, the cost of gathering and reporting this information along with the risk of fines from the CFPB if not done properly has been a major reason why so many community banks have dropped out of providing single-family residential mortgages. For example, one bank CEO with approximately $500 million in assets reported that the annual cost of compliance with HMDA was $40,000 to $50,000 based on allocation of the compliance officer's time and the cost of annual review by a consultant. The bank only originated 25 loans per year. That equates to $2,000 per loan, which is cost prohibitive.

The EGRRCP will allow banks that have satisfactory CRA ratings and originate less than 500 closed-end mortgages and less than 500 open-end lines of credit in each of the last two years to be exempt from HMDA reporting requirements thereby materially easing the administrative burden and improving the economics of this type of lending. We would expect to see many community banks reenter this market particularly as they seek to grow and diversify their loan portfolios.

To support more commercial real estate lending by community banks, EGRRCP provides regulatory relief to commercial real estate lenders in three ways:

- Expands the definition of equity that can be counted towards the 15% requirement needed to avoid classification of a construction loan as a High Volatility Commercial Real Estate (HVCRE) loan to include cash, unencumbered marketable securities, paid development costs, and contributed real property or improvements compared to just cash and marketable securities.

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[2] A guide to HMDA Reporting. Getting it Right! 2018 Edition. FFIEC. Page 3.

- Offers greater flexibility to return all or a portion of the initial 15% equity requirement once the loan is reclassified as a non-HVCRE Acquisition Development Construction (ADC) loan (subject to acceptable LTVs) rather than requiring the sale of the property or conversion to a permanent loan to remove the HVCRE classification and 150% risk weighting.
- Allows reduction in risk weighting to 100% as non-HVCRE ADC once the cash flow is sufficient to support debt service and expenses of the property in accordance with the bank's loan underwriting policy for permanent financing compared to 150% for HVCRE loans or 130% for HVCRE ADC loans proposed under the Basel III Simplification NPR.

These changes will likely reduce the amount of CRE loans classified as HVCRE, lower the risk weighting on the CRE loan portfolios for many lenders, and, as a result, stimulate more lending activity and, hopefully, job formation in our communities.

4. Other Dodd-Frank Issues Addressed

In addition to resizing risk, EGRRCP redefined risk with a number of other helpful measures including:

- the treatment of municipal deposits for the Liquidity Coverage Ratio (LCR),
- the exclusion of custodial deposits from the Supplementary Leverage Ratio (SLR) for custody banks,
- the exclusion of reciprocal deposits from the definition of brokered deposits if the reciprocal deposit is less than (i) $5 billion or (ii) 20% of total liabilities,
- the exemption from the Volcker Rule for banks with less than $10 billion in assets or trading assets of less than 5% of total assets,
- permission for use of short form call reports for Q1 and Q3 if the reporting bank is below $5 billion in total assets, and
- the extension of the regulatory examination cycle from 12 to 18 months for well-managed and well-capitalized banks with total assets below $3 billion.

More specifically, investment grade, liquid and readily marketable municipal bonds will now be included in the definition of level 2B High Quality Liquid Assets (HQLA) for the LCR calculation. This will bring more liquidity back to the municipal bond market as the largest banks subject to the LCR were limited in their municipal bond investments. Community banks are among the most active investors in such bonds and will benefit from this increased liquidity. EGRRCP excludes custodial deposits retained at the Fed (or other central bank) from the total value of deposits in calculating the SLR for any depository institution that is "primarily engaged in custody, safekeeping, and asset servicing activities." This will clearly benefit Bank of New York Mellon, State Street and Northern Trust, which are principally engaged in custodial services and may lower the cost. Taken together, the above enhancements will help with access to liquidity funds to support growth, eliminate concerns about Volcker Rule compliance, and reduce the regulatory reporting burden for small banks.

Summary and Conclusion

With the EGRRCP legislation, Congress and the Administration have agreed to regulatory relief crafted through a bottoms-up, bipartisan approach that has recently been sorely lacking in Washington. This legislation includes many common sense and practical adjustments to reduce the regulatory burden on banks without unduly increasing the risk profile.

The regulatory burden has been particularly hard on community banks with less than $10 billion in assets and most of the relief is granted to them with expanded capital options, relief from the Volcker rule, and QM and HMDA flexibility for SFR loan origination. Important clarifications and greater flexibility will likely accelerate CRE loan growth. Bank management teams and Boards will now be empowered to select the capital framework that best fits their banking institution's size, business model and loan mix, risk profile, and growth rate among other factors. With 94% of U.S. banks having assets of less than $3 billion, the increase to $3 billion in assets for the Small BHC Policy Statement will facilitate the greater use of debt to finance small bank M&A transactions.

While larger banks did not get capital relief, they received regulatory relief perhaps even more dear – an increase from $50 billion to $250 billion in the SIFI threshold and CCAR testing requirement. We think this will trigger a dam-break in mid-size bank M&A as regional banks will no longer fear the $50 billion threshold as they seek to expand their geographic presence and market efficiency. There will now be 102 regional and community banks (excluding FBOs >$100 B, brokers and specialty finance) approaching $10 billion and less than $250 billion in assets that will have enhanced opportunity to enter into the larger merger stream without concern about SIFI constraints or impediments. Among these banks, we expect to see new super-regional banks emerge over the next several years that may over time provide enhanced banking alternatives for consumers and businesses.

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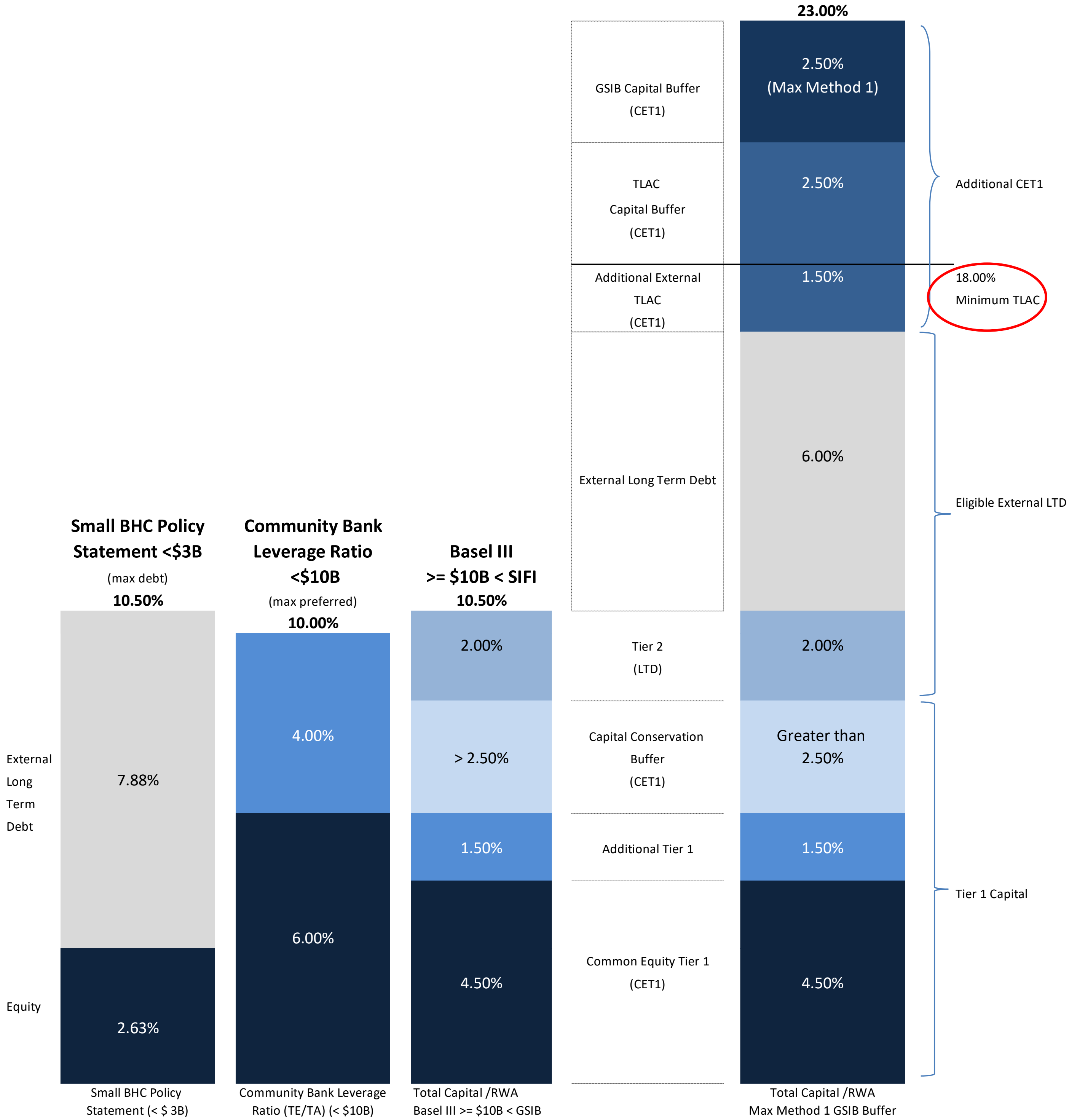
Appendix A

Comparison of Capital Frameworks

(Basel III (SIFI) Max Method 1 Buffer, Basel III, CB Leverage Ratio and Small BHC Policy Statement)



	Small BHC Policy Statement (< $ 3B)	Community Bank Leverage Ratio (TE/TA) (< $10B)	Total Capital /RWA Basel III >= $10B < GSIB		Total Capital /RWA Max Method 1 GSIB Buffer
	25.00%	60.00%	66.67%	CET1 % Total	58.70%
	N/A	100.00%	80.95%	Tier 1 % Total	65.22%
	75.00%	0.00%	19.05%	LTD % Total	34.78%
	100.00%	100.00%	100.00%		100.00%

Sources: Small BHC Policy Statement (April 2015), Basel III Capital Rules (October 2013), (TLAC Final Rule (December 2016), S.2155 May 2018.