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Bank Watch

Regulatory Landscape Overview from First Half of 2014

All is never quiet on the regulatory front, and the first half of 2014 was no exception. Below is a discussion of some (but certainly not all) developments affecting financial institutions at the federal regulatory level, from QMs, TruPS CDOs, and CCAR to payday lending, mobile banking, and the fines and penalties parade.

Qualifying Mortgages and Mortgage Servicing Rights

In January 2014 the Consumer Financial Protection Bureau (CFPB) implemented new rules intended to protect consumers shopping for a home mortgage. While some of the requirements are relatively minor and ultimately lead to a "check the box" mentality, others could have a significant impact on the way banks (community banks in particular) approach this lending area, perhaps causing some to exit the business altogether. Additionally, the value of Mortgage Servicing Rights (MSRs) may be materially affected, as new regulations increase the complexity of servicing a loan.

Generally speaking, a Qualifying Mortgage ("QM") must have the following characteristics:

» A lender must assess and verify the borrower's ability to repay the loan.

» QMs cannot contain what the CFPB considers "risky features," such as negative amortization or interest-only payment structures.

» Points and fees paid by the borrower at closing must remain below certain caps.

A January 2014 survey of 27 mortgage originating entities conducted by the National Association of Realtors highlights just how far reaching the impact of the new QM regulations may be. For example:

» 45% of respondents indicated they would not originate non-QM mortgages, which has the effect of reducing the credit available for home purchases. Given that non-QMs are commonly written to riskier borrowers, this will likely have an outsized effect on the availability of credit in the subprime market.

» No respondents indicated that rates would be the same for non-QM borrowers, but the degree to which non-QM rates would be higher varied. Again, this will likely have an outsized effect on the subprime market, in this case with regard to affordability of credit.

- 83% of respondents expect to add compliance staff and 72% expect to invest in compliance software. Additionally 11% plan to close title or other affiliated practices and 22% plan to cut staff to save costs.

The above factors will have an impact on the profitability of residential mortgage lending both from a revenue (decreased volume) and expense (higher compliance costs) standpoint.

With respect to MSRs, there are a number of new and/or enhanced rules regarding how servicers communicate with borrowers, address errors and credit payments. However, the rules that have perhaps the most impact on servicers concern the rights of borrowers facing foreclosure.

- Servicers must now contact borrowers by the time they are 36 days late paying their mortgage.
- Servicers cannot initiate a foreclosure until a borrower is more than 120 days delinquent, allowing time for the borrower to submit an application for a loan modification or other alternative to foreclosure.
- Servicers cannot start a foreclosure with a homeowner who has submitted an application for help.
- Servicers must provide timely, accurate information about a foreclosure and employees who are contacted by homeowners must be knowledgeable and have access to critical information.
- Servicers must make delinquent homeowners aware of all options available to them, and must provide detailed and timely explanations to borrowers who are not approved for loss mitigation.

Essentially, the cost of compliance, training and systems to meet the above requirements will increase, sometimes materially, the cost of doing business as a mortgage servicer, thereby reducing profitability and thus the value of MSRs.

For banks that retain their servicing rights, they will experience an even greater hit to the bottom line, from both the QM and MSR regulations. In a time when profits are getting pinched from every angle, this is just one more profit center where management will be forced to reevaluate something that has likely worked under the status quo for so long.

The Volcker Rule, TruPS CDOs, and CLOs

On January 14, 2014, federal regulators issued an Interim Final Rule, which clarifies the portion of the Volcker Rule that affects Trust Preferred Securities (TruPS) CDOs. Initial interpretations of the Volcker Rule led industry participants to believe that rules prohibiting short-term proprietary trading by insured depository institutions would affect banks owning the majority of existing TruPS CDOs. Following a significant amount of comments from the industry against the rule as it affected TruPS CDOs, as well as pushback from members of Congress, the Interim Final Rule issued in January provided that the "covered funds" prohibition under the Volcker Rule would not apply to a CDO if:

- the TruPS CDO was established, and the interest was issued, before May 19, 2010;
- the banking entity reasonably believes that the offering proceeds received by the TruPS CDO were invested primarily in Qualifying TruPS Collateral; and,
- the banking entity's interest in the TruPS CDO was acquired on or before December 10, 2013, the date the agencies issued final rules implementing section 619 of the Dodd-Frank Act.

What We're Reading

Dave Martin of Financial Supermarkets, Inc. has an interesting article on key insights to running smaller bank branches at *AmericanBanker.com*.

http://mer.cr/1rcC6yi

Susan Zaunbrecher has a nice read on key items to consider in mergers and acquisitions at *BankDirector.com*.

http://mer.cr/1mEsewb

Jack Milligan of *BankDirector.com* has an interesting whitepaper entitled "The Role of the Board in Technology."

http://mer.cr/1qpJepu

This rule also defined Qualifying TruPS Collateral as any subordinated debt instrument or trust preferred security that:

- » was issued prior to May 19, 2010, by a depository institution holding company that as of the end of any reporting period within 12 months immediately preceding the issuance of such trust preferred security or subordinated debt instrument had total consolidated assets of less than $15 billion; or,
- » was issued prior to May 19, 2010, by a mutual holding company.

The Interim Final Rule became effective on April 1, 2014.

On April 7, 2014, the Federal Reserve Board, in consideration of comments received, announced that banking entities would have two additional one-year extensions to conform their ownership interests in and sponsorship of certain collateralized loan obligations (CLOs). Only CLOs in place as of December 31, 2013, that do not qualify for exclusion under the final rule for loan securitizations would be eligible. Of note, the rules in their current state do not exclude CLOs, as they do with most TruPs CDOs, but rather simply give banks additional time to come into compliance.

CCAR and Stress Testing Results

The Federal Reserve's annual Comprehensive Capital Analysis and Review (CCAR), as well as annual stress testing mandated by the Dodd-Frank act, focuses almost exclusively on the largest banking institutions. Much has been written about the results of these tests, including the Fed's objection to five of the 30 participants' capital plans. Of those, four were based on qualitative concerns that centered on the institution's planning process and ability to forecast revenue and losses.

Based on the announced results of the 2014 CCAR, the 30 participating firms are expected to distribute 40% less than projected net income from second quarter 2014 through first quarter 2015 (in other words, an aggregate payout ratio of 60%). The institutions have a combined $13.5 trillion in assets, or approximately 80% of all U.S. bank holding company assets. It is worth noting that any limitations placed on an institution's ability to return capital to shareholders will affect the ability to raise capital, the required rate of return of capital, and thus the valuations of banking stocks. Although smaller institutions which face less scrutiny over their capital plans will be less impacted from a valuation standpoint, the influence of the valuation multiples for the largest banks on the overall market for bank stocks cannot be underestimated.

In the first quarter of 2014 the Federal Reserve Board of Governors, the FDIC and the OCC issued final supervisory guidance for stress testing for institutions with less than $50 billion but more than $10 billion in assets. Although this size range still does not encompass the typical community bank, it does demonstrate the tendency for regulatory guidance and the expectations of regulators to "trickle down" to smaller institutions over time. The guidance document discusses supervisory expectations for DFA stress test practices and offers additional details about the methodologies that should be employed, and is likely worth the 69-page read. The document can be found in the March 2014 press release section of the FDIC website, located here (http://www.fdic.gov/news/news/press/2014/pr14019.html).

Payday Loans and Other Nonbank Lending

The CFPB thus far in 2014 has shown a particular interest in the operations of payday lenders and other nonbank lending institutions. The agency conducted a survey, the results of which it provided in a March 25 press release, that contained a number of findings regarding the payday lending market, including:

- » four out of five payday loans are rolled over or renewed within 14 days;
- » many borrowers renew so many times that they ultimately pay more in fees than the amount of money initially borrowed;
- » four out of five payday borrowers either default or renew a payday loan over the course of a year; and,
- » for borrowers on monthly benefits, one out of five remained in debt for the entire year of the study.

It is unclear if what the CFPB study refers to as "fees" is actually interest charged on the loans, as the press release makes no mention of interest or interest rates otherwise. The press release notes that "with a typical payday fee of 15 percent, consumers who take out an initial loan and six renewals will have paid more in fees than the original loan amount." The press release also states that "the CFPB has the authority to oversee the payday loan market", presumably quieting any in the industry who may question the agency's authority over this market, and also making clear the agency's intent to pursue regulations in this area.

In addition to payday lending, the CFPB also looked at other nonbank institutions, including debt collection agencies and consumer reporting agencies (aka credit bureaus), and found evidence that "many companies had systemic flaws in their compliance management systems, such as consistently failing to have a system in place to track and resolve consumer complaints." None of these enforcement efforts affect the traditional banking sector directly. However, banks encounter similar issues frequently, whether with a borrower caught in a spiral of debt, attempted collections on loans, or the process by which they deal with consumer complaints. Banks also depend heavily on, and deal directly with, credit bureaus. Attention to developments in the attitude of federal regulators toward these areas can prove instructive.

Bonus: Regulators Target Mobile and Electronic Banking Issues, Fines and Penalties Machine Keeps Humming

On June 11, 2014 the CFPB opened an inquiry into the use of mobile financial services. The inquiry appears to focus on how the use of mobile devices for purposes of conducting financial transactions might benefit unbanked and underbanked customers, as well as what information is collected on consumers, how it is collected, and how it is disclosed. However, the inquiry also solicits feedback regarding privacy concerns and the potential for data breaches. This announcement continues the trend of an increased focus on the safety of electronic banking in general, particularly given all of the high profile data breaches for non-bank corporations in recent months.

And lastly, the various federal and state regulatory agencies continue to wield the settlement hammer. The following is a sample of penalties and fines announced in the month of June alone.

- On June 13, news surfaced that the DOJ is seeking more than $10 billion from Citigroup to settle an investigation into the sale and pricing of mortgage-backed securities prior to the 2008 financial crises. The fine would join that paid by JPMorgan Chase as one of the largest related to the financial crisis, and demonstrates that even with the crisis more than five years in the rearview mirror, the days of reckoning for banks are not behind us.
- On June 25, Regions Bank reached an agreement with the SEC, the Federal Reserve Board and the Alabama State Banking Department regarding inquiries involving the accounting for commercial real estate and other loans on nonaccrual status at the end of the first quarter of 2009. The Bank will pay a $51 million civil money penalty to resolve the matter. The SEC continues to pursue fraud charges against certain former employees.
- On June 17, SunTrust Banks announced the finalization of an October 2013 agreement with the U.S. Department of Housing and Urban Development and the U.S. Justice Department for a settlement related to the origination of FHA-insured mortgages and the bank's portion of the national mortgage servicing settlement. The settlement includes consumer relief of $500 million and a cash payment of $468 million for mortgage servicing misconduct, including robo-signing and illegal foreclosure practices. The DOJ press release announcing the settlement quoted Attorney General Eric Holder as saying "We expect that there will be more cases like this to come."
- Following through on the Attorney General's comment, on June 30 the DOJ announced a $200 million settlement with U.S. Bank also for allegations that it violated the False Claims Act in conjunction with originating and underwriting mortgage loans insured by the FHA. The settlement was the result of a joint investigation by HUD, Office of Inspector General, the Civil Division of the Department of Justice, and U.S. Attorney's Offices for the Northern District of Ohio and Eastern District of Michigan.

Conclusion

This article is not exhaustive, and no doubt new developments will continue to surface on a weekly, if not daily, basis. We encourage management teams for bank of all sizes to remain vigilant and informed on this topic. Perhaps the most fitting closing thought is "an ounce of prevention is worth a pound of cure."

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The Financial Institutions Group of Mercer Capital works with hundreds of depository institutions annually providing a broad range of specialized resources for the financial services industry.

Newest Webinar

Sponsored by SNL Financial

An Overview of the **Leveraged Lending Market** and Bank Participation in the Market

There has been a flurry of media reports this year that regulators—especially the OCC—are intensifying scrutiny of leveraged lending and are becoming less flexible in allowing banks to interpret the guidance. Some investors have begun to raise questions whether a new credit bubble has developed, while others see opportunities for BDCs and other specialty finance companies to gain market share. In this webinar we will take a look at one of the fastest growing markets that has emerged post crisis.

View webinar on SNL Financial's site at http://mer.cr/VRc9JV

Webinars Available for Replay

Understanding Deal Considerations

Key issues that we see when banks combine as it relates to valuing and evaluating a combination are reviewed. This is particularly critical when the consideration consists of shares issued by a buyer (or senior merger partner) whose shares are either privately held or are thinly traded.

View replay at http://mer.cr/bnkweb2

How to Profit on a Distressed Transaction

Buyers have been leery of acquiring troubled banks in non-assisted deals. With a slowly recovering economy, we take a look at the opportunities and pitfalls or making an acquisition of a "turnaround" bank.

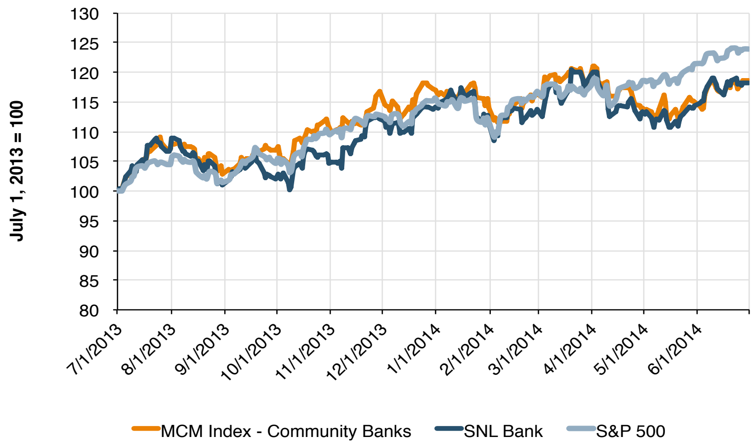
View replay at http://mer.cr/bnkweb3

Basel III Capital Rules Finally Final: What Does It Mean for Community Banks?

Finalized at last, the regulations provide direction for bank capital management decisions. This webinar, co-sponsored by Mercer Capital and Jones Day, reviews the final rules and assesses their impact on community banks.

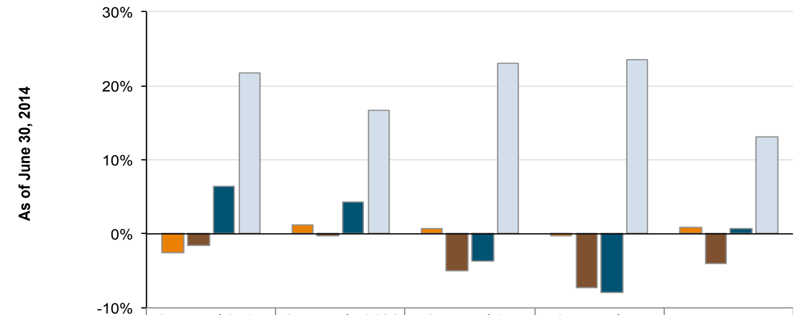
View replay at http://mer.cr/capital-rules-webinar

Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



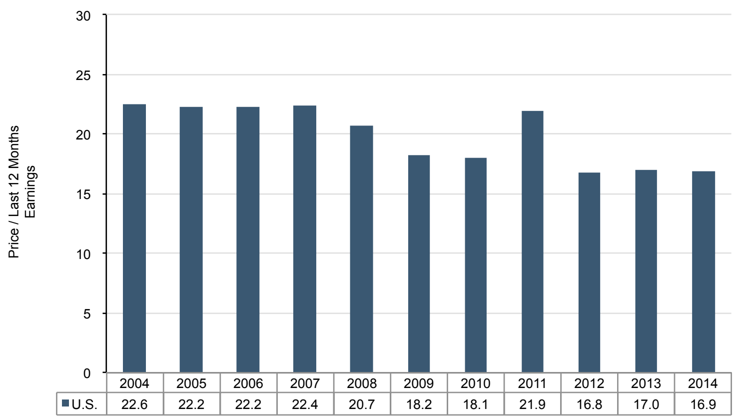
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	-2.62%	1.27%	0.68%	-0.24%	0.96%
Quarter-to-Date	-1.62%	-0.22%	-4.93%	-7.34%	-4.08%
Year-to-Date	6.40%	4.30%	-3.70%	-7.94%	0.65%
Last 12 Months	21.67%	16.62%	23.11%	23.49%	13.13%

Median Valuation Multiples

	Median Total Return				Median Valuation Multiples as of June 30, 2014					
Indices	Month-to-Date	Quarter-to-Date	Year-to-Date	Last 12 Months	Price/ LTM EPS	Price / 2014 (E) EPS	Price / 2015 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	2.62%	-0.23%	2.13%	16.51%	14.55	18.20	12.69	112.0%	124.3%	2.2%
Midwest Index	5.11%	0.94%	6.01%	28.86%	13.45	13.99	12.93	112.7%	126.3%	2.1%
Northeast Index	2.09%	0.55%	1.37%	15.62%	14.26	14.60	12.62	125.5%	132.8%	2.7%
Southeast Index	3.46%	-1.54%	-1.16%	14.97%	13.06	13.94	13.08	114.6%	117.1%	1.8%
West Index	3.48%	-2.39%	1.00%	19.73%	15.96	17.18	14.01	126.8%	138.2%	1.9%
Community Bank Index	3.09%	-0.45%	1.32%	18.63%	14.02	15.63	13.01	119.7%	126.8%	2.2%
SNL Bank Index	**3.45%**	**-0.90%**	**3.65%**	**18.28%**						

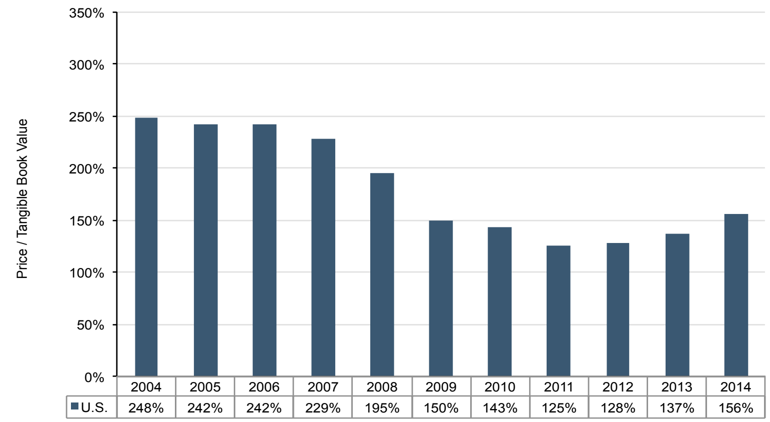
Median Price/Earnings Multiples

Target Banks Assets <$5B and LTM ROE >5%



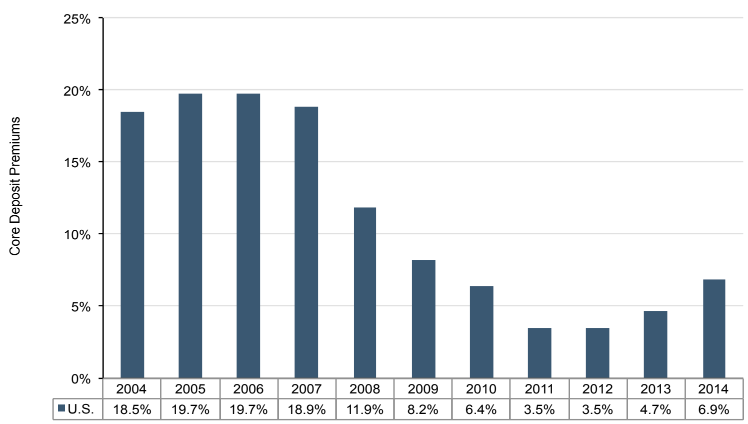
Median Price/Tangible Book Value Multiples

Target Banks Assets <$5B and LTM ROE >5%



Median Core Deposit Multiples

Target Banks Assets <$5B and LTM ROE >5%



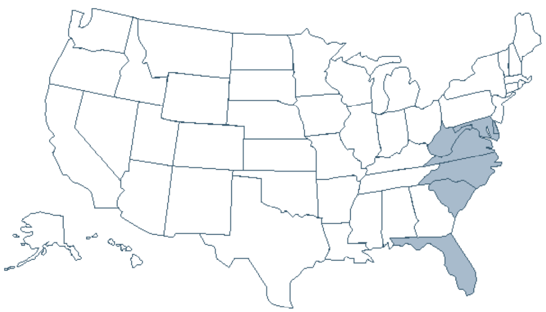
Median Valuation Multiples for M&A Deals

Target Banks Assets <$5B and LTM ROE >5%, through June 2014

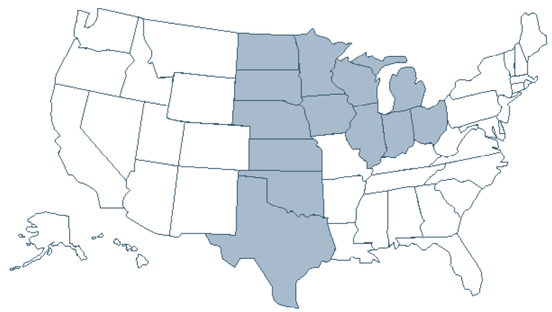
Regions	Price / LTM Earnings	Price / Tang. BV	Price / Core Dep Premium	No. of Deals	Median Deal Value	Target's Median Assets	Target's Median LTM ROAE (%)
Atlantic Coast	18.13	1.56	7.3%	3	51.60	312,005	9.19%
Midwest	18.38	1.57	7.4%	26	48.00	110,645	8.87%
Northeast	19.86	1.87	9.9%	6	53.12	295,802	8.22%
Southeast	14.83	1.61	7.2%	14	74.37	407,466	9.68%
West	19.97	1.21	3.7%	10	24.18	250,174	8.03%
Nat'l Community Banks	**16.87**	**1.56**	**6.9%**	**59**	**49.86**	**221,343**	**8.86%**

Mercer Capital's Regional Public Bank Peer Reports

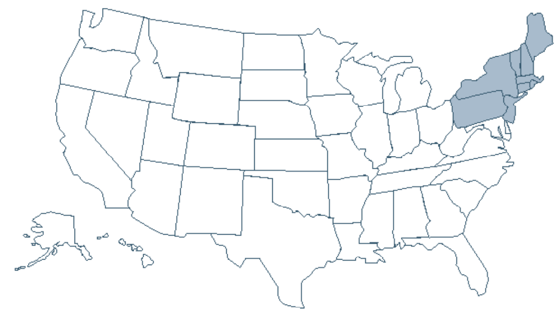
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



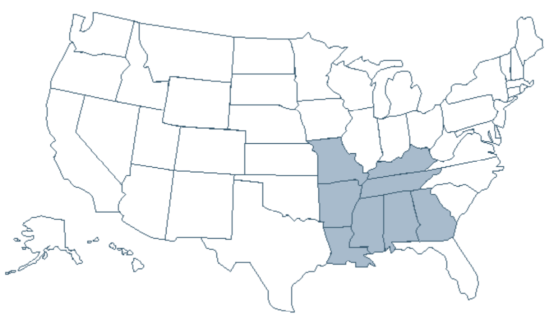
Atlantic Coast



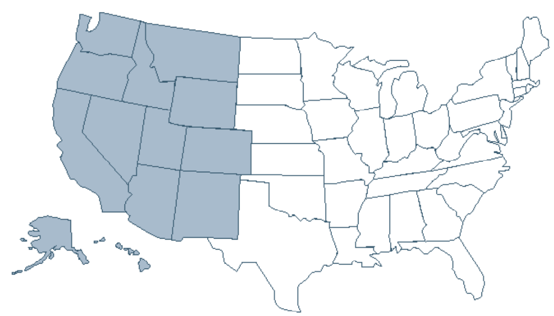
Midwest



Northeast



Southeast



West

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Mercer Capital assists banks, thrifts, and credit unions with significant corporate valuation requirements, transactional advisory services, and other strategic decisions.

Mercer Capital pairs analytical rigor with industry knowledge to deliver unique insight into issues facing banks. These insights underpin the valuation analyses that are at the heart of Mercer Capital's services to depository institutions.

Mercer Capital is a thought-leader among valuation firms in the banking industry. In addition to scores of articles and books, *The ESOP Handbook for Banks* (2011), *Acquiring a Failed Bank* (2010), *The Bank Director's Valuation Handbook* (2009), and *Valuing Financial Institutions* (1992), Mercer Capital professionals speak at industry and educational conferences.

The Financial Institutions Group of Mercer Capital publishes *Bank Watch*, a monthly e-mail newsletter covering five U.S. regions. In addition, Jeff Davis, Managing Director, is a regular contributor to SNL Financial.

For more information about Mercer Capital, visit www.mercercapital.com.

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