ALABAMA BANKERS ASSOCIATION

BOARD BRIEFS

A NEWSLETTER FOR ALABAMA'S BANK DIRECTORS

NOVEMBER 2020 • VOLUME 5 • NUMBER 5

IN THIS ISSUE

BOARD BRIEFS
is published by the Alabama Bankers Association.

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ALABAMA BANKERS ASSOCIATION
445 Dexter Ave., Suite 10025
Montgomery, AL 36104
Phone (334) 244-9456

Capital Allocation, Changing Regulations and Banks' Strategic Plans for 2021

by Wes Scott and Kevin Tran

As 2020 mercifully nears its end, it's safe to say that we're living in uncertain times in which volatility seems to be the norm rather than the exception. Currently, we are navigating the aftermath of an extremely contentious election, COVID-19 cases are spiking and there are no guarantees that the federal government will be issuing additional stimulus relief soon. The recent turbulence in the stock market and the choppiness of the VIX Index are prime examples of the daily, meaningful impact these issues are having on the economy.

Allocating and deploying capital

In light of this, every depository institution, even healthy ones, should have a comprehensive plan for raising capital that works in tandem with its strategic plan and its enterprise risk management plan. In more normal times, banks should generally have the capital that allows them to comfortably satisfy regulatory capital ratios, implement their strategic plans and weather an unexpected storm.

Currently, however, it is wise to have "safety capital," which means having an appropriate amount of capital and then a good deal more. Some have referred to this as "hoarding capital," but in these times, having excess capital is prudent not only from a business perspective but also in fulfilling certain legal compliance obligations.

When it comes to deployment, capital can be used generally for defensive and offensive purposes. More defensive uses of capital include those that are designed to shore up capital inadequacies, avoid regulatory issues, offset credit losses, assist with loan modifications and supplement lower or anemic earnings. On the other hand, offensive uses of capital include engaging in M&A activity, organic growth, reinvesting in your business (such as bolstering your cybersecurity), paying dividends, repurchasing debt with higher service costs and conducting share buybacks.

If you're like the majority of banks that find themselves somewhere between a purely offensive or defensive position, having sufficient capital allows you to play both offense and defense depending upon the issue of the moment. Having that flexibility in the current environment is simply invaluable and, frankly, could ensure your continued viability if your bank encounters difficulties in the near future.

The number of capital raises and the amount of capital raised in 2020 has been significant; however, if you are in a position where you feel you need to raise capital, please contact the authors of this Brief.

What regulatory issues tend to derail strategic plans?

We can generally simplify regulatory impact into two buckets: infrastructure-changing regulations and ordinary-course regulations.

Infrastructure changing regulations are rules like CECL, the Volcker Rule, the Fed's Small Bank Holding Company (BHC) Policy Statements, and the 2018 Farm Bill generally legalizing hemp. Essentially, these types of rules either introduce new opportunities or prohibit existing activities which may require banks to reevaluate and amend their strategic plans to incorporate these regulatory-driven changes. Consider these two examples:

- The Small BHC Policy Statement. The threshold to be considered a small BHC has crept up from $500 Million to $3 billion in just 5 years. So what does that mean for a lot of our community banks? It may provide eligible banks with more opportunity to issue subordinated debt, as discussed above, and engage in growth opportunities that previously were less attractive.
- The Volcker Rule. Meanwhile, take the Volcker Rule (though this may be more applicable to larger banks). If a bank relied on proprietary trading as a pillar of its strategic plan, the Volcker Rule likely derailed those plans. As a result, an affected bank likely would need to revisit its strategic plan and determine alternative business lines it may need to pursue to account for a business strategy that has been heavily restricted by regulation.

The second bucket involves "ordinary course" regulations. These rules are the staple capital, liquidity and leverage regulations that continue to evolve. Even though there was an enormous overhaul of the regulatory capital framework in 2013, banks are still dealing with the basic premise that maintaining minimum levels of capital reserves is good and overleveraging is bad.

Relatedly, for those on the offensive, whether growing organically or through acquisition, changing funding strategies or diversifying operations, those banks need to keep in mind important asset size thresholds. This concern is probably less of one for community banks given that thresholds have tended to trend upwards. But that being said, you never want to be caught in a position where you're aggressively pursuing growth and you end up crossing a threshold that makes you subject to a different level of regulatory compliance and scrutiny for which you're unprepared.

Ultimately, to the extent that changes occur over the years as agencies see more data and better understand trends, what a bank needs isn't a magic crystal ball trying to anticipate these changes but, instead, an enterprise-wide risk management and compliance structure to deal with these changes and mitigate the costs of evolving regulation.

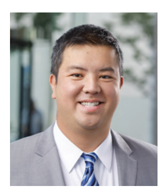
Establishing enterprise-wide risk management and compliance strategy

Having an enterprise risk management system makes a bank more agile and resilient which will become more and more important as banking becomes increasingly driven by technology. COVID-19 certainly pushed technological innovation on banks, particularly community banks.

Pre-COVID, it wasn't uncommon for community banks to focus on building relationships with their customers and their communities in person to drive business (whether lending or taking deposits). But now, everything is remote, and in-person meetings are challenging (especially when bank lobbies are closed), making technology key to providing services and building business.

But, once you start going down the path of technological innovation, there are quite a few attendant issues you have to account for, and chief among them are data privacy, cybersecurity and related regulations. As a result, having a proactive, enterprise-wide risk management function that can react to and address regulatory changes impacting your business lines in a coordinated manner allows for consistent messaging and effective communication internally and externally, and ensures regulatory considerations are always top of mind when pursuing other opportunities and initiatives.

A member of Waller's corporate practice, Kevin Tran assists clients in matters related to bank regulatory compliance, capital-raising and corporate transactions. Banks, bank



holding companies and other financial institutions benefit from the experience he gained with the Federal Reserve Board in Washington, D.C., where he served as a Financial Policy Analyst in the Capital and Regulatory Policy group in the Division of Supervision and Regulation, and as the Policy Staff Adviser/Chief of Staff to the Deputy Director for Policy. Wes Scott is a partner at Waller. Public and private financial institutions, including banks, bank holding companies and investment banks, as well as healthcare companies, including clinical trial and medical device companies, rely upon Wes Scott's experience, judgment and business acumen to close their capital market transactions. Wes has quarterbacked numerous initial public offerings, primary and secondary follow-on offerings, mergers, acquisitions, dispositions, joint ventures and other transformative transactions.

New, Now, Next in Payments

By Sarah Edwards

What's up and coming around the corner for the payments industry? Below we discuss three areas of innovation in payments that banks should be monitoring: the Real Time Payments Network, the FedNow Service, and the OCC Payments Charter.

Real Time Payments

The Real Time Payment (RTP) network – a private network owned and operated by The Clearing House – is currently the only instant payments infrastructure in the United States. Unlike traditional payments rails, such as the check network or the ACH network, the RTP network offers consumers and businesses the ability to send and receive payments instantly, 24/7/365.

"Instant" or "real time" settlement means that the transfer of final funds between the payor's and payee's financial institutions occurs with the transmission of the payment message and only seconds before the payee's financial institutions makes the payment available to the payee. In an instant payment scenario, the payee's financial institution does not incur credit risk because it receives funds from the payor immediately.

Payments on the RTP network clear and settle individually in real time with immediate finality in a real-time gross settlement or "open loop" system (there is no batch processing) for credit-only transactions. Network participants must be federally insured depository institutions, but any federally insured depository may participate. Participating institutions can integrate into the RTP network directly, or through third-party service providers, bankers' banks, and corporate credit unions.

FedNow Service

FedNow is the Federal Reserve's answer to consumer and small-business instant payments and the RTP network. Like the RTP network, FedNow will be an "open loop" system that enables payors to make payments to a broader group of payees. The FedNow Service aims to route and settle payments among the various participating financial institutions through a common network.

The FedNow Service is expected to pilot in 2021, with commercial availability in 2023 or 2024. The Federal Reserve expects the service to be open to all eligible depository institutions across the United States, no matter their size or geographic location.

For now, the Federal Reserve recommends that banks take the following steps to ensure they are able to utilize FedNow when it becomes available: (1) ensure the bank has the ability to use ISO 20022 messaging for interbank fund transactions; (2) determine how online and mobile banking and customer service support may need to change to support instant payments; and (3) stay abreast of developments in the instant payments landscape.

OCC Payments Charter

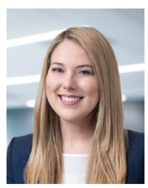
Banks should also keep an eye on the OCC's proposed Payment Charter for national money transmitters, the blueprint for which the Acting Comptroller of the Currency previewed this year.

This special-purpose charter could eliminate multi-state licensure for nonbank money transmitters by preempting state-level regulation. Unlike the OCC's proposed FinTech Charter, the

Payments Charter would not create any lending authority for chartered entities.

According to statements from Acting Comptroller Brooks, the Payments Charter would be rolled out in two phases. Phase One would allow for federal preemption in money transmission regulation and would essentially create a national money transmission license. However, newly chartered entities would not have access to the Federal Reserve's payment system. Phase Two, which is proposed to begin 18 months after Phase One, would grant chartered entities access to the Federal Reserve payment system, allowing payments to clear directly through the Reserve rather than through ACH or third-party depository institutions.

The Payments Charter proposal, while still informal, has already been challenged by an Industry Letter requesting transparency in the chartering process and an opportunity for industry comment. This initial industry concern, along with the change in leadership at the OCC anticipated with a change in the administration in Washington, may doom the Payments Charter before it is formally proposed. Even if doomed, however, we do not anticipate national money transmitters to abandon their push for federal regulatory reform.



Sarah Edwards is an attorney in McGlinchey's Consumer Financial Services Compliance group and is based in the firm's New Orleans office. Her work focuses on helping financial services clients comply with federal and state regulations, particularly with respect to offering new or updated products in money transmission as well as in the brokering, lending, and servicing spaces.

FHA Posts Proposed Rule Permitting Acceptance of Private Flood Insurance

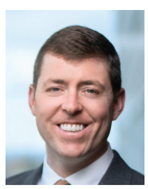
By Heather Howell Wright and Austin Holland

On November 23, 2020, the U.S. Department of Housing and Urban Development (HUD) published in the Federal Register a proposed amendment to Federal Housing Administration (FHA) regulations that would allow lenders to accept private flood insurance policies on FHA-insured properties located in Special Flood Hazard Areas. HUD will accept comments for 60 days following the date the proposed rule, Acceptance of Private Flood Insurance for Federal Housing Administration (FHA)-Insured Mortgages (Docket No. FR-6084-P-01), is published.

The proposed rule would allow borrowers the option of purchasing private flood insurance on FHA-insured mortgages for properties located in Special Flood Hazard Areas by amending FHA regulations at 24 CFR sections 201, 203, and 206 as follows:

- 24 CFR § 204.16a would be amended to include the definition of "private flood insurance" from the Biggert-Waters Flood Insurance Reform Act.
- 24 CFR § 203.15a would be amended to include a "compliance aid" provision allowing mortgagees to accept private policies, without further review, where the policy contains the language: "This policy meets the definition of private flood insurance contained in 24 CFR 203.16a(e) for FHA-insured mortgages."
- HUD also proposes to amend 24 CFR § 201.28(a) (Property Improvement and Manufactured Home Loans), § 203.343(b) (Single Family Mortgage Insurance), § 206.45(c) (Home Equity Conversion Mortgage Insurance), and § 206.134(b) (Home Equity Conversion Mortgage Insurance) to permit borrowers to obtain private flood insurance.

The proposed rule announcement provides an explanation of the history of the Flood Disaster Protection Act of 1973 (the FDPA), as amended by the National Flood Insurance Reform Act of 1994, and the Biggert-Waters Flood Insurance Reform Act of 2012 (Biggert-Waters). HUD's authorization that lenders may accept private flood insurance policies comes nearly two years after the Board of Governors of the Federal Reserve System, the Farm Credit Administration, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency (the interagency regulators) issued a final rule in February 2019 implementing the portion of Biggert-Waters mandating acceptance of private flood insurance. While the interagency regulators' final rule requires federally regulated lenders to accept private flood insurance went into effect on July 1, 2019, FHA's existing rules do not permit private flood insurance to satisfy the mandatory purchase requirement of the FDPA. Importantly, HUD advised in the proposed rule that it "will not permit Mortgagees to exercise their discretion to accept flood insurance policies, provided by private insurers or mutual aid societies, that do not meet the definition and requirements for a private flood insurance policy as laid out in this rule." As a result, HUD cautioned that "[d]ue to the differences between HUD and the Federal regulators' rules, compliance with the Federal regulators' Final Rule should not be interpreted as compliance with HUD's requirements." Given this significant and explicit distinction by HUD, federally regulated lenders that originate FHA-insured loans should be mindful that their policies and procedures are designed to ensure compliance with both the interagency regulators' Final Rule and HUD's eventual final rule on the topic of acceptance of private flood insurance.



Heather Howell Wright is a partner at Bradley. She helps financial institutions identify operational risks and determine business solutions to mitigate those risks. Austin Holland is also an associate at Bradley. His practice focuses on regulatory compliance matters, government enforcement actions, and financial services litigation. He has represented clients in a variety of matters, but his practice is particularly focused on issues with an emphasis on matters related to housing.

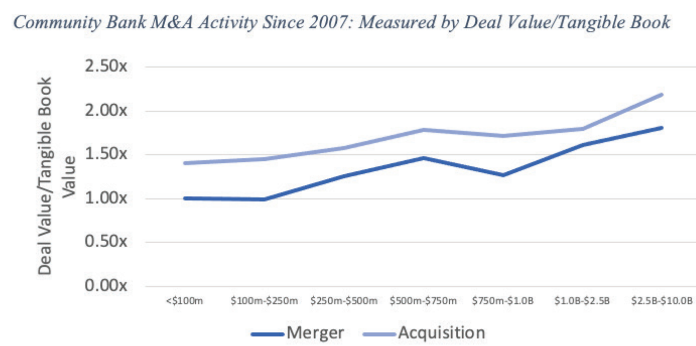
COVID, Capital, Scale & Opportunity: A Case for Community Bank Mergers

by Michael Murphey

COVID has accelerated change in our economy, and banking is no exception. We all know the issues: (i) declining Net Interest Margin, (ii) the need to reduce costs and grow fee income, (iii) a potential shift from branches to digital. These challenges are arising in a time when we are not sure of our bank's credit quality, much less that of peers. In our opinion, capital is the way to address these issues.

Capital allows a bank to build scale, and the fastest way for a community bank to build capital and scale is through mergers. If properly executed, mergers will lower costs and increase cashflow for reinvestment into fee generating products, growing ROA and franchise value.

This is not lost on the markets. The following graphs reflect 2,604 Community Bank M & A valuations since 2007, parsed by asset size of the acquired bank and dollar value of merger deals done by year. These charts evidence two findings: (i) size matters...a $500m bank is 27% more valuable than a $100m bank and (ii) 2020 merger activity is at record levels, despite carrying valuations 30-50% lower than acquisitions (for our purposes, "Mergers" are stock for stock deals, "Acquisitions" are cash for stock deals). The balance of this article will discuss why mergers are gaining popularity, and how this concept could be applied here in Alabama.



Source: S & P Global Market Intelligence

Source: S & P Global Market Intelligence

How do Mergers Differ from Acquisitions, and why are Mergers Popular now?

Historic preference for Acquisitions is best summarized by two well know adages:

- Banks are sold, not bought: Selling shareholders make M & A happen, and they want high valuations. In mergers both buyer and seller share strategy execution risk, lowering Day One share value for selling shareholders in return for potential higher post synergy returns down the road. In acquisitions, the acquirer bears all synergy risk, providing more immediate

value to the seller, but none of the longer-term upside.
- Cash is king: Older, more conservative individuals, who commonly make up most community bank shareholder base, typically prefer cash over stock.

COVID has changed these valuation propositions as follows.
- Significant falloff in Acquisition valuations makes Mergers more attractive to selling shareholders: Valuations for community bank acquisitions have fallen from 1.61x Tangible Book in 2019 to 1.34x in 2020. 2020 merger valuations are 0.94x book, with considerable upside from (i) a return to normalized valuations levels post COVID and (ii) higher earnings from realization potential of synergies.
- Willingness to accept stock: Cash is king, but not when valuations are at historic lows. Stock provides the selling shareholder the time to realize post COVID market bump and merger efficiencies discussed above.

Beyond COVID, if your bank directors, management, and shareholders have a three to five-year investment horizon, we believe acceleration of digitization and the reality of a very low rate environment require scale will meaningfully impact your return. We believe the additive capital accumulation from selling shareholders entering the consolidated equity base provides a bank the "firepower" to successfully execute mergers and build scale much faster than capital constrained acquisition transactions. Further, it is our contention that community bank mergers of similar size and geography carry manageable integration risk. Directors and officers probably know each other from common business or civic interests, credit portfolios are similar and IT infrastructures are not complex. These factors provide a solid platform to build out a merger strategy and enhancing shareholder value.

The following table summarizes strengths and weaknesses of community bank merger and acquisition transactions.

	Merger	Acquisition	Why Merger now?
Board/Management succession	In place, provides time to generate enhanced returns	None, sell stock when multiples at pre COVID levels	Biggest factor driving decision drives decision
Selling shareholder	Stock only, low valuation	Cash, higher valuation	Low current valuations
Bank Integration issues	More, split board & management	Less, acquirer board and management	- Contiguous markets - Long time competitors -Small scale
Capital	Additive	Constrained by Leverage	
Asset Size	Larger, more capital	Smaller, less capital	Scale is key post COVID
Synergies	More, larger asset base	Less, smaller asset base	
Bank Valuation	Higher, more assets & synergies	Lower, smaller asset base & synergies	
Near term acquisitions	Yes, more capital[1]	No, less capital	
Acquiring shareholder	More upside, more scale	Less upside, less scale	

Legend: Red negative, Green positive, Blue ongoing critical issue

[1] assumes no material merger issues

How Have Mergers Performed?

Mergers are frequently criticized for not meeting projected synergies due to inefficiencies associated with management and board level clashes. Our findings do not support this conclusion. To evaluate this concern, we reviewed 12 merger and 203 acquisitions that occurred in 2016. For comparability to Alabama's community banking landscape, we focused on deals involving total assets approximating $500 million. We then calculated the 2016 ROA and Efficiency Ratio weighted by asset size of the merged banks and compared those results to the actual ROA or Efficiency Ratio of the consolidated bank at FYE 2019 or when the bank was sold.

Our results indicate ROA improved 12 basis points with mergers and 15 basis points with acquisitions, essentially the same result. Interesting to note that mergers achieved enhanced ROA through cost cuts, while acquisitions grew through revenue enhancement. It therefore appears small dollar mergers perform as well as acquisitions in delivering enhanced profitability to their shareholders.

		Asset size ($mm)		2016 Asset Weighed		Earlier of 2019 or exit	
	Count	Buyer	Seller	ROA	Eff Ratio	ROA	Eff Ratio
Merger	8	$294	$227	0.88	73.9	1.00	65.9
Acquisition	17	$384	$121	1.02	56.5	1.17	57.0

How Could Mergers Impact Alabama's Community Banking Landscape?

The maps to the right represent a county view of Alabama's banking market based on the headquarter location for 105 banks and savings & loans under $2.5B in assets. Counties in green indicate the presence of a bank headquarters of the size indicated in the map title. The darker the shade of green, the more banks headquartered in that county.

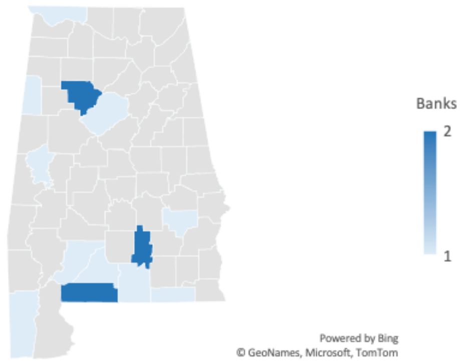
Given our belief that Alabama banks in close proximity to one another probably have a good idea of each bank's management style, culture and credit book, we believe a merger of banks of similar size in nearby markets could achieve scale economies to enhance ROA and build capital to pursue bolt on acquisitions, thereby building shareholder value.

Conclusion

If you are a shareholder, director or officer of a community bank and have a three to five year investment horizon, a merger with one or more peer banks in nearby markets may provide an opportunity to maximize your return and better serve your community. Determination of an equitable exchange ratio and development of a logical, easy to execute merger plan is critical to a successful transaction. These services are core skills of community bank focused investment banks.

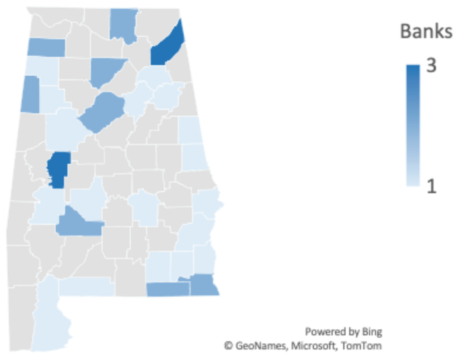
Mike Murphey is a senior advisor who supports Porter White's Community Banking practice. He has spent forty years in the southeastern US banking industry in various capacities related to commercial lending, including relationship management, underwriting, credit, and portfolio management.

Banks < $100mm



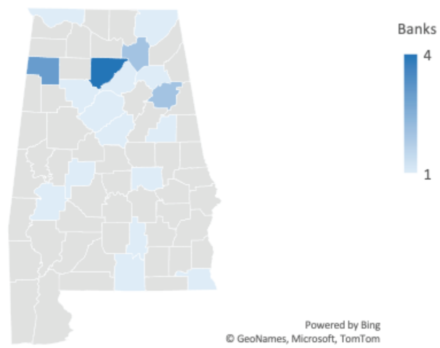
Count	16
Assets ($mm)	61
ROA (%)	-0.12
NIM (%)	3.49
Efficiency Ratio (%)	81.7
Loan/Deposit (%)	50.3
Leverage (%)	13.8
NPA/Assets	2.8
NCO (%)	0.39

Banks $100mm-$250mm



Count	40
Assets ($mm)	156
ROA (%)	1.03
NIM (%)	3.77
Efficiency Ratio (%)	72.9
Loan/Deposit (%)	68.1
Leverage (%)	11.4
NPA/Assets	1.46
NCO (%)	0.11

Banks $250mm-$500mm



Count	25
Assets ($mm)	345
ROA (%)	1.19
NIM (%)	3.76
Efficiency Ratio (%)	60.8
Loan/Deposit (%)	68.9
Leverage (%)	12.3
NPA/Assets	1.35
NCO (%)	0.21