

Board Briefing

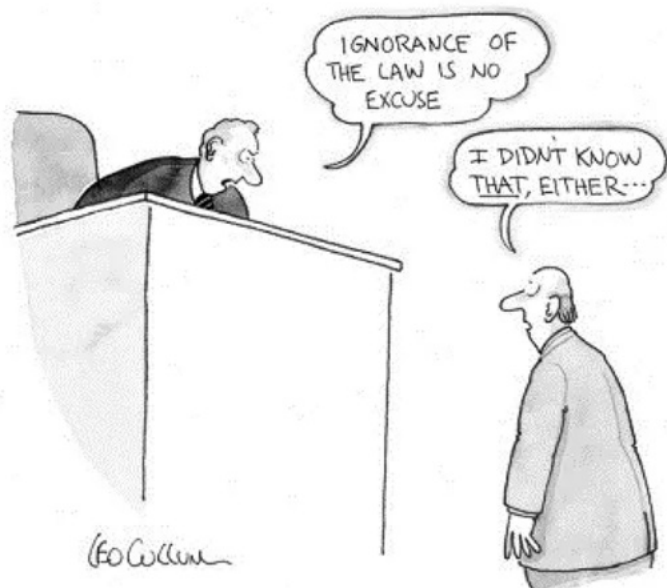
A TOOL FOR MAXIMIZING YOUR MEETINGS

Q1 / 2022

Welcome to the latest issue of *DD&F Board Briefings*, in which we offer insights on current events, address upcoming issues and deliver take-aways for you and your Board members. These Briefings are intended to be educational, discussion-starters and strategy development tools. This issue is designed for use in your first quarter board meetings.

What's Happening Now:

When DD&F's President, Randy Dennis, was in college, he thought that a class or two in Latin would help him in his then-chosen field of medicine. His instructor, Dr. Pietro Bruno Bragadin, was of pure Italian descent and spoke with a wonderful accent. Unfortunately, he gave daily grades based on participation and if a student was unprepared for a lesson, he had to be prepared for Dr. Bragadin to boldly state (with two fingers touching in the air) "Mr. Dennis, F (always pronounced "eFFa") for the day."



Almost 50 years later, Randy still remembers Dr. Bragadin's daily Latin phrases like "nihil novi, sub sole" which simply means "nothing new under the sun." Fortunately, Randy never made it to medical school, and Dr. Bragadin never actually taught him a Latin phrase that is very important for 2022: "Ignorantia juris non-excusat." If your Latin is rusty, too, that phrase translates "Ignorance of the law is no excuse." It is with this principle in mind that we highlight some regulatory updates which affect our industry, so you may always find yourself on the right side of the law and avoid getting an "eFFa" for the day.

Regulatory Updates

- Asset-size thresholds for "small bank" and "intermediate small bank" for CRA purposes was updated for 2022 by the Federal Reserve Board and the FDIC. Here are the updates (effective January 1, 2022):
 - Small bank: assets of less than \$1.384 billion as of December 31 of the prior 2 calendar years;
 - Intermediate small bank: assets of at least \$346 million and less \$1.384 billion as of December 31 of the prior 2 calendar years.
- A Crypto-Asset Roadmap is in development by the FDIC, Federal Reserve and OCC. This document is intended to provide clarity on permissible crypto-related activities and will be forthcoming throughout 2022.
- The FDIC's new Office of Supervisory Appeals became fully operational in December 2021 and will begin to consider and decide appeals of material supervisory determinations. Appealable items include ratings for CAMELS, IT, Trust, CRA and Consumer Compliance, to name a few. [Click here](#) to see the whole list.
- An interagency Computer-Security Incident Notification [rule](#) requires banks to notify its primary federal regulator

no later than 36 hours after a “computer-security incident” rising to the level of a “notification incident” has occurred. The rule also requires bank service providers to notify at least one bank-designated point of contact at each affected customer bank ASAP when it determines it has experienced a computer-security incident that has, or is likely to, materially disrupt or degrade covered services provided to the bank for four or more hours.

- “Computer-security incident” is defined as one resulting in actual harm to the confidentiality, integrity or availability of an information system or the information that the system processes, stores or transmits.
- “Notification incident” is defined as a significant computer-security incident that;
 - a) disrupts or degrades, or is reasonably likely to disrupt or degrade, the viability of the banking organization’s operations,
 - b) results in customers being unable to access their deposit and other accounts, or
 - c) impacts the stability of the financial sector.
- A reminder from the OCC: Banks are prohibited from making most equity investments in venture capital funds.
- The OCC released their 2022 assessment fees and guidelines, accessible [here](#). Regulatory assessment fees and surcharges are worth factoring into consideration when deliberating national vs state charters, along with examination styles, perception of regulatory style and the reputation of a given state’s bank department.
- As a 2022 priority, the Financial Accounting Standards Board (FASB) is evaluating a proposal which would require all US companies, including banks, to write off M&A premiums (or goodwill) over perhaps 10 years. Exact details on the proposal are forthcoming, but as goodwill treatment has continued to be brought under scrutiny over the years, one speculates whether this issue will raise more questions than answers and thus be relegated to the back burner yet again.

Industry Update

Having touched on the dry, yet necessary components, let’s shift focus to the state of the industry as a whole. The FDIC’s most recent quarterly report on the industry shows a total of 4,839 FDIC-insured institutions with an aggregate net income of \$63.9 billion in Q4/2021, a 4.4% improvement over Q4/2020. Net income reported for full-year 2021 was \$279.1 billion, up 89.7% from 2020. The increase was primarily attributable to negative provisions expenses, boosted by continued economic growth and improvements in credit quality. By Q4/2021, provisions for expected credit losses for community banks declined \$914.9 million (74.0%) from Q4/2020 but increased \$39.2 million (13.9%) from Q3/2021.

4th Quarter 2021	
Number of Banks	4,839
New Banks	0
Merged Institutions (w/ other FDIC-Insured Institutions)	72
Merged Institutions (w/ Credit Unions)	2
Bank Closings	1
Bank Failures	0

The following chart shows a year-over-year picture of the median trends of profitability metrics for community banks.

MEDIAN TRENDS AT COMMUNITY BANKS, Q4 ‘21

	ROAA		NIM*		Efficiency ratio		NCOs/ average loans*		YOY deposit growth		YOY loan growth	
	Percent of banks improved		Percent of banks improved		Percent of banks improved		Percent of banks improved		Percent of banks improved		Percent of banks improved	
	1	2	1	2	1	2	1	2	1	2	1	2
Q4/21 total assets category												
<\$3B	1.01	48.6	3.31	34.0	65.08	40.4	0.01	58.7	12.8	26.9	1.1	23.7
\$3B-\$10B	1.20	48.5	3.14	28.1	57.04	38.1	0.03	57.9	12.7	30.9	1.3	26.0
All <\$10B	1.12	48.5	3.21	31.2	61.45	39.3	0.02	58.3	12.7	28.9	1.2	24.9

Data compiled Jan. 31, 2022.

ROAA = return on average assets; NIM = net interest margin; NCO = net charge-off

Analysis limited to U.S. banks trading on the Nasdaq, NYSE or NYSEAM that reported earnings up to Jan. 28, 2022, and disclosed assets of at most \$10 billion, as of Dec. 31, 2021. The middle-tier parent and ultimate parent must also have total assets less than \$10 billion as of the most recent quarter available. For each of the six financial metrics, banks are excluded from the median and percentage change calculations when data is not available for both the most recent quarter and the year-ago quarter.

Data is for the quarter ended Dec. 31, 2021, and is based on GAAP filings.

* The year-over-year comparison represents the change in values rounded to two decimal places.

Percentage of banks improved reflects the number of banks that showed year-over-year improvement in the metric as a percentage of total banks that reported the metric for the quarter.

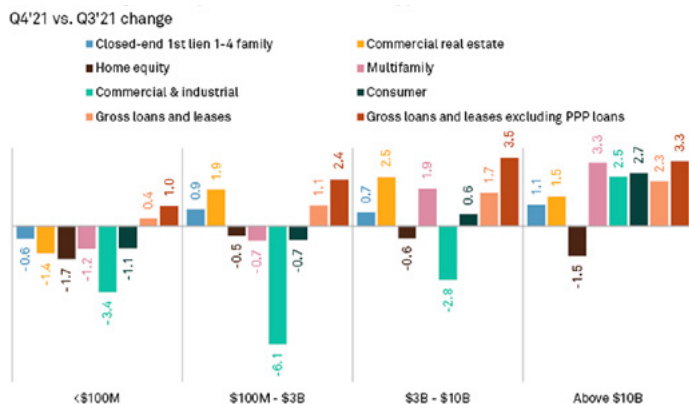
Source: S&P Global Market Intelligence

Lending

The 2021 Shared National Credit ("SNC") Review Report indicated that credit risk for large, syndicated loans improved modestly, but remains high, largely due to lingering effects of COVID. Recovery in commodity prices has led to improvements in lending to the oil and gas sector, although this is partially offset by weakening in CRE (hotels, offices, and retail sub-sectors). For reference, the 2021 SNC portfolio included 5,764 borrowers with \$5.2 trillion in commitments, an increase of 2.1% from 2020.

Loan growth is on the rise, albeit slowly. According to S&P Global, during Q4/2021, U.S. community banks grew their overall loan portfolios 2.4% over Q3/2021, excluding PPP loans. Community banks in the West and Southwest saw the most growth quarter over quarter, even considering declines in C&I lending (PPP runoff). Banks in all regions experienced growth in CRE lending.

MEDIAN LOAN GROWTH BY BANK ASSET SIZE AND TYPE (%)



Data compiled Feb. 10, 2022.
 PPP = Paycheck Protection Program
 Consumer loans exclude home equity loans.
 Home equity loans include revolving open-end one- to four-family loans (home equity line) and closed-end junior lien one- to four-family loans.
 Analysis includes U.S. commercial banks, savings banks, and savings and loan associations.
 Nondepository trusts and banks with a foreign banking organization charter are excluded.
 Data based on regulatory filings as of Dec. 31, 2021.
 Loan categories are not representative of the entire loan portfolios.
 Source: S&P Global Market Intelligence

And for the first time since Q2/2019, the decline in banks' loan to deposit ratios reversed trend! As of the end of the fourth quarter 2021, the aggregate loan to deposit ratio was 57.1%, up from 56.01% in Q3/2021, but still below a high of 73.4% in 2019. Overall, according to Fed projections, deposits

are anticipated to grow 3% and loans are expected to climb 6.75% in 2022 over 2021.

Efficiency Ratios

Although loan growth is ticking back up, net interest income and non-interest income have not been growing at the same rate as non-interest expenses. As a result, banks are experiencing higher efficiency ratios. The cause for increase in noninterest expenses is most likely due to higher labor costs (bonuses/incentives rising in order to maintain employment levels) and the overall effect of inflation on every-day expenses, in general.

Yields

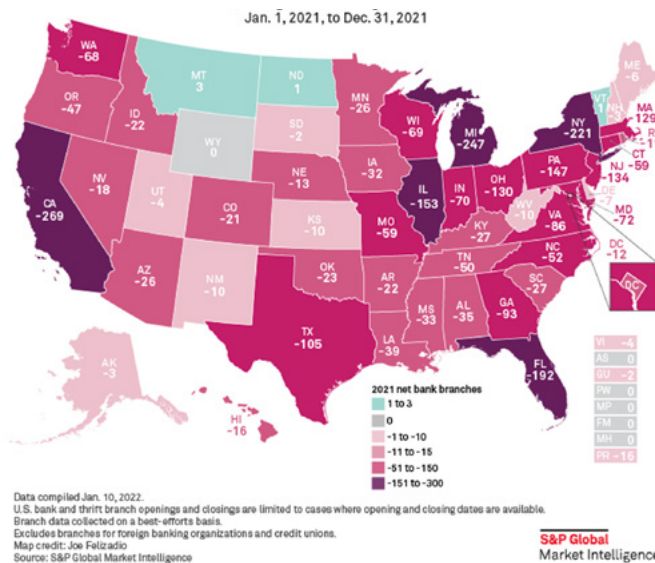
Seeking yields on excess cash while waiting for loan growth to gain speed continues to cause sleepless nights for chief investment officers who have the pleasure of watching the economic indicators and any hint of when exactly the Fed might begin to raise rates in order to determine where on the yield curve they want to land. In general, banks continued to move cash into bonds securities portfolios during Q4/2021, and while investment in 15-year bonds did increase, there was also more movement into shorter-term securities. It's one thing to watch the movement of the big banks and analyze their strategy. It's another to support the communities in which you live and operate through longer-term state and muni bonds, while still feeling leery of the long-term interest rate risk. The intricate dance of yield management continues to unfold.

Branches

Living through a pandemic changed the way this country worked, schooled, shopped and banked. A confluence of events – a shift out of branches (even if temporary), a digital response to banking needs during periods of extended lockdowns, a surge in deposits following unprecedented federal economic incentives/assistance, non-existent loan growth – forced the banking community to critically assess margin improvement solutions. The sheer number of branches serving (or not serving) the communities began to

be evaluated very seriously. The year 2020 saw a net closure of 2,130 branches, 1,182 of which were closed in the fourth quarter alone. The year 2021 exceeded that with a net closure of 2,927 branches.

NET BANK BRANCH OPENINGS AND CLOSINGS ACROSS US AND TERRITORIES



Interestingly, moving into 2022, although banks continue to whittle away at their branch networks, certain markets are seeing the establishment of new branches. The pandemic not only made banks re-evaluate their footprints, but it also triggered a re-evaluation by the residents of many states of their own footprint, who then decided to move elsewhere. As states like Florida, Texas and Tennessee experience an influx of new residents, serving those residents might mean certain banks open new branches.

DD&F was ranked #1 in the nation for Branch Acquisitions in 2021 by S&P Global Market Intelligence. If you are evaluating your branch networks, we'd love to help you in that process. If you are considering other options to improve your bank's margins, we provide services which may reveal hidden revenue opportunities, including Operational Assessments, Branch Network Evaluations and Core Assessments.

STATES WITH THE MOST NET OPENINGS/CLOSINGS IN JANUARY 2022

State (active branches*)

	Active branches	Net openings/closings	Openings	Closings
Net openings				
Arkansas	1,307	4	4	0
Texas	6,327	3	8	5
Tennessee	1,959	2	2	0
Net closings				
New Jersey	2,525	-19	1	20
Ohio	3,231	-18	3	21
California	6,156	-15	1	16
Pennsylvania	3,675	-13	1	14
Kentucky	1,530	-12	2	14
Michigan	2,083	-12	0	12
New York	4,340	-8	0	8
Idaho	428	-7	0	7
Maryland	1,325	-7	1	8

Data compiled Feb. 9, 2022.
* Active branch data based on the FDIC's June 30, 2021, Summary of Deposits filings and pro forma adjusted for branch openings or closings as of Jan. 31, 2022.
Ranking based on U.S. bank and thrift branch net openings/closings for January 2022. Credit union and foreign organization branches are excluded.
Limited to states with at least two net openings, or seven or more net closings.
Branch openings and closings are limited to cases where opening and closing dates are available.
Branch data collected on a best-efforts basis.
Source: S&P Global Market Intelligence

What Comes Next:

Credit Union Activity

As 2021 M&A activity among banks rebounded following a lull in 2020, credit unions mergers have also jumped up. Credit unions completed 168 deals in 2021, and of those, 13 were bank acquisitions. An estimated 25 such deals could be announced in 2022. There's no shortage of opinions on the topic of credit unions acquiring banks. This briefing is not intended to pass judgment one way or the other, but rather to provide food for thought and a clearer picture of what is happening and possibly why.



What is the impetus for this movement on the part of credit unions?

1. Membership expansion
2. Product line expansion (particularly small bus. lending)
3. Market expansion
4. Add new talents to the workforce
5. Branch & ATM network expansion
6. Develop economies of scale
7. Acquire deposits needed for growth
8. Diversify the balance sheet
(insurance, wealth management, trust, etc.)
9. Defense mechanism (prevent competitors from entering market)

Why would a bank consider a credit union offer?

1. Some banks find the increased regulatory pressure too much and are seeking a way out
2. No banks are interested in acquiring them
3. Family-owned community banks may have aging owners and no clear succession plan
4. Higher prices to shareholders
5. Credit unions make 100% cash offers
6. Knowing credit unions tend to keep branches open and retain a higher percentage of existing employees

Things to consider:

1. Banks need to assess the potential tax consequences of a buyout by a credit union. While credit unions will usually gross up the purchase price to cover all or most of the tax, careful tax planning is critical.
2. Credit unions are faced with considering the business loan cap set by the NCUA and incorporating an expanded field of membership.
3. Credit union/bank transactions take longer to complete as there are added regulatory steps in the process.
4. Certain state regulators, like Iowa, Colorado, Nebraska and Tennessee have thrown up opposition or outright prohibited these types of deals.

If you are considering your options, we have experience working with both banks and credit unions and would be happy to help you both analyze and accomplish your goals. We have been helping our clients buy and sell branches, banks, thrifts and credit unions since 1993.

Inflation

While the effects of inflation may be causing consumers to spend more on...everything...the predicted rate hikes by the Federal Reserve shine a beacon of hope for banks who stand to benefit from these changes, even if only in the short-term. How? Banks are hoping to redeploy high levels of cash into securities when rates increase. Also, new loans are able to be priced at higher rates while deposit rates lag.

Interestingly, as one contributor to this article notes, human nature drives us to seek the best rates on new borrowings from any source available, yet we are more hesitant to make changes in our deposit services. For bigger banks, these rate hikes may translate to significant increases in earnings. In the longer-term, deposits rates will rise, thus squeezing margins; not to mention, rising rates associated with inflation mean banks earn less as loans are paid back with “cheaper dollars.” This tends to offset the higher margins realized in the short-term.

Regulatory Scrutiny

It’s no secret that the regulatory burden on financial institutions has become intense over the past few decades. And while the regulators expect all the regulations to be adhered to, they do seem to zero in on some favored areas, typically following political and even social trends. Consumer Compliance is a hot button right now. That means Fair Lending, CRA, Fair Credit Reporting, flood insurance... they are taking these very seriously.

Once the “Consumer Compliance glasses have been assumed by the regulators, just about anything can become a fair lending issue.

Here are some key points for community bankers to take to heart:

1. Branch Opening/Closing Policies. Compliance and CRA Examiners have long recommended that banks have a written “Branch Closing Policy,” even small banks with few branches that have never closed a branch and have no intention of doing so. However, while we agree that all banks with branches should have a Closing Policy, we think that it is almost as important to have a “Branch Opening Policy.”

Branch closure decisions raise significant CRA and Fair Lending issues. When making decisions regarding closing or opening a branch, profitability and convenience (to the bank) should not be the only factors considered. A bank’s policy should clearly set out a decision-making process not just for new brick and mortar branches but also LPOs or even the placement of bank owned ATMs. In addition, a branch closing policy should describe a methodology to assess the negative impact of the availability of financial services to the community or area affected. Similarly, an opening policy needs to set out a framework to assess the benefit to the area in terms of community development and services provided by the new branch, loan production office (“LPO”) or ATM. Having these policies in place will provide a ready answer when an examiner points to a map and asks, “Why there?” – with the implied second-guess question, “Why not HERE?”

Along those lines, we have also noted an increase in examiner concern regarding branch closures that may (or may not be) contemplated as part of a purchase or merger application.

2. Small Business Data Collection. Fair warning – required collection of small business data is coming. The Dodd-Frank Act required the CFPB to obtain data regarding lending to female- or minority-owned businesses. Exactly how this was to be accomplished was put off until recently when the CFPB proposed required collection and reporting data on small business lending, in a similar manner to HMDA data. It is likely that all banks will need to collect such data, even if not required to report it. Accordingly, all banks should expect a greater examiner focus on small business lending, not just for CRA but also for their fair lending reviews. Monitoring commercial lending has not previously been a major consideration in fair lending compliance risk management, but banks should consider adding such a review to their internal fair lending oversight program.

3. Fair Lending. Examiners have also signaled an even greater level of concern for Fair Lending performance in general and the application process, in particular. The lead article

in the most recent issue of the Federal Reserve publication, *Consumer Compliance Outlook* is titled “[Advanced Topics in Adverse Action Notices under the ECOA](#).” This article should be required reading for all loan officers and loan operations personnel. In recent months, we have found it interesting that mortgage LPOs have drawn more questions related to fair lending and disparate impact. Although LPOs are not considered under CRA, they are a part of the fair lending equation. *If you are in doubt about an LPO’s impact on your fair lending, give us a call.*

4. Medical Debt & Fair Lending. A recent report issued by the CFPB regarding medical debt on credit reports shows the need for uniform treatment when evaluating credit reports. The report states that “Medical bills placed on credit reports can result in reduced access to credit ... even when the bill itself is inaccurate or erroneous.” The report goes on to state that medical debt on credit reports is disproportionate by race, which means this is a potential fair lending issue for examiners. Banks should review loan policies and underwriting procedures to determine if they contain sufficient specificity to ensure consistent treatment of medical debt by loan officers.

Resources

The OCC recently announced a schedule of virtual [Community Bank Director Workshops](#) which kicked off in February. The Federal Reserve has also released a [Synthetic Identity Fraud Mitigation Toolkit](#) which contains four modules which employees can work through to learn more about current identity fraud methods and how to be on alert for them.



We understand that Risk Management is vital to your institution’s success, and we offer a full range of Risk Management products and services designed to help you recognize potential issues and address them before they ever see the light of day.

Here's the Gist:

*Starting out 2022 on the right foot is important.
To help you do that, we offer three pieces of advice:*

1. Take a very close look at any policy or procedure which might feasibly be connected with Fair Lending. If you're in doubt, please give us a call. In fact, if you feel at all uncertain about any aspect of Risk Management for your institution, consider that a "liver quiver" you can't afford to ignore.

2. We live in curious times. Change is in the air (as it always is), and if your organization hasn't been actively planning and strategizing ten steps ahead....well, you need to get there. The next big strategic planning session may need to happen now. We can help.

3. Succession planning is a topic that many prefer to defer, yet every scratched date or flipped page on the calendar increases the urgency. Planning for the next generation of your organization is a complex process that may require thinking creatively, and now is the time to take that step. Give us a call.

We recognize that there are not always easy or pat answers to the issues, questions or challenges facing our industry, our country, our world. But we believe that there is wisdom to be found in the past and from the lessons that have been learned, and we know that, according to the wisest man who ever lived, "there is nothing new under the sun." At DD&F, we know that behind every institution there are families and individuals with values, hopes and dreams, and we are honored to serve as your trusted advisor.

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Joe Buehler, a Senior Risk Specialist for DD&F, has over 35 years of experience working in the banking industry including 18 years of regulatory examiner experience at the Federal Reserve. He has extensive experience in Compliance Risk Management, including Fair Lending risk.

Founded in 1993, DD&F Consulting Group provides consulting services to the community banking industry nationwide, helping clients achieve growth, performance and security. We have a special affinity for helping Boards stay aligned and energized and would love to talk with you about our Strategic Planning or Board Training services.