Board Briefing

A TOOL FOR MAXIMIZING YOUR MEETINGS

Q3 / 2023

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.

What's Happening Now:

Migration happens every spring, but this one brought an unexpected number of Black Swans: from March 8-12, we witnessed the self-liquidation of Silvergate Bank and back-to-back failures of Silicon Valley Bank and Signature Bank. After a brief pause, on May 1st, the $229 billion First Republic Bank was closed by the FDIC. It was enough to make the most experienced bird watchers, I mean, bankers, scratch their heads. What was going on? Are these Black Swans or canaries in the coal mine, signifying greater trouble ahead? There may not be an easy answer, for a bank failure is the result of a series of decisions and variables that are numerous, multi-faceted and rarely fully controllable.

Hot topics during the past few months include liquidity, the AOCI ratio, the rising cost of deposits, ever-shrinking margins, soft landings or a Russian Luna-25 spacecraft moon crash (or maybe a recession), etc. In essence, on the yellow brick road of life, we have ventured through meadows of sunny, carefree times with low interest rates and high margins and find ourselves treading a bit more carefully in darker canopied, thickly forested regions where potential dangers lurk behind every tree. Should that make us long for the fondly remembered "Kansas" or hope there really is a Great and Powerful Oz which, as we all know, turned out to be nothing more than smoke and mirrors? No. It should make us go back to the basics and remember what banking is, re-establish the connection between community and bank, rediscover sound economic principles, and refocus our business strategy. Fight for self-reliance and keep doing the hard work of running a good bank. Well, now that we feel better, let's dive into some noteworthy regulatory updates.

Regulatory Updates

FedNow

As of July 20, the Federal Reserve announced that its interbank instant payment system, FedNow Service, is live and available for sign-up. This tool allows an instant transfer of money for customers any time of day, any day of the year… and also gives scammers a new tool to play with offering faster payouts for their devious behaviors.

FFIEC Updates to BSA/AML Exam Manual

On August 2, the FFIEC issued an **update to the BSA/AML exam manual**. According to an ICBA summary, there are no new instructions or increased focus on any areas. The updates are related to due diligence programs for correspondent and private banking accounts as well as special information-sharing procedures to deter money laundering and terrorist activity.

Deposit Insurance Fund Restoration Plan

In mid-April, on the heels of the SVB and Signature Bank failures (and a few weeks preceding the First Republic Bank failure), the FDIC issued a staff recommendation memo addressing the need to replenish the Deposit Insurance Fund. For background, the Fund has a statutory minimum or "reserve ratio" of 1.35% (Fund net worth/value of estimated insured deposits), and if the reserve ratio falls below that, the FDI Act requires the FDIC's Board to adopt a restoration plan. Currently, the Fund must reach its reserve ratio by 9/30/2028. As of 12/31/2022, the balance of the Fund was around $125B, but the failures of SVB and Signature cost the Fund $20 billion and $2.5 billion, respectively. Of that $22.5 billion, only $3.3 billion was required to cover insured deposits. Pursuant to "systemic risk determinations made" on March 12th, the FDIC also covered $19.2 billion of uninsured deposits, which by statute will be recovered by special assessments. A proposal released in May indicated the special assessments will only impact an estimated 113 banks, so organizations with assets of $50 billion or greater would pay more than 95% of the special assessment. No organizations with assets under $5 billion would be subject to the special assessment. As of March 31, 2023, the Fund balance was $116.1 billion (a reserve ratio of 1.11%), and it is estimated the balance fell another $13 billion with the First Republic failure.

The recent failures, which represented unprecedented numbers of uninsured depositors, have called into question the purpose and function of the Fund. Proposals have been made to "reform" the Fund with varying options: a) maintain the current structure of limited coverage (with a possible increase in deposit insurance limit); b) provide unlimited coverage of all deposits; or c) implement targeted coverage which would allow for higher or unlimited coverage for business payment accounts. A statement issued by FDIC Board Member Jonathan McKernan noted, "The FDIC does not have the statutory authority to backstop all banks' uninsured deposits, whether implicitly or explicitly." The rationale behind Option C is that theoretically, business payment accounts pose the greatest threat to the economy and should, therefore, be protected. This begs the question as to why banks (who pay the assessment fees which replenish the fund) should be held accountable for businesses lacking the foresight to better manage their deposits... Stay tuned for further developments.

Proposed Capital Requirement Changes

As a further backstop against big bank failures, regulatory proposals have been made to change the capital requirements for the largest banks. Possible changes include:

1) A 16% increase to the CET1 (common equity tier 1) capital ratio requirements for banks with more than $100 billion in assets.

2) Requiring the inclusion of accumulated other comprehensive income (AOCI) (which includes unrealized losses and gains on available-for-sale (AFS) securities) in capital ratios for banks with $100 billion to $700 billion in assets.

3) Requiring banks to use a standardized approach to calculating credit and operational risk, as opposed to the use of internal models.

Currently, only "global systemically important banks" are required to take those marks against their capital ratios, while other banks can opt-out from having accumulated other comprehensive income impact their capital. According to S&P Global Market Intelligence, the current proposal would require over half of big banks to increase their capital position. There has already been significant push-back from banks, banking trade groups, and industry experts who argue that the existing capital requirements are perfectly adequate, and the proposed changes will restrict lending and other activities and only benefit nonbanks. There have also been predictions from regulators that such a proposal will encourage regional M&A, as banks within range of the $100 billion threshold will be unwilling to make that leap without a substantial increase in size and resources. Even regulators have expressed concerns about the overarching effects of the proposal.

What does this mean for community banks? Nothing is imminent, but banking regulations are like high fashion – everything trickles down. What you see on the runways of Paris and Milan may seem completely unrelated to what you wear, but it eventually finds its way to the most basic retailer. Actions taken on larger banks lay the foundation for regulators to be more attentive to mid-sized and community bank capital levels in exams. The public comment period to provide feedback on this **proposed ruling** is November 30, 2023. This is an unusually long comment period, so make sure to submit your feedback.

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OCC & Civil Money Penalties Related to Overdraft Program

In July, the OCC assessed a $60 million civil money penalty against Bank of America for "violations of law relating to its practice of assessing multiple overdraft and insufficient funds fees against customers for a single transaction." In short, this an alleged UDAAP violation under Federal Trade laws due to what the OCC considers "inadequate disclosure in the deposit account agreement."

With both the OCC and the FDIC focusing on UDAAP violations (affectionally known as re-presentment issues), this is a good time to review for compliance and update any account agreements and disclosures used by your bank for use of debit cards. Banks get caught in a bind as the merchant can re-submit the customer item and create a new overdraft, leading to a charge for the new overdraft. Without crystal clear language in disclosures, customers can claim they did not realize an item could be re-submitted and regulators tend to hold banks accountable. Note the OCC, as an agency, made a judgmental enforcement decision under a highly subjective regulation and then assessed a large monetary penalty.

Now is an excellent time to take a closer look at the wording in your account agreements. DD&F's compliance team is well-equipped to help your institution tighten up any confusing wording and eliminate any areas of concern for regulators.

M&A News

Due to the uncertain economy, rising rates and declining securities values, there has been a lull in M&A activity. Even the regulators seem to be taking their time in issuing decisions on the M&A that does come their way. An enhanced regulatory focus on general liquidity and soundness of institutions, particularly the big institutions, has resulted in the addition of some interesting provisions to some recent (big bank) mergers. For instance, requiring the surviving institutions to provide an updated resolution plan (aka living will) within 6 months after consummation of the transaction. These are usually only required every 3 years. This just shows a higher level of caution and focus on soundness of the bigger banks.

Although many banks may have hit "pause" on any merger plans, various sources seem to see indicators of an uptick in M&A on the horizon. Despite lower bank earnings (due to higher funding costs, tighter net interest margins and smaller balance sheets), there are enough extraneous factors circulating to prompt community banks to consider consolidation sooner rather than later. For some, it may make more sense to gain economies of scale through mergers, while others may simply want to avoid the hassle and expense of increased regulation. Either way, now is a good time to begin getting ready – whether you are a potential buyer or seller.

If you're unsure of what factors to consider or would like to think through your potential M&A strategy with some really great, M&A-loving people, then reach out to DD&F's Expansionary team today!

Industry Updates

The table to the right provides a snapshot glance at where the industry ended up at the end of Q1/2023:

1st Qtr '23		Change from Q4/22
# of Banks	4,672	-34
New Banks	1	1
Merged Institutions (with other FDIC-insured institutions)	31	--
Merged Institutions (with credit unions)	0	--
Bank Closings (self liquidated)	1	--
Bank Failures	2	2
# Banks on FDIC "Problem List"	43	4
Net Income	$79.8B	+$11.5B from Q4/22

The failure of First Republic is not reflected in the FDIC's Quarterly Report for the 1st quarter. What is reflected in the Q1 report is that the industry continues to see a steady reduction in total number of banks as a result of consolidation. The table below shows the changes from the fourth quarter of 2022 to the first quarter of 2023.

FDIC Quarterly Report - Q1/2023	All Banks	Community Banks
Total Number	4,762	4,230
Net Income	**+ 16.9%** (Reflects accounting treatment of failed banks)	**- 4.29%**; 56.8% of all community banks reported lower net income
ROAA	+ 20 bp to 1.36%	- 21 bp to 1.27%
Net Interest Margin	- 7 bp to 3.31%	- 22 bp to 3.49%
Cost of Deposits	+ 43 bp to 1.42%	+ 39 bp to 1.14%
Yield on Loans	+ 32 bp to 6.08%	+ 16 bp to 5.36%
Noninterest Expense	+ $5.4B (4.0%)	- $120.2M (0.1%)
Efficiency Ratio	- 900 bp to 53.0% (reflecting an improvement in efficiency)	+ 218 bp to 62.83% (reflecting a reduction in efficiency)
Provision Expense	No Change	- 17.3%
Assets	+ $119.6B (0.5%)	+32.9B (1.2%)
	- $14.6B (0.1%) (due to loans transferred to the FDIC for	More than 2/3 of community banks reported quarterly loan

What Comes Next:

Economic Update

The Federal Reserve continues to use what it perceives to be its primary monetary policy tool (rate increases) to put the brakes on the economy. The most recent rate hike of ¼ of a percentage point means that since March 2022, the fed funds rate has been increased by 525 basis points. Although there was a hint of optimism at the most recent Fed meeting headed by Chairman Powell, the FOMC is taking a "wait and see" approach with the economy and forecasting. Inflation is still very much an issue (the June change in core CPI was 4.8% and the Fed's target is 2%), and to the average American, life is still very expensive. As Chairman Powell continues to say, there is a lag effect to everything the Fed is doing. That might be an understatement.

Although there is talk of achieving a "soft landing," some economists caution against cheering too quickly. There are similarities between our current situation and the months preceding the 2008 "Great Recession" when it was largely believed that the Fed had achieved a "soft landing." A few months later, it was clear the country was in a deep recession. It is tricky (and perhaps unwise) to make too many predictions in this post-Covid economy. There are still large vacancies in commercial real estate across the country (according to Kastle.com, the top 10 cities in the U.S. show only a 48.6% average occupancy), layoffs continue to be announced (the recent bankruptcy of Yellow Freight will affect 30,000 employees) and it may be that the recent bank failures do indicate trouble ahead.

The Deposit Challenge

Climbing rates present a challenge to banks in the form of shrinking margins and increased deposit competition. Since Q4/2022, U.S. community banks under $10 billion have seen a 32-basis point increase in cost of funds (to 0.85%). In 2021, before the Fed's tightening policy, the average cost of deposits was 0.25%. Average deposit costs have not increased equally across the country – the Northeast region and the SouthCentral region have increased the highest, 0.94% and 0.89%, respectively.

As interest rates have climbed, depositors have begun to actively rate shop, which means some banks are losing their depositors. According to S&P Global Market Intelligence, dozens of banks lost 5% or more in their deposit base during Q1/2023.

Now is a good time to put on your thinking caps to attract, keep or creatively draw back those depositors. There are basically two levers to pull: employees and customers. When it comes to incentivizing employees, some banks have switched focus from loan growth to rewarding deposit growth. Others are putting pressure on regional presidents to drive deposit growth within their regions. On the customer side, some banks have simply begun to offer high-cost products. It's important to focus on new customer growth with these campaigns, or you might find you've cannibalized your own low-cost depositors. In general, it's always a good idea to build relationships with customers, rather than having single-service households.

Remember that the easier it is to open a deposit account, the better. If your bank doesn't have the technology to offer easy, online account opening, YOU might want to get on that train. And pay attention to compliance issues when playing the deposit growth game. Problems arise from a lack of training, a lack of monitoring or excessive incentives.

While it may be humbling to scramble for something which was in such abundant supply less than a year ago, in our 40+ years of advising financial institutions, it has never been a bad idea to grow DDA balances.

If you're struggling to adjust your "levers" or are concerned about compliance implications, let DD&F's Operational, Performance and Risk experts offer their insight and expertise.

Managing Liquidity

Have you heard it said, "don't punish everyone for the mistakes of a few?" In banking, this often seems to be the way it plays out. Certain banks make headlines and then everybody else pays – whether through reputation or regulation. Another common saying might be "don't put all your eggs in one basket." Beware of a concentration in funding sources.

Let me recap. The pandemic triggered events which exposed certain conditions in the banking industry. Government-mandated shutdowns paralyzed our economy. In response, massive amounts of money were pumped into the system, leading to modern day record inflation. The Federal Reserve stepped in to shift the balance by tightening monetary controls and hiking rates. These rate hikes impacted the securities market, causing bond rates to drop. Unfortunately, banks had invested heavily in these securities when the recently distributed government money flowed through the American people into their deposit accounts. As the unrealized losses began to be taken into account and earnings dropped, it became apparent that there was a critical solvency problem.

"Liquidity" is a buzzword right now, but the problem goes beyond liquidity. It is an issue of solvency, the ability to make good on financial obligations. Bear with me a second. Banks operate by taking deposits from customers. Those deposits are a financial obligation requiring repayment. Because banks make money by lending that money out and investing it in securities, etc., those deposits are not sitting in heaps of cash in vaults. Due to fractional reserve banking, more money is lent out than was deposited and while this normally does not cause problems, it certainly can.

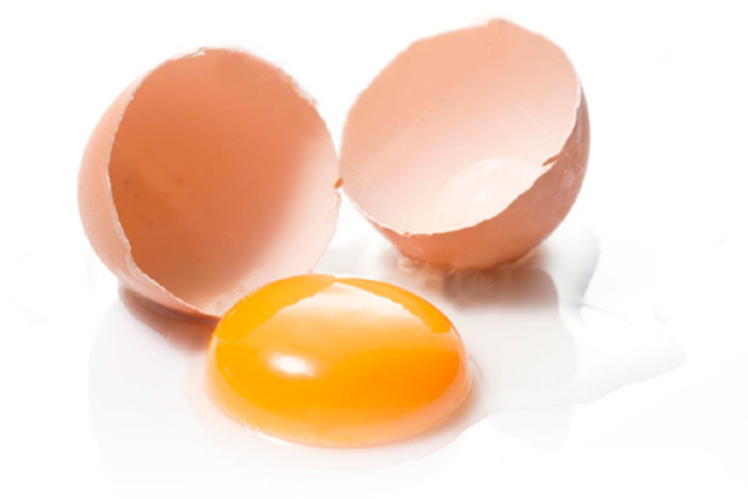
Given recent economic conditions (and monetary tightening policy), not only are banks struggling with their net interest margins and lower loan volume, but the investments they made with many of those deposits are upside down. When a depositor comes calling for their money, they expect that money to be there. The problem is compounded by the issue of uninsured depositors who know their deposits exceed the FDIC insurance limit, so when they smell trouble, they are first in line to get their money out.

For example, even a well-capitalized bank which has a disproportionate number of similar-type clients with large deposit volumes exceeding the FDIC limit, may be at risk of becoming technically insolvent (as a result of the securities mark to market). If their uninsured depositors become afraid that their deposits are at risk, that fear can cause a bank run. The solution to this solvency problem is focusing on better on and off-balance sheet liquidity.

In response to the recent failures, regulators have already begun to ask for daily liquidity reports from some banks. A better strategy would be to encourage stress testing for banks. If illiquid but solvent, capital can be raised. If illiquid and insolvent, well, you have your work cut out for you. Remember to diversify your client base, manage liquidity, and conduct stress tests.

From an acquisition standpoint, banks with excess capital and strategic objectives may find this a good time to look for hidden gems. If regulators do make life more difficult for all banks, then the winds of M&A may begin to blow again.
At the core of so many troubles is a failure to see the big picture. Rapid growth-driven success models tend to result in more spectacular failures than in long-term successes.

Truly strategic planning is something that takes time but is one of those investments that Fed rate hikes can't touch. Invest in planning for the big picture with DD&F's Strategic Planning services.



Here's the Gist:

We covered a lot of ground with this one, but over the last few weeks of summer, this will give you an interesting beach read. What is the gist? In the words of Paul Harvey, "At times like these, it's important to remember there have always been times like these." A year and a half ago, when we were selling a lot of branches, everyone was complaining because they were so liquid. We reminded them of the wisdom of Bernard Baruch who said, "buy straw hats in the wintertime for summer shall surely come." Thankfully, many agreed, we sold all the branches and now the acquirers are still smiling.

> *"At times like these, it's important to remember that there have always been times like these."*
>
> PAUL HARVEY

With that in mind, look at our present with a bit of distance. Realize that it's not the best of times or the worst of times. It is, however, a great time to familiarize yourself with the past and learn from history. If you're a young banker, new to the industry, talk to older, more experienced bankers and learn from them. If you're an older, experienced banker, invest in the younger generation. Don't bail on them – teach them what you've learned. You don't even know how much you know.

Mistakes are made in our societies when we fail to learn from the past and merely repeat what previous generations did. In the wisdom of Solomon, "there is nothing new under the sun." There's no denying that fact, but there is also the hope that humility combined with knowledge and understanding will lead to a strategy for recognizing opportunity and finding success even during challenging times. Uncertain times are exceptionally full of strategic opportunities.

Speaking of strategy, that is the gist of it. No matter how well you think you have it under control, if your institution's strategic plan is a bit dusty, then you're not doing your job well. And frankly, strategy isn't done well in a vacuum. We would love to help you develop a strategic plan that does more than check the boxes.

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