Board Briefing

A TOOL FOR MAXIMIZING YOUR MEETINGS

Q1 / 2024

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:

In a nutshell, it's an election year, inflation is being stubborn, rates are still high, the Fed is hinting at lowering rates (which makes sense given that a big chunk of interest-bearing US public debt will be maturing this year), liquidity and securities portfolios still keep many of you up at night, fraud continues to be a problem, M&A may pick back up this year, regulators keep turning up the heat, and banks have more competition than ever before despite there being fewer banks than ever before.

In the words of the shrunken head in Harry Potter, "Take it away, Ernie…It's gonna be a bumpy ride!" First stop: Regulatory Alley.

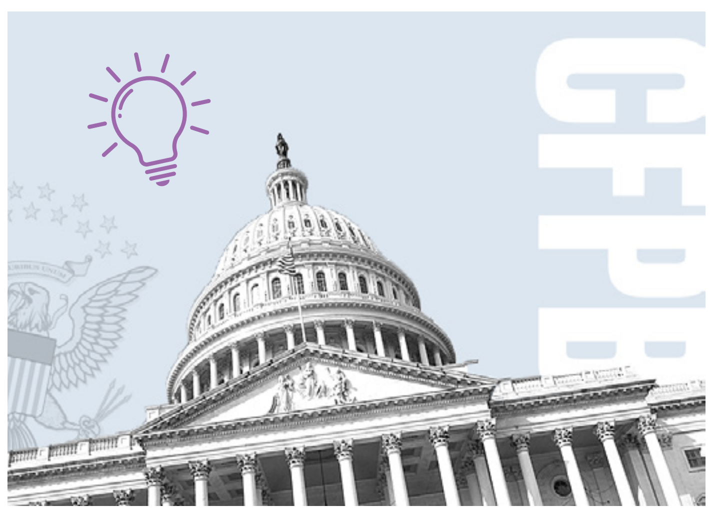
Regulatory Updates

<u>CFPB</u>

Section 1071: The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in 2010 in response to the myriad of financial debacles that effectively ushered in the Great Recession, was intended to fix and prevent the systemic problems from happening again. Well, if you're looking for a practical illustration of "visiting the sins of the fathers upon the children and the children's children to the third and fourth generation" as talked about in Exodus 34:7, Dodd-Frank has that feel about it. In August 2023, the CFPB announced a final ruling on Section 1071, which is an amendment to the Equal Credit Opportunity Act in Dodd-Frank, requiring financial institutions to collect and report certain data in connection with credit applications made by small businesses, including women- or minority-owned businesses.

With Section 1071, the CFPB has built in additional reporting requirements for small business loan applications. A resolution to overturn the CFPB's 1071 rule passed both the House and Senate but was vetoed by President Biden. A subsequent Senate vote to overturn the President's veto fell short of the required two-thirds majority.

Who does this impact? Rather than being tied to asset size, 1071 requires any financial institution that has generated at least 100 small business loans in each of the two preceding calendar years to comply with the additional reporting requirements. "Small business" is defined as a business concern with $5 million or less in gross annual revenue for its preceding fiscal year.



What counts as a small business loan? According to the CFPB, an extension of business credit under Regulation B counts as a qualifying loan.

What does this mean for me? Relevant applications pertaining to small businesses must collect a number of data points (depending upon whether the loan was approved or denied) which will be reported to the CFBP by June 1 of the calendar year following the loan application. The timing of the ruling's applicability is phased depending upon the number of small business loans historically made by your institution.

Section 1071 Timing	
Criteria For Timelines	**Compliance Date**
At least 2,500 CO's in both 2022 & 2023	1-Oct-24
Between 500 - 2,500 CO's in both 2022 & 2023; AND at least 100 CO's in 2024	1-Apr-25
Less than 500 CO's in 2022 & 2023; BUT at least 100 in both 2024 & 2025	1-Jan-26

*CO means "covered origination"

A summary of Section 1071 by the ICBA can be found here and a summary by the CFPB can be found here.

OCC

2024 Assessment Fees: The OCC has published their 2024 assessment rates here.

Proposed Rules (& Requests for Public Comment):

CFPB - Overdraft Services for $10B Institutions: The CFPB is proposing to update several exceptions in Regulation Z to extend consumer credit protections that generally apply to other forms of consumer credit to certain overdraft credit provided by institutions with assets more than $10B. Comments must be received by April 1, 2024.

CFPB - Prohibition of NSF Fees on Instantaneous Transactions: In the same vein as the previous proposed rule, the CFBP proposes to eliminate insufficient fund fees for transactions in which customers initiate payment transactions that are instantaneously declined, such as ATM or debit card transactions. Comments must be received by March 25, 2024.

OCC – Business Combinations Under the Bank Merger Act: The OCC issued a proposed rule to update its rules for business combinations involving national banks and federal savings associations and to clarify how applications will be reviewed under the Bank Merger Act. Comments must be submitted to the OCC within 60 days of its publication in the Federal Register. Specifically, the proposed rule includes:

- Removing expedited review procedures that allow certain filings to be deemed approved as of the 15th day following the close of the comment period.
- Removing a section specifying four situations in which an applicant may use the OCC's streamlined business combination application rather than the full interagency Bank Merger Act application.

Interagency Update on CRA: The Community Reinvestment Act celebrated its 46th birthday in 2023, so to celebrate, the supervising agencies gave it a bit of a facelift. A final rule summary on updated CRA guidelines was issued by the FDIC, OCC and Federal Reserve. Don't delay. It's time to determine how the new CRA rule impacts your bank.

Interagency Proposed Call Report Updates

The FFIEC published a proposal to revise the Call Report to be consistent with the joint agencies' proposed changes to the regulatory capital rule. The changes would impact FFIEC 031, banks that would be subject to the expanded risk-based approach under the proposed capital rule, and technical revisions to FFIEC 041 and FFIEC 051. The effective date for the proposed capital rule is July 1, 2025, and reporting changes would take effect Q3/2025. Comments are due by March 26, 2024.

It's not easy to stay on-top-of and in-compliance-with regulatory changes. That's why our Risk team is here, to make sure you're in good form with your regulators. Wondering how things will affect your bank? Give us a call.

M&A News

It is no secret that M&A activity – across all sectors – slumped during 2023. Much of the slump was related to the Federal Reserve's unprecedented rate increases which caused an equally unprecedented loss in most banks' investment portfolios. While this has not affected regulatory capital, in an acquisition, the losses must be recognized. As a result, banking industry M&A plans were put on the back burner. Apparently, there appears to be some optimism moving into 2024. Since January 1, 2024, 11 deals were announced, 4 of which are credit unions proposing to acquire banks.

Interestingly, of the deals announced, the average price/book per deal varied greatly depending upon whether it was a bank or credit union acquirer. For the three credit union deals with banks (which reported price), the average price/book and price/tangible book was 141.3% and 141.8%, respectively. For the banks acquired by banks, the same metrics were 92.4% and 93.3%, respectively, and for all deals that reported price, it was 110.7% and 111.5%, respectively. Overall, for price/tangible book, the high was 156.4% (a credit union-bank deal) and the low was 52.2% (a bank-bank deal).

But wait, you ask, "what about the securities losses?" Digging into the deals, it appears the first 11 deals are self-selecting to get around the mark to market losses. Except for the credit union acquisitions, pricing is down significantly to take some losses into consideration. The more interesting statistic was that the average loss on the securities portfolios for all 11 transactions, as a percent of Tier 1 capital for the banks being purchased, was 17.01%. On the buyside, the average loss was practically the same at a loss of 16.62% of capital.

In addition to regular M&A, the threat (or opportunity) of additional bank failures lurks in the shadows. Many institutions are facing significant liquidity stresses which may not outlast the hoped-for rate cuts. In addition, if a bank's credit quality takes a hit, which is not unlikely given that inflation is still causing financial stress on many Americans, then that may be the straw that breaks the camel's back.

According to an analysis by LendingTree of about 310,000 users in the 100 largest US metros, over 27% of consumers have debt that is delinquent by more than 90 days.

If you're considering M&A this year and want to talk over your options, give us a call. Or, if you want to be ready to jump on failed bank opportunities, DD&F's Expansionary team has expertise to train your team on the process and provide assistance with everything else – from bidding to closing.

Industry Updates

Here's a glance at the industry's standing as of Q3/2024 (based on the most recent FDIC Quarterly Banking Report).

3rd Qtr '23		Change from Q2/23
# of Banks	4,614	-31
New Banks	2	1
Merged Institutions (with other FDIC-insured institutions)	28	--
Merged Institutions (with credit unions)	0	--
Bank Closings		--
Bank Failures	1	1
# Banks on FDIC "Problem List"	44	1
Net Income	$68.4B	-$2.4B from Q2/23

From Q2/2023 to Q3/2023, the number of banks dropped from 4,645 to 4,614. Consider that 20 years ago, in 2003, the total number of institutions (both commercial and savings) was 9,181, almost double the number of banks in existence today. Where have all the banks gone? Over the past 20 years, there have been 547 bank failures (89% occurring between 2008 – 2013), 893 new charters, and 4,685 mergers.

Banking Snapshot: Then & Now			
	Q3/2023*	2003	Change
# of Banks	**4,614**	**9,181**	**- 4567**
Total Assets	$23.4T	$9.1T	+ $14.3T
Total Loans	$12.3T	$5.4T	+ $6.9T
Total Deposits	$17.2T	$5.2T	+ $12T
Net Income	$218.64	$120.61	+ $98.3
Average ROA	1.25%*	1.38%	- 13bp
Average ROE	13.13%*	15.05%	- 192bp

*ratios annualized

Turning our eyes back to the present, we note that the industry profit performance for the 3rd quarter was a return on assets of 1.17% and a return on equity of 12.18%. Net income declined from Q2, driven by lower NII and higher realized losses on securities. Banks overall experienced a tiny increase in net interest margin (+3bp), although for community banks (which represent 90% of all banks) net interest margins declined 14 bp as cost of deposits rose at a faster rate than yield on loans. Total deposits for all banks declined by $90.4 billion (-50bp) from Q2, although deposit levels are still well above pre-pandemic levels. As of 2021, domestic deposit levels had jumped nearly 38% over 2019 levels, and only $1.0 trillion of those $4.9 trillion deposits have moved away.

The following table shows a side by side of changes from Q2/2023 to Q3/2023 for all banks and community banks.

FDIC Quarterly Report - Q3/2023	All Banks	Community Banks
Total Number	4,614	4,166
Net Income ($)	**- 3.4%**	**- 4.8%**; 55% of all community banks reported lower net income
ROAA	- 4 bp to 1.17%	- 5 bp to 1.01%
Net Interest Margin	+ 3 bp to 3.30%	- 14 bp to 3.35%
Cost of Deposits	+ 28 bp to 2.33%	+ 25 bp to 1.84%
Yield on Loans	+ 31 bp to 5.63%	+ 21 bp to 5.19%
Noninterest Expense	- $1.0B (-0.7%)	+ $200.7M (1.2%)
Efficiency Ratio	+ 22 bp to 55.8%	+ 6 bp to 63.9%
Provision Expense ($)	- 9.3%	+ 8.2%
Assets ($)	- $56.2B (-0.2%)	+20.8B (0.8%)
Loans ($)	+ $45.9B (0.4%)	+ 165.0B (9.8%) 88.5% of community banks reported quarterly loan growth
Deposits ($)	- $90.4B (-0.5%)	+ $23.2B (1.0%)
Capital Ratios		
Leverage ratio	+ 16 bp to 9.26%	+ 3 bp to 10.7%
Total Risk-based Capital ratio	+ 19 bp to 15.36%	N/A
Tier 1 Risk-based Capital ratio	+ 18 bp to 14.02%	+ 2 bp to 13.76%

What Comes Next:

Economic Update

Uncertainty never seems to go away, and the interest rate outlook for 2024 is no different, especially for banks considering their individual IRR positions and reliance on net interest margins for profitability. Will the Fed start a series of declines in the Fed Funds rate or stay put for a while longer? Will the landing be soft and smooth or hard and bumpy? Will unemployment rise or fall? How will the bond market react to whatever happens and will the yield curve normalize or stay inverted? What assumptions should the bank use in its IRR modeling?

As of the January 2024 FOMC meeting, the Fed has decided to stay put. Plus, the compilation of Fed Governors and Fed bank presidents, as of September 2023, had a range of interest rates at 5.4 - 5.6% for 2023 declining to 4.4% - 6.1% during 2024 and to 2.5% - 5.6% in 2026. This is not really a "Fed projection" but just a compilation of certain parties' personal opinions.... albeit informed opinions.

A similar compilation of the same opinions as of the September analysis show a range of unemployment rates at 3.7% - 4.0% for 2023, then rising slowly up to 4.7% in 2025. Likewise, the same group sees GDP at 1.8% - 2.6% for 2023, dropping to 0.4% - 2.5% in 2024 ("soft landing" in 2024?) and then growing again to 1.4% - 2.5% in 2025.

Finally, the group saw the PCE (personal consumption expenditures) inflation measure at 3.1% - 3.8% in 2023 and dropping to 2.0% - 2.7% in 2026.

If you're wary of these personal opinions, maybe the Vanguard Mutual Funds US economic outlook for 2024 suits you more. Init, Vanguard sees 0.5% GDP growth, 4.8% unemployment, 2.3% Core inflation and 3.5%-4.0% Fed funds rate. Um, maybe they didn't get the memo from the Fed compilators and formed their own opinions.

Then again, J. P. Morgan Asset Management in its 2024 Market Insights outlook for 2024 keeps it simple and expects 2% GDP growth (and "0" recessions), 4% unemployment and 2% inflation. They, perhaps quite wisely, stayed away from the "guess the Fed" exercise by simply saying interest rates have peaked for this cycle in October 2023, rate cuts to start in 2024 and the yield curve to "...gradually steepen...". Welcome news to banks if that happens!!

Increased Regulatory Scrutiny

We are approaching the one-year anniversary of the SVB, Signature and First Republic failures, and from what we're hearing, regulators are taking steps to ensure such failures don't catch them unawares again. These steps are taking the form of unexpectedly intense examinations, zeroing in on interest rate risk modeling and liquidity stress testing. When it comes to interest rate risk modeling, regulators are asking targeted questions about betas, decay rates and prepay rates on loans. Now is the time to get your documentation and studies together to fully support assumptions used in your modeling. As far as liquidity stress testing, regulators have been asking for specific stress tests under various scenarios as well as detailed strategies to address potential outcomes If you do not currently have a liquidity policy, or you think it might be out of date, now is the time to put one together. The regulators want to ensure you are fully aware of the risks facing your bank and that you have contingency plans in place to prevent those worst-case scenarios. As we'll dive into later, regulators are also paying close attention to fintech collaborations.

If you feel unprepared in the face of such regulatory scrutiny, our experienced team is available to help prepare or update your policies and ensure that you have done the necessary stress tests and prepared contingency plans.

Commercial Lending

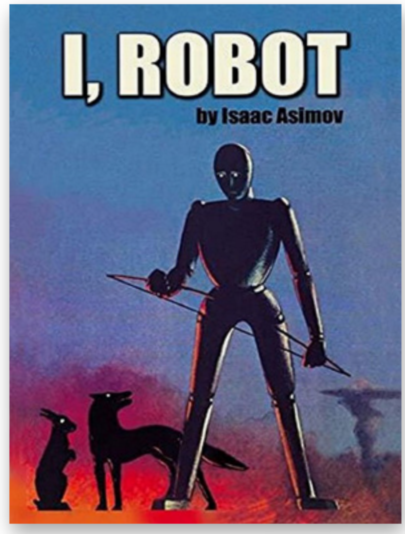
Depending on where you live, commercial real estate lending could be tricky or doing really well. Big city office space is a mess and companies are having to get creative to get bodies in the buildings. In some locations, commercial space is being converted to residential dwellings, but that process doesn't happen overnight. If the expectation was that post-pandemic, people would flock back to the offices, that hasn't quite happened. Many workers have shifted to a partial remote situation and only go into the office part of the time. However, CRE loans for residential apartments in growth areas show more promise. With mortgage rates, down payments and closing costs higher, more and more young people are putting off buying houses in favor of renting. This presents an opportunity, but beware: regulators are paying close attention to commercial real estate portfolios.

AI

If you're not being bombarded daily with articles and hype about AI, then you must have gone off the grid. Earnings calls tout the many benefits AI will bring a given firm, and print media spews a constant river of stories about how AI will make things better...or much worse. More than one observer has likened the hoopla and hype to the dot com era (and subsequent bust). If you do read the articles, you may be left asking yourself how all the hype gets turned into practical realities. Those are good questions, seldom answered to any degree of satisfaction.

At the end of the day, what exactly does it all mean? Well, other than AI literally meaning Artificial Intelligence, according to the "CoPilot" AI app in Microsoft Bing:

"(AI) refers to computer systems capable of performing tasks that historically required human intelligence, such as reasoning, making decisions, or solving problems."



Yes, but how will AI affect my bank? CoPilot says, among other things:

"With AI, banks can better protect their customers' accounts, secure payments, improve return on investments, and personalize content, investments, and next-action recommendations for their customers."

There is no shortage of content out there regarding AI. For inquiring minds, we have personally found the following interesting and informative:

- *The Artificial Intelligence and Generative AI Bible* by Alger Fraley (dives into the MANY acronyms and definitions)
- *Artificial Intelligence – Bliss or Peril for Future Humanity: Understanding the Basics of AI in our Everyday Lives* by Will Davis (an overview of AI and its implications and potential directions)
- *The Age of AI and Our Human Future* by Henry Kissinger, Eric Schmidt and Daniel Huttenlocher (a conceptual treatise on AI and major questions and concerns that are unanswered)
- *I, Robot* by Isaac Asimov, the famous sci-fi author, published in 1950, establishing the Rules of Robots.

Technology & Fraud

AI seems an appropriate segue into technology and its many associated risks (and opportunities). On the one hand, the predominant theory is that failure to adopt cutting-edge technology will result in swift extinction. There is partial truth in that line of thinking and also a bit of peer pressure/ fear tactics.

Yes, technology is inevitable, and no bank needs to stick its metaphorical head in the sand and refuse to adopt technology out of fear. To remain competitive and meet (or exceed) customer expectations, banks do need to invest in digital innovation.

On the other hand, no bank should proceed without a solid understanding of the regulatory expectations, the risks involved, a thorough due diligence of any fintech partnership and solid risk management practices in place to minimize your vulnerability to cyberattacks, malware, data breaches and other techno challenges that threaten to compromise our operations, reputation and customer trust. In addition to scrutinizing liquidity positions, regulators are also looking closely at fintechs and banks catering to fintechs (BAAS).

DD&F understands the tricky line banks walk when balancing technology expectations with the desire to maximize fee income through BAAS. There are both challenges and opportunities when collaborating with fintechs. We would love to help you align your ambitions with the proper risk evaluations and sort through regulatory/fintech relationship management.

Here's the Gist:

The beginning of a year always holds such promise and anticipation, particularly election years. Ok, if not promise, then at least anticipation. Can we not be both optimists and realists? We have no crystal ball, so we can't tell you what's around the next bend, but we can say with confidence that there will always be banks who thrive regardless of the environment. We'd like that to be you.

Our advice is to be ready for increased regulatory scrutiny (get your house in order), and be prepared for opportunities that can come from an improving economy, lower inflation, lower rates and strong employment, BUT keep a watchful eye on downsides lurking in the shadows.... strengthen your balance sheet (liquidity and capital, especially), clarify your strategy, know your principal risks, manage overhead and sharpen your pencil for making loans.

Author:
Ashley Floyd, Senior Consultant

Contributor:
J. Robert Kelly, retired banker with experience in auditing, finance, operations and risk management