Lender Liability, Bank Litigation and Arbitration

By: Mike Degan and Jeff Heuer

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Defined

- Lender Liability is any alleged wrongful action or inaction by the lender, alleged contractual breach or defect, or alleged breach of any statute, regulation or the common law that <u>TENDS</u> to provide the borrower, guarantor, grantor or one standing in their shoes with a claim and/or a defense to an action
- It is typically about <u>LEVERAGE</u>

Typical Claims and Defenses

- Breach of contract
- Contract enforceability
- Oral modification
- “Good faith and fair dealing”
- Fraud and misrepresentation
- Breach of statutory/common law duties – What is the duty?
- Mortgage lending

Typical Claims and Defenses

- Borrower control
- UCC (and not only RA 9)
- UDAAPs
- *Prima Facie* tort
- ECOA
- Commercial impossibility
- Breach of privacy/confidentiality

Typical Claims and Defenses

- Negligent loan administration and servicing
- Failure to fund
- Tortious interference with contract/business expectancy
- Conspiracy and RICO
- Slander and libel

Recent Developments

- Eight Missouri Supreme Court <u>lender</u> cases in 2011-12 Term – *MMPA, fraud, deficiency calculation, priorities, holder and evidence proof, negligent misrepresentation, arbitration, constitutional challenges, unlawful detainer*
- If is is happening in Missouri . . .

Recent Developments

- *FirstBank v. Fischer and Frichtel*, (decision issued April 12, 2012); deficiency calculation after foreclosure
- *Brewer v. Missouri Title Loans*, (Mo banc 2012); enforceability of arbitration clause

Recent Developments

- *Kreisler & Kreisler v. PNC,* 657 F.3d 729 (8th Cir. 2011); *LDJ Investments v. FirstBank (S.D. IL 2012)* – 365/360
- *BOA v. Narula,* 261 P.3d 898 (KS App 2011) – breach of contract, enforceability, fraud, duty and negligent misrepresentation

Recent Developments

- *In re Checking Account Overdraft MDL* (SD FL) – Regions Bank and SunTrust Bank decisions on enforceability of arbitration provisions
- *Robinson v. Regions Bank* (WD MO 2011) – District Court denies remand to state court under CAFA and orders arbitration in "high to low" case

Recent Developments

- *Sherzer v. Homestar* (3rd Circuit) – CFPB seeks expansion of TILA rescission rights; simultaneously argues same position in three other Appellate Courts
- *Epps v. JP Morgan Chase (4th Cir. 2012) –* state debt collection laws not preempted by NBA

Trend # 1

- What is Old is New Again!

Trend #2

- Rise of the “Professional” Plaintiffs Attorneys
- Know when you are in a workout or a dispute and when you are in a cage match

Trend #3

- Regulators are not the Financial Institutions’ friend
- But need they be your enemy?

Query

- Are commercial loans and consumer loans different?
- Not as much as you might think!
  - Parallel claims and defenses
  - Similar claim genesis
  - Identical bases

Trend #4

- Migration between the consumer world and the commercial world

Trend #5

- Recognize who are your “peers”

Best Practices

- Develop a strategy
- Don’t “run” the borrower’s business
- Don’t become the borrower’s advisor
- Don’t act suddenly or erratically
- Honor agreements/act honorably
- Clean files

Best Practices

- Know your opposition
- Talk it out
- Keep the group small
- Is the deficiency worth pursuing?
- Develop a strategy
- Golden Rule

Modification Agreements

- Opportunity to reset relationship and fix problems
- Revisit the loan documents
- Time to obtain:
  - waiver of (existing) claims and defenses
  - acknowledgement of debt and guaranties
  - venue/governing law

Trends in Leasing, Lending and Financing

By: Dale Dixon, Adam Kirshenbaum and Aaron Johnson

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Trends in Leasing

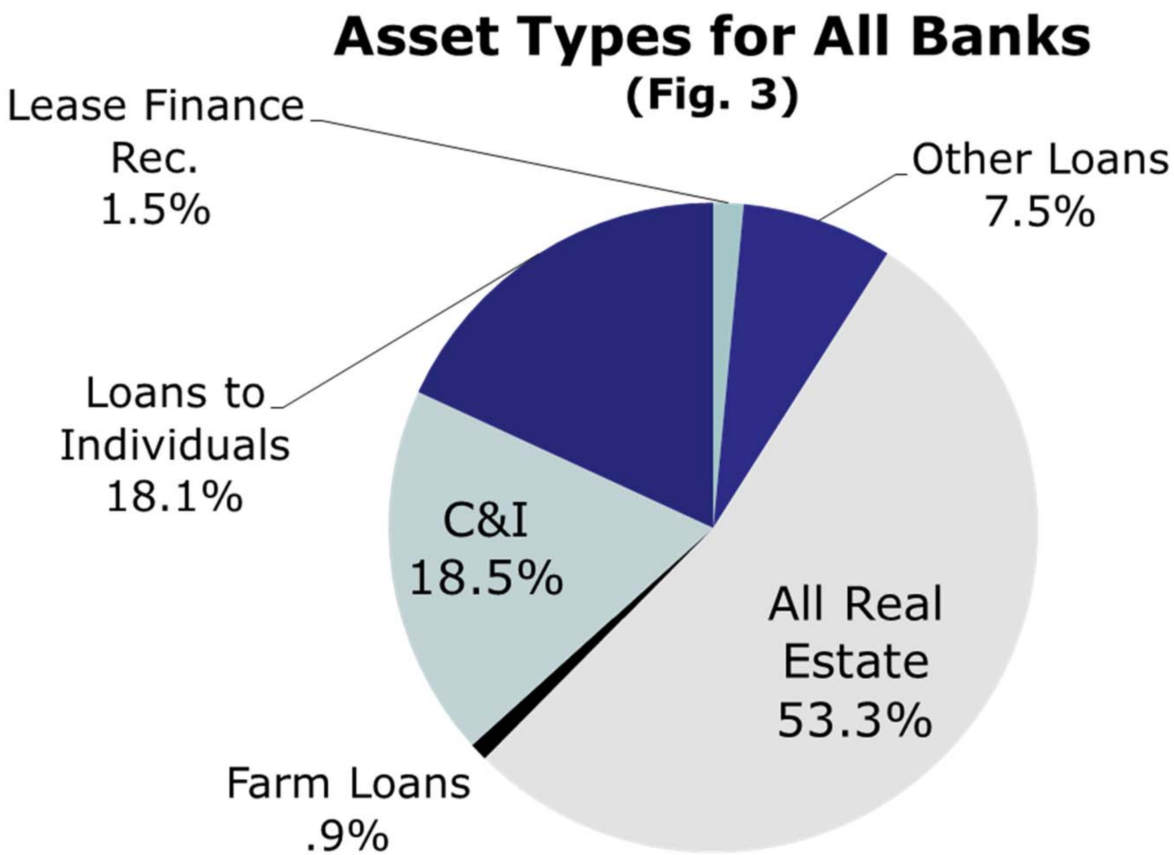
- Banks of all sizes have found significant success in the commercial equipment financing and leasing industry over the past several decades
- According to the 2010 Survey of Equipment Finance Activity, banks generate approximately 49% of all equipment financing and leasing activity, which confirms the viability of the banking industry as a significant participant in the commercial equipment industry

Trends in Leasing

- Leases and commercial and industrial assets make up a small portion of banking assets nationwide (Fig. 3*), with only around 20% of all bank assets being held in these two categories

*Source: FDIC statistics and data

Trends in Leasing

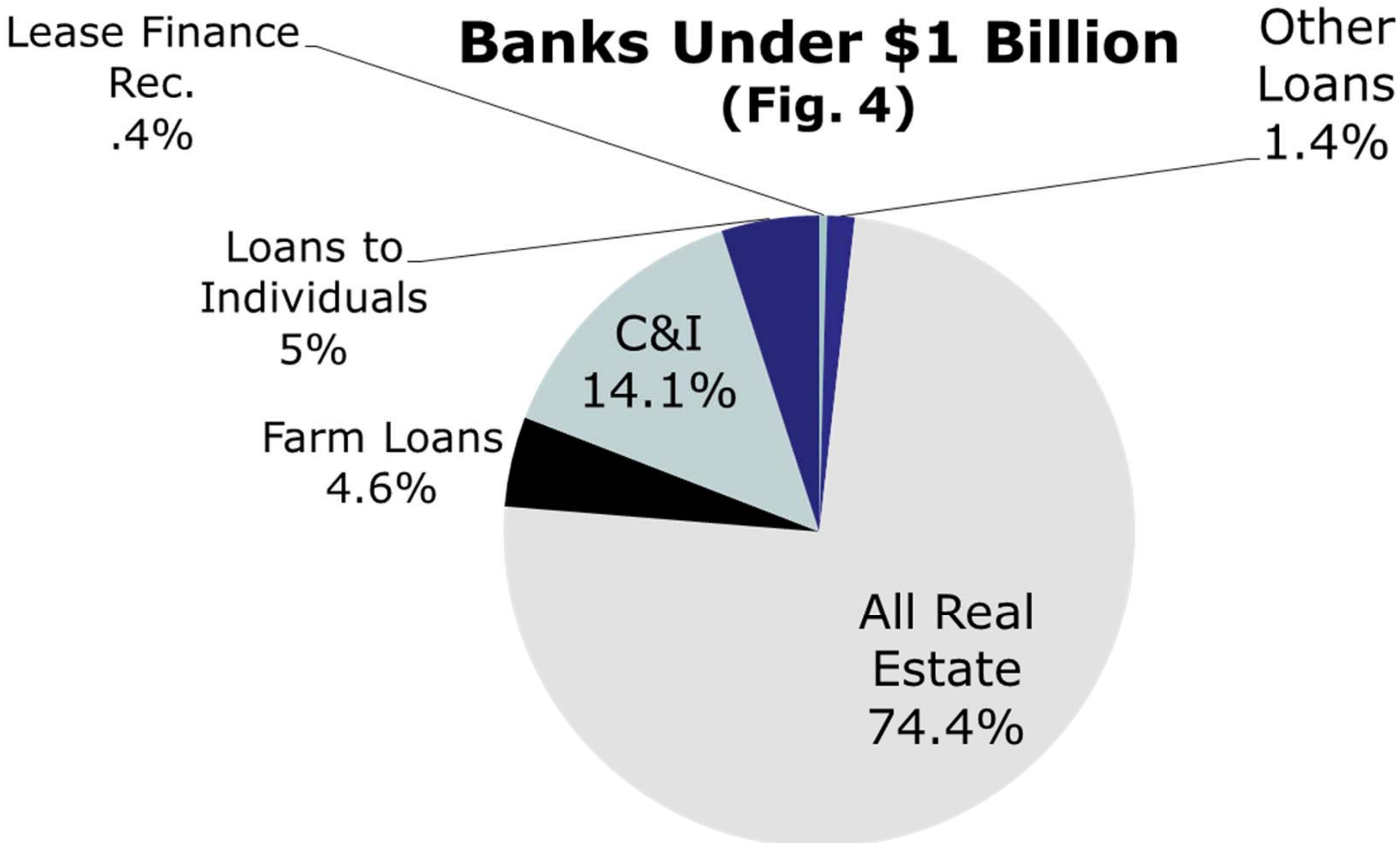


Trends in Leasing

- Banks with assets under $1 billion (Fig. 4*) have fewer assets in the two categories with approximately 14.5% of small bank assets consisting of lease and commercial and industrial loans

*Source: FDIC statistics and data

Trends in Leasing



Trends in Leasing

- Many different ways for community banks to participate in the commercial equipment and leasing area, such as
  - syndication of equipment transactions,
  - single-transaction funding,
  - funding of lines of credit for independent lessors and equipment finance companies,

Trends in Leasing

  - purchase of existing equipment finance and leasing operations, and
  - maintenance of a full-service (internal) equipment financing and leasing operation.

- Banks may limit their involvement by utilizing outsourcing options or broaden their involvement by developing a full-service internal leasing division or subsidiary

Trends in Leasing

- In January and February 2012, the Equipment Leasing and Finance Association conducted a confidential internet survey of approximately 400 equipment managers and consultants throughout the U.S. regarding what's hot, what's not in equipment leasing for 2012
- Figure 1 shows a comparison between the overall results of the 2012 and 2011 surveys
  – The lower the score the better, and the larger the year-over-year difference the greater the trend towards ("+") or away ("–") from a given type

Trends in Leasing

Figure 1

Equipment Type	2012 Score	2011 Score	Difference
MEDICAL	2	2	+0
OIL/GAS/ENERGY	4	4	+0
MACHINE TOOLS	7	8	+1
HI-TECH/COMPUTERS	8	10	+2
TRUCK/TRAILERS	8	8	+0
RAIL	12	14	+2
CONSTRUCTION	15	18	+3
TELECOM	20	19	-1
MARINE/INTERCOASTAL	21	20	-1
PLASTIC	21	25	+4
AIRCRAFT	21	14	-7
CONTAINER/CHASSIS	21	16	-5
AUTOMOBILES	24	24	+0
FF&E	24	27	+3
PRINTING	30	30	+0

Trends in Leasing
Main Points of Negotiation

- Structure – getting title to the Lessor
- Tax Indemnification / Representations
- Remedies calculation

Trends in Leasing

- After largely being shutdown in 2008, the securitization market started to recover for equipment issuers in 2009 and 2010. Issuances in 2011 totaled $7.2 billion, compared to $8.4 billion in the market's peak year, 2006. While a decline from its peak, the market for equipment lease ABS improved much more than with other asset classes.
- New issuances may grow again this year. A portion of that growth may stem from new issuers entering the market to augment the traditional-bank and warehouse-debt offerings.
- This may result in more capital being available for non-investment grade leasing and finance companies.

Trends in Leasing

- Certain rating agencies suggest that the credit quality of ABS backed by new agricultural and construction equipment loans in 2012 will be strong, as in 2011, and deal issuance will continue at a steady pace.

✓ The healthy state of the agricultural sector will benefit the credit quality and performance of new and existing transactions.

✓ The few existing deals with a material exposure to the construction sector will see marginal improvement as the sector improves slowly following the recession.

Trends in Leasing

- The credit quality of both new issuance and existing deals backed by both small- and mid-ticket equipment leases will be stable, supported by a modest improvement in economic conditions and robust structural features such as sequential pay and excess spread.

✓ Uncertainty about the economy, such as the possibility of a double dip recession, will lead to conservative credit enhancement levels in 2012 issuance compared with pre-recession levels.

Trends in Commercial Lending

- Volume of commercial lending is on the rise
  - Lending in 2011 increased by 8% over lending in 2010, according to the Federal Reserve
- Tighter underwriting standards have limited deal flow, creating competition for the best deals and resulting in terms that are borrower friendly
  - Syndicated deals with strong borrowers tend to be oversubscribed, creating opportunity for negotiations of even more favorable terms

Trends in Commercial Lending

- Recent trends in middle market and large cap financing terms include:
  - Lowering LIBOR Floor
  - Increased Use of Incremental Loan Facility
  - Covenant Lite Loans
  - More Exit Options for Borrower

Trends in Commercial Lending

- Lowering LIBOR Floor
  - From 2009 until 2011, LIBOR Floor of 2% to 3% common
  - Starting in 2011, LIBOR Floor commonly reduced to between 1% and 1.75% or eliminated completely
  - Also pressure from borrowers to reduce margins

Trends in Commercial Lending

- Increased Use of Incremental/Accordian Facilities
  - Allows Borrowers to add new term loan or increase existing loan up to pre-negotiated amount without obtaining additional lender consent
  - In many cases, amount is unlimited subject to compliance with certain financial covenants test (generally a debt ratio test)

Trends in Commercial Lending

- Covenant Lite Loans
  - Larger baskets for other debt, investments, acquisitions, restricted payments and other activities of the borrower
  - Fewer or less restrictive financial covenants
    - For very strong borrowers, may see no financial covenants or covenants that disappear if ratings or other thresholds met
  - Cure rights allow sponsors to cure financial covenant defaults by contributed capital to borrower

Trends in Commercial Lending

- Increased Flexibility for Borrowers
  - Option to repurchase loans on a non-pro-rata basis at less than par through a Dutch auction process
  - Sponsors and other affiliated parties may get option to purchase portion of term loans on market, subject to voting restrictions and % caps
  - Option to have electing lenders extend the maturity of loans without consent of other lenders (but only extended as to amount held by consenting lenders)

Unauthorized Practice of Law

- Unauthorized Practice of Law in Missouri
  - In relevant part, section 484.010.2 defines the "law business" as "the drawing or the procuring of or assisting in the drawing for a valuable consideration of any paper, document or instrument affecting or relating to secular rights."
  - An exception allows completion of standard forms by a person who is not a lawyer so long as (a) no fee, and (b) no legal advice

Unauthorized Practice of Law

- Recent Cases

  Eisel v. Midwest BankCentre, 230SW3d 335 (Mo.2007)(*en banc*). Missouri Courts have addressed the UPL Statutes in the context of document preparation many times

  – The UPL Statutes provide for treble damages

  – Treble damage provisions make these cases attractive to plaintiffs

Unauthorized Practice of Law

Hargis v. JBL Corporation, SC1639, Supreme Court, December 20, 2011. Defendant was not conducting the unauthorized practice of law

- An administration or processing fee which is a disguise for doc-prep fee will violate the UPL Statutes.
- Although "Procurement" may be somewhat indefinite, it is clear that it involves more than merely passively gathering or obtaining information, data or documents from third parties or other sources

Unauthorized Practice of Law

Jitterswing, Inc. v. Francorp, Inc., 311 SW3rd 828 (Mo.Ct.App. 2010)

– Court refused to enforce a forum selection clause which would have removed the case to Illinois given strong public policy printed in UPL in Missouri

Unauthorized Practice of Law

<u>Janson v. LegalZoom.com, Inc.</u>, 727 F.Supp.2nd 782 (2010)

– Docs purchased over the internet prepared on servers in California

– Docs provided for California governing law and a California forum selection clause

- Purchase of paper in which a documentation or administration fee was charged

LLC Interests as Collateral

- Restriction on Pledge of LLC Interests
  - LLC operating agreements often restrict assignment

LLC Interests as Collateral

Meecorp Capital Marks, LLC v. PSC of Two Harbors, LLC, Civil No. 09-2067, 2011 U.S. Dist. LEXIS 142576 (D. Minn. Dec 12, 2011)

- The court held several LLC pledges invalid because the pledgors failed to satisfy technical notice and unanimous consent provisions in the governing documents and the control documents of the pledged entities

LLC Interests as Collateral

Lebedowicz v. Meserole Factory LLC, 2011 WL 6380290 (N.Y. Sup. Ct. 2011)

- A security agreement signed by members of an LLC on behalf of an LLC, and in their personal capacities, do not grant a security interest in the member's LLC interests. The LLC itself did not have rights in that membership interest.

LLC Interests as Collateral

In re McKenzie, 2011 WL 2118689 (Bnkr. E.D. Tenn. 2011)

- Descriptions of equity interests pledged
- Prior written consent required

- Modern Rule –
  - Restriction enforceable with respect to assignments of contractual right
    - Restriction not enforceable with respect to assignments of economic right
    - No assignments permitted if agreement provides that an assignment is void

LLC Interests as Collateral

- UCC Section 9-408
- Due Diligence

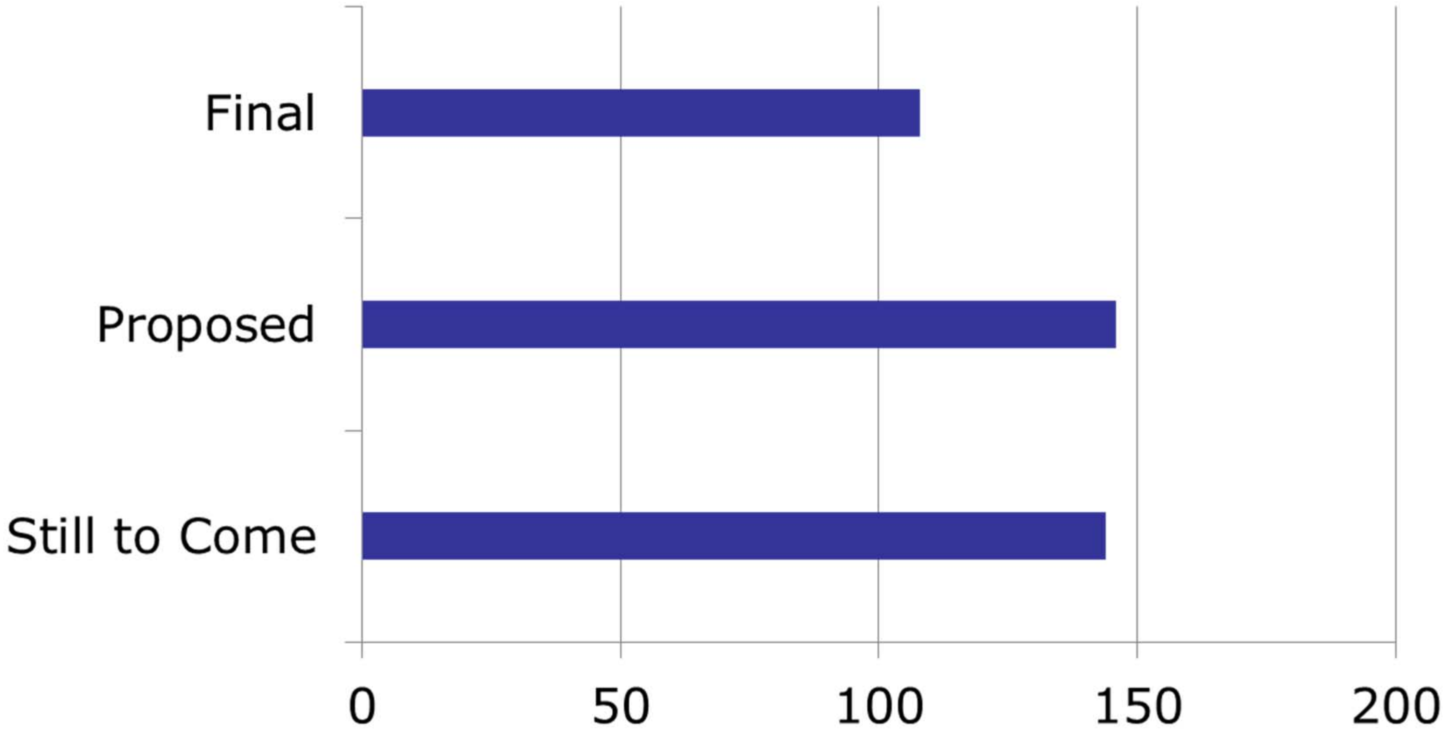
Regulatory Update

By: Jeff Makovicka

Dodd-Frank Rules Update

- **Progress on Dodd-Frank Rules**
  - As of May 1, 2012, of the estimated 398 total rulemaking requirements, 108 (27.1%) have been met with finalized rules and rules have been proposed that would meet 146 (36.7%) more.
  - Rules have not yet been proposed to meet 144 (36.2%) rulemaking requirements.

Dodd-Frank Rules Update



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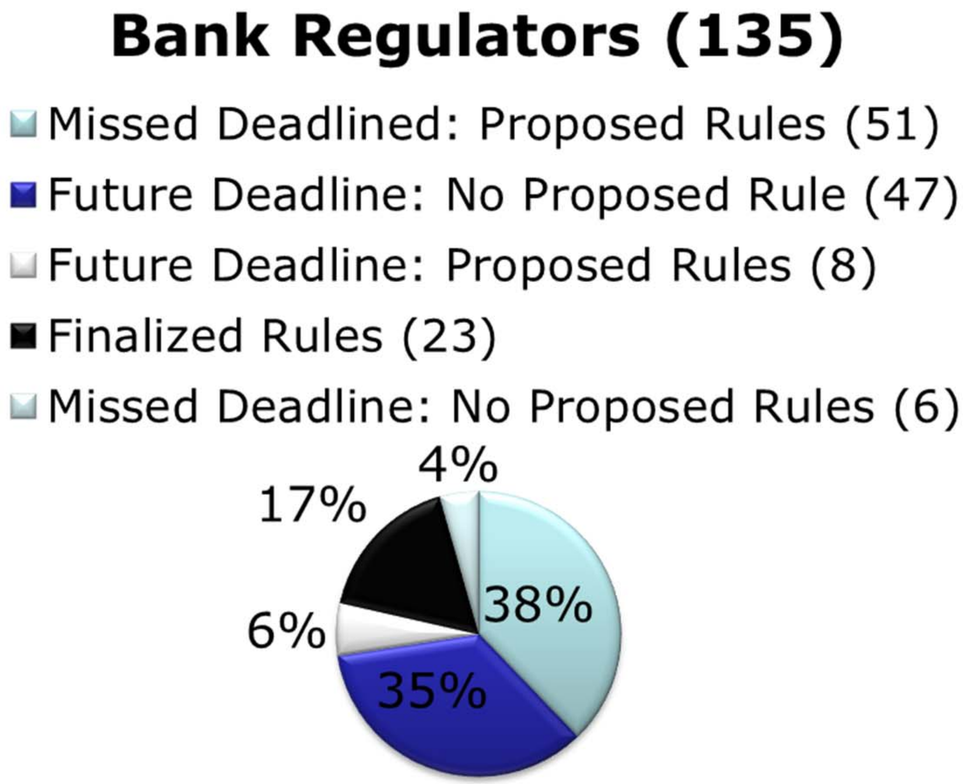

Safe Act Examinations

Consumer Finance Protection Bureau

- Sole rule making authority and responsibility for maintaining Federal Registration System
- Supervisory and enforcement authority for entities with more than $10 Billion
- Issued examination procedures in March 2012

Safe Act Examinations
Consumer Finance Protection Bureau

- CFPB Supervisory and Enforcement Authority

- **Depositories**
  - Banks, thrifts, and credit unions over $10 billion in assets (as well as their affiliates)
- **Non-Depositories**
  - Payday lending, mortgage, and private student loan markets
  - “Larger Participants” in non-bank markets
  - Entities that pose risks to consumers with regard to consumer financial products or services

Safe Act Examinations

- Entities with less than $10 Billion in assets will be examined by primary regulator

Safe Act Examination Keys

Adoption of Polices and Procedures

- MLO identification and ensuring MLO compliance and training.
- Compliance with unique identifier.
- Procedure for obtaining criminal history reports.
- Process verification of accuracy and annual renewals.

Safe Act Examination Keys

Adoption of Polices and Procedures

- Procedure for independent testing (internal or external)
- Insuring compliance with certain third parties

Qualified Mortgage Rules

- Both the “qualified mortgage” (QM) and “qualified residential mortgage” (QRM) rules are mandated by Dodd-Frank—and by statute must be finalized by January 13 of next year.
- The CFPB is expected to issue a final QM rule this summer, most likely in the third quarter.
- Initial QRM proposal was so narrow that even members of Congress said it was too restrictive- expect a revised proposal sometime this year.

QM and QRM

- Key to the QM rule will be whether the QM provides a "safe harbor" against ability-to-repay challenges, or merely a "rebuttable presumption."
- If it provides only a presumption, costly litigation is likely as well as reduced credit availability and more cost prohibitive products for those who do not qualify.

QM and QRM

- **Lender's liability will increase for mortgages**
  - Borrowers may raise ability-to-repay challenges for the life of the loan, increasing potential liability to lender.
  - Failure to prove ability-to-repay may result in reimbursement of all payments made by a borrower.

Interchange

- Dodd-Frank’s Durbin Amendment requires the Federal Reserve to regulate interchange fees and how transactions are routed.
- The final rule mandates 21 cents per transaction and five basis points to cover fraud losses.
- An interim rule would allow an additional one cent per transaction to cover fraud prevention efforts.

Interchange

- Final rule also prohibits network exclusivity arrangements by <u>all</u> banks.
- Banks which do not currently meet this standard will need to renegotiate network agreements and add unaffiliated networks as a routing option for their cards.

Interchange

- No final rule yet on fraud costs.
- The interim rule requires issuers to meet flexible, nonprescriptive fraud prevention standards in order to receive a fraud prevention adjustment, which is, under the interim rule, 1 percent.
- Federal Reserve will issue a final rule at any time which <u>could</u> (and we emphasize could) increase the amount of the adjustment.

Interchange

- According to Federal Reserve data released on May 1, the average interchange fees for banks with more than $10 billion in assets dropped 45 percent between 2009 and 2011's fourth quarter. The Fed's final rule implementing the Durbin Amendment became effective Oct. 1, 2011.
- Based on the data, the average fees exempt banks with less than $10 billion in assets received remained unchanged at 43 cents during the fourth quarter.

CFPB Actions

- Protection of Privileged Information
- Know Before You Owe Mortgage Loan Incentive
- Pursuit of Discriminatory Lenders and "Silent pickpocket" discrimination
- Expansion of Complaint System
- Investigation of Overdraft Programs

Opportunities of the Nebraska New Markets Job Growth Investment Act

By: David Lutz

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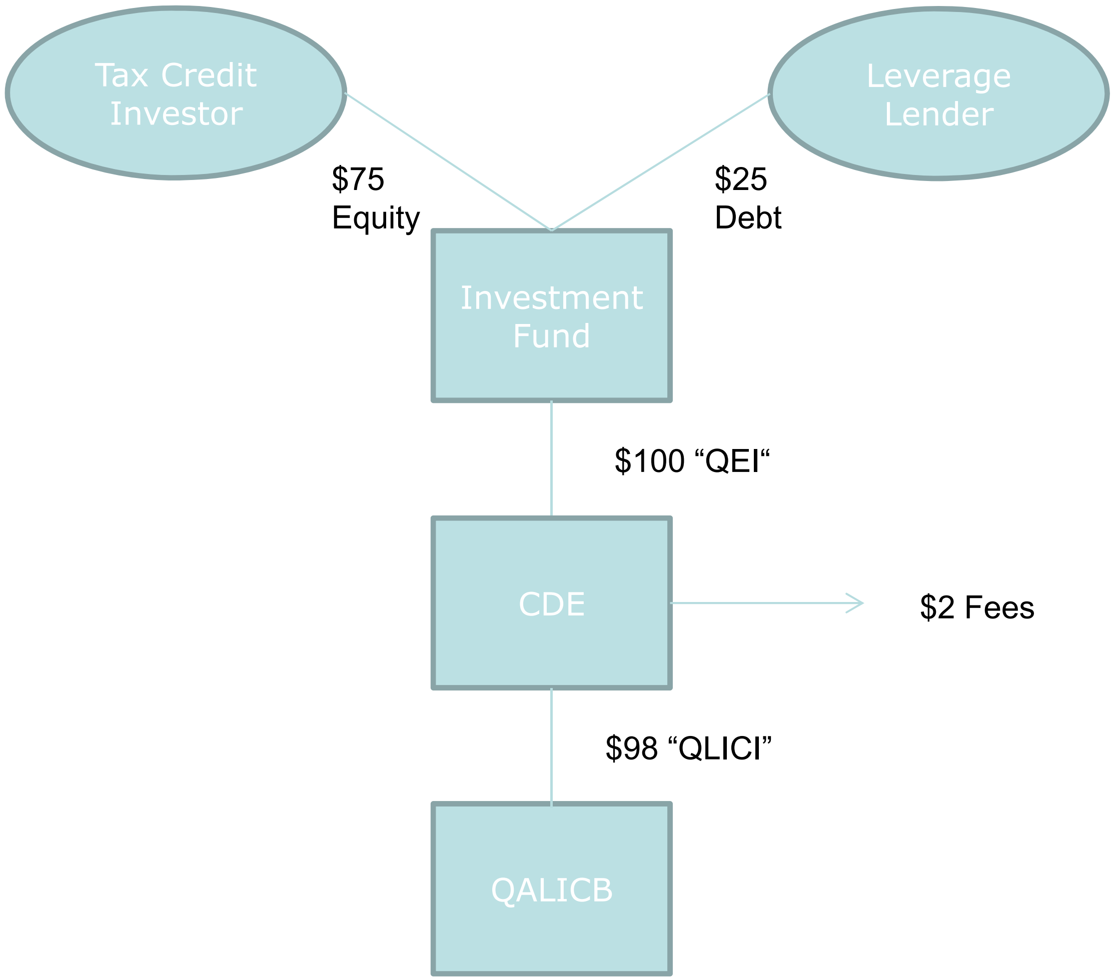
Overview

- The New Markets Job Growth Investment Act (the “Act”), LB 1128, was signed into law on April 11, 2012.
- The Act is largely based on the Federal New Markets Tax Credit under Section 45D of the Internal Revenue Code, which was added to the Code in 2001.
- The Act is intended to bring additional New Markets Tax Credit transactions to Nebraska. Of $29 billion in Federal New Markets Tax Credit investments, Nebraska has only received $50 million.
- The tax credit can be used by corporations, individuals, estates and trusts against income tax, and can also be used as a credit against insurance premium tax and bank franchise tax.
- The tax credit is equal to 39% of the amount of a “qualified equity investment”. The credit is taken over a 7 year compliance period: 0% for years 1 and 2, 7% for year 3, and 8% for the next four years.
- Total amount of tax credits are capped at $15 million per fiscal year.
- Tax credits cannot be sold but can be specially allocated by a partnership

Structure



Tax Credit Investor
Leverage Lender
$75 Equity
$25 Debt
Investment Fund
$100 “QEI“
CDE
$2 Fees
$98 “QLICI”
QALICB

Terms

- A CDE is a "qualified community development entity" that has entered into an allocation agreement with the CDFI Fund that includes Nebraska as a service area
- A QEI is a "qualified equity investment"; (1) any equity investment in, or long-term debt security issued by, a CDE that is acquired solely in exchange for cash at its original issuance; and (2) the CDE must invest at least 85% of the proceeds of the investment in QLICIs within 12 months
- A QLICI means a debt or equity investment in a QALICB
- A QALICB means a "qualified active low income community business". Any single QALICB is limited to $10 million of QLICIs. To qualify as a QALICB:
  – At least 50% of the total gross income of the entity is derived from the active conduct of a trade or business within a low-income community
  – At least 40% of the use of tangible property of such entity is within a low-income community
  – At least 40% of services performed by such entity are performed in a low-income community
  – No more than 5% collectibles or non-qualified financial property
  – Must be an operating business (less than 15% revenue from real estate)
  – A QALICB will qualify as a QALICB for the entire compliance period if the CDE reasonably expects at the time of the investment that the QALICB will continue to satisfy the above requirements for the entire term of the QLICI

New Market Tax Credit (NMTC) Program Eligibility and Severely Distressed Status, as of 2011.

The red areas on the map are Census tracts that the CDFI Fund has determined are Eligible and meet the Primary Criteria requirements for the CDFI Fund's New Market Tax Credit (NMTC) Program Severely Distressed Status, as of 2011. Orange areas are Census tracts that are NMTC Eligible and meeting the requirements for Secondary Criteria Severely Distressed Status. Yellow areas indicate those Census tracts that meet the NMTC Program Eligibility but are not Severely Distressed. Gray areas on the map are considered ineligible for NMTC Program funding. The 2011 data includes USDA Food Desert status in its calculations. For more information about the NMTC Program, please see our Data Directory.

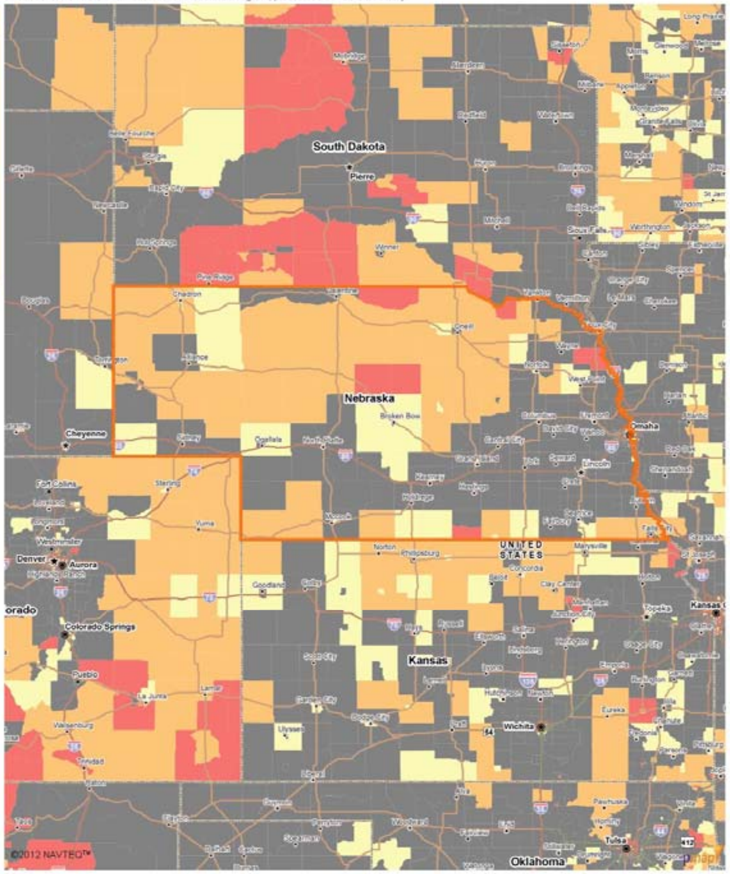
Legend

Year
2011

Variable
Type

- Insufficient Data
- Eligible
- Severely Distressed - Primary
- Severely Distressed - Secondary
- Not Eligible

Shaded by: Census Tract
Source: CDFI Fund and TRF



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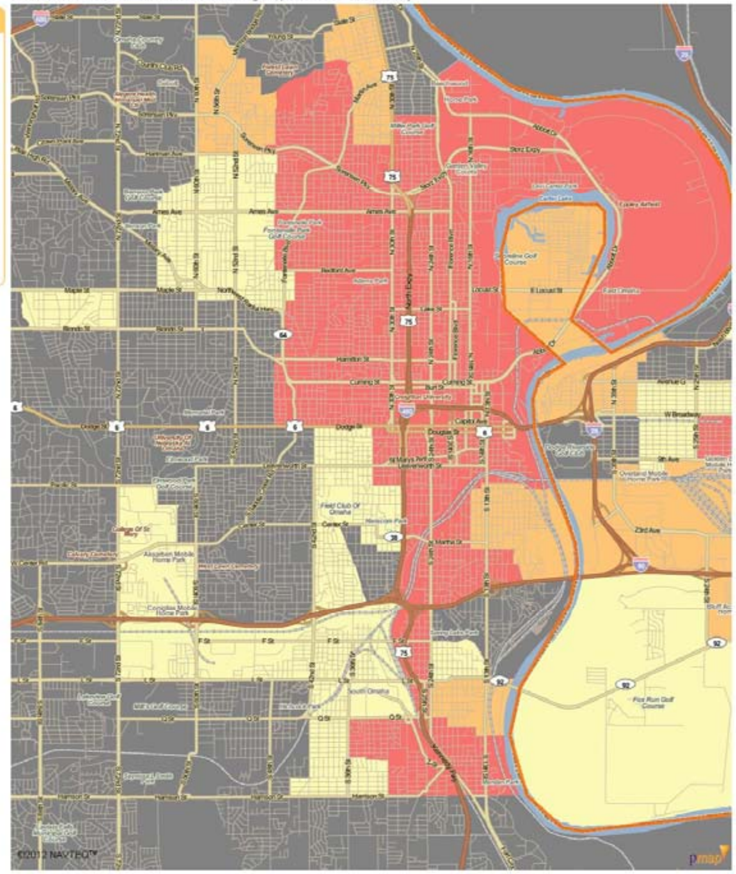

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Opportunities for Banks

- Investor: makes an equity investment in an investment fund to partially fund a QEI. Amount of equity is based on a negotiated price per credit.
- Leverage Lender: makes a loan to the investment fund to partially fund a QEI. Subject to forbearance during tax credit compliance period.
- CDE: receives the QEI and makes QLICIs. The CDE typically receives upfront fees and ongoing fees for the management of the business. A CDE must have entered into an allocation agreement with respect to a Federal allocation, so the opportunities to participate as a CDE are limited.
- QALICB: receives the proceeds of the QLICIs and the remaining benefit of the NMTC investment (banks typically can't qualify, but subsidiaries can)
- Direct Lender to QALICB

Opportunities for Banks

- **What are the benefits to banks?**
- The NMTC provides a subsidy that helps banks participate in projects in low-income communities that might not otherwise be eligible for financing.
- Bank investors receive a tax credit against state taxes (now available pursuant to the Act) for making qualified equity investments in CDEs.

Opportunities for Banks

- NMTC participants can also earn interest income on their investments, depending upon how they are structured.
- Bank may receive positive CRA consideration for NMTC investments, provided the investments benefit a bank's assessment area.

Navigating the New M&A Landscape for Banks

By: Joyce Dixon, Dale Dixon and
guest speaker Adam Fiedor
with St. Charles Capital

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M&A Landscape

- Market Trends
- Dodd-Frank Ramifications
- JOBS Act Implications
- Documenting the Deal

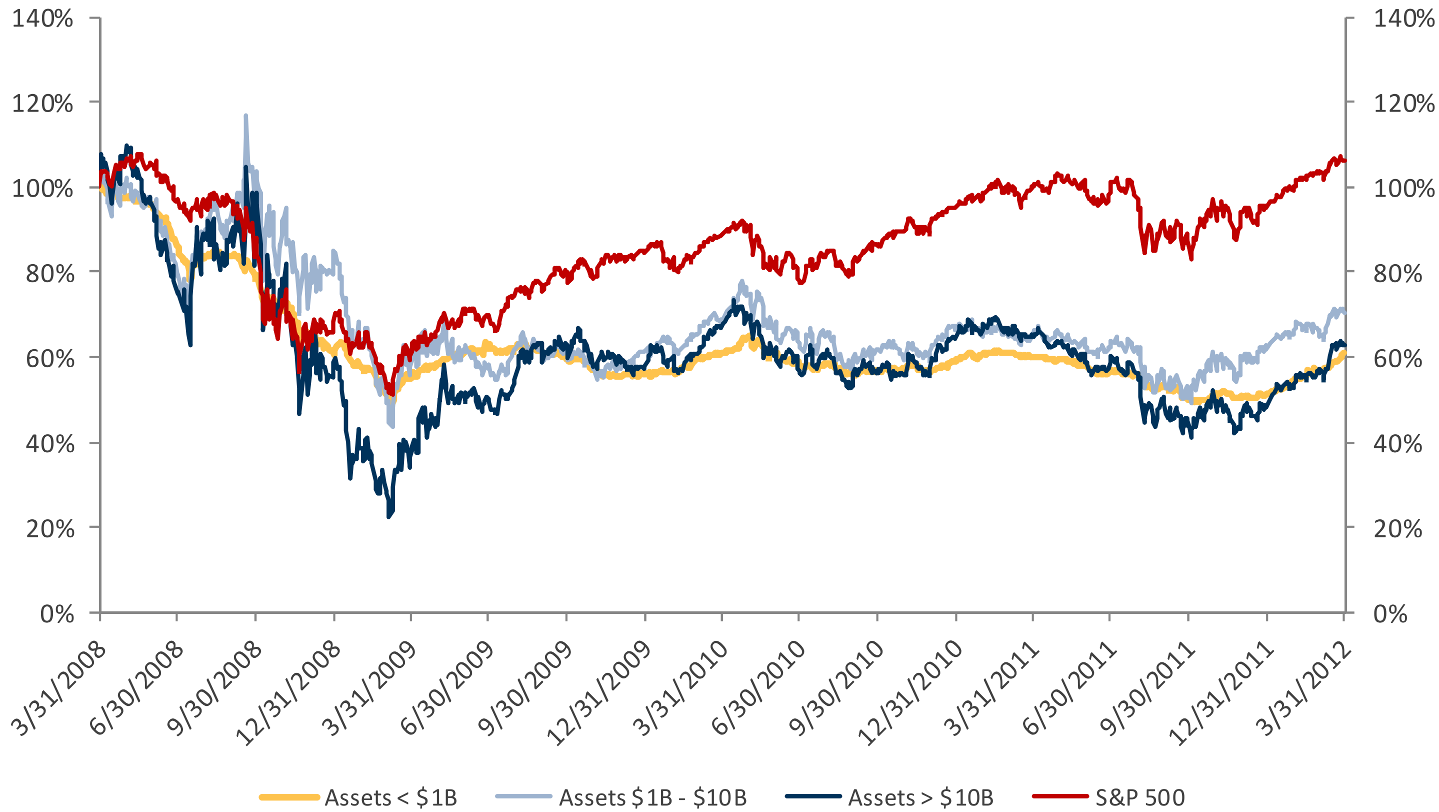
Stock Market Performance

Banks have significantly underperformed the S&P 500 over the past year due to regulatory uncertainty and slower than anticipated economic recovery

Banks have rallied with the broader market since year-end 2011

Small, micro-cap bank performance is down but less volatile due to nominal trading volume

Bank Index Returns 3/31/2008 - 3/30/2012 (Daily)

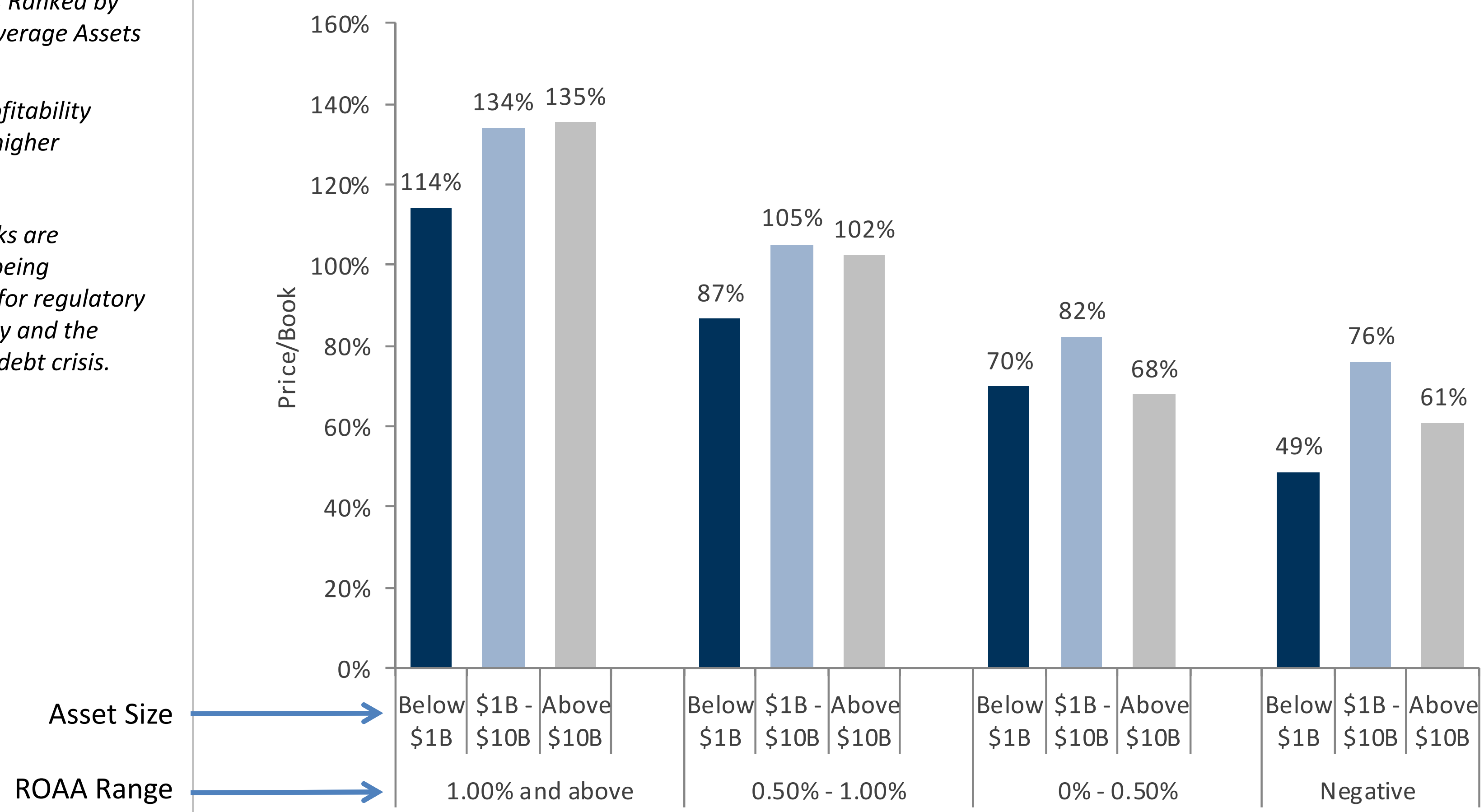


Source: SNL Financial

Public Banks Valuation by ROAA

Public Banks Ranked by Return on Average Assets

- *Higher profitability results in higher valuation*
- *Large banks are currently being penalized for regulatory uncertainty and the European debt crisis.*



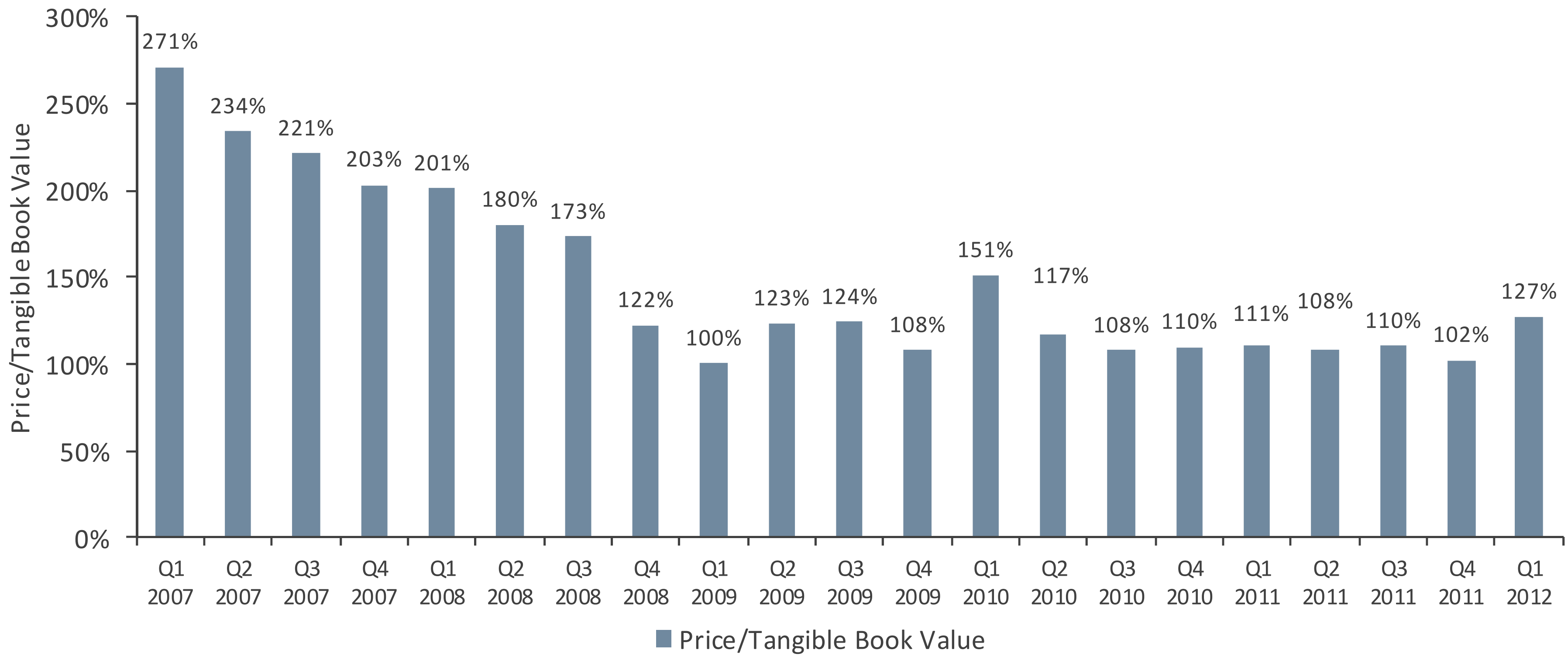
Note: Financial Data as of December 31, 2011 and Market Data as of March 30, 2012. Excludes public banks with asset size under $100 million and 3-month average daily trade volume under 1,000. Sample size: ROAA above 1.00%: 87 (18, 51, 18); ROAA 0.50% - 1.00%: 138 (51, 64, 23); ROAA 0% - 0.50%: 95 (47, 41, 7); Negative ROAA: 76 (41, 32, 3)

Source: SNL Financial

National Transaction Multiples – Quarterly

- **Exit multiples and the number of bank M&A transactions remain at historic lows driven by the slow economic environment and regulatory uncertainty**

National Average Price / Tangible Book Value



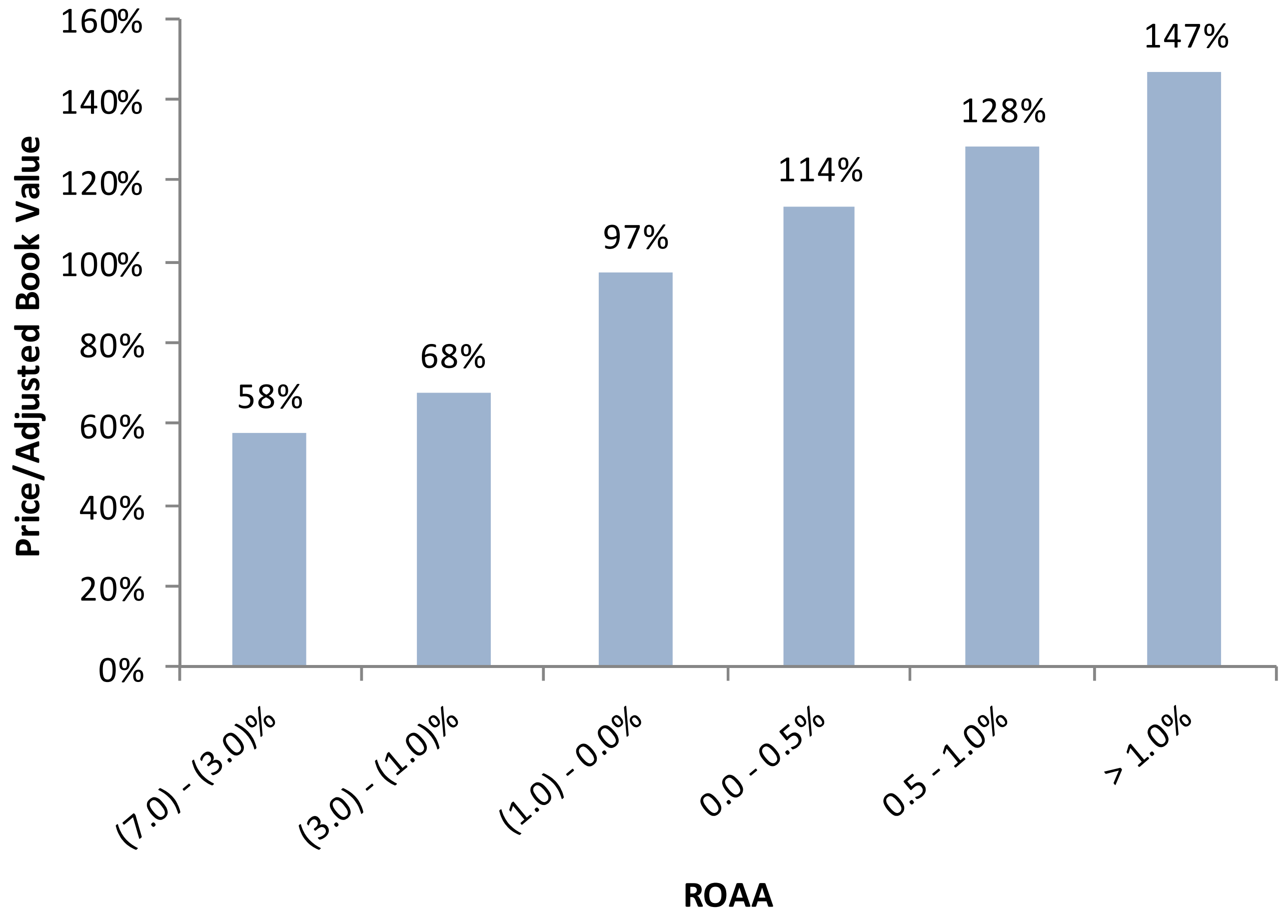
(1) Median Price to Earnings Excludes all multiples over 40x

Source: SNL Financial

M&A Valuations by Profitability

- Pricing on national M&A transactions later than 1/1/2010 based on ROAA

Median Price to Adjusted Book Value by ROAA



Price to Adjusted Book adjusted to reflect an 9% equity/assets ratios, all excess equity added dollar for dollar
Includes deals with publicly announced transaction data

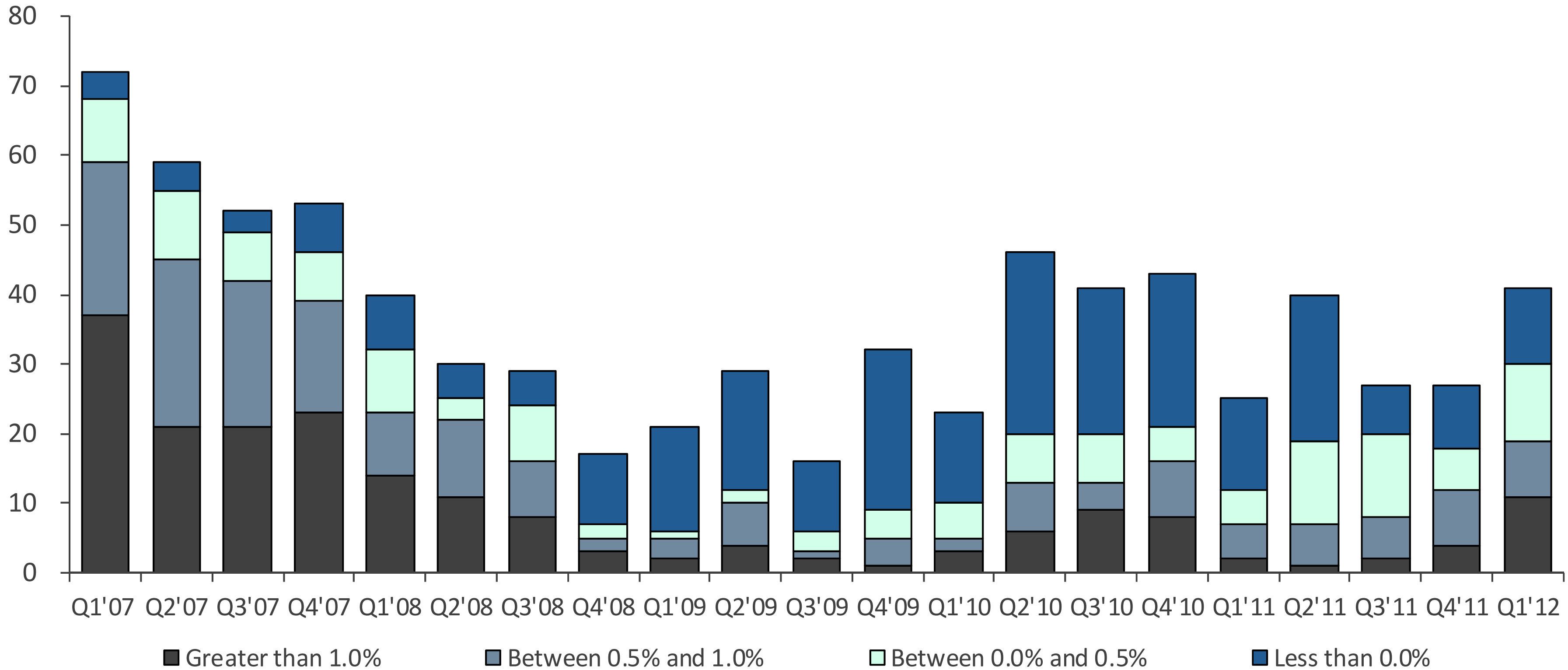
Source: SNL Financial

INVESTMENT BANKERS
St Charles Capital

Selling Banks by ROAAs

› **Although the industry is improving, distressed sellers continue to make up a large portion of the transactions**

Number of Transactions by ROAA per Quarter



Source: SNL Financial

With Low Pricing – Who is Selling?

Weak Banks

Under regulatory order to raise capital

Healthy Banks

Health of Owners / Management

Too small to prosper

Raising Capital

New "Norm" for Bank M&A

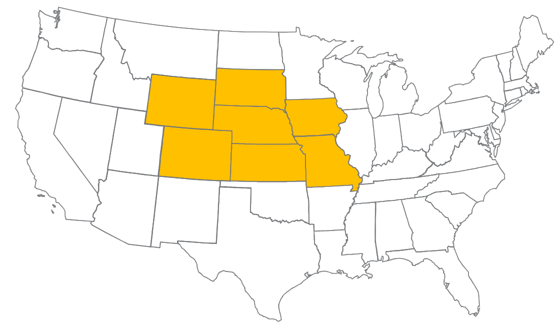
- **Less profitability in the industry**
  - Costs associated with asset quality
  - Regulatory burden
- **Banks are being required to operate with more capital**
  - ROAE for investors will decline
- **Lower profit levels result in lower valuations**
  - Same Price/Earnings results in lower Price/Book

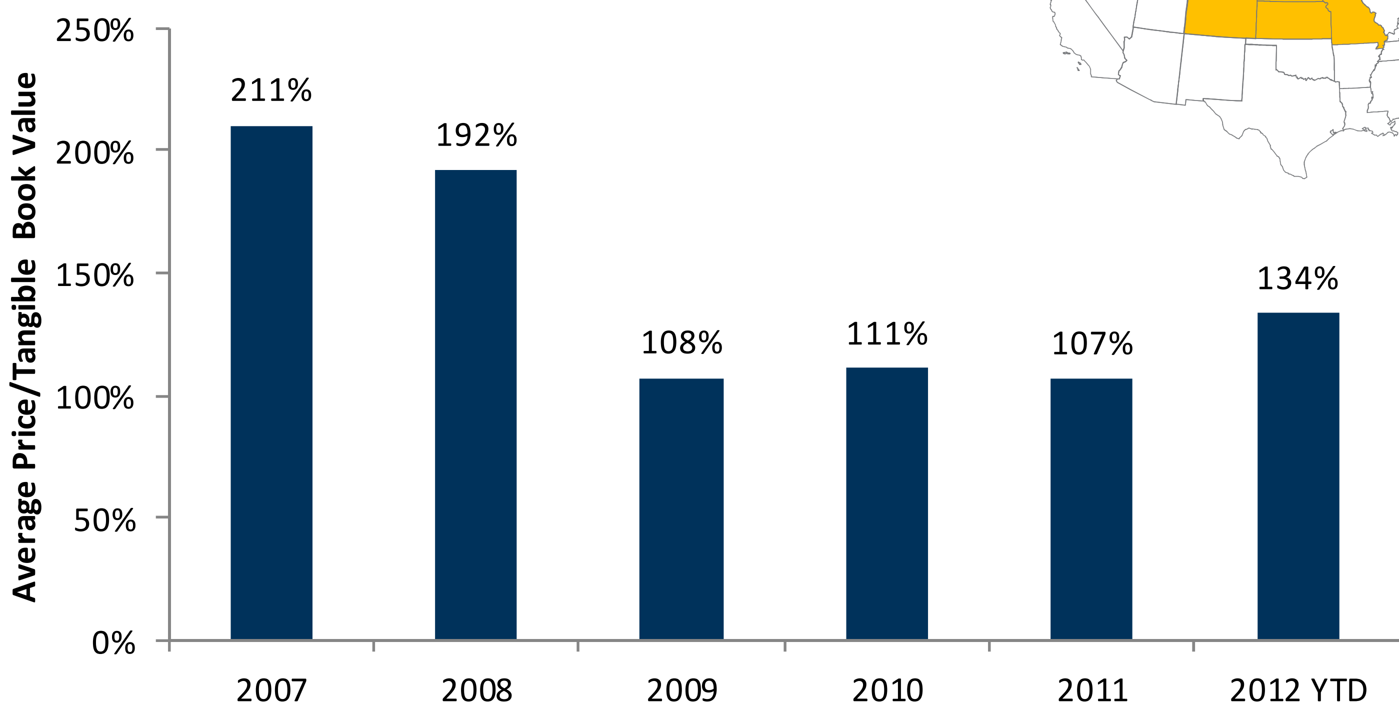
(Dollars in thousands)	Pre-Crisis	New "Norm"	% Change
Assumed Bank Size	$300,000	$300,000	
Typical ROAA	1.00%	0.80%	
Net Income	$3,000	$2,400	(20.0%)
Equity / Assets	7.5%	8.5%	
Equity Base	$22,500	$25,500	13.3%
Typical ROAE	13.3%	9.4%	
Price / Earnings	15.0x	15.0x	
Valuation	$45,000	$36,000	(20.0%)
Price / Book	200.0%	141.2%	

Regional Transaction Multiples

- Regional bank M&A multiples have decreased similar to national trends over the last few years

- Regional economy has performed better than the national trends





Includes bank control transactions with announce dates later than 1/1/2007 acquisition targets in CO, IA, KS, MO, NE, SD, & WY

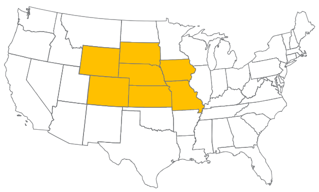
Source: SNL Financial

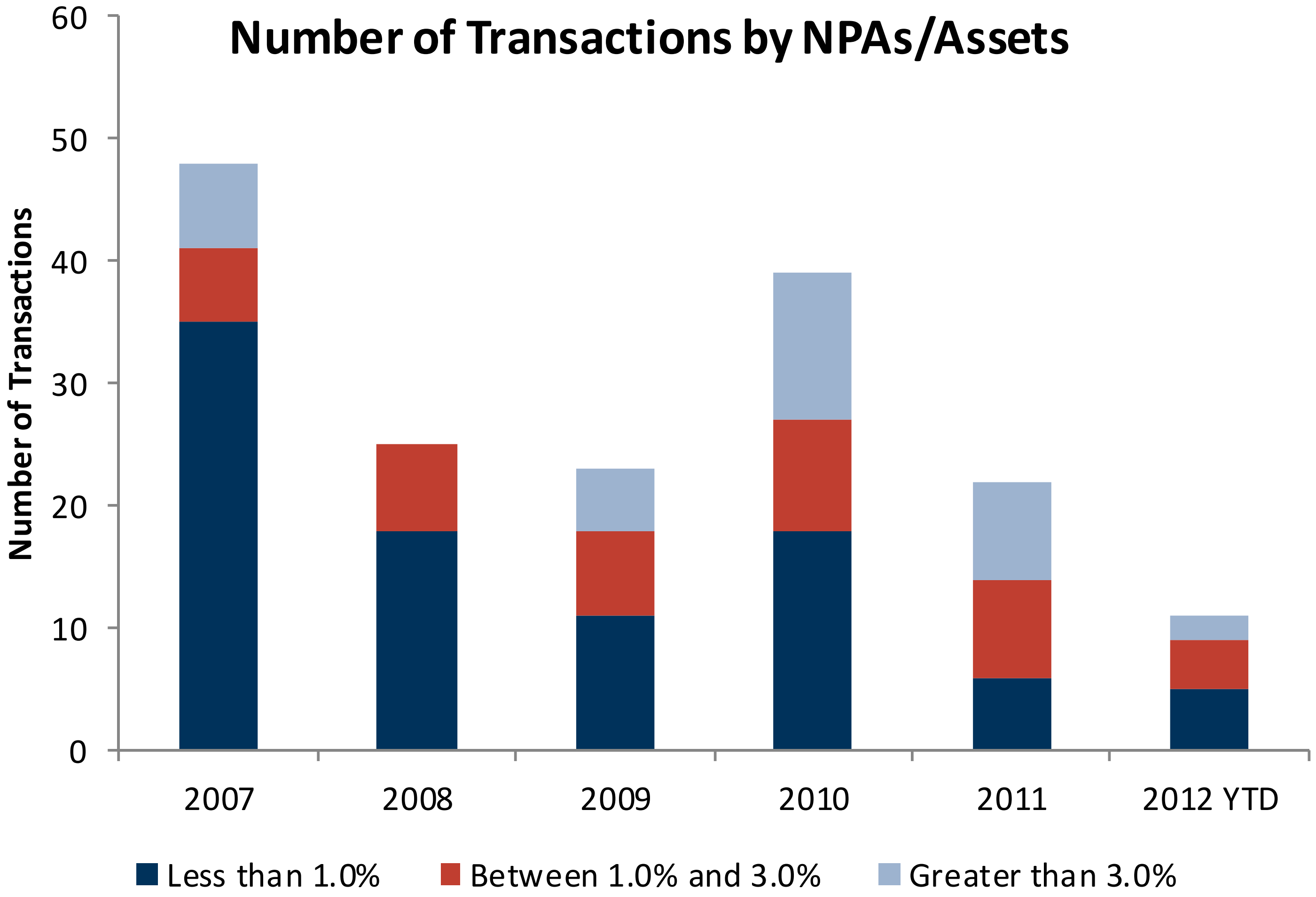
Regional Transaction Volume by Asset Quality

<u>*Screening Criteria:*</u>

Announce date later than 1/1/2007

Target states in CO, IA, KS, MO, NE, SD, & WY

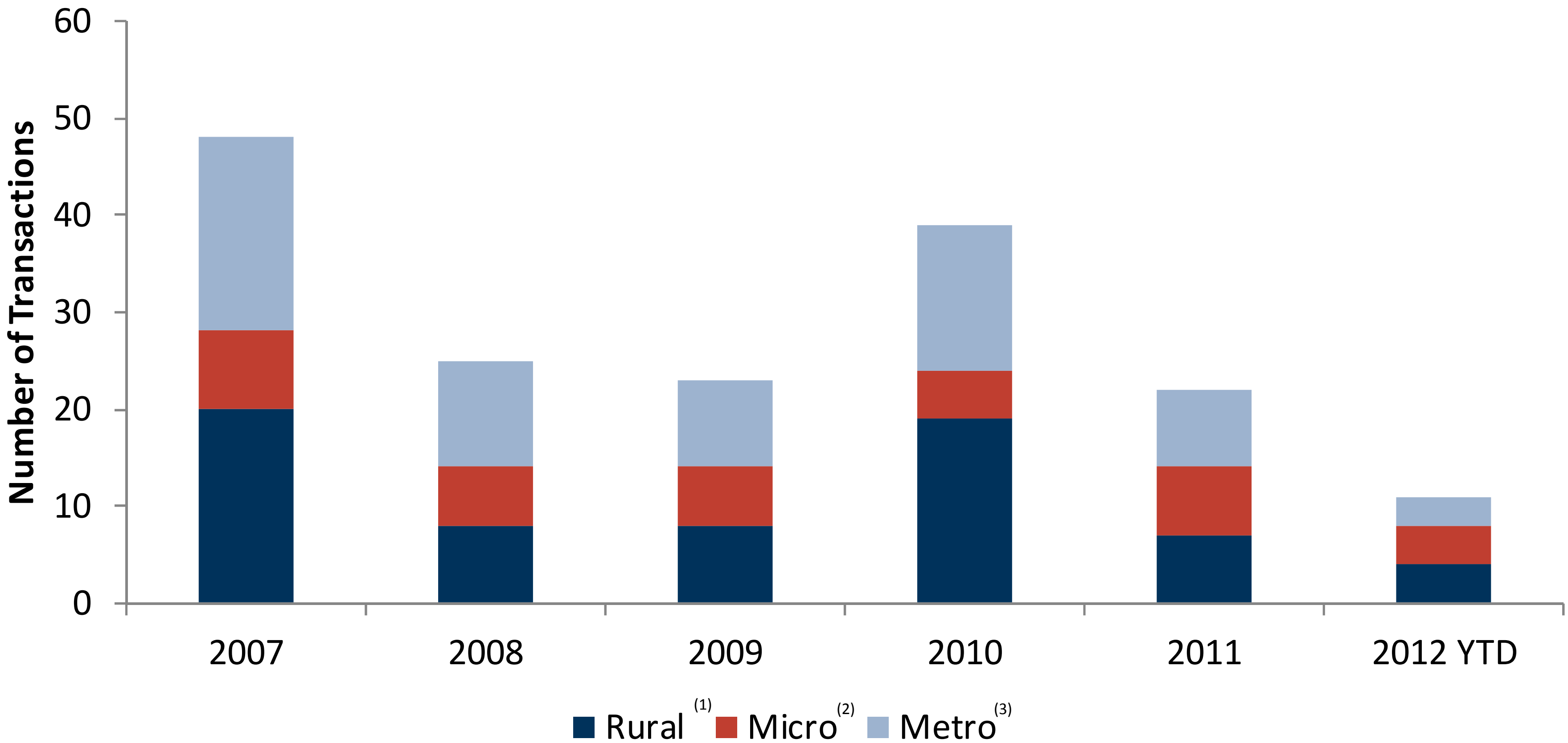




Source: SNL Financial

St Charles Capital
INVESTMENT BANKERS

Regional Transaction Volume by Market Type



(1) No urban areas with population greater than 10,000
(2) At least one urban area with population between 10,000 and 50,000
(3) At least one urban area with population of 50,000 or more
Includes all transactions with announce dates later than 1/1/2007 and acquisition targets in CO, IA, KS, MO, NE, SD, & WY

Source: SNL Financial

Regional Transaction Multiples by Market

Regional healthy bank transaction multiples:

Eliminated non-profitable and high non-performing asset (“NPAs”) quality concentrations

Regional M&A Pricing by Market Type - 1/1/2009 - 2012 YTD					
Market Type	Average Price/ Tangible Book	Average NPAs/Assets	Average ROAA	Average Assets ($000s)	Number of Transactions
Rural	109.4%	1.12%	0.98%	54,565	24
Micro	136.0%	1.04%	0.91%	126,896	11
Metro	124.0%	1.02%	0.78%	74,740	19

Includes all transactions with the following criteria:
Announce date later than 1/1/2009
Acquisition targets in CO, IA, KS, MO, NE, SD, & WY
NPAs/Assets less than 4% and ROAA greater than 0%

Source: SNL Financial

M&A Landscape

- Too Much Harness for the Horse?
  - Impact on earnings
  - Mitigating the costs
  - Increased supervision

M&A Landscape

- Dodd-Frank Ramifications
  - Regulatory Compliance
  - Supervision Issues
  - Interstate Transactions
  - Size Really Does Matter

M&A Landscape

- Maybe Bigger Isn't Better
  - Regulatory burdens of big and "highly complex" banks
  - Dodd-Frank bias towards smaller banks

M&A Landscape

- Capital Considerations
  – Given the paramount importance to regulators of sustaining increased overall capital levels in the banking industry, the effect of an M&A transaction on capital is probably the <u>single most important factor</u> in determining whether a deal will be pursued and whether it can be consummated

M&A Landscape

- Requirements that acquirers be well capitalized, as well as additional supervisory policies limiting acquisition capacity based on CAMELs ratings and other supervisory limitations has substantially narrowed the field of potential acquirers
- Before proceeding, buyers will require insight on the effect of an acquisition on their overall capital planning, including impact on regulators' willingness to approve future dividends, and any requirement to raise capital as a result of the transaction

M&A Landscape

- Prior notice and approval for certain acquisitions
  - Dodd-Frank requires prior Federal Reserve approval for any financial holding company to acquire a company with total consolidated assets exceeding $10 billion. Previously, only after-the-fact notice had been required.

M&A Landscape

- Interstate bank acquisitions and mergers
  - Dodd-Frank amends the Bank Holding Company Act to require an acquiring bank holding company to be “well capitalized” and “well managed” in order to make an interstate bank acquisition
    - Previous standards required that a bank or bank holding company be “adequately capitalized”

M&A Landscape

- Interstate de novo branching by national and state banks
  - Dodd-Frank facilitates de novo interstate branching by eliminating the "opt-in" requirement that previously permitted states to prohibit de novo branching by a bank whose main office is located in another state
    - Formerly, in many states, a national bank or state-chartered bank had to establish branches through acquisition transactions, and the branches or bank to be acquired must have been in existence for at least five years

M&A Landscape

- Trust Preferred Considerations
  - While the Collins amendment grandfathered Tier 1 capital treatment for outstanding trust preferred stock issued by banks with less than $15 billion in assets as of December 31, 2009, banks with $500 million or more in consolidated assets will generally not be able to rely on future trust preferred issuances to meet increased capital needs

M&A Landscape

- Acquirers in distressed transactions acquiring significant equity positions risk assuming trust preferred obligations generally held at the bank holding company level
  - See recent litigation - BankAtlantic breached covenant in selling a substantial amount of its banking assets to BB&T

M&A Landscape

- Jumpstart Our Business Startups (JOBS) Act Implications
  – Number of shareholders at which small banks must become a reporting company has been raised from 500 to 2,000 shareholders of record

M&A Landscape

- Permit stock consideration for companies near the prior limit
- Ability to raise more capital and build more branches

M&A Landscape

- Easier to go private now too—permitted to do so with 1,200 shareholders of record instead of 300
  - Avoid expenses of a public company
  - Avoid the need to pursue a reverse stock split
- Relaxed other rules to make it easier to raise capital privately

M&A Landscape

- Negotiating and Documenting the Deal
  - Picking a suitor
  - “Pre-Nuptial” Agreements
  - Disclosure and due diligence
  - Indemnification
  - Representations and warranties

M&A Landscape

- Picking a Suitor
  - Pricing
  - Funding
  - Existing Trust Preferred Securities

M&A Landscape

- "Pre-Nuptial" Agreements
  - Confidentiality Agreements
  - Letters of Intent
  - Two stage structures

M&A Landscape

- Disclosure and Enhanced Due Diligence
  - Data Production
  - Diligence Procedures

M&A Landscape

- Indemnification Issues

  Generally, there is no longer an unlimited guarantee for all liabilities arising in connection with pre-closing events

  - Baskets
  - Deductibles
  - Aggregate Caps
  - Survivability Period

M&A Landscape

- Representations and Warranties

  As the basis for indemnification this section of the definitive agreement is the most important

  – Fundamental representations
  – The Big Four
    - Taxes
    - Environmental risks
    - Loan quality and ALL
    - Regulatory compliance
  – Purchaser representations

M&A Landscape

Conclusions

- Pent up demand
- Succession plans
- Regulatory compliance:
  - Burden and opportunity
- Revamping strategic plans

FEDERAL RESERVE BANK *of* KANSAS CITY

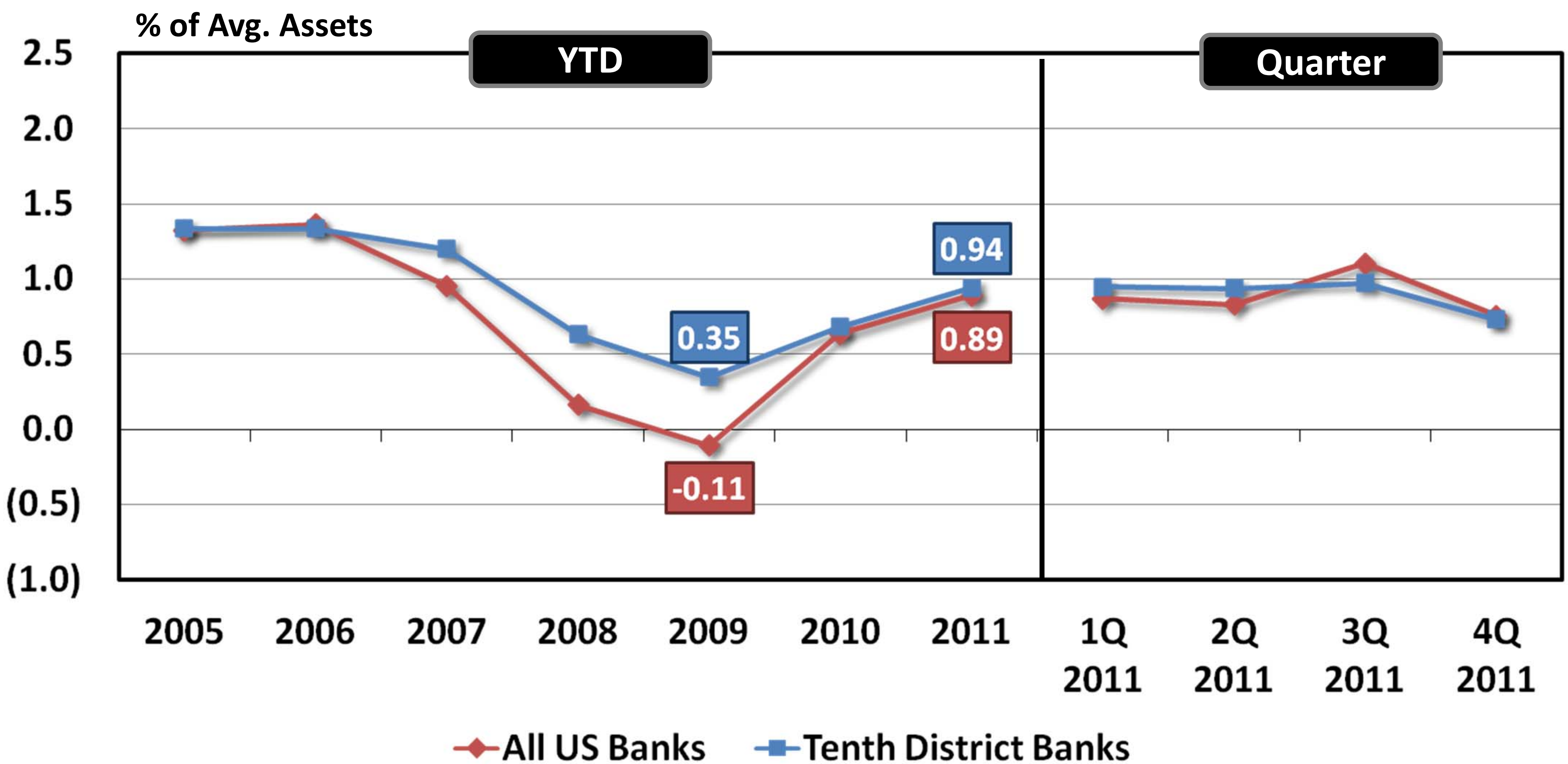
Tenth District Banking Conditions

Rick Lay	Nick Hatz
Assistant Vice President	Managing Examiner

Agenda

- Bank Performance Trends (Nick)
- Asset Quality and Problem Assets (Nick)
- Capital Planning and Dividends (Rick)
- Bank and BHC/SLHC Ratings (Rick)
- Community Bank Challenges (Rick)
- Emerging Industry Trends (Nick)

Earnings Have Improved From 2010 Levels

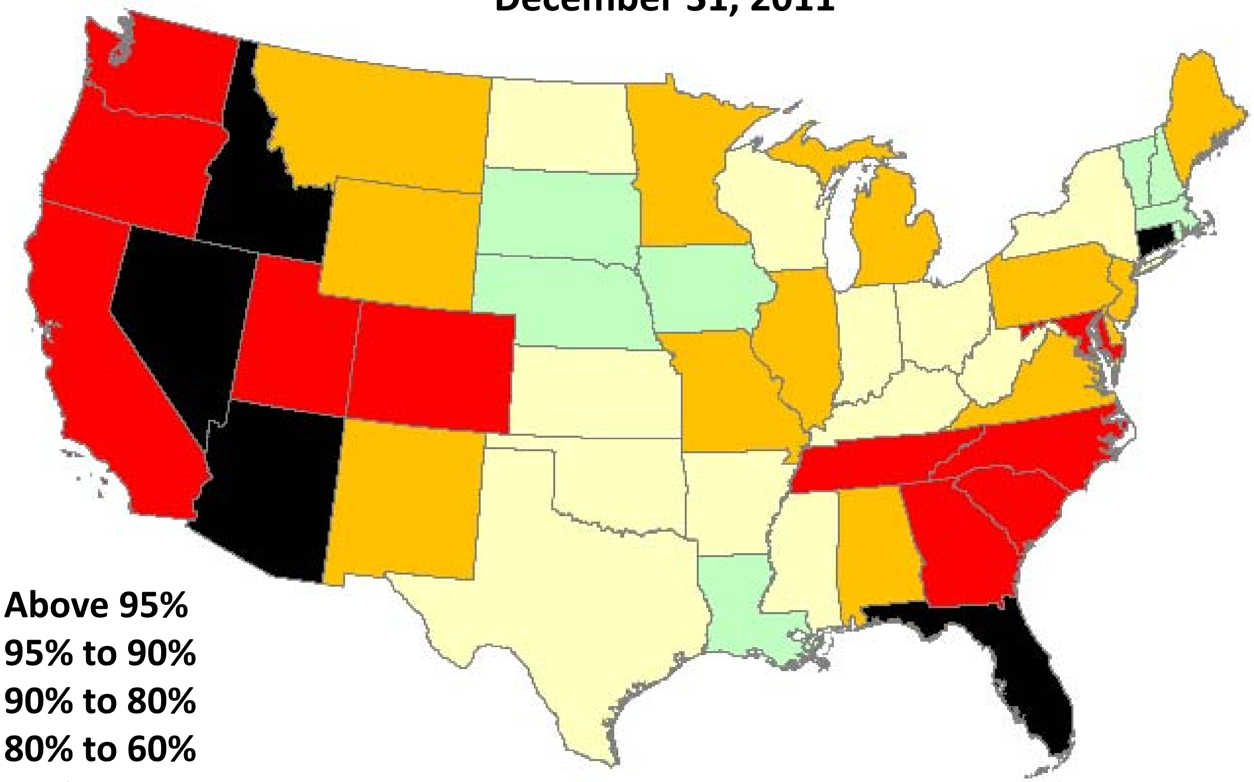


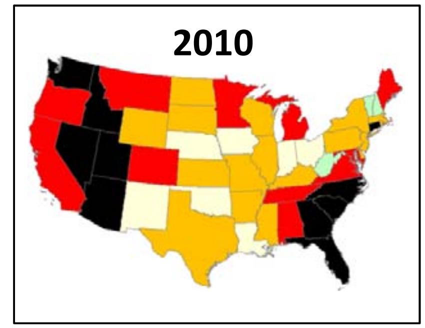
* YTD = Net Income (YTD), as a percentage of average assets (TTM) - Annualized
* Quarter = Net Income (Quarter), as a percentage of average assets (Quarter) - Annualized
Source: Reports of Condition and Income

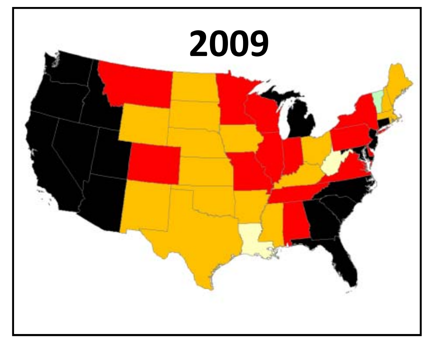
Overall, Industry Profitability Has Improved

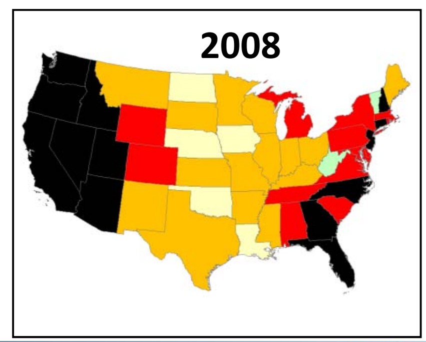
Percent of Banks Earning a Profit

December 31, 2011





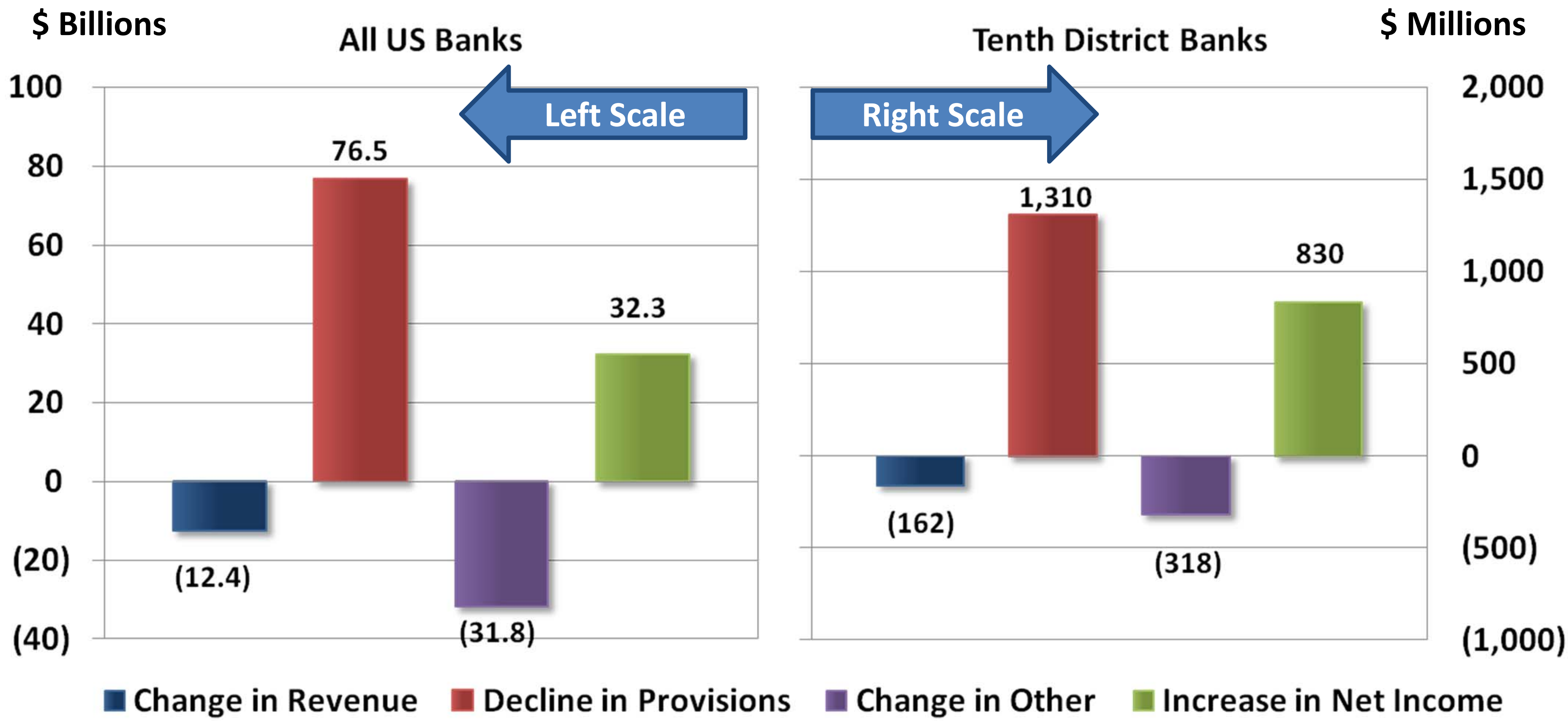




- **Above 95%**
- **95% to 90%**
- **90% to 80%**
- **80% to 60%**
- **Under 60%**

* Percentage of banks with positive net income (YTD)
Source: Reports of Condition and Income

Earnings Increase in 2011 is Driven by Declining Provision Expense



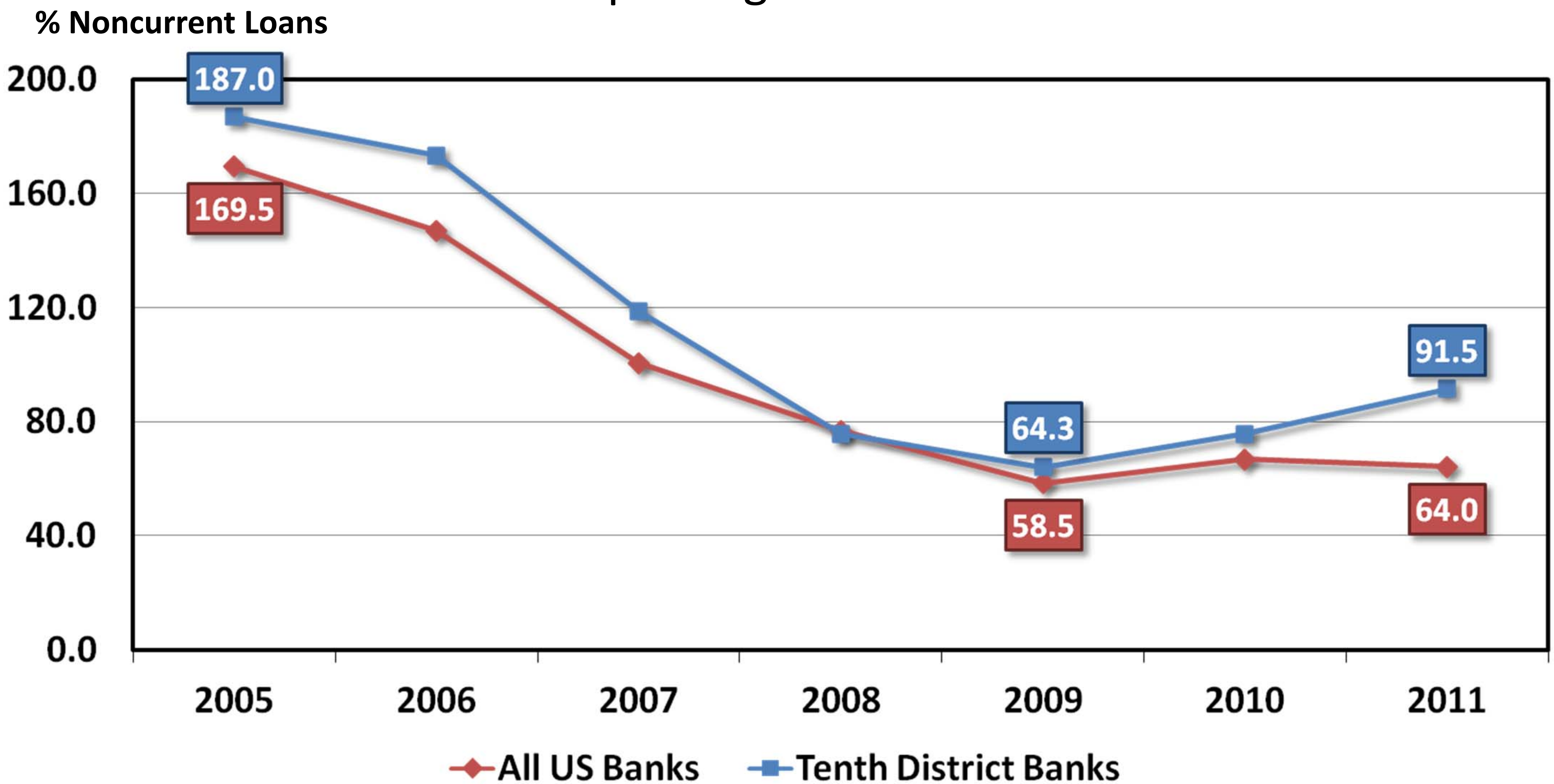
Change From December 2010 to December 2011

* Revenue defined as net interest income + non-interest income

Source: Reports of Condition and Income

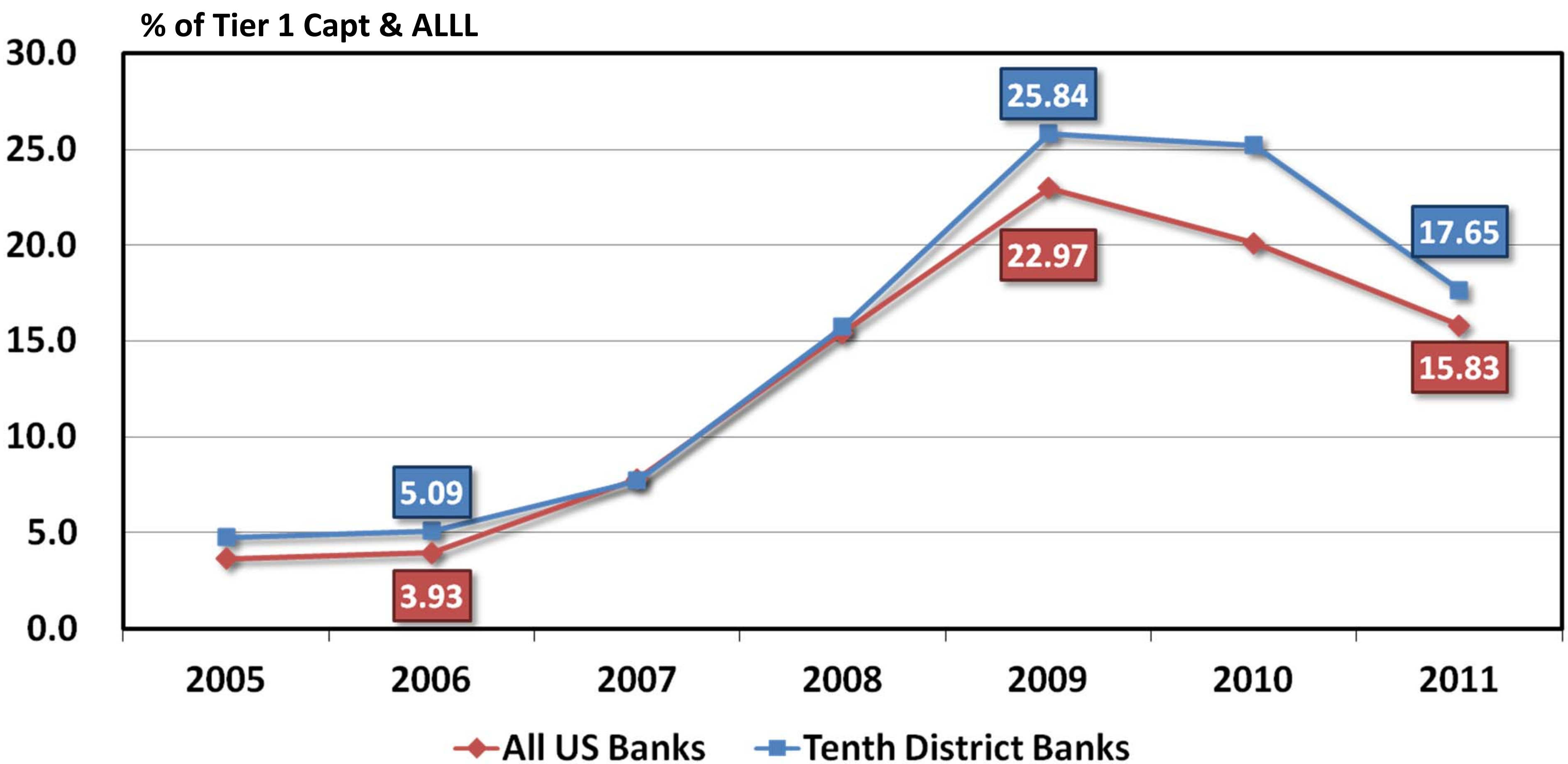
Coverage Ratios Remain Low,

While Improving For District Banks



* Loan loss reserves to loans 90+ days past due and in nonaccrual status
Source: Reports of Condition and Income

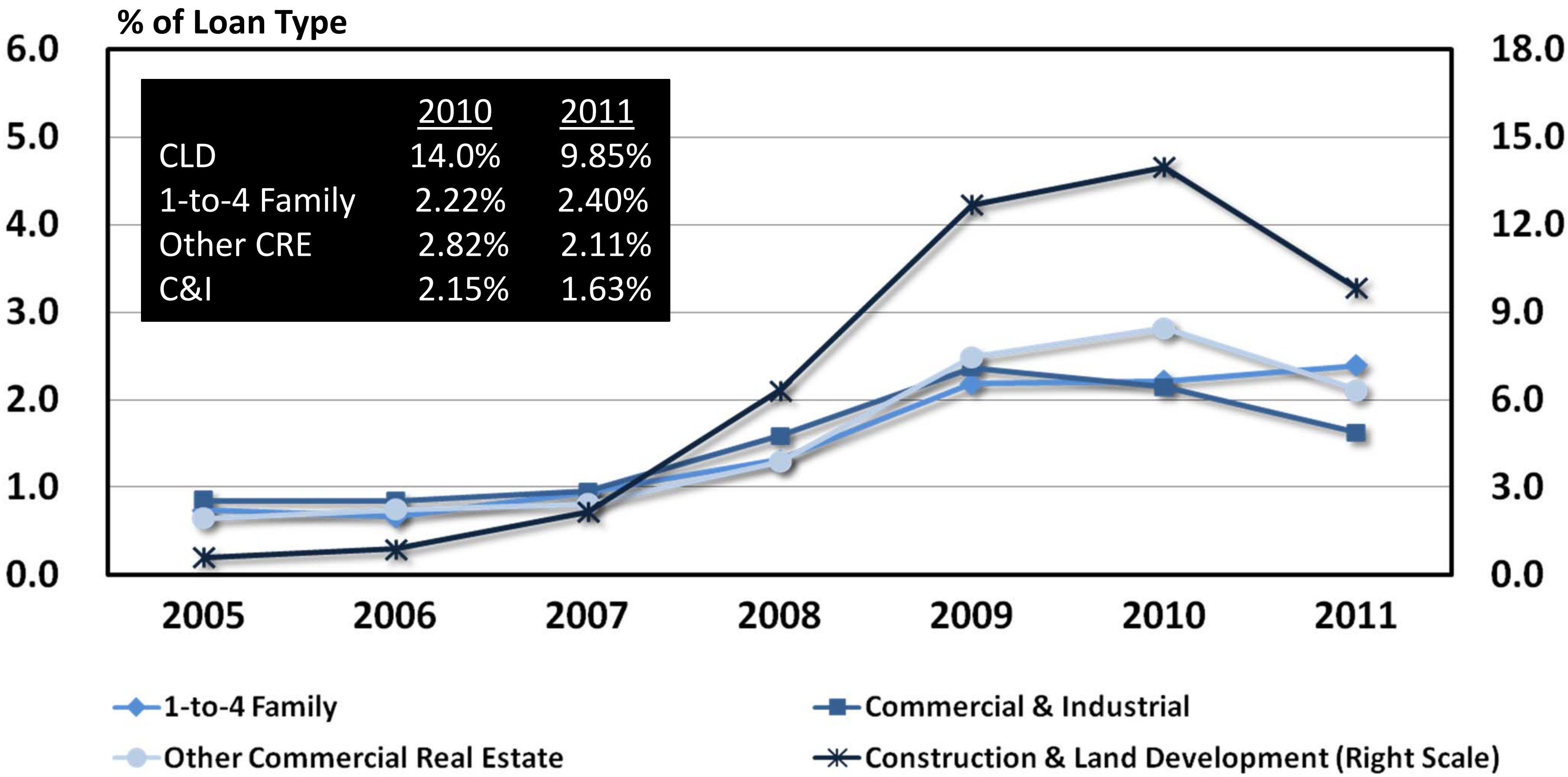
Texas Ratio Has Improved



* Nonaccrual loans + Other Real Estate Owned as a percentage of Tier 1 Capital + Allowance for Loan and Lease Losses
Source: Reports of Condition and Income

Noncurrent CLD Loans Declined

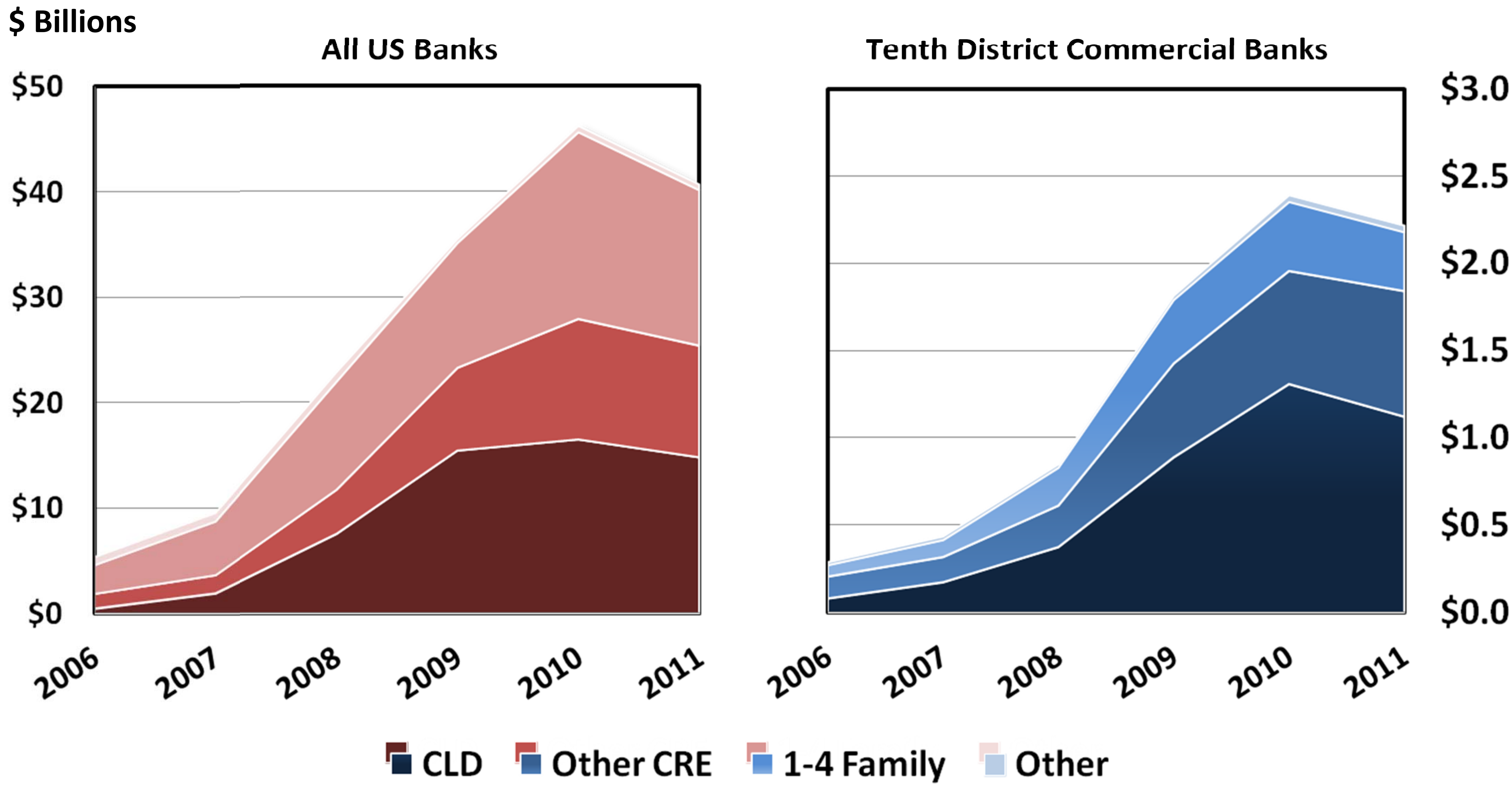
(Tenth District Commercial Banks)



	2010	2011
CLD	14.0%	9.85%
1-to-4 Family	2.22%	2.40%
Other CRE	2.82%	2.11%
C&I	2.15%	1.63%

* Problem Assets = Loans 90+ days past due + nonaccrual loans + OREO as a percentage of total loans + OREO
**Noncurrent loans as a percentage of loan type - noncurrent includes loans 90+ days past due and nonaccrual
Source: Reports of Condition and Income

Other Real Estate Remains High



Source: Reports of Condition and Income

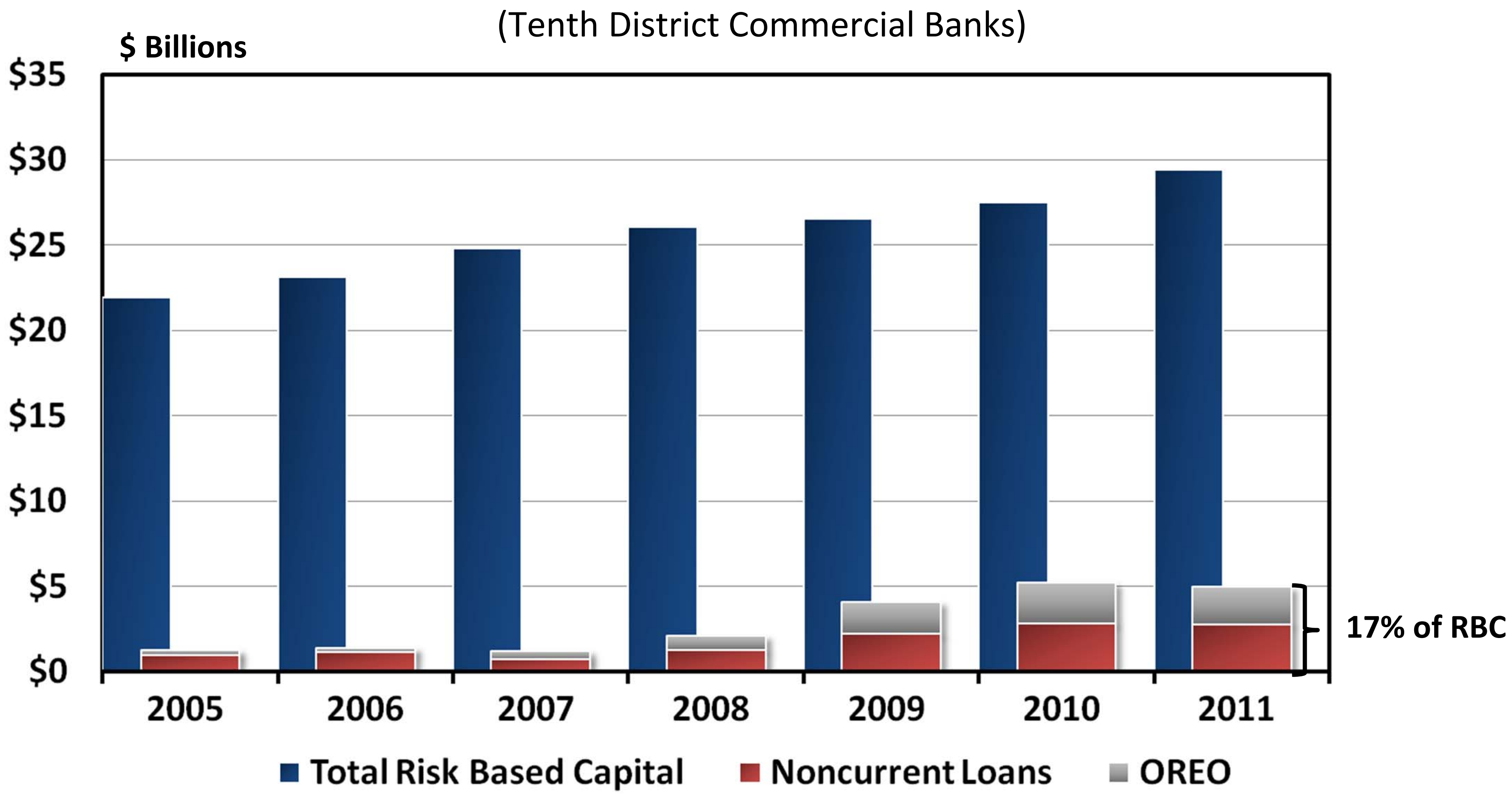
Transfer of Problem Assets Considerations

Risk Management

- Conduct Due Diligence
- Assess Effects on Balance Sheet & Loss Exposure
- Ensure Ability To Manage New Assets
- Ensure Use Of Appropriate Accounting Treatment
- Use Independent Valuations
- Ensure Compliance With Policies

Source: SR 11-15

Level Of Capital Has Risen



Source: Reports of Condition and Income

Capital Planning – Best Practices

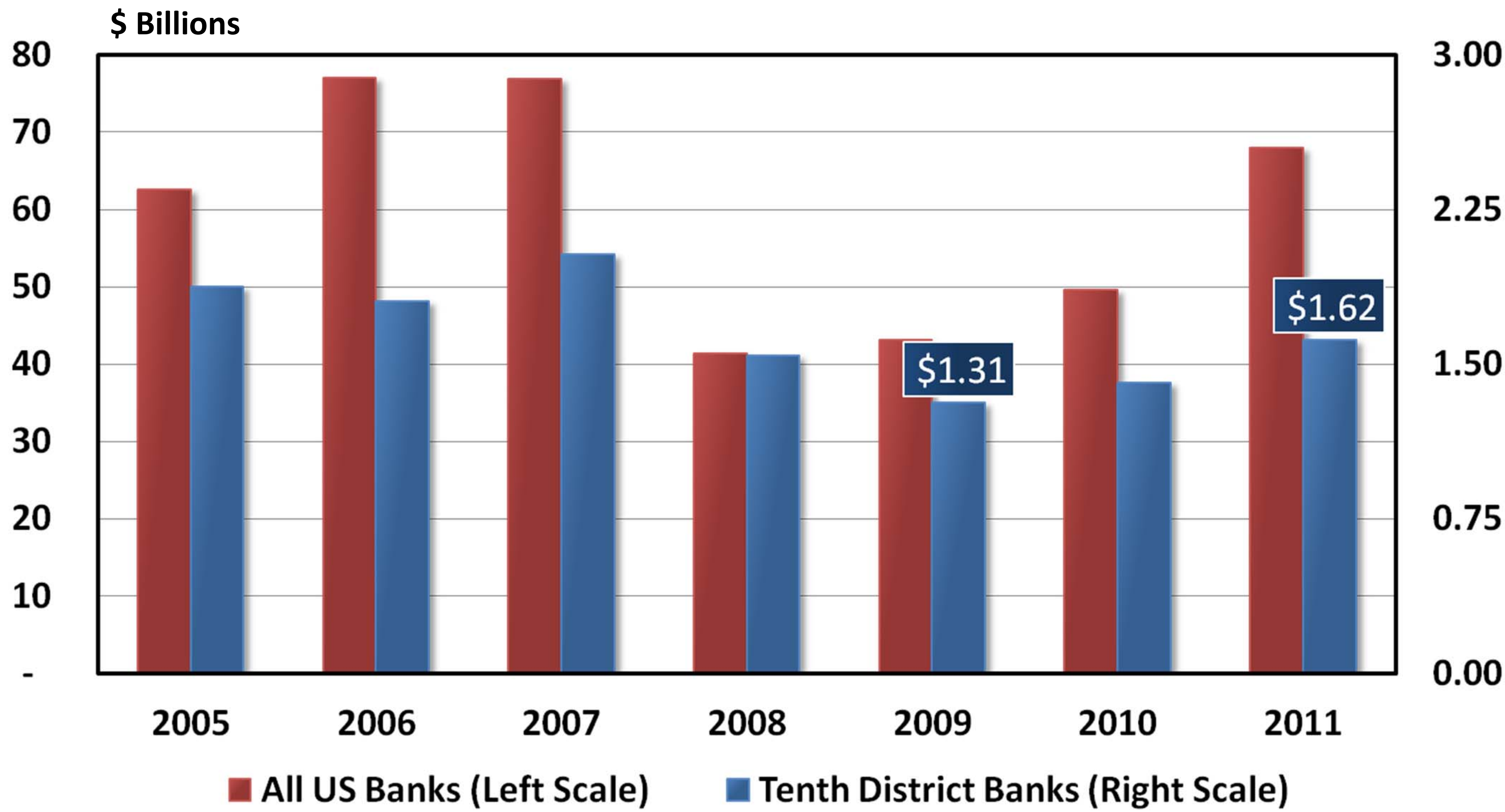
Analysis Considerations

Impact of Adverse Conditions	Key Assumptions	Measures of Capital	Review of Balance Sheet	Review of Income Statement
• Both Bank & Holding Company • Short & Long Term Impact	• Impact Due to Changes in Key Assumptions • "Think Outside the Box"	• More than just Regulatory Measures • Investor, Depositor and Counterparty Needs	• Growth in Loan Types (Concentrations) • Liabilities (Retail Deposits, Brokered Deposits, Cost of Funds, etc.)	• Interest Rate Assumptions • Dividend Payments

Capital Planning - Examiner Expectations

- Capital Levels Should Support Risk Levels
- Board and Senior Management Oversight & Planning
  - Analysis results are used to support decision making
  - Review of the impact of potential adverse outcomes on business lines and the overall organization
- Increased Emphasis on Forward-Looking Analysis When…
  - Loan or investment concentrations exist
  - Identifiable heightened areas of risk or key vulnerabilities exist
  - Reduction in capital being considered
  - Uncertain economic conditions exist

Dividends Increased In 2011



Source: Reports of Condition and Income

Dividend Considerations

Dividend Policies

- Clearly articulate organization's objectives and approaches for maintaining strong capital position
- Account for potential drain on resources

Factors for Level of Dividends

- Asset quality considerations (reserve levels, write-downs, and concentrations of credit)
- Implicit and explicit liquidity and credit commitments
- Current and prospective cash flow and liquidity
- Quality and level of current and prospective earnings
- Level, composition, and quality of capital
- Ability to raise additional capital

Inform The Federal Reserve Bank When…

- Dividends cannot sufficiently be funded by net income available to shareholders for past four quarters (net of dividends)
- Contemplation of a material increase in dividends
- Earnings retention is not consistent with capital needs
- Minimum regulatory capital adequacy ratios are not met, or are in danger of not being met

Community Bank Profile

Bank Statistics in 2006	Community Banks* (Under $1 Billion)	Failed Banks* (Under $1 Billion)
Return on Average Assets (TTM)	1.07	1.09
Noncurrent Loans	0.36	0.49
Tier 1 Leverage Ratio	9.48	8.96
Tier 1 Risk-Based Capital Ratio	13.20	10.46
Total Risk-based Capital Ratio	14.27	11.66
Asset Growth	4.63	15.23
CRE Concentration Ratio	167	439
Coverage Ratio	122	64
Dependency Ratio	15.47	31.88

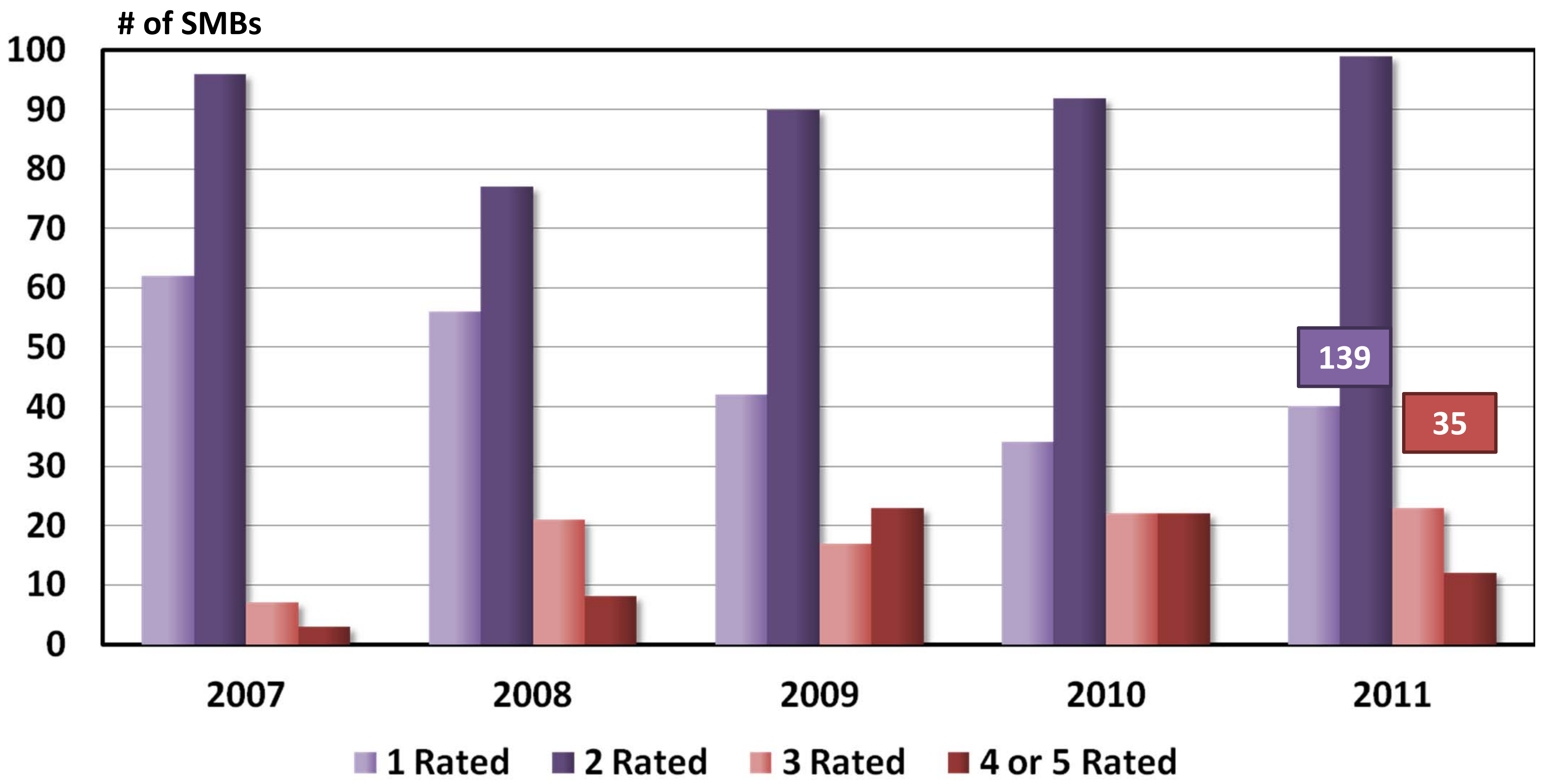
* Banks as-of December 31, 2010. Bank failures through December 31, 2010

** Ratios are based on the median ratio for bank group, which has been adjusted for outliers

Source: Reports of Condition and Income – December 2006

Bank Ratings Improving

(Tenth District State-Member Banks)



Source: National Examinations Database

Consideration For Rating Upgrade

Adversely Classified & Nonperforming Assets

Core Earnings

Liquidity and IRR positions management

Level of Capital & Capital Planning Process

Improvement & Sustainability

Risk Management
- Projections & Assumptions
- Board Review & Oversight
- Address Weaknesses & Deficiencies

Source: SR 12-4

BHC & SLHC Ratings

- R (Risk Management) in RFI

- F (Financial Condition) in RFI

- I (Impact) in RFI

R (Risk Management) in CORE

C (Capital) and E (Earnings and Liquidity) in CORE

O (Organization Structure) in CORE

Composite Ratings

2011 Supervisory Matters

- 68 Matters Requiring Immediate Attention and 141 Matters Requiring Attention Cited
- Decline From 2010 Examinations

2011 Supervisory Matters (Cont'd)

Issue #1: Credit Risk

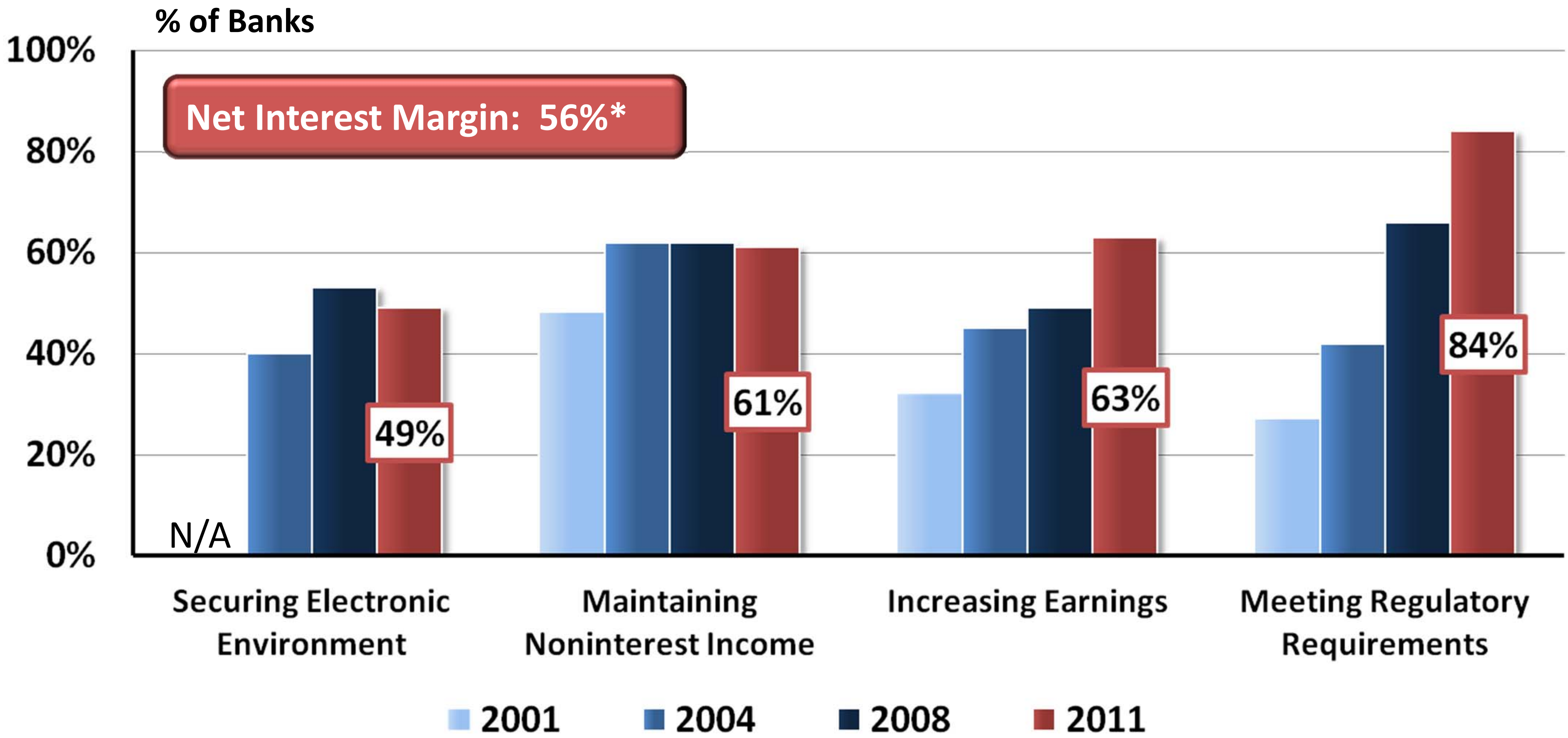
- Credit Administration
- Policy Enhancements
- Financial / Cash Flow Monitoring
- Concentrations Monitoring & Reporting
- Loan Review / Risk Rating Accuracy
- OREO / Nonaccrual / TDR Reporting
- Investment Portfolio Analysis

Issue #2: Corporate Governance

- Strategic Planning
- Succession Planning
- Directorate Qualifications / Independence
- Frequency / Reporting Policy Exceptions
- Board Minutes Documentation

Issue #3: ALLL Methodology and / or Adequacy

Regulatory Compliance Most Significant Challenge Facing Community Banks



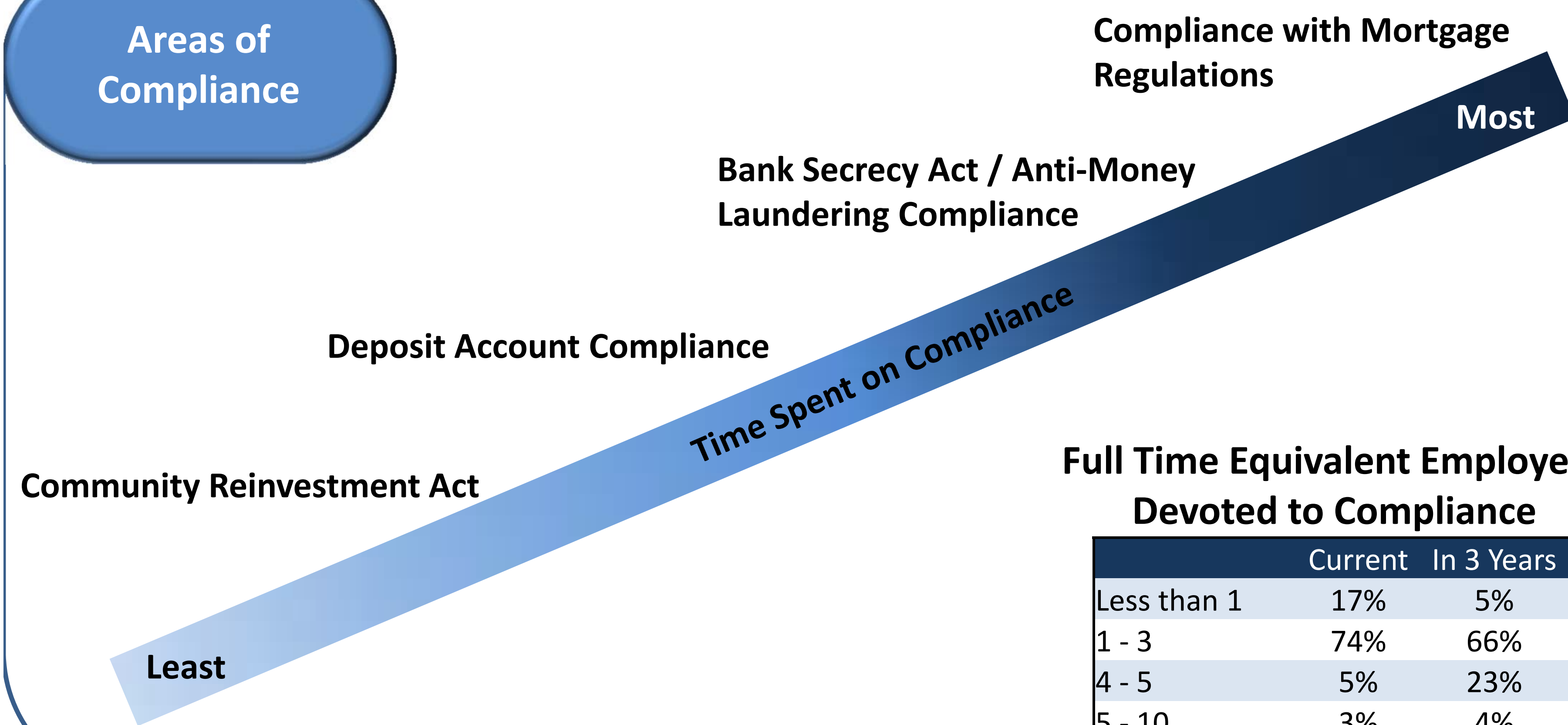
* Net Interest Margin was introduced in the 2011 survey, so no historical information is available

Source: 2011 Survey of Community Depository Institutions in the Tenth Federal Reserve District

Mortgage Regulations Most Time Consuming,

While Overall Compliance Staffing Levels Expected To Increase

Areas of Compliance



Full Time Equivalent Employees Devoted to Compliance

	Current	In 3 Years
Less than 1	17%	5%
1 - 3	74%	66%
4 - 5	5%	23%
5 - 10	3%	4%
More than 10	1%	2%

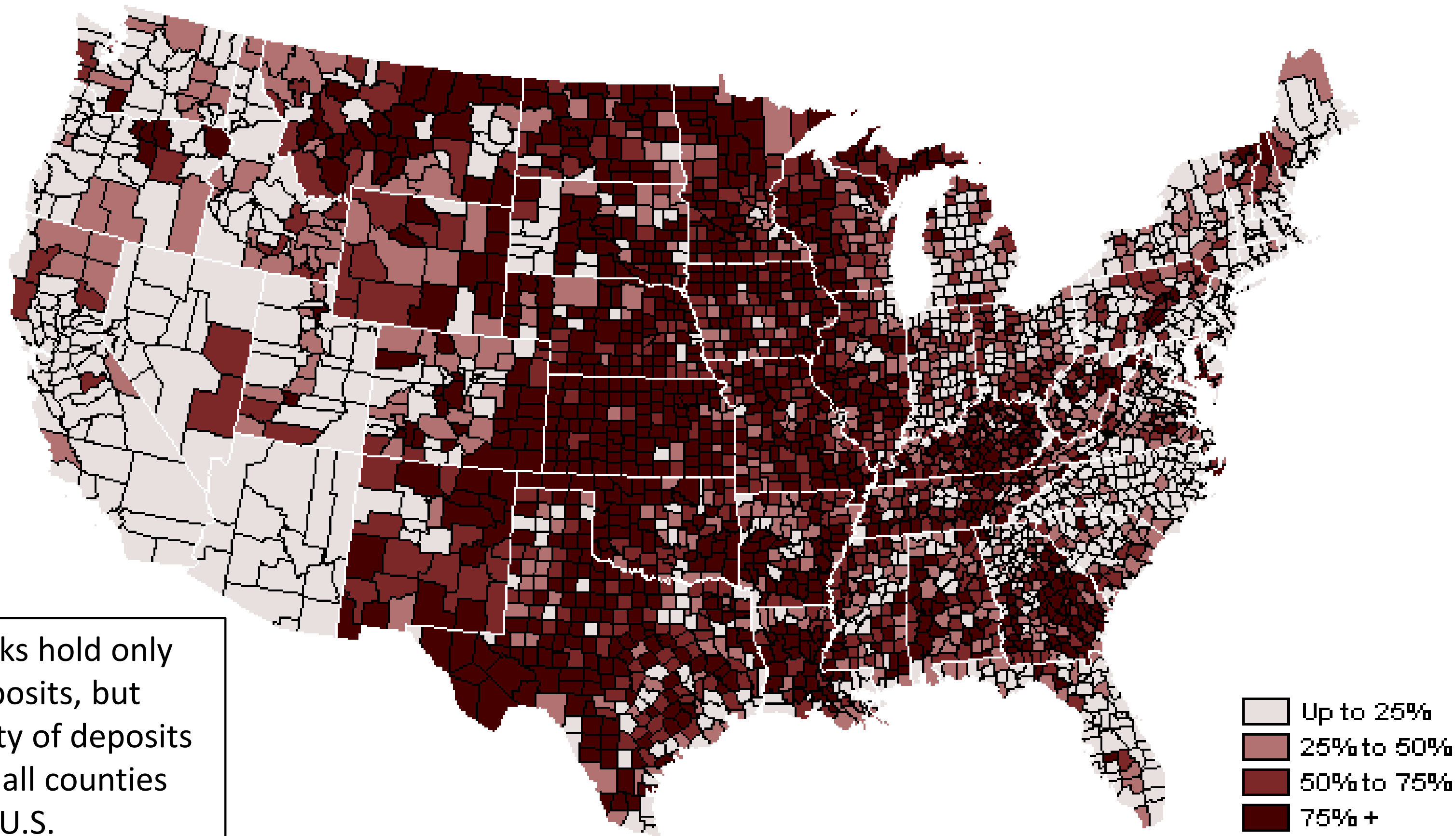
Source: 2011 Survey of Community Depository Institutions in the Tenth Federal Reserve District

Actions to Support Community Banking

- Increased National and Local Outreach
- Community Depository Institutions Advisory Council (CDIAC)
- Involvement in Board of Governors' Community/Regional Bank Subcommittee Projects

Deposit Market Share of Community Banks

(Commercial Banks less than $1 Billion)



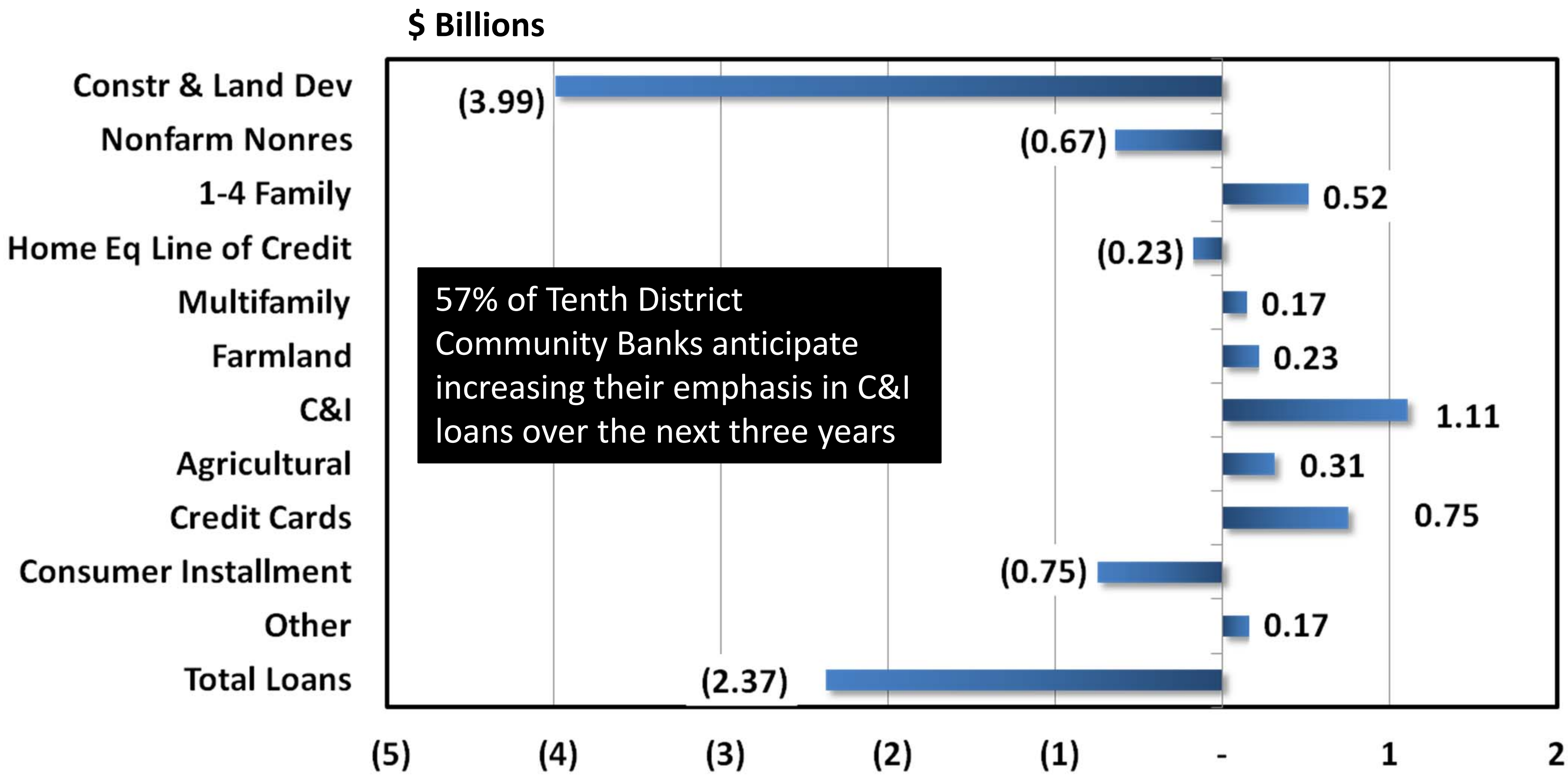
Community banks hold only 11% of total deposits, but have the majority of deposits in nearly half of all counties throughout the U.S.

Source: FDIC Survey of Deposits (June 2011)

Loan Portfolio Composition

Change From December 2010 to December 2011

(Tenth District Commercial Banks)



Source: Reports of Condition and Income

Commercial & Industrial Lending

- Risk Management requires commitment from bank management to control risks and monitor collateral
- Primary loan types are seasonal or working-capital loans
- Often have unique loan structures
- Lenders need to understand the related industry for risk management of the loan

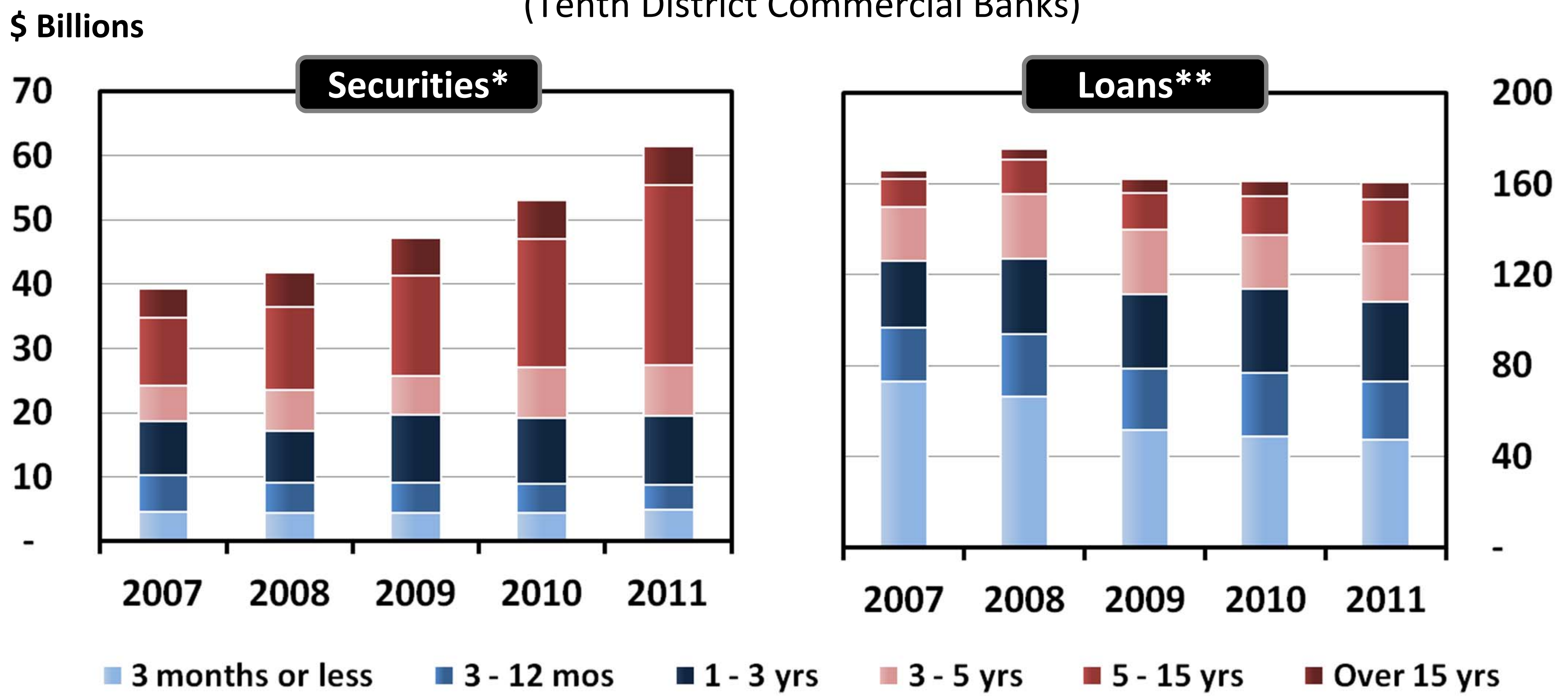
Commercial & Industrial Lending

Common "Red Flags"

- Receivables Collection Slowdown
- Noticeably Rising Inventory Levels
- Inventory Turnover Slowdown
- Existence of Heavy Liens on Assets
- Concentrations of Noncurrent Assets
- High Levels of Intangible Assets
- Substantial Long-Term Debt Increases
- Major Gap Between Gross & Net Sales
- Rising Cost Percentages
- Rising Level of Total Assets (In Relation To Sales)

District Securities Portfolio Indicates Greater Maturity Dates

(Tenth District Commercial Banks)



* Securities includes (1) securities issued by the US Treasury, US Gov't agencies, and states and political subdivisions in the US; (2) other non-mortgage debt securities; and (3) mortgage pass-through securities

** Loans includes all loans and leases, excluding those in nonaccrual status

Source: Reports of Condition and Income

Interest Rate Risk Expectations

Characteristics of Model

- Reasonably Captures Risks
- Measures Impact of Interest Rate Changes
- Identifies Significant Positions

Evaluation and Use of Model

- Appropriate For IRR Profile
- Testing Scenarios Appropriate For Institution's Risk Profile and Current Economic Conditions
- Effective Model Validation Policy

Source: SR 12-2