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CHANGES TO SMALL BHC POLICY STATEMENT

IMPLICATIONS FOR M&A, CAPITAL PLANNING, and INVESTMENT STRATEGY

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On April 9th, the Board of Governors of the Federal Reserve System issued the Final Rule to implement Public Law 113-250 enacted on December 18, 2014 that updates and amends the Small Bank Holding Company Policy Statement (the "Policy Statement").[1] This final rule will become effective in May 2015, 30 days after being posted in the Federal Register. Pursuant to the Policy Statement, BASEL III capital rules and reporting requirements WILL NOT apply to the small bank holding companies and small savings and loan holding companies (small BHCs) which meet the following criteria:

Less Than $1 Billion in Total Assets
AND
(i) Not engaged in significant non-bank activities,
(ii) No significant off-balance sheet activities conducted through a non-bank subsidiary, and
(iii) No material amount of SEC registered debt or equity securities outstanding (other than TPS)

As a practical matter, while the Policy Statement has had the "materiality standard"[2] since 2006, there have been very few small BHCs that have been excluded from use of the Policy Statement due to application of this standard. Despite this new rule from the Fed, BASEL III rules and regulations WILL continue to apply at the bank level even if their holding companies are covered by the Policy Statement. This creates an interesting dichotomy whereby banks with less than $1 billion in assets which are regulated by the FDIC, OCC and/or a State banking regulator will still be subject to Basel III capital rules and regulations while the associated bank holding company WILL NOT. Banks will continue to be required to file quarterly call

[1] Federal Reserve System Final Rule. FRB Docket No. R-1509. RIN 1700-AE 30. "Small Bank Holding Company Policy Statement; Capital Adequacy of Board Regulated Institutions; Bank Holding Companies; Savings and Loan Holding Companies." April 9, 2015.

[2] Determinations of the materiality of SEC registered debt and equity securities are made on a case-by-case basis by the Board of the Federal Reserve based on a number of factors to assess the complexity of a firm including: the number and type of classes and series of stock issued; the holding company's market capitalization; the number of outstanding shares; the average trading volume; the holding company's history of issuing equity and debt securities (including private placements); the nature and distribution of ownership; listing on a national exchange; qualification as a "smaller reporting company" under SEC rules; and the amount, types and terms of any debt issued by the entity.

reports while small bank and thrift holding companies will only be required to file annual FRY-9SP short form reports.

As highlighted below, the Policy Statement will include roughly 88% of the bank and savings and loan holding companies in the U.S. that represent about $436 billion or 2% of total U.S. BHC assets as of year-end 2014.

Total BHCs (including S&L HC)

	< $ 1 Billion	> or =$1 Billion	Total
($,000s)	BHC	BHC	BHC
Number of Institutions	88% 4,248	12% 579	100% 4,827
Amount of Assets	2% $ 436,044,847	98% $17,809,577,491	100% $ 18,245,622,338

Source: SNL Financial; data as of December 31, 2014

While the change in capital structure allowed by the Policy Statement may not directly impact the majority of U.S. banking assets, it does provide a very real opportunity for 88% of U.S. BHCs to optimize their M&A Strategy, Capital Planning, and Investment Strategy.

M&A Strategy

- More Senior Debt to Fund Cash Portion of M&A Consideration: Holding companies that meet the Qualitative Requirements (shown in the bottom of the box on the prior page) may use senior debt to finance up to 75 percent of the purchase price of an acquisition (that is, they may have a debt-to-equity ratio of up to 3.0:1), but are subject to a number of ongoing requirements (the principal ones of which are discussed below). This higher level of debt at the BHC that is reinvested in the subsidiary bank as equity will create higher levels of double leverage and require careful evaluation of the holding company's ability to service its debt and operate in a safe and sound manner..

  - Principal Ongoing Requirements: The principal ongoing requirements are that a qualifying holding company: (i) reduce its parent company debt in such a manner that all debt is retired within 25 years of being incurred; (ii) reduce its debt-to equity ratio to .30:1 or less within 12 years of the debt being incurred; (iii) ensure that each of its subsidiary insured depository institutions is well capitalized; and (iv) refrain from paying dividends until such time as it reduces its debt-to-equity ratio to 1.0:1 or less. These longer repayment terms provide small BHCs with substantial flexibility to repay debt over time from operations. It should be noted that current market terms generally require repayment within 10 years. However, with the explicit 25 year repayment period allowed in the Policy Statement, a market may develop for longer maturity senior debt that will enable these institutions to take advantage of the longer repayment horizon.

- **Trade-Off Between Higher Leverage and Expedited Approvals**: The trade-off for higher levels of leverage is that a qualifying small BHC may not use the expedited procedures for obtaining approval of acquisition proposals or obtaining a waiver of the stock redemption filing requirements applicable to bank holding companies under the Board's Regulation Y (12 CFR 225.4(b), 225.14, and 225.23) unless the bank holding company has a pro forma debt-to-equity ratio of 1.0:1 or less. So while a small BHC can use higher senior debt leverage, the Policy Statement specifically provides that a qualifying small BHC may not use expedited procedures for obtaining approval for acquisition proposals or stock repurchase programs if leverage is 1.0:1 or more.

- **Retain Selected Assets at the BHC**: As small BHCs are not required to comply with Basel III capital ratios, certain assets such as goodwill, DTAs, MSRs and others that attract high risk weighting or capital deductions, may be retained at or moved to the BHC to limit such adjustments. This will require careful planning of transaction structure to optimize the capital impact of M&A transactions for small BHCs while complying with all intercompany transaction requirements under Section 23A and 23B of the Bank Holding Company Act.

Capital Planning

- **Add a Bank Holding Company to Organizational Structure**: Given the financial flexibility provided by the Policy Statement, banking organizations without a holding company should consider adding a bank holding company as the owner of the banking subsidiary. To dimension the market opportunity, there are currently approximately 5,788 banks but only 4,248 BHCs with total assets of less than $1 billion. As such, there are a substantial number of banks that currently do not have a BHC and therefore could not take advantage of the Policy Statement.

Banks vs BHCs

	< $ 1 Billion		> or =$1 Billion		Total	
($,000s)	BHCs	Banks	BHCs	Banks	BHCs	Banks
Number of Institutions	88%	92%	12%	8%	100%	100%
	4,248	5,788	579	676	4,827	6,464
Amount of Assets	2%	11%	98%	89%	100%	100%
	$ 436,044,847	$ 1,320,997,920	$ 17,809,577,491	$14,195,721,718	$ 18,245,622,338	$ 15,516,719,638

Source: SNL Financial; data as of December 31, 2014

- **Shift from Sub-S Bank to Small BHC Structure**: Similar to appeal of forming a BHC for a taxable bank or savings and loan subsidiary, sub-S banks could benefit from forming a BHC. According to the Subchapter S Bank Association, Inc., there are approximately 2,500 banking organizations that have elected sub chapter S status but (based on 2014 year end SNL Financial data) there are only 136 sub-S BHCs with total assets of less than $1 billon. This highlights the potential opportunity for sub-S banks to form a BHC to take advantage of the capital planning flexibility offered by the Policy Statement. While sub-S banks provide significant tax advantages by avoiding double taxation of income distributed to their owners, sub-S banks are not able to issue preferred stock and are limited to no more than 100 shareholders. Small sub-S BHCs will be able to raise additional debt capital that can be down streamed as equity capital to the sub-S bank to support growth while avoiding the limitation on number of owners.

- **Replace TARP, SBLF and/or Trust Preferred Securities with Senior Debt**: Small BHCs with existing holding company capital instruments (other than common stock) and limited ability to replace such capital can now issue senior debt at the BHC level and downstream equity to the bank subsidiary to meet bank-level Basel III capital requirements while complying with the Policy Statement at the BHC.

- **Fund Stock Repurchases and Dividend Distributions with Senior Debt**: For a small BHC, rather than relying solely on dividends from its bank subsidiary to fund stock repurchases and dividend distributions, the company can utilize senior debt to supplement funding requirements. This provides substantial flexibility to fine tune a BHC's capital structure to enhance overall return on equity.

- **Substitute Senior Debt for Bank Level Sub Debt**: A small BHC that expects to remain below $1 billion in assets for the planning horizon may find it advantageous to substitute potentially low cost BHC senior debt for high cost bank-level subordinated debt.

- **Lower Weighted Average Cost of Capital**: The Policy Statement will allow up to 3:1 BHC leverage (75% senior debt funding) which, as shown below, could lower a BHC's cost of capital to about 6.15% compared to approximately 12% for 100% common equity funding. (For illustrative purposes only, we assumed 7% pre-tax cost of senior debt, 12% cost of equity, and 75% senior debt funding. The ability of any small BHC to operate at 75% senior debt level is dependent upon meeting debt service coverage requirements along with the other Principal Ongoing Requirements.) In contrast, BHCs that must comply with the Basel III capital requirements of 8.5% tier 1 capital, where 85% represents common equity and 15% represents preferred, face an indicative after-tax cost of capital of about 11.55%. The chart below highlights the cost of capital advantage that may accrue to small BHCs through the Policy Statement. Over time, reducing the cost of capital should bolster valuations for smaller BHCs.

Hypothetical Weighted Average Cost of Capital Calculation

	Permitted Amount	BTX Cost of Capital	ATX Cost of Capital @ 40%	Weighted Average Cost of Capital
100% Equity Funded				
Equity	100%	12.00%	12.00%	12.00%
				12.00%
85% Equity Funded	Permitted Amount	BTX Cost of Capital	ATX Cost of Capital @ 40%	Weighted Average Cost of Capital
Equity	85%	12.00%	12.00%	10.20%
Non-Cum Perp. Preferred	15%	9.00%	9.00%	1.35%
				11.55%
Small BHC 25% Equity Funded	Permitted Amount	BTX Cost of Capital	ATX Cost of Capital @ 40%	Weighted Average Cost of Capital
Equity	25%	12.00%	12.00%	3.00%
Non-Cum Perp. Preferred		9.00%	9.00%	0.00%
TPS		8.00%	4.80%	0.00%
Senior Debt	75%	7.00%	4.20%	3.15%
				6.15%

> 50% Reduction in ATX Cost of Capital

- **Increase "Bail-in" Debt**: Senior or subordinated BHC debt invested as equity capital in a wholly-owned banking subsidiary acts as de facto bail-in debt that is available to absorb losses at the bank level and avoid losses by the FDIC.[3]

INVESTMENT STRATEGY

- **Optimize Investment Ownership:** Certain assets, such as investments in other financial institution capital instruments or non-agency securitizations with high SSFA or Gross Up risk weightings, may offer an attractive risk/return profile to a bank but face capital deductions or punitive risk weighting

[3] Bail-in debt is referred to in Title II of the Dodd Frank Act whereby a single point of entry is established for the resolution of systemically important banking institutions. In this context, upon the failure of the institution, bail-in debt from the BHC is converted into capital to support the bridge bank in the orderly resolution of the failed bank. While small BHC's with less than $1 billion in assets would certainly not be considered systemically important, the Policy Statement in essence encourages greater use of debt by small BHCs which if invested as capital in the bank would ultimately provide additional cushion against losses.

based on Basel III rules.[4] Such investments may be better placed at the BHC level without Basel III penalties. It should be noted that intercompany transactions between affiliates are subject to 23A and 23B restrictions. These restrictions limit the aggregate amount of covered transactions to 10% or less of the capital stock and surplus of the individual bank or 20% of all banks. In addition, the transfer has to be done at fair market value on terms and conditions that are consistent with safe and sound banking practices.

When implemented in May 2015, the Small Bank Holding Company Policy Statement will provide substantial financial flexibility for bank and savings and loan holding companies with less than $1 billion in assets to add BHC level debt that can bolster capital levels, facilitate funding of M&A and strategic transactions, and lower the cost of capital for small BHCs. In addition, small BHC's can optimize Basel III bank level risk weighting and capital deductions by moving assets between the bank and BHC as consistent with 23A and 23B restrictions. We think the Policy Statement will also encourage banks and savings institutions, including sub-S banks, without holding companies to amend their organizational structure to add a holding company to benefit from the ability to bolster their capital structure with senior or subordinated BHC debt.

[4] SSFA is the abbreviation for Simplified Supervisory Formula Approach for risk weighting applicable to non-agency securitizations for U.S. banking organizations. The SSFA approach uses the risk weighting of the underlying asset collateral, delinquency of the collateral, attachment and detachment points of support tranches among other factors in determining the appropriate risk weighting for a non-agency securitization. The Gross Up method is a much simpler approach to risk weighting that factors in underlying collateral risk weighting and the size of the senior tranches, if any, which the investment supports.

__Thomas W. Killian__ is a Principal of Sandler O'Neill + Partners, L.P. His 36-year career in commercial and investment banking includes seven years of commercial banking experience with NationsBank, structuring and arranging leveraged finance transactions; two years with Salomon Brothers, transacting capital markets and advisory assignments for a variety of major corporations; five years with J.P. Morgan, managing financial advisory and capital raising activities for banks and thrifts in the Western region of the United States; and 22 years with Sandler O'Neill, advising banks, thrifts, and insurance companies on a variety of capital markets, strategic advisory and M&A assignments.

At Sandler O'Neill, Mr. Killian has managed the successful execution of 13 M&A transactions representing over $2.4 billion in deal value and $8.5 billion of capital raising transactions. Most recently, he advised the FDIC on the successful least cost resolution of Doral Bank using a multiple acquirer strategy. He has co-managed the Sandler O'Neill team responsible for successfully completing 17 pooled trust preferred transactions that raised over $7 billion for approximately 650 financial institutions. Included in Mr. Killian's capital raising transactions are eight recapitalization and restructuring transactions that involved complex capital structures designed to preserve tax benefits for the issuing institutions. He functions as a primary resource in structuring and implementing complex capital markets transactions for financial institutions.

Mr. Killian holds a Bachelor of Science from the University of North Carolina at Chapel Hill, where he was a John Motley Morehead Merit Scholar, and a Masters in Business Administration from Northwestern University's J.L. Kellogg Graduate School of Management. He has represented Sandler O'Neill in conferences with the Federal Financial Institutions Examination Council, the Federal Reserve, the Federal Deposit Insurance Corporation, and SNL Financial to discuss capital structure, Dodd-Frank and Basel III related issues. His articles have appeared in Bank Accounting & Finance, U.S. Banker and Modern Bankers, a publication of the Peoples Bank of China.

Mr. Killian is also a founding board member of Students Bridging the Information Gap, a 501(c)(3) charity that provides computers, books and other support to African schools and orphanages.

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