FINANCIAL REGULATION

Bloomberg BRIEF

COMMUNITY BANKING & CREDIT UNIONS

Special Edition June 2014

BY THE NUMBERS

COMPILED BY EMIL EFTHIMIDES, BLOOMBERG DATA

	2008	2013
Number of Community Banks	8,170	6,550
Amount of Community Bank Assets	$3.02 trillion	$2.8 trillion
Average Amount of Community Bank Loans	$256.9 million	$427.3 million
Share of U.S. Banking Assets Held by Community Banks	21 percent	18 percent
Total Community Bank Profit	$236.6 million	$28.8 billion
Percent of Community Banks That Reported at Least One Quarterly Loss	43 percent	20 percent
Percent of Community Banks That Raised Capital	67 percent	51 percent
Number of Community Bank Failures	19	24
Number of Community Bank Charters Issued	97	2
Number of Community Bank Mergers	285	230
Number of Credit Unions	7,968	6,687
Amount of Credit Union Assets	$824 billion	$1.08 trillion
Credit Union Asset Growth	7.43 percent	3.93 percent
Credit Union Membership Growth	2.02 percent	2.61 percent
Total Credit Union Net Worth	$88.95 billion	$114.49 billion
Total Credit Union Loans	$566 billion	$645.22 billion
Credit Union Loan Growth	7.08 percent	7.98 percent
Total Credit Union Shares and Deposits	$681.13 billion	$910.09 billion

Sources: *FDIC, NCUA, Bloomberg LP*

INTRODUCTION

MELISSA KARSH, BLOOMBERG BRIEF

Welcome to Bloomberg Brief: Financial Regulation's special edition on the impact of post-crisis reforms on credit unions and community banks — defined in this issue as those with less than $10 billion in assets — in the U.S.

Bank failures spiked after the 2008 financial crisis and community banks and credit unions are still recovering, as new bank charters have not yet picked up. Credit unions have also continued to consolidate since 2008, Bloomberg data show.

This supplement sheds light on the current state of regulations impacting the more than 6,000 commercial banks and savings institutions with fewer than $10 billion in assets and the close to 7,000 state and federally chartered credit unions. In 2014, these companies continued to face compliance challenges, Volcker Rule requirements, derivatives rules, credit rating alternatives, stress testing guidelines, housing reforms and capital regulations.

As many struggle to adapt to regulators' overhaul of financial supervision under the Dodd-Frank Act, Federal Reserve Chairman Janet Yellen addressed community bank regulatory concerns at a conference in May. Yellen said the Fed would tailor its supervision of community banks to reduce their regulatory burden, and that small lenders shouldn't face the same sort of oversight as the biggest financial firms.

"A one-size-fits-all approach to supervision is often not appropriate," she said at the Independent Community Bankers of America conference.

In this issue, U.S. Comptroller of the Currency **Thomas J. Curry** says the key for risk management at community banks is to make sure it's appropriate. Democratic Senator **Sherrod Brown** says regulation is about leveling the playing field. The Federal Reserve Bank of Minneapolis' **Ron J. Feldman** says rising supervision and regulation costs are expected to hit smaller banks hardest. National Credit Union Administration Chairman **Debbie Matz** discusses the regulator's risk-based capital rule for credit unions.

CONTENTS

Bloomberg Brief Financial Regulation

Bloomberg Brief Executive Editor *Ted Merz, tmerz@bloomberg.net, +1-212-617-2309*

Bloomberg Brief Managing Editor *Jennifer Rossa, jrossa@bloomberg.net, +1-212-617-8074*

Bloomberg News Managing Editor *Otis Bilodeau, obilodeau@bloomberg.net, +1-212-617-3921*

Financial Regulation Editor *Melissa Karsh, mkarsh@bloomberg.net, +1-212-617-4557*

Newsletter Business Manager *Nick Ferris, nferris2@bloomberg.net, +1-212-617-6975*

Contributors
Adam Litke, alitke2@bloomberg.net, +1-212-617-1716
Cady North, cnorth5@bloomberg.net, +1-202-416-3414
Melissa Avstreih, mavstreih@bloomberg.net, +1-202-654-4390
Lili Cai, lcai10@bloomberg.net, +1-212-617-9117
Mary Ann Thomas, mthomas172@bloomberg.net, +1-212-617-2517
Emil Efthimides, eefthimides@bloomberg.net, +1-609-279-3652
Kim Chipman, kchipman@bloomberg.net, +1-312-443-5978

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REGULATORY CHANGES IN 2014

ANALYSIS BY CADY NORTH, BLOOMBERG GOVERNMENT

Community Banks, Credit Unions Face Rules on Stress Testing, Capital This Year

Community banks face a great deal of regulatory action this year as post-crisis rule implementation, aimed at making the financial system safer, continues. Rules on stress testing and credit ratings under the Dodd-Frank Act and Basel III's capital standards are still being implemented, while the Volcker Rule, which bans banks' proprietary trading, means new reporting challenges. Community banks and credit unions also face compliance challenges due to their size. As a result of new reforms, they've had to increase staff and the amount of time spent on compliance. Community banks say they're now more reliant on outside consultants and third parties for regulatory solutions, stress test models and updating these models at a fast enough pace to meet the new regulations.

Volcker Rule

The Volcker Rule is one area where there could be significant costs for community banks if they engage in trading activity that isn't exempted by the rule. Collateralized debt obligations won an exemption and banks were given more time to divest collateralized loan obligations. Other exempted assets include U.S. Treasuries, government-sponsored enterprise (GSE) agency obligations and municipal obligations.

To the extent that community banks engage in any of the un-exempted activities — such as using trading activities to manage liquidity — they will have to comply with new reporting requirements, including adopting a liquidity management plan, beginning in July 2015. If a community bank engages in any exempted activities under the rule, documenting existing risk management policies will suffice.

Derivatives

The Commodity Futures Trading Commission also created exemptions for banks with $10 billion or less in assets, from mandatory derivatives clearing requirements. There are still some additional recordkeeping and risk management practices with which all entities will have to comply.

One area to watch is the CFTC's reauthorization legislation, currently being debated in Congress. There have been efforts to change the applicability of the rules to end users and community banks.

Basel Capital Standards

For the first time, community banks will have to calculate risk-weighted assets and comply with Basel III capital requirements starting in January 2015.

Certain types of activities will be exempted, including banks with less than $15 billion in assets being able to count trust preferred securities as Tier 1 capital and the continuance of a 50 percent risk weight for residential mortgages. Community banks can make a one-time election to filter out accumulated other comprehensive income, or AOCI, as long as they make that election before the first filing, and unlike larger banks, they don't have a supplementary leverage ratio requirement.

There's still time through January to work out what these changes mean for community banks, and banking regulators are trying to provide as many resources as they can leading up to that point.

Separately, the National Credit Union Administration is working on risk-based capital requirements for credit unions with assets of more than $50 million. The proposal includes a higher base ratio at 10.5 percent than the banking regulators' plans to avoid the complexity of implementing an additional capital buffer. According to the proposal, with 92 percent of credit unions already well-capitalized, the rule would impact about 200 institutions.

Comments on the requirements, which are expected to be phased in over time, were due at the end of May. Many credit unions and industry groups have spent time talking to regulators and legislators on Capitol Hill about this rule to reduce the requirements and ease compliance burdens.

Stress Testing

Another big issue on the agenda for this year is the concept of stress testing, which is becoming a favored risk management tool for regulators. Since the crisis, the tool has been used on the largest banks. Now regulators want to see bank-run scenarios at regular intervals as part of examinations even for smaller institutions.

The Office of the Comptroller of the Currency issued stress test guidelines for banks with $10 billion or less. While not as strict as methods prescribed for larger banks, the OCC did recommend stress testing to a high degree of granularity, including evaluating specific loan balances and the impact on portfolios and the entire enterprise.

The NCUA also plans to conduct stress tests on credit unions with $10 billion or more in assets and has a rule in the works.

There may be significant costs involved with the stress tests, according to some of the mid-sized banks, which say they are spending as much as $1 million on systems and model validation for stress tests.

Credit Ratings

Community banks face new rules related to credit ratings and evaluating securities purchases.

The OCC has mandated the use of credit rating alternatives to value instruments. The guidance includes a matrix of key factors each bank must consider depending on the type of security. Community banks will have to determine independently the default risk and creditworthiness of the issuer. While credit ratings can be used, they must be supplemented with the bank's own due diligence. As a result, banks are evaluating third party solutions.

Similarly, the NCUA released guidance on confirming default risk and creditworthiness. The NCUA said management must confirm the independence and reliability of the third parties used in the credit assessment.

The Securities and Exchange Commission is also separately working on rules to change ratings agencies' methodologies and address some of the conflicts of interest. It's been difficult for the SEC to find consensus on this issue, resulting in rule delays.

Housing

Community banks have been concerned with GSE reform and what is going to happen with bills to dismantle Fannie Mae and Freddie Mac.

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REGULATORY CHANGES IN 2014...

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Recent developments in the Senate Banking Committee, which set aside discussion on GSE housing reform bill for the time being, signal that passage this year is probably not likely. The Consumer Financial Protection Bureau has completed more rules on housing reform, putting in place new mortgage rules in early 2014, including new disclosure forms and underwriting standards established through the qualified mortgage (QM) rule.

Bank regulators are working on an upcoming final rule requiring 5 percent credit risk retention for securitizations across the board, though mortgage securitizations will be the most impacted. At the bank holding company level, the rule's impact may be small.

This rule has languished because of lingering concerns that the supply of funding to commercial real estate may be adversely affected as banks apply the retention rule in full to their commercial mortgage-backed securities (CMBS) issuing desks. The current version looks more like the QM rule, which provides underwriting standards, instead of requiring a particular type of mortgage implementing down payment minimums.

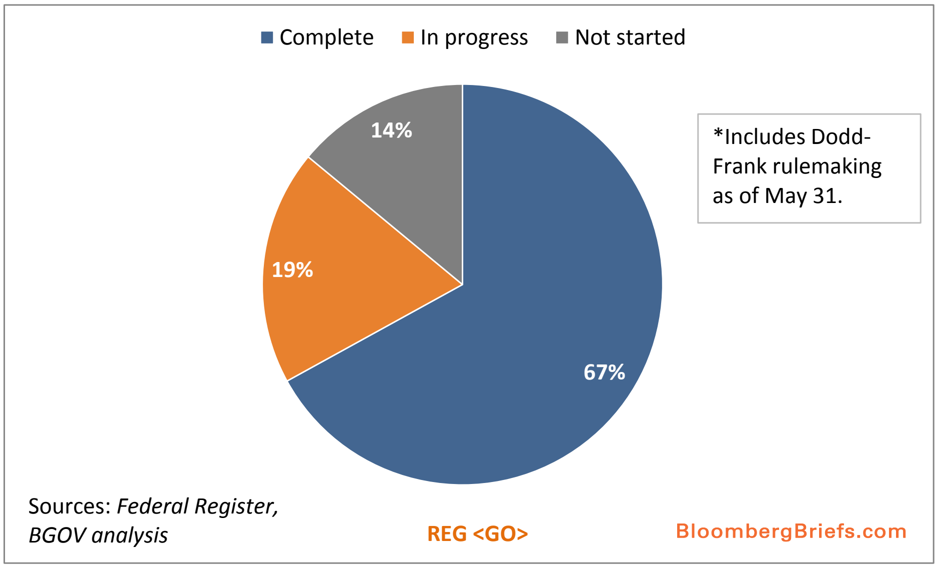
Too-Big-to-Fail

Community banking groups are also continuing to push for proposals that address too-big-to-fail (TBTF) funding advantages, such as the Brown-Vitter bill, which would impose a 15 percent capital requirement for the largest banks under the theory that Dodd-Frank doesn't prevent future bailouts.

While most TBTF proposals won't become law, hearings on Capitol Hill continue to fuel debate and headlines on the issue.

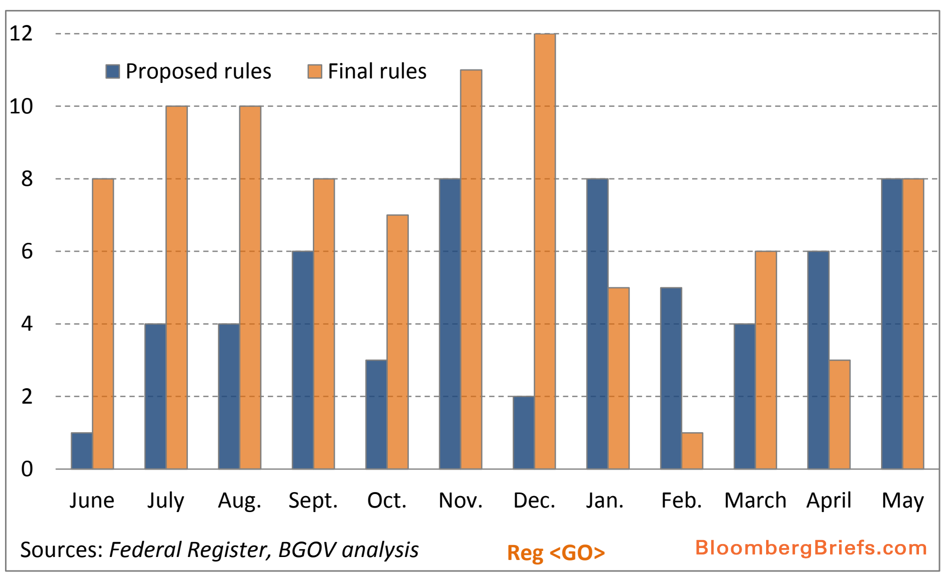
Cady North is a senior finance policy analyst with Bloomberg Government.

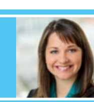
About a Third of Dodd-Frank Rules Are Incomplete After Four Years



More than five years after the financial crisis and nearly four years after Dodd-Frank became law, about 33 percent of the rules are still being written or haven't been proposed. Final rules expected for risk retention, ratings agencies and stress tests for credit unions will affect the community banking and credit union sector.

Dodd-Frank Rulemaking Continued to Increase in May





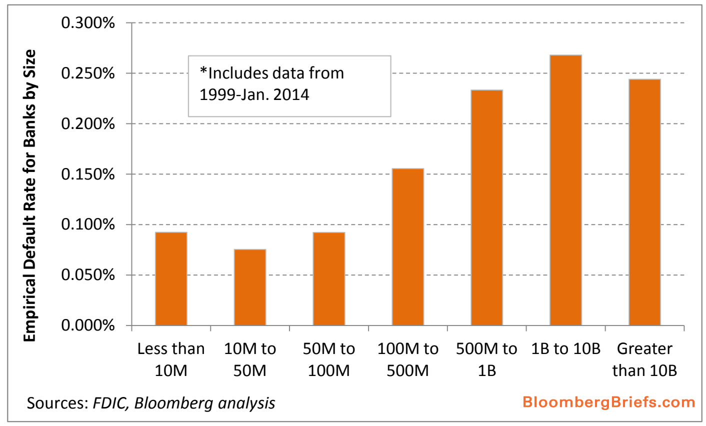
DEFAULT PROBABILITY

LILI CAI, QUANT RESEARCHER AT BLOOMBERG LP

Smaller Banks Have a Historically Lower Default Rate Than Larger Banks

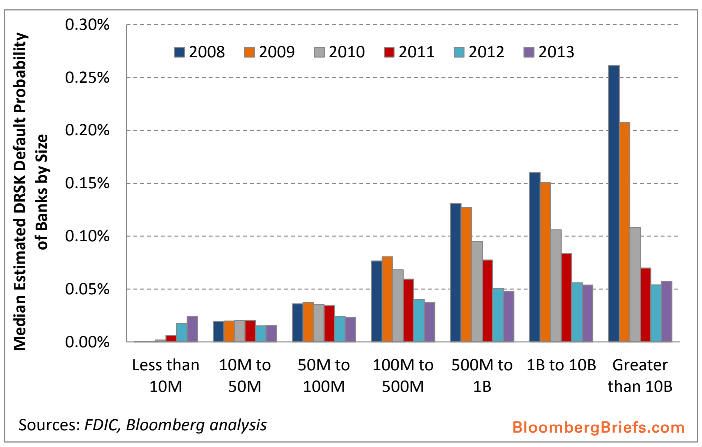
The default rate of small banks is significantly lower than the default rate of larger banks, according to Bloomberg DRSK analysis that looked at private bank defaults from 1999 to January 2014. However, while small banks — or those with less than $10 million in assets — have some of the lowest default rates in the industry, small banks' median and average default probability is actually on the rise, albeit from a very low level, the data show. The Private Default Risk (DRSK) analysis provides an independent evaluation of private company credit health by combining fundamental data, industry risk, market sentiment and business cycles in a quantitative model calibrated to Bloomberg's private default database.

Banks With $1B-$10B Have Highest Default Rate



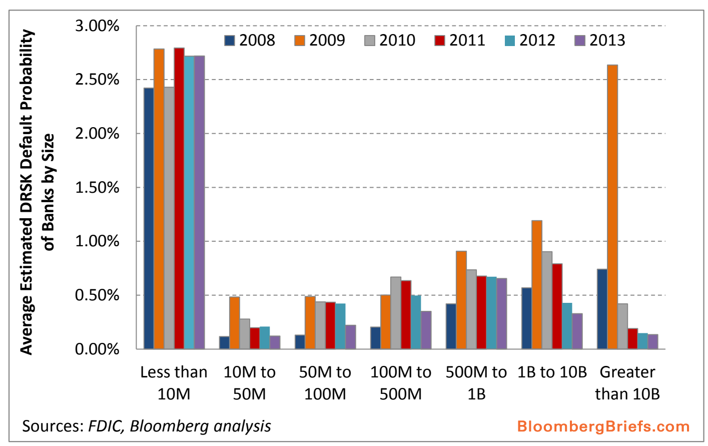
The highest historical rate of default is seen with banks in the $1 billion to $10 billion asset range, according to Bloomberg analysis. Small banks have some of the lowest rates of default compared to larger institutions.

Median Default Probability Up for Smallest Banks



Small banks' median estimated DRSK default probability is much lower than that of large banks, though it has increased in recent years. At the same time, large banks' median default rates have started to ebb, Bloomberg analysis shows.

Average Default Probability Down From '09 Peak



The average — rather than median — estimated DRSK default probability for banks with less than 10 million in assets was very high from 2008 to 2013, matching that of the largest banks in 2009, according to Bloomberg analysis. This is due to outliers in a small sample size. Overall, the private banking industry's average default probability is on the decline.

Q & A: RISK MANAGEMENT

OCC's Curry Says Banks Don't Need a 'Rolls-Royce' for Appropriate Risk Management

U.S. Comptroller of the Currency **Thomas J. Curry** told Bloomberg's Melissa Karsh that one size doesn't fit all when it comes to risk management at community banks. Curry said he's seen some inadequate third-party provider oversight, especially in the area of technology, and stressed the importance of paying attention to these relationships, which if unmonitored could adversely impact information systems, security or bank reputation.

Q: What role did community bank risk management play during the crisis?

A: That plays a central role in the supervision of community banks in general. Those institutions that had sound risk management and risk management structures in place are the ones that were able to survive and thrive from the crisis. That's where our focus is. We're really the boots on the ground supervisor and, while capital is extremely important as a cushion against loss and adequate reserves as well, it's the risk management culture and practices at an institution that keep it all together and make it successful.

Q: How has this evolved over time?

A: The whole concept of risk management is evolving. One of the byproducts of any financial crisis is you pay more attention to lessons learned. Being a supervisor of almost 2,000 banks — many of which are community banks — we have a good vantage point to see which bank's practices were successful and that's really part of our booklet on community banks. That was an attempt to see what factors utilized by banks led to their success and ability to withstand the crisis. One of the advantages we have is we see such a wide universe of practices, from very small institutions to significant community bank organizations to mid-size or regional institutions and larger institutions. What we think we're able to do here in our policy and supervisory shop is to take those proven concepts and tailor them to the particular institutions that we supervise. We don't believe that one size fits all. We do think you can glean appropriate general theories and practices and tailor them to a specific institution.

Q: What's the difference between risk management at community banks versus larger banks?

A: There are different risks that you're trying to assess, manage and monitor. That's not getting at in terms of those basic principles of sound risk management — that you have proper risk identification, prudent risk limits that are clearly articulated throughout the bank and effective risk monitoring. You don't need to have a Rolls-Royce for every institution. It should be the bank management and board looking to see what's appropriate, given the business strategy and risk of the institution. The key for community banks is making sure it's appropriate.

Q: What types of emerging risks are you keeping an eye on?

A: I go back to learning from our experiences as a supervisor. For the last several years we've been publishing the semi-annual risk perspective every six months, which I'm very proud of. It's split into two parts and we have a section that focuses on emerging risks for community banks. We're trying to be more transparent and let community banks understand where we think emerging risks are developing. That's to signal to community bank management boards the areas that we think they should pay attention to. It's also areas where we will be focusing our supervisory or examination resources, on a going forward basis. We've also tried to be a leader in the development of sound supervisory policies. We focus on operational risk as the big umbrella, cyber threats fall under that and last October we issued third-party vendor guidance. All of those are related. It's where we see the critical areas that bank management boards need to pay attention to, especially critical service providers. From a risk management standpoint, that's where the significant impacts are to community banks. What gets overlooked is that we're in these banks, we visit, we have people who are familiar with local economic conditions, they're in a position to communicate informally some of the insight that we've garnered as a national organization.

Q: What role do third parties play?

A: That's an important risk area so the appropriate or commensurate level of attention should be paid to those relationships. Third-party providers have been an important means for community banks to offer additional products and to keep pace with technological change. That doesn't mean that there aren't some potential downsides that they have to be aware of, mitigate and monitor. That's really the purpose of the third-party vendor guidance. We highlighted that they need to manage them very closely because they could have an adverse impact on information systems, security or on the reputation of the institution.

continued on next page

AT A GLANCE

Hometown/Residence: Boston

Education: Manhattan College graduate (summa cum laude), where he was elected to Phi Betta Kappa; Law degree from New England School of Law.

Professional Background: Served as a director of the Federal Deposit Insurance Corp. and as chair of the NeighborWorks America Board of Directors; Served five Massachusetts governors as the Commonwealth's Commissioner of Banks. Served as Acting Commissioner from Feb. 1994 to June 1995.

Favorite restaurant: Regina's in the North End of Boston

Mentor: Family/siblings/parents

Favorite vacation spot: New England

Charitable giving: Combined Federal Campaign, Church

Q&A: RISK MANAGEMENT…

continued from previous page

Q: Have there been instances of third parties having an adverse impact?

A: Broadly speaking, this is throughout the OCC system of national banks and federal thrifts where there's been significant operational breakdowns, there has been some tie-in to either lax or inadequate oversight of third-party vendors, whether it's products that are being sold to customers at the bank and things like that. Again, it's particularly acute in the technology area where most community banks do rely on technology service providers for core banking and other information services. Because it's core, we are emphasizing the need to have commensurate oversight.

Q: The Federal Financial Institutions Examination Council (FFIEC), which you also chair, recently issued guidance on cyber security — a topic also on the radar for community banks. How do these relate across agencies?

A: This is an issue that cuts across all institutions. The consensus at the FFIEC was that it would be appropriate to pay particular attention to community institutions and that includes state and federally chartered banks and credit unions. We saw the opportunity to assist community banks in their ability to respond to the potential for cyber threats, whether they're from fraudsters or a terrorist-related threat. We want to increase awareness, to take a close look at our own examination supervisory policies and procedures and to make sure on an interagency and federal banking agency basis that we're appropriately monitoring the significant technology service providers, from a supervisory standpoint.

Q: What's the best way for community banks to work with the OCC on some of these issues?

A: It gets lost sometimes, especially when you're coming out of an adverse economic cycle, that there's a unique relationship between an institution and its supervisor. We have examiners throughout the country that know both the communities and the economies that our community banks are operating in. But we also have the advantage of being a national organization and having very talented people on the ground, in our field and district offices and headquarters here in Washington. Those operate as resources to banks that have questions. We're more than happy to help. Our examiners travel bank to bank so they are in a position to see what the best practice is in a particular area. That's one of the unsung byproducts of supervision and gets shared on a banker to examiner basis on the ground during examination. We need to do a better job at the government, especially when we're proposing new rules or adopting new rules, to help community banks understand what the requirements are and to focus their attention so we get meaningful comments and a rule that works at the end of the day or works as best it can under the statutory framework. That's really what drove us in some of the more recent rules to have prepared community bank summaries. We did that two-page summary of the capital rule about community banks. We do it now for all of our communications out of Washington — whether it's a policy document or not — we have a box that says whether this particular pronouncement applies or not to a community bank and if it does we have bullets as to what the key or salient features are. So if we all understand the rules and they are clearly communicated, it's easier for everybody, both the community bank and our supervisors.

"We want to increase awareness, to take a close look at our own examination supervisory policies and procedures and to make sure on an interagency basis that we're appropriately monitoring the significant technology service providers."

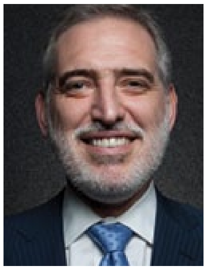
Q: Are you planning any other specific guidelines for community banks?

A: Probably the most important thing that we're doing is that semi-annual risk perspective, which is expected this month. I'm a firm believer about being transparent about what we think the issues are. What we're going to focus on is critically important to institutions — one to help focus them on assessing the risks that apply to them, which are somewhat unique, and to have fewer surprises in the examination and supervisory context.

RISK INSIGHT

COMMENTARY BY ADAM LITKE, HEAD OF RISK STRATEGY AT BLOOMBERG LP

Community Banks Face Rule Compliance Challenges, Financial and Technology Risks



Adam Litke, head of risk strategy at Bloomberg LP, says community banks, which are exempt from most of the new Dodd-Frank capital rules, still face major challenges, including complying with consumer protection rules and financial and technology risks that may impact performance.

Community banks are the smallest yet most numerous entities in the U.S. banking system. They are dwarfed by behemoths such as Bank of America Corp., Wells Fargo & Co. and JPMorgan Chase & Co. which are more than 1,000 times as large. What they lack in size they make up for in numbers. Statistically this presents a conundrum. They make up 94 percent of all banking institutions in the U.S., while controlling only 14 percent of assets, according to the Federal Deposit Insurance Corp. At the same time, they make 46 percent of small loans to farms and businesses.[1] This leaves them in a very strange position; they are small yet they are very important politically and play an influential role in important segments of the economy. Despite being exempt from most of the new capital rules under the Dodd Frank Act, they still face a substantial challenge. There are three key areas that will significantly impact their performance over the next few years.

Compliance

Unlike other parts of Dodd-Frank, consumer protection rules apply to all banks regardless of size since they are about the customer and not about safety and soundness. Nonetheless, these rules can have a perverse effect on small banks. The Federal Reserve Bank of Minneapolis [2] provides some interesting data on compliance costs and their effect on profitability. This data shows that smaller banks, particularly those under $100 million of assets and 20 employees (there are 2,000 banks in this cohort), will show a large change in return on assets due to hiring. Adding just one typical employee for compliance can lower return on assets by as much as 23 basis points. Larger banks have much better economies of scale and the drag on profit will be much smaller as a percentage of earnings. (See related story, page 11).

Three Major Financial Risks

The current low interest rate environment poses somewhat unique risks for community banks. Since the financial crisis these banks have moved large portions of their portfolios into municipal bonds.[3] This poses three types of risk: interest-rate risk, credit risk and liquidity risk.

First, municipal bonds tend to be fixed-rate securities. This means that the banks are much more exposed to a rising rate environment than they would be in more typical lending activity. Also, unlike larger banks, most community banks do not participate in the derivatives market and are not equipped to manage their interest-rate risk off-balance sheet. Second, municipal bond holdings expose banks to significantly more concentrated credit risk than they have in their more diversified lending books. This is particularly true in states where municipalities have significant pension liabilities that may impact their ability to pay. In addition, what community banks are known for is the supposed ability to know their customer. These banks have no such edge in evaluating municipal credits and, in fact, may be at a structural disadvantage due to their relatively small staffs.

The third and most difficult risk to quantify is liquidity risk. As we saw in the financial crisis, muni bonds can become very illiquid very fast. This is not a huge problem when comparing them to held-to-maturity loans, although they do take longer to roll off the books. On the other hand, if they are taking up the same space on the balance sheet that is usually taken by Treasuries, then the liquidity coverage ratio of the bank will be severely impacted. This makes a bank with large muni holdings much more likely to rely on the Fed's discount window in order to stay solvent in a crisis. We have to make this assumption as if the banks are simply taking deposits and purchasing a mixed portfolio of Treasuries and municipal bonds. If this is true then they would cease to serve their stated social purpose of providing lending in the local business market.

Technology Risk

The final area where community banks are exposed in an outsized way is technology risk. Large banks have large IT security staffs that are constantly on guard against outside attacks. Despite this, they often suffer denial of service events and are exposed to the constant threat of a major data breach. Community banks that want to move into various forms of electronic banking are exposed to the same type of attacks. While a community bank is a small target and therefore is not likely to pose any sort of systematic risk, it also has many fewer resources at its disposal to protect itself. It is hard to imagine a bank with fewer than 100 employees that has one team of people implementing software and another team trying to break it. They simply can't afford the personnel.

Size Matters

Community banks provide an important service to the U.S. economy that would not be easily replaced by larger institutions. At the same time, their small size means they pose less risk to the financial system and can be more lightly regulated. On the other hand, the exigencies of the modern world mean that they are still exposed to an increasing regulatory burden. Even if they don't have all of the expenses of a large bank, they may still have larger expenses when measured as a percentage of assets. It remains to be seen whether we can find a balance that allows these institutions to thrive, or if they will fade away under a burden of ever larger costs.

[1] *FDIC Community Banking Study, 2012, http://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf*
[2] *https://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=5102&*
[3] *http://www.stlouisfed.org/publications/cb/articles/?id=2447*

QUANTIFYING REGULATION

GUEST COMMENTARY BY RON J. FELDMAN, MINNEAPOLIS FED

Small Banks Hit Hardest by Rising Supervision, Regulation Costs: Minneapolis Fed V.P.

Ron J. Feldman, executive vice president of the Federal Reserve Bank of Minneapolis, says increases in the cost of bank supervision and regulation will have the largest effect on banks with assets under $50 million, though there's no accelerated rate of consolidation due to the higher costs.

Many community bankers worry that increases in the cost of banking supervision and regulation (S/R) will lead more community banks to merge or otherwise cease to exist. The Federal Reserve Bank of Minneapolis has developed an approach to quantifying the cost of increased S/R on banks. We also measured the rate of community bank consolidation.

We found that:

- increases in the cost of S/R should have the largest effect on the smallest banks, those with assets under $50 million, with much smaller effects on larger banks; however,
- there is no accelerated rate of decline among community banks, with consolidation rates consistent with historical patterns.

Costs of S/R

No broad or robust data exist on the cost of S/R. We know that the level of S/R has increased after the financial crisis and that this should raise costs for banks. We do not know how much costs have risen.

We try to put a number on this cost through the following approach. We measure the cost of regulation by assuming that it manifests itself as new staff. We then determine how those increases in staff would reduce bank earnings. Of course, banks respond to more S/R in many ways and not necessarily through the hiring of staff. But it seems very likely that meaningful responses to more S/R show up as lower earnings, either because they require higher expenses or lead to lower revenue. So our method is a useful framework to quantify the costs of increased S/R, regardless of hiring.

We do not have data on the number of staff that banks have hired in response to increased S/R. As a result, we must make assumptions on both new hires and salary. More generally, given this uncertainty, we provide a "regulatory cost calculator" that allows users to put in their own assumptions (the calculator and related analysis can be found at *www.minneapolisfed.org/banking/data/regcostcalc/index.cfm).*

We do run a representative case of increased hiring due to S/R informing our assumptions with existing research. Under this case, the hit to earnings is twice as large for banks with assets of $50 million relative to other asset groups. Earnings at the median small bank fall by 23 basis points, or by about one-third. About 15 percent of these smallest banks would move from profitable to unprofitable under our assumptions regarding regulatory costs. By way of context, there were roughly 1,000 banks with assets under $50 million at the time of our analysis.

Our results reflect the intuition that larger banks can comply with increased S/R costs more easily than smaller banks. Hiring one-half or one person is a relatively big hit to earnings for banks with assets less than $50 million even relative to a bank with assets of $100 million.

Fall in the Number of Community Banks

The number of community banks has been falling for some time. Higher costs of S/R should reasonably lead to a faster fall in the number of community banks than would otherwise occur. Put another way, we should expect to see a change in historical patterns if, all else equal, increases in the cost of S/R lead more banks to leave the business, most typically through merger or acquisition.

To determine if faster consolidation is occurring, we estimate the amount of decline we would expect among community banks based on historical patterns. We made such estimates as of mid-2013 for mid-2014 and have updated them each quarter. We then compare the actual amount of consolidation with the estimated amount. We make these comparisons for the nation and for all the states located in the Ninth Federal Reserve District. We also use different estimating models.

So far, we have found that the rate of consolidation is consistent with historical patterns, both for the nation and for the Ninth District states. The higher costs of S/R noted above have not been associated with higher than expected rates of decline in the number of community banks. (Our analysis of consolidation can be found at *www.minneapolisfed.org/banking/data/consolidation/index.cfm).*

Important But Uncertain Issues

We undertook this analysis to further quantify these important community bank issues. Community banks provide services, such as lending to small firms, that are not always easily replaced. Raising the costs of providing these services might diminish the amount of services provided. The consolidation of community banks might also diminish the availability of these services. These issues therefore deserve meaningful attention; our analysis is meant to inform this debate.

Of course, our analysis has limitations. We cannot directly observe either the costs of S/R or how many community banks would exit absent that increase. Therefore, we rely on indirect observations and assumptions. That said, our work suggests that increased S/R will hit the smallest banks the hardest. While one would expect higher costs to lead to higher than normal consolidation, the rate of consolidation to date has been consistent with historical patterns.

Ron J. Feldman is executive vice president and senior policy adviser at the Federal Reserve Bank of Minneapolis. The views expressed here are those of the author and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System. Underlying work is referenced at minneapolisfed.org/banking/community bank/.

BLOOMBERG SOLUTIONS

CREDIT/COLLATERAL ANALYSIS

MUNI FA <GO> Financial analysis for municipal securities provides comprehensive financial information including historical fundamental data and financial statements.

In Millions of USD except Per Share	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
12 Months Ending	2008-06-30	2009-06-30	2010-06-30	2011-06-30	2012-06-30	2013-06-30
Accounting Standard	US MUNI	US MUNI	US MUNI	US MUNI	US MUNI	US MUNI
Statement of Activities (Income S...						
Total Revenues	4,283.6	4,331.5	4,185.4	4,179.3	4,317.3	4,521.0
Total Operating Expenses	4,157.5	4,249.9	4,145.7	3,913.0	4,053.3	4,155.5
Excess (Deficiency) of Revenues ...	126.1	81.7	39.7	266.2	264.1	365.5
Total Other Financing Sources & U...	-236.2	-195.7	-85.1	-182.7	-215.7	-212.6
Net Change in Fund Balances	-110.1	-114.0	-45.3	83.6	48.4	152.9
Fund Balances Beginning	707.9	597.9	483.5	437.2	520.1	571.7
Fund Balances Ending	597.9	483.5	437.2	520.1	571.7	722.6
Statement of Net Assets (Balance ...						
Cash & Near Cash	815.0	625.7	561.2	966.2	1,235.3	791.3
Total Assets	1,560.7	1,271.7	1,438.9	1,766.6	2,088.9	1,706.7
Accounts Payable	78.7	70.7	70.9	61.7	56.8	54.1
Total Liabilities	962.7	788.2	1,001.7	1,246.5	1,517.2	984.1
Reserved for Encumbrances	148.3	139.0	134.6	--	--	--
Reserved for Other	30.9	28.0	30.6	26.3	31.1	112.8
Unreserved General Fund	255.9	156.7	114.9	493.8	540.6	609.8
Total Fund Balances	597.9	483.5	437.2	520.1	571.7	722.6
Total Liabilities and Fund Balances	1,560.7	1,271.7	1,438.9	1,766.6	2,088.9	1,706.7

MTCL <GO> Mortgage collateral analysis determines relative prepayment risk of a mortgage bond compared to its benchmark collateral.

For more information, contact:

Mary Ann Thomas
Mortgage Markets & IR Derivatives Application Specialist
+1-212-617-2517
mthomas172@bloomberg.net

Jacob Kotlyar
Sales Representative
+1-212-617-6782
jkotlyar@bloomberg.net

Q & A: SENATE VIEW

Sen. Brown Urges a 'Level Playing Field' for Community Banks and Regulation

Senator **Sherrod Brown**, an Ohio Democrat, told Bloomberg's Melissa Karsh via e-mail that when it comes to community banks and regulation it's about leveling the playing field. The senior Senate Banking Committee member said ending the taxpayer-funded subsidy for the biggest banks will help community banks compete.

Q: What's your position on community banks and regulation?

A: I'm focused on ensuring that consumers and all financial institutions have access to a level playing field. Just 18 years ago, the six largest banks in the United States had assets equal to 18 percent of our gross domestic product. Today, the six largest banks have assets equal to 63 percent of our GDP. The largest six banks are twice as large as the next 50 largest, and the next 50 include a number of the large regional banks across the country.

The too-big-to-fail status of our nation's six-largest banks amounts to a taxpayer-funded advantage over mid-sized and community banks. Meanwhile, community banks — which haven't engaged in the risky practices of Wall Street — often face the same regulatory burdens that the nation's biggest banks do. So when it comes to community banks and regulation, it's about ensuring a level playing field.

Q: How would you lessen the regulatory burden on community banks?

A: Most everyone understands the important role that community banks play — from Fed Chair Janet Yellen to Consumer Financial Protection Bureau Director Rich Cordray. Sometimes small banks still get caught up in rules. For example, Senator Vitter and I would exempt community banks from the Basel 3 capital standards — they were meant for international bankers, not local ones. There are a number of common sense ways that we can do more to lessen the regulatory burden on community banks. That's why I'm working to advance efforts like my bipartisan Privacy Notice Modernization Act through the Senate. This bill, which I've worked on with my Kansas Republican Jerry Moran, will allow community banks to only send consumer privacy notices when the bank changes its policy. It's a burdensome requirement that is simply not serving consumers — and it will create significant savings for banks across the country. I'm hoping the legislation will come up for a vote and will be signed into law soon.

Q: What's the status of your bill on higher capital standards for big banks?

A: The common sense, bipartisan legislation, from myself and Sen. Vitter, will ensure that the biggest banks have enough shareholder equity to back up their sometimes risky practices so taxpayers don't have to. We're saying that the biggest banks should have equity levels that are the same as the biggest banks had back in the 1930s. This will prevent excessive leverage, which can be so seductive when the sun is shining, but as Lehman Brothers and Bear Stearns showed us, catastrophic when markets go south.

In 2010, I introduced legislation with Sen. Kaufman to limit the amount of non-deposit liabilities that any single institution could have relative to the entire U.S. economy. Two years after we received just 33 votes in the U.S. Senate, Governor Tarullo — in Fed speak — supported our approach. I plan to reintroduce this bill.

Q: Should it be the job of legislators or regulators to set capital standards?

A: While we're still building support for our bill in Congress, it is already influencing actions by regulators. In April, bank regulators finalized a new higher percent leverage ratio for the eight-largest banks — 50 percent higher than existing law — making the financial system more stable. This move was voluntary. That these regulators did this on their own says a lot about the persuasiveness of public opinion.

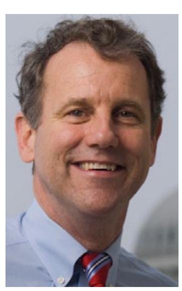
Q: So are these tougher rules leveling the playing field for community banks?

A: Studies estimate that megabanks have a 70-80 basis point funding advantage — a subsidy, provided by the expectation of taxpayer support, of up to tens of billions of dollars per year. Bloomberg has estimated that megabanks' funding advantage gives them a subsidy of up to $60 billion per year. And an IMF report found that government support lowers the funding costs for big banks by up to $70 billion per year. Senator Vitter and I requested that the Government Accountability Office look into the government's support of the megabanks. We expect results from the GAO in July to also confirm that the largest banks are able to borrow below-market interest rates. Ending the taxpayer-funded subsidy for the biggest banks will help community banks compete.

Q: Why is it important to limit the government "safety net" so that it covers only traditional banking operations?

A: I've heard from American manufacturers that banks' commodities trading might be driving up the price of energy and raw materials. Their involvement in the oil, energy, and metals markets, as well as their ownership of warehouses, tankers, and power plants, creates the potential for conflicts of interest and manipulation, and the threat of systemic risk.

AT A GLANCE



Mentor: My first and best mentor, my mom Emily Brown

Reading List: "Winesburg, Ohio" by Sherwood Anderson; "Team of Rivals" by Doris Kearns Goodwin; "And The Mountains Echoed" by Khaled Hosseini

If you could have another career: Center fielder for the Cleveland Indians

Charitable Giving: Mom's favorite charity, Bread for the World, dad's favorite charity, Heifer International, and Ohio food banks and free clinics

Favorite Vacation: Train trips out west to national parks and baseball stadiums when my daughters were growing up

Favorite Restaurant: Night Town in Cleveland **Hobbies**: Scrabble, baseball, reading and writing

COMPLIANCE BURDENS

GUEST COMMENTARY BY HESTER PEIRCE, MERCATUS CENTER

Dodd-Frank Changes Small Bank Interaction, Compliance Resources, Says Peirce

Hester Peirce, senior research fellow at the Mercatus Center at George Mason University, says following Dodd-Frank Act rules, community bankers are spending more time studying new reforms and guidance documents and less time interacting with customers.

The Consumer Financial Protection Bureau recently explained that "whatever the costs of regulation, the costs of not regulating adequately can be even larger." That throwaway line betrays the bureau's default position — more regulation is presumed to be better, and the burden of proof is on anyone who disagrees. The bureau's regulatory mindset might explain why a survey[1] conducted by my colleagues and me at the Mercatus Center at George Mason University found that fears about the CFPB are affecting the way small banks plan for the future.

To the CFPB's credit, the above-referenced statement was made in a report[2] looking at regulatory costs borne by financial institutions — a helpful contribution to the scant work on the costs of regulation to banks. The consumer agency conducted an in-depth study of compliance costs at seven banks, including four banks with less than $10 billion in assets. The goal of the study was to better understand ongoing compliance costs with respect to checking accounts, savings accounts, debit cards and overdraft programs.

One of the interesting findings of the study was that "the two smallest institutions had in-scope compliance costs of about 4 percent and 6 percent, respectively, of their estimated total retail deposit operating expense," compared to 1 percent to 2 percent for the five largest participants. In other words, regulations make life disproportionately hard for small banks. This is Jamie Dimon's regulatory "moat" of protection around large banks in action: regulations give large banks a leg up because compliance burdens fall more heavily on their smaller rivals.

The bureau rightly cautions that the study's very small sample size precludes generalization to the bank population as a whole. Nevertheless, the finding is consistent with prior work.

According to a Federal Reserve analysis[3] of empirical studies on bank regulatory costs, "average compliance costs for regulations are substantially greater for banks at low levels of output than for banks at moderate or high levels of output." As a result, regulatory costs "may inhibit the entry of new firms into banking or may stimulate consolidation of the industry into fewer, larger banks." The Federal Deposit Insurance Corp. has emphasized[4] that economies of scale are likely to affect the survival prospects of only the very smallest banks.

But even for those banks that can keep their doors open, regulations are increasingly determining how they operate and whom they serve. The Mercatus Center's survey of 200 small banks found that Dodd-Frank — despite its exemptions for small banks — is changing the way they interact with customers, the resources devoted to compliance, and the types of products and services they offer. Approximately 70 percent of respondents indicated that their business activities had been affected by the CFPB, and two-thirds have added compliance personnel specifically in response to the consumer agency.

Many surveyed banks reported that they are rethinking their provision of mortgages, overdraft protection, and remittance services. The bureau's study excluded the cost to banks of foregone products and services on the theory that "[w]hile opportunity costs represent a cost to the bank, such lost profits do not necessarily reflect a loss to society," since "it may be true that consumer benefits from avoiding those transactions are equal or greater than the loss in bank profits." Once again, the CFPB fails to give adequate weight to the fact that consumers lose out when banks cease serving businesses and individuals out of fear of tripping over ill-defined rules.

As one Mercatus Center survey respondent explained, the bureau's "misguided attempts to define basic products and services has caused us to hold off on updating current or introducing new products and services until they figure out [what] they are doing."

At particular risk are the bank customers that a big bank would not consider worth dealing with, either because the customer's needs are too small or her creditworthiness is ascertainable only from information outside of the standard metrics big banks review.

As an American Enterprise Institute study[5] on community banks explained, "small businesses and individuals who do not fit neatly into standardized financial modeling or who live outside of metropolitan areas" rely particularly heavily on small banks.

A banker told me recently that his son is in law school as preparation for following in his father's footsteps. Perhaps that is a sign of the times. Gone are the days when being a community banker was about figuring out how best to serve local businesses and consumers. Now bankers are spending less time interacting with customers and more studying new rules and guidance documents. Currently it is their job to convince the regulators not to add to the already towering pile of rules.

The process ought to work the other way around — regulators should be required to show that their planned initiatives will achieve the intended benefits without imposing costs that swallow up those benefits.

Hester Peirce is a senior research fellow focusing on the regulation of the financial markets at the Mercatus Center at George Mason University.

1 http://mercatus.org/publication/how-are-small-banks-faring-under-dodd-frank
2 http://files.consumerfinance.gov/f/201311_cfpb_report_findings-relative-costs.pdf
3 http://www.federalreserve.gov/pubs/staffstudieS/1990-99/ss171.pdf
4 http://www.fdic.gov/regulations/resources/cbi/report/cbi-eff.pdf
5 http://www.aei.org/files/2013/05/06/-the-impact-of-doddfrank-on-community-banks_164334553537.pdf

Q&A: BANK VIEW

Urban Partnership CEO Farrow Says Regulation Is Spurring a 'Fear Factor' Among Banks

William Farrow, president and CEO of Chicago-based Urban Partnership Bank, told Bloomberg's Kim Chipman in an interview that since August 2010 the community development bank, which serves economically distressed communities, has been visited by regulators more than 70 times, including state and federal official and audit firm visits. He said the "pendulum may have swung" too far in this regard. The following interview has been edited and condensed.

Q: What is your outlook on regulation for small community banks?

A: While the intent of many of the regulations is good, at this point they have created a series of challenges. For community banks, there is a higher cost of tracking and achieving compliance and keeping up with the rules. It's difficult for consumers and customers to actually start creating wealth because a lot of times they can't qualify due to the hurdles being set so high. For example, UPB opened a single family mortgage product and had about 80 inquiries, but following pre-checks to see who was likely to qualify, we only had four applications qualify.

On the bank side, there is a fear factor out there. I find this ironic because banks and financial firms are risk-based. Yet a bank can't make a mistake now, because if you make a mistake some of the repercussions can be pretty severe and punitive. For example, a recent National Federation of Independent Business survey on small businesses showed that for the first time the biggest concern among companies polled was government requirements, which is telling. For small banks, they must have expensive compliance people who are bid up by big banks, which have armies of compliance people.

Q: Are you in touch with regulators?

A: I've kept track of how many times the bank, which has been in existence since August 2010, has been audited, examined, visited or really anything related to potential regulation. The last time I looked, the bank had over 70 visits, which includes state and federal officials, audit firms, etc. This shows that you have this environment where banks must comply with rules and this drives behavior, such as having to bring in people for a loan review, which is in essence what examiners check. So from a small bank perspective, you have to take your credit people offline and this may stifle your ability to get loans done. For example, if you want to do a loan review and make sure risk ratings are alright, you must bring in your bankers and credit staff to sit down with the auditors, which can slow down your deals from the outside and serving customer needs. I'm not saying this is wrong, but it's an unintended consequence. The pendulum may have swung a bit too far. I'm sure it will settle into the right place.

UPB has good relationships with our regulators because we see them all the time. They are trying to be noninvasive, but they have a job to do, which is very detailed. Regulation starts at the top with big banks, where most issues can be dealt with, and then takes time to ripple down. There's an active dialogue between small banks and the regulatory community and they try to respond. You want to see responses come faster, but it is what it is and you just have to soldier through. We are starting to see a lot of consolidation of small banks, and a rising tide of bigger and bigger banks. I'm concerned about the possibility of community banks vanishing and being replaced by mid-tier regional banks that don't serve the community.

Q: What's been the biggest challenge in the current regulatory environment?

A: Generally, technology is the biggest challenge. If you use a third-party vendor you must make sure they are compliant.

Q: What about balancing profitability?

A: You have to become more efficient. We have chosen to lean very heavily on technology. For instance, we have a new model for retail and we want to bring people into the banking system. We recognize people today use a bank on their way to go somewhere else, or they use a tablet or their phone or they take a picture of a check. The infrastructure of a bank — the buildings, etc. — is very expensive. That can be replaced by tablets. We have "UPB Anywhere," which is a platform for retail and commercial customers so they can bank 24/7 and know where they stand.

Q: What are your main growth goals over the next five years?

A: The bank is not profitable now. I have two banks that I'm running — a resolution bank, and the acquired portfolio from ShoreBank. That generates about $18 million of problem loan expenses a year. Last year we lost $14 million. We are hopeful that once we get done with that, the needle will go to the other side and a good part will continue on the path to profitability. When we assumed the ShoreBank footprint, I started to focus on creating small branches, with the maximum being about 1,500 square feet and as small as 755 square feet at the branch inside a Wal-Mart store in Chicago's Pullman neighborhood. That branch is currently the only one open seven days a week, with about two million visitors a year. We are trying to change to more of a commercial bank structure because we want to create jobs. The retail aspect is a mission because a lot of employees of our customers don't have banking relationships, and we want to bring them into the banking system. They do shop at Wal-Mart and want to go through drive-thrus and use various technologies. Small banks have to do that to remain competitive.

AT A GLANCE

Education: Has a master's degree in management from Northwestern University and a bachelor's degree from Augustana College in Rock Island, Ill.

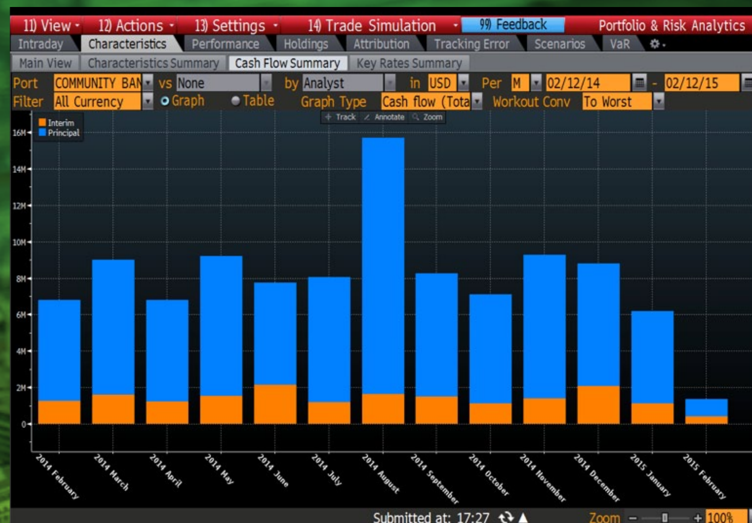
Professional Background: Former executive vice president and chief information officer at the Chicago Board of Trade and has held senior positions at First National Bank of Chicago and Bank One Corp.

Directorships: Sits on the boards of the Federal Reserve Bank of Chicago, Denver-based CoBank Inc. and the Illinois Institute of Technology.

BLOOMBERG SOLUTIONS

PORTFOLIO LIQUIDITY RISK/INTEREST RATE RISK

PORT CF <GO> Cash flow analysis to forecast principal and interest payments received each month on a portfolio level to determine investing activities and anticipate a bank's liquidity needs.



PORT SN <GO> Scenario analysis to stress test the portfolio for the impact of rising interest rates over a time horizon for changes in unrealized market value.

Name	P&L% (+25bp)	P&L% (+50bp)	P&L% (+100bp)	P&L% (+200bp)	% Wgt
COMMUNITY BANK SAMPLE	17.83	15.92	12.46	6.38	100.00
Securitized Debt	36.15	33.68	29.61	23.39	60.89
Government Debt	3.00	1.62	-1.25	-7.07	13.81
U.S. Municipal Debt	1.73	0.28	-2.70	-8.72	25.30

For more information, contact:

Mary Ann Thomas
Mortgage Markets & IR Derivatives
Application Specialist
+1-212-617-2517
mthomas172@bloomberg.net

Jacob Kotlyar
Sales Representative
+1-212-617-6782
jkotlyar@bloomberg.net

Q & A: INDUSTRY VIEW

ICBA's Cole Sees More Differentiation Between Bank Models in Future Regulation

Chris Cole, senior vice president and senior regulatory counsel at the **Independent Community Bankers of America,** told Bloomberg's Melissa Karsh that mortgage regulations have been the most significant post-financial crisis reforms facing community banks. Cole said the ICBA is urging regulators to take a tiered approach to regulation, rather than focus on a one-size-fits-all solution.

Q: What's the most significant post-crisis rule facing community banks?

A: It's been mortgage regulation because that's where Dodd-Frank targeted. Specifically, it's been the new qualified mortgage (QM) requirements, the ability to repay rule, which is part of the truth in lending rule, and with that are the requirements on escrowing for community banks because a lot still don't escrow on mortgages. Then there are the servicing requirements, which include an exemption for the most onerous requirements of 5,000 mortgages. There are still a lot of community banks that are over the threshold and are subject to the requirements. The Basel III capital requirements, which aren't Dodd-Frank-related, are the next biggest challenge. After that, has been the increasing regulatory examination scrutiny of community banks dealing with risk management in all phases.

Q: Is the increasing regulatory exam scrutiny from a specific regulator?

A: No, it's coming from all of them. In 2009 to 2010, there was a real increase in scrutiny by regulators dealing with safety and soundness issues, including all phases of risk management. That's meant a new emphasis on having contingency funding plans in case your funding goes, having a capital plan and monitoring your interest-rate risk and also having your officers and your board overseeing this more carefully than they did previously.

Q: Is Basel III a future challenge still?

A: Yes, Basel III would be on top of that list. It starts to phase in next year and will gradually continue until 2019. There are going to be further Dodd-Frank rules that might have some extensive burdens. For instance, the Consumer Financial Protection Bureau (CFPB) is required to set up a system of data collection on all small business lending similar to the Home Mortgage Disclosure Act, where banks have to keep track of the zip codes where they make mortgages. That could be complicated. The Financial Accounting Standards Board (FASB) has one proposal in particular that deals with how you determine your allowance for loan and lease losses. It wants to look into the future at expected loss rather than the present incurred loss model. The Comptroller of the Currency has said moving to that system there will be a 30 to 50 percent increase in loan-loss reserves, which would be quite a hit for all banks. Community banks are concerned that an expected loss model would mean sophisticated modeling and buying sophisticated software programs, hiring more consultants to determine how to predict the future on these, and that economic data and forecasting would have to be inputted.

Q: Are you meeting with regulators for more community bank exemptions?

A: It's meeting with them and making sure they differentiate between a community bank model and a more complicated bank's model. We call it tiering the regulatory system. The focus is on basing regulations on complexity and the bank business model, rather than a one-size-fits-all type of regulation. For instance, with the Volcker Rule we were hoping regulators would completely exempt banks under $10 billion, but they didn't. They did put provisions in that say 'if a bank under $10 billion is doing proprietary trading or other activities that make it subject to Volcker, then the compliance is a lot simpler.'

Dodd-Frank had a lot of tiering. There's the systemically important financial institution designation at $50 billion, the requirements of stress testing only go down to banks with $10 billion and only banks with over $1 billion are going to be subject to the incentive compensation requirements.

Q: What about compliance costs?

A: Community banks are hiring more compliance specialists and consultants. For instance, a $500 million to $1 billion bank used to get by with one compliance person and now they are hiring an extra person and sometimes even a third. You can't blame it all on Dodd-Frank. It's coming from the agencies with the amount of scrutiny they are taking, from the capital requirements, from FASB. It's coming from every direction and some community banks seem overwhelmed by it.

Q: What's your regulatory outlook three to five years from now?

A: We'll be successful with a tiered approach. Just like you saw with Volcker and Basel III, you'll see more and more of the agencies differentiating between the community bank and the large bank with rules. Hopefully, some of this regulation will be cut back because it's too much right now.

And too much regulation is killing the community bank industry. You're seeing it in consolidation. The principles of recent mergers are giving regulation as one of the reasons for the mergers, so it's having a negative impact.

AT A GLANCE

Residence/Hometown: McLean, Virginia

Education: University of Virginia, B.A. with Honors and J.D.; Georgetown University, Master's of Law in Taxation

Professional background: Tax attorney, Treasury Department; Counsel, Marriott Corporation; V.P. and assistant general counsel, First Virginia Banks

Mentor: Paul Geithner, president of First Virginia Banks and uncle to Treasury Secretary Tim Geithner

Summer reading: Tim Geithner's "Stress Test"

Favorite vacation spot: Sanibel, Florida

LOBBYING

ANALYSIS BY MELISSA AVSTREIH, BLOOMBERG INDUSTRIES

Banking, Credit Union Groups Increase Lobbying Spending on Housing Reforms

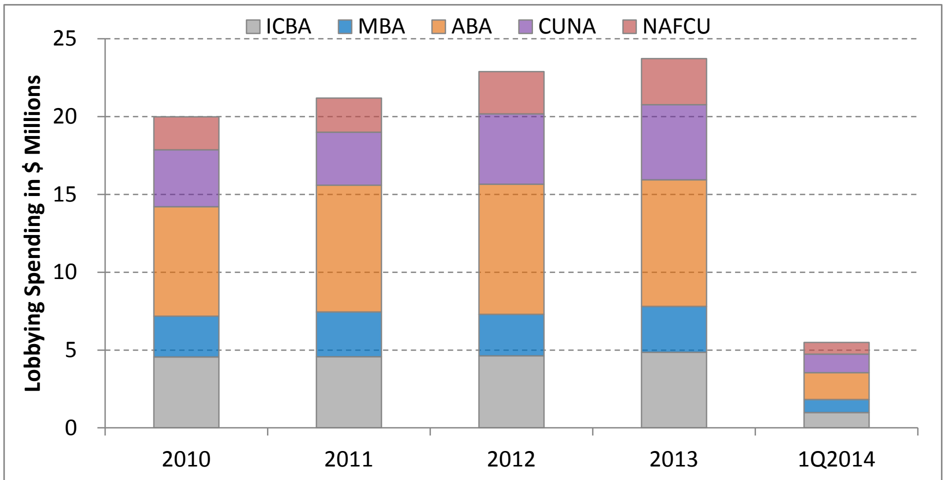
Industry trade associations for community and mortgage bankers and credit unions have increased their spending on lobbying since 2010 when the Dodd-Frank Act was enacted. The five groups spent a total of $23.7 million on lobbying in 2013, up from $22.9 million in 2012 and about $20 million in 2010, according to data compiled from U.S. Senate lobbying filings.

The American Bankers Association, which represents banks of all sizes including community banks, has spent the most on lobbying of the five groups, reaching a total of $8.14 million in 2013 and $1.73 million as of the first quarter of 2014, the filings show. The Independent Community Bankers of America, which represents about 6,500 community lenders, spent $4.85 million on lobbying in 2013 and $990,000 as of the first quarter of this year, while the Credit Union National Association, the largest of the trade organizations representing credit unions, spent $4.83 million and $1.2 million, respectively.

Common lobbying issues in the first quarter of this year, where total lobbying spend among the groups was $5.48 million, included housing reforms related to government-sponsored enterprises and the Consumer Financial Protection Bureau's ability to pay rule, according to the filings. The groups were also focused on legislation, which has since become law, that prevented extreme rate hikes in flood insurance policies.

Melissa Avstreih is a government affairs analyst with Bloomberg Industries in Washington, D.C.

Lobbying Spending on Track for Another Strong Year



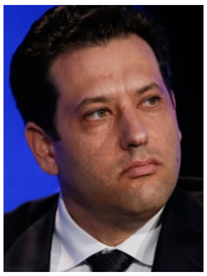
Sources: *U.S. Senate, Bloomberg Industries analysis* BloombergBriefs.com

VOICES

COMPILED BY MELISSA KARSH

Community Banks, Credit Unions Tackle 'Deluge' of Regulations, Urge Dialogue

Speaking in earnings calls, comment letters and on television and radio, community bank and credit union officials discuss regulatory challenges as well as possible routes for continued dialogue with regulators. More specifically, those in the credit union industry remain focused on the National Credit Union Administration's risk-based capital proposal. Comments have been edited and condensed.



Steven Sugarman
Source: *Bloomberg/ Patrick T. Fallon*

"Importantly, Chairman Yellen discussed how the Fed is taking and looking at concrete steps to make sure that the too-big-to-fail guidelines do not result in banks termed too-big-to-fail having a competitive and cost advantage over the community banks and regional banks that serve a lot of the engines of the economy out there. And so it was nice to hear her talk about the Fed's proactive stance to make sure that there are regulatory capital surtaxes on things that could disadvantage the community and regional banks."

— Steven Sugarman, president and CEO of Banc of California, in a May Bloomberg Television interview on Federal Reserve Chairman Janet Yellen's speech on community banks.

David W. Kemper

"That's the biggest challenge in the industry — rationalizing retail distribution and also how you can especially with some of these regulations on the lower balance, checking account customer. It's very hard to make any money on those. So a lot of people are leaving the banking system now because the banks because of regulation can't bank them profitably. I think it's a very unfortunate situation because they're going to have more expensive alternatives in the shadow banking system through payday loans and pawn shops and those kinds of things. So that, to me, is overkill on regulation, but the industry is going to lose a lot of those accounts because they can't make any money on it."

— David W. Kemper, chairman and CEO of "super-community" bank Commerce Bancshares, on an April earnings call.

Jill Castilla

"The impact of the significant changes to the regulatory landscape remains our biggest compliance issue. While community banks have aggressively allocated resources to understanding and implementing the regulations introduced by Dodd-Frank as well as new accounting rules by Basel III, the complexity and sheer volume introduces a much higher level of regulatory and legal risk. Coupled with restrictions on capital and new methodology for the calculation of the allowance for loan losses, the community bank business model may need to shift in order to remain competitive and viable. Even with the overwhelming flood of new regulation, I'm encouraged by the eagerness and capabilities of community bankers to embrace these well-intentioned rules and hopeful that the rule-makers will acknowledge and address the disparate impact of new regulations on community banks."

— Jill Castilla, president and CEO of Citizens Bank of Edmond, in an e-mailed response to a question on the biggest regulatory challenges faced by community banks.

P.J. Hoffman

"In the last few years, credit unions have been deluged with regulations from a number of different regulators including the Consumer Financial Protection Bureau (CFPB) promulgating the recent mortgage rules last year and the National Credit Union Administration (NCUA) introducing a risk-based capital proposed rule that would put credit unions at a significant disadvantage as compared to banks. All of the recent rules increase regulatory burden and therefore compliance costs, which hurt credit unions and their members. We anticipate even more rules from the CFPB this year on issues such as reloadable pre-paid cards, overdraft and payday lending. Regulators such as the CFPB should consider ways to address important issues while taking into consideration that credit unions were not responsible for the financial crisis and continued to extend credit to their members even when banks did not. They could also tailor rules to more narrowly target the bad actors in the marketplace while providing either exemptions or carve outs for smaller institutions like credit unions."

— P.J. Hoffman, regulatory affairs counsel at the National Association of Federal Credit Unions (NAFCU), in response to an e-mailed question on significant regulatory challenges for credit unions.

Cutler Dawson
Source: Bloomberg/Joe Marquette

"Given the major shortcomings of the present proposal, significant dialogue needs to occur between NCUA and credit unions. A flawed RBC rule is no better, and in fact considerably worse, than no rule at all. ... Many of these changes put credit unions at a competitive disadvantage to the banking industry. We cannot support a rule that has such broad sweeping negative implications for the industry and our membership; particularly when the increased capital requirements are not commensurate with the level of risk within the industry and the financial stability and performance of credit unions over time."

— Cutler Dawson, president and CEO of Navy Federal Credit Union, in a May comment letter on the National Credit Union Administration notice of proposed rulemaking governing risk-based capital.

RISK-BASED CAPITAL

COMMENTARY BY DEBBIE MATZ, NCUA

Risk-Based Capital Rule for Credit Unions Is Final Piece of Post-Crisis Reforms: Matz

Debbie Matz, chairman of the National Credit Union Administration, says credit union losses could have been reduced and failures prevented during the financial crisis if its proposed risk-based capital rule had been in place. Matz says that once the proposed rule becomes final, NCUA will join other regulators that require financial institutions to hold capital commensurate with the risk in their portfolios.

Just a few years ago, our country's financial system plunged into the most serious crisis since the Great Depression and triggered a recession that cost millions of Americans their jobs, homes and savings. As the recovery from that recession continues and gains strength, my financial regulator colleagues and I have internalized the hard and expensive lessons we learned. We are re-shaping our approach to regulation to both prevent a recurrence and to keep pace with the evolution of the industries we are charged to protect.

Over the years, the credit union industry has been consolidating into fewer institutions with more sophisticated products and services and high-tech tools. Keeping the industry safe requires that the regulator stay ahead of these trends.

To be effective, modern regulation must anticipate potential risks and encourage prudent growth and innovation in order to protect the safety and soundness of the industry.

NCUA has the responsibility for protecting an industry with assets of more than $1 trillion and more than 96 million consumers who are members of credit unions. That's why, in recent years, the agency has built a stronger, yet more flexible, regulatory framework. The Regulatory Modernization Initiative, which I introduced, is intended to streamline regulations where feasible and ensure that our regulatory regime keeps pace with the changing financial services industry.

Since 2009, the NCUA board has strengthened or introduced a number of rules to mitigate risk to the credit union system.

Chief among these are rules:

- governing corporate credit unions, which were hit hard by sales of faulty mortgage-backed securities;
- requiring that all credit unions have plans to access emergency liquidity; limiting concentration risks from loan participations;
- and improving transparency for investors and users of credit union service organizations.

In addition, the NCUA board recently initiated stress testing of the largest credit unions.

The final piece of this sweeping regulatory reform effort is a proposed rule which would require credit unions that hold high levels of risk on their books to be held to a higher capital standard. The comment period for this proposed rule just closed May 28. When the rule becomes final, NCUA will join financial regulators worldwide who require the financial institutions they regulate to hold capital commensurate with the risk in their portfolios.

Critics contend that because most U.S. credit unions survived the crisis with relatively strong capital, this rule is not necessary. However, that survival required an infusion of $20 billion from NCUA's Central Liquidity Facility and $6 billion from NCUA's line of credit at the U.S. Treasury.

Even with that extraordinary level of assistance, 102 credit unions still failed during the economic downturn. Although many of those failed credit unions appeared to have high net worth ratios, they actually lacked sufficient capital to protect against their risks.

Those failures cost the National Credit Union Share Insurance Fund three-quarters of a billion dollars. This cost had to be paid by all surviving credit unions, which as cooperatives, are required by law to share in the losses on a pro-rata basis.

Had NCUA's proposed risk-based capital rule been in place before the crisis, the $750 million in losses would have been substantially reduced, and several credit union failures could have been prevented.

By way of background, NCUA is required by law to update credit unions' risk-based capital standards as financial regulatory capital standards evolve and to be comparable with other federal financial agencies. NCUA must also consider "all material risks" to federally insured credit unions. So while the new Basel III international capital standard focuses mainly on credit risk, NCUA's capital standard, to comply with the Federal Credit Union Act, also accounts for interest rate and concentration risk as well.

While NCUA's proposed rule is complex, its purpose is simple: credit unions that choose to take higher risks would be required to hold more capital, shed some of their risky assets, or do both.

This risk-based capital rule is still a work in progress as NCUA reviews public comments. Undoubtedly, changes will be made to reflect thoughtful input from stakeholders and others with knowledge of the credit union industry.

Taken together, the changes introduced by the Regulatory Modernization Initiative are intended to prevent the agency and the industry from repeating past mistakes so credit unions and their members will be less vulnerable to another economic downturn. As important, this stronger regulatory framework, built on lessons of the past, is designed to position the industry to withstand the challenges of the future.

Debbie Matz is the eighth board chair of the National Credit Union Administration. She is also one of 10 voting members of the Financial Stability Oversight Council and serves on the Federal Financial Institutions Examination Council (FFIEC).

CONSOLIDATION

ANALYSIS BY MARY ANN THOMAS, BLOOMBERG LP APPLICATION SPECIALIST

Smaller Credit Unions Decreasing at a Faster Rate Than Larger Credit Unions

The consolidation of credit unions have increased in recent years, according to data compiled by Bloomberg. There were 6,623 credit unions in the first quarter of 2014, down from 6,687 in 2013 and 8,268 in 2007, the data, based on National Credit Union Administration numbers, show (Chart 1).

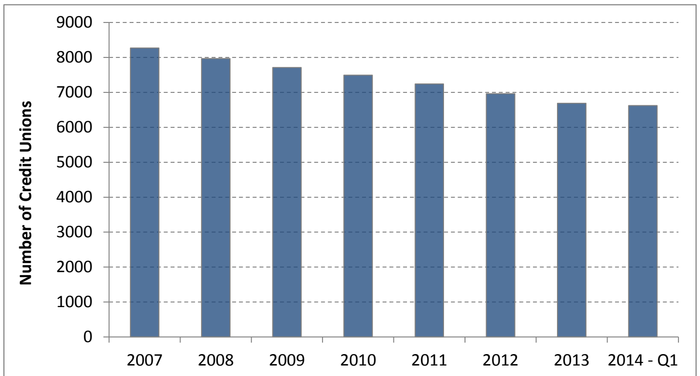
As the number of credit unions decrease, asset growth has been increasing (Chart 2). Large credit unions are growing at a faster rate, outperforming the smaller credit unions. Still, federally insured credit unions with more than $500 million in assets led other asset classes in most performance measures, the NCUA reported in June. They held $751 billion in total combined assets, or 68 percent of the total assets in the quarter, the NCUA said in the report. These 445 credit unions also reported a higher return on average assets, the agency said.

As of the first quarter of this year, five credit unions exceeded the $10 billion in assets threshold before the cut-off date for the 2014 testing cycle versus three in 2008, the data show (Chart 3). These credit unions are subject to more regulatory requirements from the NCUA, including capital planning and stress testing rules. The NCUA board approved these additional rules in March for credit unions with more than $10 billion in assets to provide greater security to the credit union system.

At the same time, federally insured credit unions are also facing new requirements on derivatives investment. The NCUA's final derivatives rule permits credit unions to engage in limited derivatives activities for the purpose of mitigating interest rate risk. The final rule addresses permissible derivatives and characteristics, limits on derivatives, operational requirements, counterparty and margining requirements, and the procedures a credit union must follow to apply for derivatives authority.

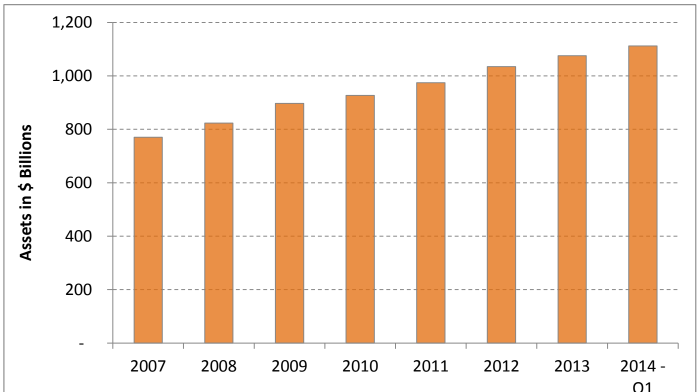
Mary Ann Thomas is a mortgage markets and interest-rate derivatives specialist at Bloomberg LP.

Number of Credit Unions Has Fallen Since 2007



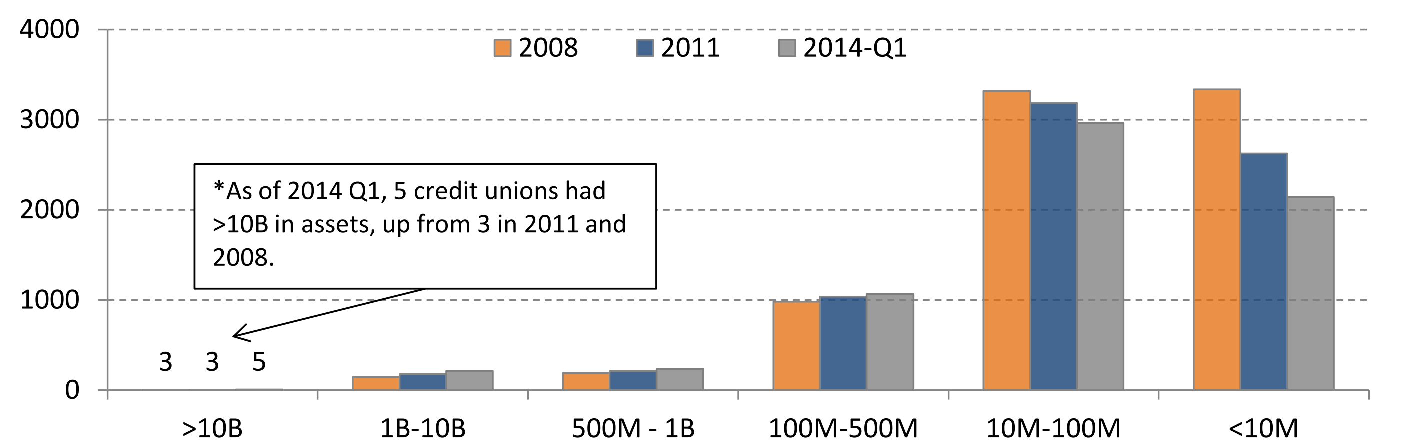
Sources: *NCUA, Bloomberg analysis* BloombergBriefs.com

Credit Union Assets Have Grown Since 2007



Sources: *NCUA, Bloomberg analysis* BloombergBriefs.com

Most Credit Unions Have $10M-$100M in Assets, Have Experienced Drop Since '08



Sources: *NCUA, Bloomberg analysis* BloombergBriefs.com

FURTHER RESOURCES

Regulators, Legislators Focus on Community Banks, Credit Unions in Research Reports

The **Federal Deposit Insurance Corp.** expanded its quarterly banking profile for the first quarter of 2014 to include a new section on the performance of community banks, which represent 93 percent of all FDIC-insured institutions. FDIC Chairman Martin Gruenberg said the goal was to provide a deeper understanding of the community banking industry, which represents 14 percent of banking industry assets. The report showed that community banks registered the strongest growth.
http://1.usa.gov/1wuCN9u

The **Federal Reserve Bank of Kansas City** released a bulletin in May with details on the new capital rule for community banks, including key changes and areas of supervisory focus. The bulletin includes information on planning for the new requirements, which take effect for community banks on Jan. 1, 2015, and risk-weighting changes and data requirements.
http://bit.ly/SKAyir

The **Federal Financial Institutions Examination Council**, or FFIEC, held a webinar in May on cyber security preparedness for community financial institutions, where it highlighted key areas of focus for senior management and boards of directors. The presentation, which is available on the FFIEC's web site, said the management and boards of the financial institutions should focus on setting the tone from the top and building a security culture, identifying, measuring mitigating and monitoring risks and creating a governance process to ensure ongoing awareness and accountability.
http://1.usa.gov/1kMxnBT

In March, the **Federal Reserve Bank of New York** released a series of research reports on the nation's largest banks' too-big-to-fail subsidy. Among the key findings were that bank size has benefits and costs, with the upside being potential economies of scale and lower operating costs and the downside is the "too-big-to-fail problem."
http://nyfed.org/1kiihzj

The **Consumer Financial Protection Bureau** issued its fifth semi-annual report to Congress at the end of May, which included information on rules that impact both community banks and credit unions. In testimony before the Senate Banking Committee in June, CFPB Director Richard Cordray said the agency has benefitted from ongoing dialogue with community banks and credit unions.
http://1.usa.gov/1qo6zs9

Senator **Tim Johnson**, a South Dakota Democrat, and **Mike Crapo**, an Idaho Republican, wrote a June letter to the National Credit Union Administration about the agency's January risk-based capital proposal. In the letter, the senators say that the proposal to strengthen capital requirements for credit unions could end up reducing their ability to make loans.
http://bit.ly/1nvC7vJ

In a Filene Research Institute report, **Andrew Turner**, an adjunct professor at the University of Wisconsin Law, asked, whether the Consumer Financial Protection Bureau is "listening" to credit unions. The March report examined how credit unions can appeal to the CFPB with data and structured arguments.
http://bit.ly/SKGR5C

The **National Credit Union Administration** released its May report, which highlighted its approval of final stress testing rules for the largest credit unions. The report included a chairman's corner with "little-known facts about risk-based capital" as well as an overview of capital planning requirements for when NCUA performs stress tests, which included a timeframe and steps.
http://bit.ly/TFuqbT

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For more information, contact:

Mary Ann Thomas
Mortgage Markets & IR Derivatives Application Specialist
+1-212-617-2517
mthomas172@bloomberg.net

Jacob Kotlyar
Sales Representative
+1-212-617-6782
jkotlyar@bloomberg.net