FJ CAPITAL MANAGEMENT, LLC

Investing in Financial Services for Decades

White Paper

Benefits of Regulatory Roll-back on Community Banks and Structural Industry Consolidation Trend

May 2018

Contents

Executive Summary

The pendulum has swung in favor of regulatory relief for depository institutions, and we expect this relief to come in multiple forms.

FJ Capital Management's Investment Team follows regulatory and political developments closely, and our goal with this White Paper is to provide an updated assessment of the regulatory landscape.

The *Senate* regulatory reform bill is effective in addressing some of the key concerns hanging over the banking industry, especially for community banks. This paper also highlights how regulatory agencies can affect change given the new roster of regulatory leaders, who have views and agendas favorable to banking.

Moreover, the *Financial Stability Oversight Council (FSOC)* is positioned to play a more central role in coordinating and guiding change within these organizations under the leadership of *Treasury Secretary, Steve Mnuchin*.

Last summer, *Treasury* released its first report on *Core Principles of Financial Regulation* setting the tone for regulatory reform in the *Trump Administration*. Importantly, most of the recommendations contained in the *Treasury* report on regulatory relief dated June 2017 can be substantially enacted without legislative approval. We anticipate *Congress* and the regulatory bodies will take a measured and sensible approach to spur credit growth, but not a complete roll-back of *Dodd-Frank Act (DFA)* rules. This view falls in line with the *Administration's* broader goal of growing the U.S. economy.

As a result, we expect no slow-down in the pace of bank mergers and acquisitions (M&A). While a challenging regulatory environment has been a contributor to industry consolidation in the past, it has been one of many factors; and potential increases in profitability and bank valuations tied to regulatory reform should continue to support M&A activity.

Changing of the Regulatory Guard

Seven out of the ten heads of the regulatory agencies have been confirmed by the *Trump Administration*. For banks, the *Office of the Comptroller of the Currency (OCC)* and the *Federal Reserve Board (FRB)* have new leadership, while the new head of the *Federal Deposit Insurance Corporation (FDIC)* is expected to be confirmed before the August recess.

- ***Joseph Otting***, head of the *OCC*, a former executive at *OneWest Bank,* was sworn in November 27, 2017, and continues to view excessive regulation as weighing on economic growth. In January, the agency released its operating plan priorities for 2018. A top priority is to change management to address new regulation requirements. In interviews, *Otting* also underscored three policies that need work in the near term: *Bank Secrecy Act (BSA/AML), Community Reinvestment Act (CRA)* and small-dollar lending. The *OCC* will be proposing changes to the *CRA* as early as April 2018.

- ***Jay Powell****, FRB Chairman*, and ***Randall Quarles,*** *FRB Vice Chair of Supervision*, have both been appointed by the current *Administration*. The industry will focus on *Quarles*, who has served as *Vice Chair* since October 2017, as *Powell's* role is more significant in determining monetary policy. *Quarles* is viewed as a pragmatist who will not favor a complete overhaul of the *DFA*. While the *FRB* will likely take a more measured approach under this leadership, the current regulatory climate would slow the pace of new regulation.

- ***Mick Mulvaney***, *Interim head* of the *Consumer Financial Protection Bureau (CFPB)*, is another game-changer. Upon taking over as interim head of the agency, he halted the issuance of new regulations, directed industry-wide reviews of existing regulation and put a hold on new hires. *Mulvaney* has been gathering industry feedback to determine whether the *CFPB* should change any regulations it inherited from the other federal agencies. The *Bureau* will determine whether existing rules would need to be changed based on compliance burden; effectiveness in advancing the agency's mission of increasing access to financial products and services; and whether the rule is incompatible with new technology.

- ***Jelena Williams***, the *Incoming Head of the FDIC*, is expected to be confirmed before the August recess. *Williams* is currently the Chief Legal Officer at *Fifth Third Bancorp (NASDAQ: FITB)* and was a former staffer for *Senate Banking Committee Chairman*, *Rick Shelby*, in 2010. *Williams* is open to innovation and will support technology and will also be more favorable toward regulation of small dollar loans -- both *Fifth Third Bancorp (NASDAQ: FITB)* and *U.S. Bancorp (NYSE: USB)* have expressed interest in getting back into the space.

The following table summarizes the new agency heads and their stances on key policies. As these stances take shape through reform initiatives and achievements, we believe community banks will benefit in various ways.

Chart 1: Leaders of Financial Regulatory Agencies

Heads of Agencies	Joseph Otting	Jay Clayton	Ben Carson	Alexander Acosta	Chris Giancarlo	Mick Mulvaney	Jerome Powell	Brian Montgomery	Jelena McWilliams	Melvin Watt
Agency	OCC	SEC	HUD	DOL	CFTC	CFPB	FRB	FHA	FDIC	FHFA
Trump Appointee (Y/N)	Y	Y	Y	Y	Y	Y	Y	Y	Y	N
Status	Confirmed	Confirmed	Confirmed	Confirmed	Confirmed	Appointed as Interim Head	Confirmed	Pending Confirmation	Pending Confirmation	Term expires Jan 2019
Former Positions	Former OneWest Executive.	Co-managing partner at Sullivan & Cromwell	Neurosurgeon	Dean of Florida international University College of Law	CFTC Commissioner	OMB Director	Fed governor	Partner at Collingwood Group, LLC	Chief Legal Officer at Fifth Third	Incumbent; Mike Bright (GNMA) floated as likely replacement.
Policy Stance	• Foster economy through reduced regulation. • Preserve the safety and soundness of the banking system.	• Focus on capital formation and less on enforcement.	• Pro market, less government. • Could influence zoning reforms at state level.	• Backs initiative to review and scale back regulations.	• Modify DFA rather than wholesale change to rules. • Supports tech-centered market environment.	• Critical of the influence wielded by the CFPB. • Limit CFPB from interfering with financial services market.	• Mirror a "Yellen" Fed. • Moderate stance on regulatory reform. • Tailor rules for community banks. • DFA pertinent to sound financial system.	• Will look into misuse of **False Claims Act** that impacted banks post crisis. • Reassess capital to protect tax payer. • Favors reducing size of FHA.	• Open to innovations in the financial space. • Staffer for former Senate Banking Committee chairman, Rep Richard Shelby in 2010. • Expected to be positive for small dollar loans - FITB and USB expressed interest in getting back into space. • Personal views on banking system not well-aired.	• Incumbent role since 2014, appointed by Obama. • Previously served in Congress. • Views are independent of party lines, and have gained the respect of those on both aisles of Congress. • A strong proponent of affordable housing, while critical of the "Net Worth Sweep," engineered by the Obama Administration.

Source: FJ Capital Management

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Senate Regulatory Relief Bill (S. 2155): Expected to be Enacted by the End of the Second Quarter of 2018

The ***Economic Growth, Regulatory Relief, and Consumer Protection Act (S.2155)*** is now in the *House Financial Services Committee* awaiting a decision led by *Chairman Jeb Hensarling*, who prefers the *Senate* bill include more of the provisions contained in the ***Financial Choice Act (H.R. 10)*** that passed in the *House* last June. Our expectations are for the *House* to commit to the *Senate* version with minimal changes by *Memorial Day* of this year, given the impending mid-term elections and the risk of the *House* going to the Democrats. *Hensarling* is facing growing pressure from the industry to support the *Senate* bill. ***The Independent Community Bankers of America (ICBA)*** organized a policy event on Capitol Hill in April and met with over 300 congressmen and women to reiterate the importance of passing *S. 2155*. Financial regulatory reform is the final piece of major legislation expected to be passed this year by the *GOP* Congress. <u>We expect enactment by the second quarter.</u>

Chart 2: Key Provisions of the *Senate* Regulatory Reform Bill

Key Provisions of the Senate Regulatory Reform Bill	Implications
SIFI Threshold raised from $50 billion to $250 billion.	• Reduces the current number of banks subject to enhanced prudential oversight from 38 to 22 institutions. • Immediately ends enhanced oversight for all banks with less than $100 billion in assets including relief from annual stress tests • Banks between $100 billion and $250 billion will be exempt 18 months after enactment.
Liquidity Coverage Ratio: Allows investment grade municipal bonds to be reported as level 2B liquid assets under the liquidity coverage ratio (LCR).	• Expands high quality liquid assets (HQLA). • Allows more large banks to investment in municipal securities. • Potentially reduces the funding costs for state and local governments.
Mortgage disclosure and QM requirements: • Mortgage loans are deemed a QM (qualified mortgage) if originated by banks under $10B and kept on book. • Exempt from disclosure requirements under HMDA for small banks with less than 500 mortgages and 500 HELOCs in the last two years. • Removes the 3-day wait period required for combined TILA/RESPA mortgage disclosure if creditor extends to a consumer a second offer of credit with a lower annual percentage rate	• Reduces the regulatory burden on small mortgage lenders relieving them of regulatory risk by deeming loans held on book as QM • Reduces origination costs by eliminating disclosure and the 3-day wait period required under TILA/RESPA.
$1B asset threshold raised to $3B for compliance with 18-month exam cycle for well-managed and well-capitalized banks.	• Reduces regulatory burden for 323 additional small banks.
$10B asset threshold raised: • Raises the threshold for banks subject to DFAST to $250 billion. • Raises the threshold for banks required to set up risk committees to $50 billion.	• Reduces regulatory burden on more than 100 additional bank holding companies
Small Bank Capital Simplification: Sets a single leverage ratio (regulators to determine from 8% to 10% range) that would relieve banks with assets less than $10 billion from capital and leverage requirements.	• 40% of covered banks already meet the higher end of the range. • The remaining banks would be required to raise on average $50MM in additional capital.
Small Bank Holding Company Policy Statement: Raises the asset threshold from $1B to $3B (versus the initially proposed $5B).	• Allows more small BHCs to use sub debt for M&A (323 additional small banks expected to benefit)
Supplemental Leverage Ratio for Custody Banks	• Allows the exclusion of certain central bank deposits from total leverage exposure (the SLR denominator) for a custody bank--defined as a "depository institution holding company predominately enaged in custody, safekeeping and asset servicing activities. • Bill includes a rule of construction that nothing in this provision would limit the US banking agencies' authority to tailor or adjust the SLR or any other leverage ratio for any bank that is not a custody bank.

Source: FJ Capital Management

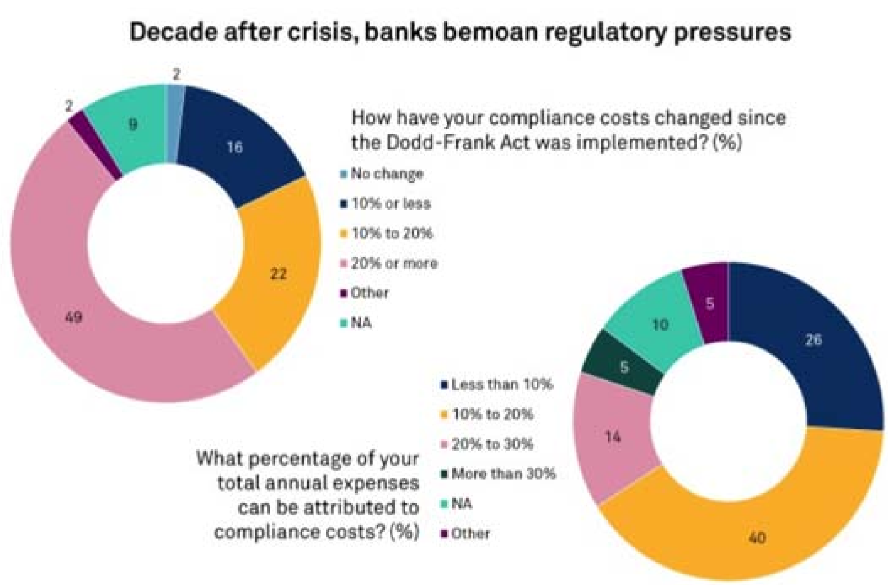
Legislative Impact: Higher Regulatory Asset Thresholds Mean Regulatory Relief for Many Banks

The ***Dodd-Frank Wall Street Reform and Consumer Protection Act***, also known as the ***Dodd-Frank Act (DFA)***, enacted on July 21, 2010, made sweeping reforms of the financial system following the financial crisis. It reaches across all federal financial regulatory agencies and almost every part of the nation's financial services industry. Tailoring has been a key theme behind regulatory reform both within the industry and among top regulators. Among the main criticisms, arbitrary risk designations set by regulators sized by assets are not seen to be commensurate with the actual risk the institution poses through its business lines and exposures.

The *Senate* bill calls for raising the $1 billion, $10 billion and $50 billion thresholds. The banking industry would secure a major win resulting from these changes, which would relieve institutions from super regionals to community banks from some of the more onerous requirements that have capped earnings growth and raised the cost of doing business.

According to the third quarter *2017 S&P Global Market Intelligence* survey, in which 102 banks and credit unions provided input, 49% of respondents noted compliance costs rose 20% annually for many U.S. banks since the enactment of *DFA*. Some 40% claimed compliance costs account for 10% to 20% of their annual expenses.

Chart 3: Breakdown and Annual Growth of Regulatory Costs



Source: S&P Global Market Intelligence

Raising the $10 billion threshold to $250 billion[1] relieves nearly 100 banks from the regulatory stress tests, which would free these institutions to make higher dividend payouts or stock repurchases. Prior to the crisis, bank dividend payouts averaged 43%. Since the crisis, payouts have dropped sharply and have been hovering below 30%[2] for the last four years. Relief from mandatory stress tests, and especially the *Federal Reserve Board's Comprehensive Capital Analysis and Review (CCAR),* could give banks below $100 billion assets less of a binding constraint on its ability to payout dividends.

Raising the $50 billion threshold[3], which has automatically deemed a financial institution a systemic risk, will impact approximately 16 institutions.

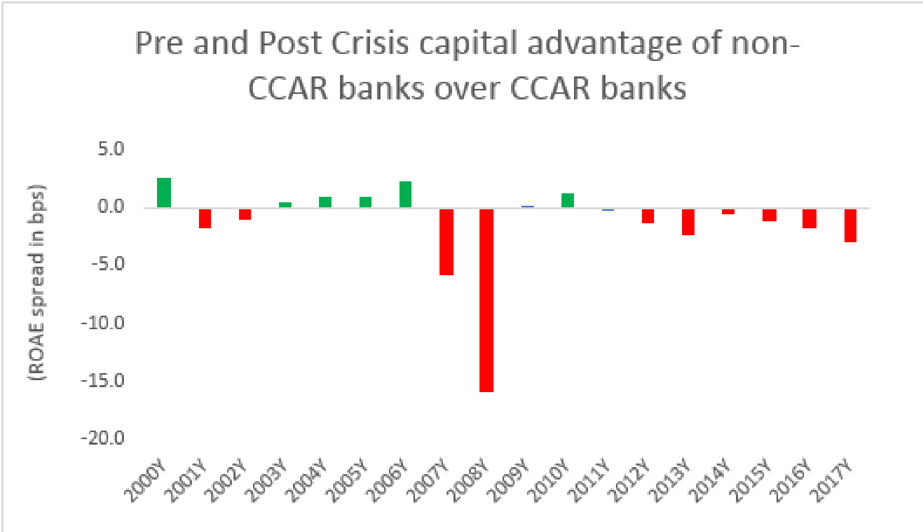
The net result of this change will be increased return-on-equity (ROE) for banks and thus higher capacity to pay sellers demanding higher valuations, given improvements and expected improvements in the operating environment. Prior to the 2008 financial crisis, *CCAR* banks have been generally outperforming. This relationship shifted incrementally negative post-crisis as banks subject to enhanced prudential standards were required to hold more capital and to contribute more of their earnings to compliance costs. The divergence in the ROE is evident between *CCAR* and non-*CCAR* banks with assets greater than $30 billion throughout the recovery.

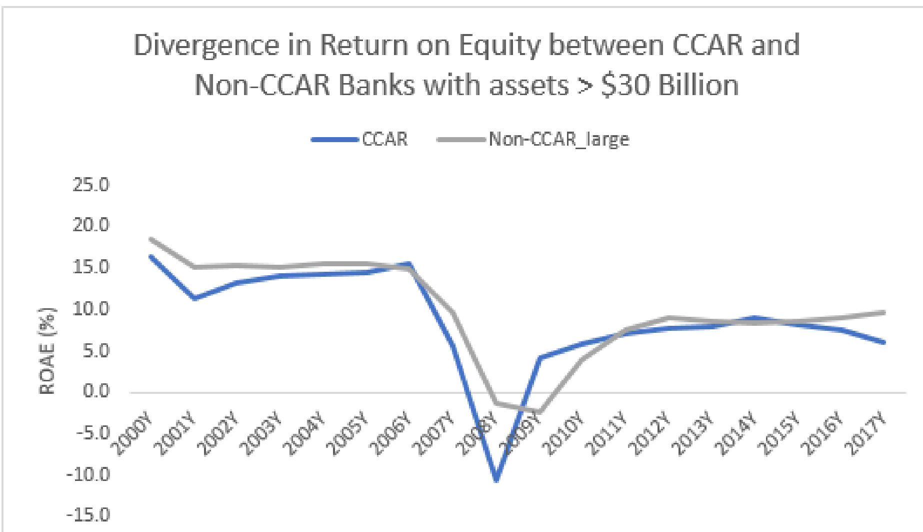
[1] $10 billion ($50 billion) threshold will be raised to $100 billion upon the passage of the bill, and to $250 billion in 18 months. The bill includes supervisory leeway for the *Federal Reserve Board* for those above $100 billion.

[2] Threshold used by the *Federal Reserve Board* for heightened supervisory scrutiny.

[3] All U.S. based banks with total assets of less than $100 billion would be exempt from the *SIFI* designation or enhanced prudential standards upon the effective date of the legislation. Banking entities with assets between $100 billion and $250 billion will be exempt after 18 months. Bill does not relieve foreign banking organizations with $100 billion or more in assets from enhanced prudential standards.

Chart 4: CCAR vs Non-CCAR Performance





Source: FJ Capital Management

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Chart 5: List of Institutions Currently Subject to Enhanced Prudential Standards

	Company Name	Total Assets ($000)
Companies subject to CCAR post-Senate bill	JPMorgan Chase & Co.	2,533,600,000
	Bank of America Corporation	2,281,477,000
	Wells Fargo & Company	1,951,757,000
	Citigroup Inc.	1,842,465,000
	Goldman Sachs Group, Inc.	916,787,000
	Morgan Stanley	851,733,000
	U.S. Bancorp	462,040,000
	PNC Financial Services Group, Inc.	381,450,622
	TD Group US Holdings LLC	380,907,238
	Bank of New York Mellon Corporation	371,758,000
	Capital One Financial Corporation	365,692,669
	HSBC North America Holdings Inc.	273,486,377
	State Street Corporation	238,496,136
	Barclays US LLC	157,927,000
	MUFG Americas Holdings Corporation	154,557,404
	DB USA Corporation	148,248,000
	RBC USA Holdco Corporation	141,974,824
	Credit Suisse Holdings (USA), Inc.	141,413,215
	UBS Americas Holding LLC	140,698,850
	BNP Paribas USA, Inc.	139,136,085
	BMO Financial Corp.	131,102,466
	Santander Holdings USA, Inc.	128,294,029
Companies relieved from CCAR post-Senate bill	BB&T Corporation	221,642,000
	SunTrust Banks, Inc.	206,633,681
	American Express Company	181,148,000
	Ally Financial Inc.	167,148,000
	Citizens Financial Group, Inc.	152,709,681
	Fifth Third Bancorp	142,193,410
	Northern Trust Corporation	138,590,457
	KeyCorp	138,064,055
	Regions Financial Corporation	124,584,404
	M&T Bank Corporation	118,593,487
	Huntington Bancshares Incorporated	104,184,505
	Discover Financial Services	100,086,645
	BBVA Compass Bancshares, Inc.	87,320,579
	Comerica Incorporated	71,691,612
	Zions Bancorporation	66,287,746
	CIT Group Inc.	49,278,725

Source: FJ Capital Management

Legislative Impact: New Capital Options and CRE Relief

The recent *Senate* bill provides a statutory override of the U.S. banking agencies' *Basel III* capital rules for higher-risk commercial real estate exposures, which will provide some relief and clarity on the capital treatment of these loans. While not a direct result of *DFA*, the new *Basel III* capital requirements under the international *Basel III* accord have been unduly burdensome. Allowing small bank holding companies to maintain a single leverage ratio as an off-ramp from current *Basel III* capital rules would also help to alleviate these burdens.

Basel III was intended to improve the quality and quantity of capital for all banking organizations.

- The new capital rules raise the required capital for all banks subject to rules and emphasize the use of common equity through the introduction of the Common Equity Tier 1 (CET1) ratio.
- It provides stricter eligibility for capital instruments included in CET1, additional Tier 1 or Tier 2; limiting the inclusion of intangible assets, including mortgage servicing assets, deferred tax assets, and significant investments in unconsolidated capital of financial institutions.
- Basel III also imposes the capital conservation buffer of 2.5%, which requires all banks as small as $500 million in assets to maintain a capital buffer outside of periods of stress.
- Moreover, the removal of reliance on the credit rating agencies have left banks to rely on the gross-up approach or default to the costly 1,250% asset risk-weight for certain assets.

Given these heightened capital requirements, most community banks would gain considerable balance sheet flexibility upon electing the single leverage ratio of 8% to 10%. Based on the most recent regulatory data, 40% of community banks already meet the higher end of the range while the remaining banks would be required to raise on average $50 million in additional capital.

Community banks first became subject to the rules on January 1, 2015, triggering a phase-in period through January 1, 2019. The rule was intended to capture the largest and the systemically risky banks, but the rise in the risk weights on certain types of commercial real estate (CRE) may have disproportionately affected small banks because they invest relatively heavily in commercial real estate. CRE represents 50% of small bank loan portfolios compared to 25% for the large banks. Community banks have used their knowledge of local real estate trends and superior service to gain an edge over their much larger counterparts, but current capital rules have been eating away at this advantage.

- Capital requirements impose a 150% risk-weight on the riskier CRE loans or High-Volatility CRE (HVCRE), under the HVCRE guidance, applicable to banks with assets greater than $250 billion.

- Recent guidance on High-Volatility Acquisition, Development and Construction (HVADC) loans applicable to all other banks, lowers the overall risk-weight on high-risk CRE loans to 130% and removes key exemptions which have allowed community banks to apply a lower risk-rating on certain CRE loans.
- Specifically, the newly proposed HVADC rule will eliminate the exemption on loans that carry a 15% equity contribution.
- The recent *Senate* bill provides a statutory override of the U.S. banking agencies' *Basel III* capital rules for higher-risk commercial real estate exposures, as well as relief and clarity on the capital treatment of these loans.
- The *Senate* bill restores the exemptions and the much higher risk-weight for high-risk CRE loans and provides additional clarity in the definition of such loans with grandfathering for loans made prior to January 1, 2015.
- Furthermore, allowing small bank holding companies to maintain a single leverage ratio as an off-ramp from current *Basel III* capital rules would help to eliminate these burdens altogether.

Legislative Impact: Easing of Liquidity Requirements and Impact on Deposit Funding

The *Senate* bill includes changes to two liquidity rules currently applicable to bank holding companies with assets above $50 billion and $250 billion. The bill would allow for the inclusion of municipal securities as *Level 2B* liquid assets in the construction of the *Liquidity Coverage Ratio (LCR)*, which requires banks to hold sufficient levels of *High-Quality Liquid Assets (HQLA)* to withstand net cash outflows in a 30-day stress period. Changes to *LCR* would lead to the redeployment of cash and short duration securities into higher yielding assets. *Goldman Sachs* estimates this shift could lead to gains of 1% to 2% in earnings per share.

The bill also permits custody banks to eliminate funds deposited with a central bank from inclusion in the *Supplemental Leverage Ratio (SLR)*. While this change would impact at least four[4] of the *Global Systemically Important Banks (GSIBs)* under the bill's current definition -- a depository institution holding company predominately engaged in custody, safekeeping and asset servicing activities -- relief to *SLR* would improve funding costs on core deposits in this rising rate environment as the pressure on large banks to bid up for higher-quality deposits subsides and as the pool of banks subject to the liquidity rules drop with changes in the asset thresholds. Changes to *SLR* would add nearly $800 billion of balance sheet capacity for the largest custody banks currently subject to the rule, which would also improve earnings per share.

Chart 6: Changes to the Supplemental Leverage Ratio

As of 2017Q4		Total Assets	B3: SLR (%)		Reduction in Capital
		($bil)	Current	Senate	($bil)
GSIBs: eSLR, 5%	JPMorgan Chase & Co.	2,534	6.5	7.5	28
	Citigroup Inc.	1,842	6.8	7.3	12
	Bank of New York Mellon Corporation	372	6.1	8.7	7
	State Street Corporation	238	6.5	9.2	4

Source: FJ Capital Management, Regulatory Data

Deposit betas have been mild during this rate hike cycle in absolute terms, hovering between 0% and 20%, because the pace of rate hikes have been very slow relative to previous periods. It took nine quarters to raise the *Fed Funds Rate* 100 basis points, while in the prior two cycles, it only took a third of the time to get to these levels.

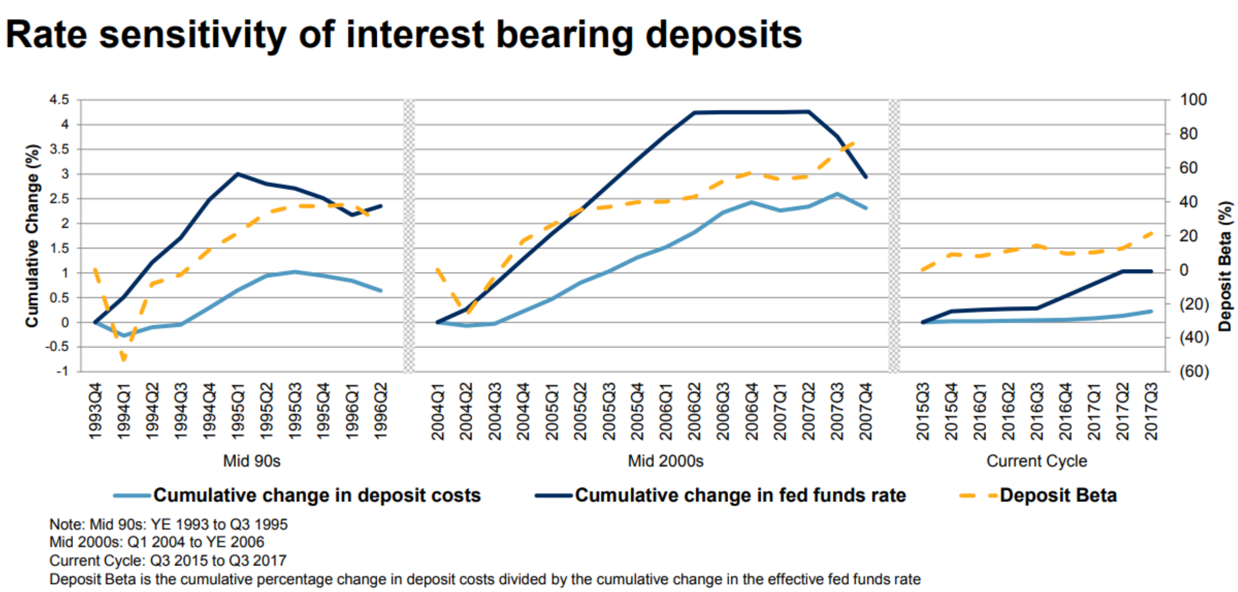
However, deposit betas are slightly higher in this period relative to the number of hikes as compared to the rate hike cycles in the 90s and mid-2000s. In the prior two cycles, 100-basis

[4] *State Street Corporation (NYSE: STT), Bank of New York Mellon Corporation (NYSE: BK), Citigroup Inc. (NYSE: C), and JP Morgan Chase & Co (NYSE: JPM)*

point change in the *Fed Funds Rate* corresponds to no, or little change in the deposit beta. However, in the current period, a 100-basis point change in *Fed Funds* has resulted in a deposit beta of 20%. While not a definite science, this difference can be attributed to increased regulatory liquidity requirements that raises the demand for core deposits.

As requirements for the *LCR* and *SLR* are eased, deposit betas likely could react more in line with historical trends. In other words, with additional easing in liquidity requirements, we could see some relief for deposit betas which could be maintained at 20% despite additional rate hikes this year.

Chart 7: Long-term Relationship Between Fed Rate Hikes and Deposit Betas



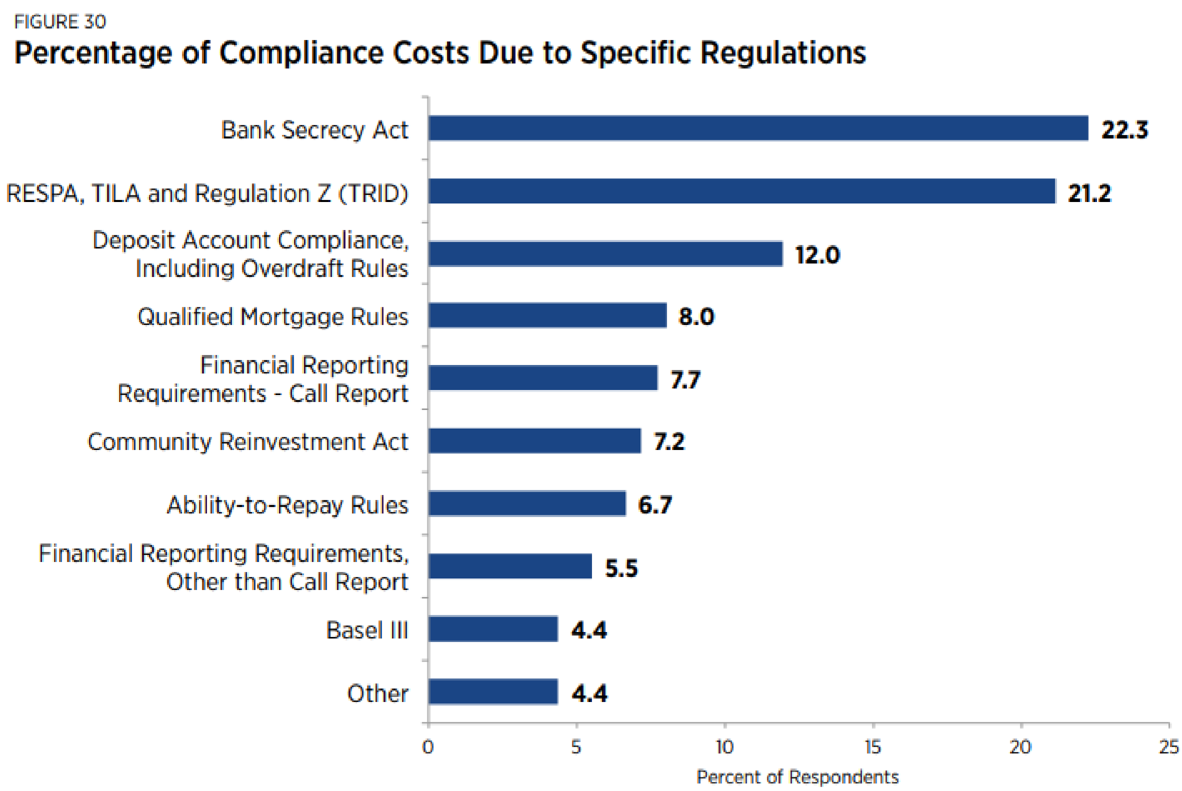
Source: U.S. Banking Sector: Which Way Will It Trend, S&P Global Ratings

Legislative Impact: Improving Mortgage Lending Capacity and Eliminating Red Tape to Expedite Originations.

Under the *Senate* bill, legislators propose easing the regulatory burden for mortgage origination activities conducted by banks with satisfactory *Community Reinvestment Act (CRA)* ratings. This would be achieved by lifting the disclosure requirements under *HMDA* for small banks that originated less than 500 mortgages and 500 home equity lines of credit in the last two years. It would also remove the 3-day wait-period required for combined *Truth in Lending Act/Real Estate Settlement Procedures Act (TILA/RESPA)* mortgage disclosure if the creditor extends to a consumer a second offer of credit with a lower annual percentage rate. Both measures would reduce origination costs and delays, so banks can compete on speed with the nontraditional lenders that often tout the benefits of instantaneous loan approvals.

The Senate bill also includes a provision that would deem mortgage loans a qualified mortgage if it is originated by banks under $10 billion in total consolidated assets and held on book. This would effectively reduce the regulatory burden on small mortgage lenders relieving them of regulatory and legal risk associated with mortgage lending.

Chart 8: RESPA, TILA and Regulation Z (TRID) Carry the Second Highest Compliance Cost



Source: Community Banking in the 21st Century, Conference of State Bank Supervisors

Residential real estate lending is an important line of business for community banks as it accounts for on average a fifth of total interest income. Whereas for banks with assets greater than $10 billion, the share of average interest income is around 17% and closer to 10% for banks with assets greater than $250 billion. Regulatory scrutiny was raised through heightening consumer protections which translates to increased documentation and legal risks. The *CFPB's* mortgage disclosure requirement or the *TILA/RESPA Integrated Disclosure rule (TRID)*, rank among the top pieces of legislation attributing to the increased cost right below the *Bank Secrecy Act* and *Anti-Money Laundering (BSA/AML)* laws. *Qualified Mortgage (QM)* rules also rank in the top four in terms of burden.

Regulatory pressures have weighed on 1-4 family lending, which accounts for on average 26% of a community bank's lending activities. Despite improved sentiment, the *2017 Conference of State Regulators*' survey underscored 65% of respondents citing the *CFPB's* mortgage rules as a reason for planned withdrawals from the market. One surveyed banker said they were wasting too much time on mortgage loans, and there was too much risk associated with these loans. Twenty-three percent of respondents noted increased regulatory liability as a challenge and more than 40% of respondents cited "a slower pace of business" or "delayed closings".

Community banks remain frustrated by regulation, but there has been a turn of the tide noted in last year's survey with burden reduced in some areas under the *Economic Growth and Regulatory Paperwork Reduction Act*. In the same survey, 80% of the banks will continue to offer mortgages compared to 76% in 2016. A larger 5% had planned to exit from or substantially limit mortgage originations compared to 2.9% in 2017. Community banks shifted from grappling with new regulatory pressures to discussing what potential reform might entail. Many bankers are finding solace in regulatory reform slowing the growth and rate of change in existing regulation as a win.

The *DFA*-mandated *QM* rule forced banks to maintain higher lending standards for home mortgages. It imposes rigorous standards of proof that a loan is not high-risk. Banks are also required to document that a borrower has the ability to repay the loan and the mortgage has no nonstandard contract structures such as balloon payments.

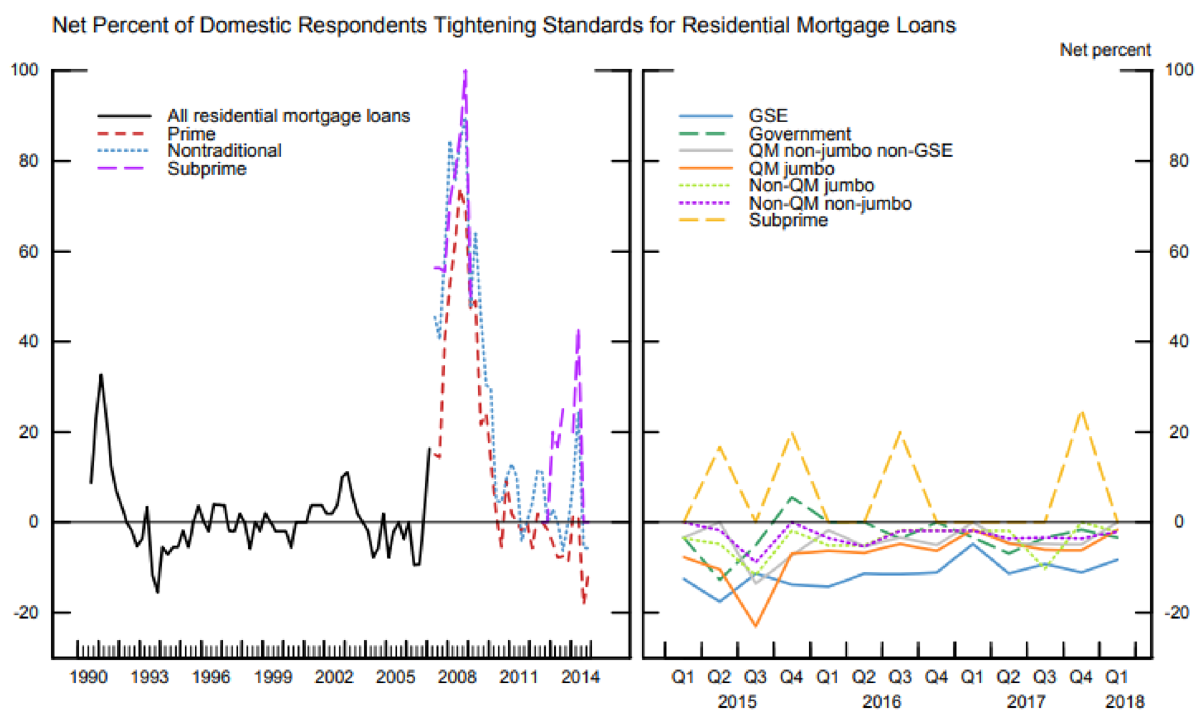
The main benefit of making *QM* is safe harbor, which provides protection against lawsuits by borrowers and against attempts by borrowers to avoid foreclosure. Legal protections are even higher for loans that are not high-priced. A high-priced loan is one with an interest rate that exceeds the average *Prime* rate by more than 1.5% for a loan secured by a first lien or by 3.5% for a junior lien.

The *Senate* bill includes a provision that would deem mortgage loans a *QM* if they are originated by banks under $10 billion in total consolidated assets and held on book. This would effectively reduce the regulatory burden on small mortgage lenders, relieving them of regulatory and legal risk associated with mortgage lending.

Based on a study conducted by the *Federal Reserve Bank of Philadelphia*, the size of the asset determines the rule's impact on a banking organization. Banks with assets under $100 million have the largest share of mortgages affected by the *QM* rule at 20% on average. In other words, smaller banks lose out on more lending opportunities because of increased regulation as compared to their larger counterparts. Heighten regulatory scrutiny has also forced banks to tighten underwriting standards.

Based on the *Federal Reserve's Senior Loan Officer Opinion Survey (SLOOS),* banks have on balance been tightening standards for most residential mortgage products throughout the recovery.

Chart 9: Tightening Lending Standards for Residential Mortgage Loans



Source: Survey of Loan Officer Opinion Survey, Federal Reserve Board

Overall, the *Senate* bill would reduce origination costs by paring back disclosure requirements and eliminate legal risk for the smaller banks that are already choosing to hold their mortgages on book. Together, these changes would foster more lending by community banks, some of which have lost as much as 20% lending capacity post *DFA*.

Legislative Impact: Technology

The *Senate* bill provides legislative support for combating cyber-fraud and increasing the use of technology to speed up new account processing. The *Social Security Authority* is directed to create a new database containing people's names, dates of birth, and social security numbers, for use in responding to identity-verification requests. It also directs the *Treasury Department* to submit a report to *Congress* on the risks of cyber threats to financial institutions and U.S. capital markets.

While technology provides new opportunities for the banking space, it also contributes to increased competition and cyber risk. Community banks often claim nonbanks pose increased risk to their profitability through the ability to easier and more quickly originate loans and open accounts. The *Senate* bill addresses these concerns through a provision that makes it easier for banks to open new accounts and engage in transactions online by authorizing the use of scanned driver's licenses to meet identity verification requirements.

This provision will start to level the playing field for traditional banks attempting to remain competitive considering the spate of technological changes in the industry. Additionally, cyber risk is a rising concern and contributing to operating costs. In 2017, the average cost of a data breach in North America was $1.3 billion for enterprises and $117,000 for small and mid-sized businesses, according to *Kaspersky Lab*. Companies are allocating more of their budgets to IT security, with 18% for enterprises in 2017, up from 16% in 2016. Even small businesses with fewer resources are investing more in IT security budgets -- 14% in 2017 compared to 13% in 2016. Financial institutions reported having one of the highest IT security budgets, ranking 4th in a 2016 survey by *PricewaterhouseCoopers,* with about 40% of firms with more than $1 billion in revenue budgeting $10 million or more. In 2016, financial phishing increased 13% to 48% of all phishing detections.

Consolidation

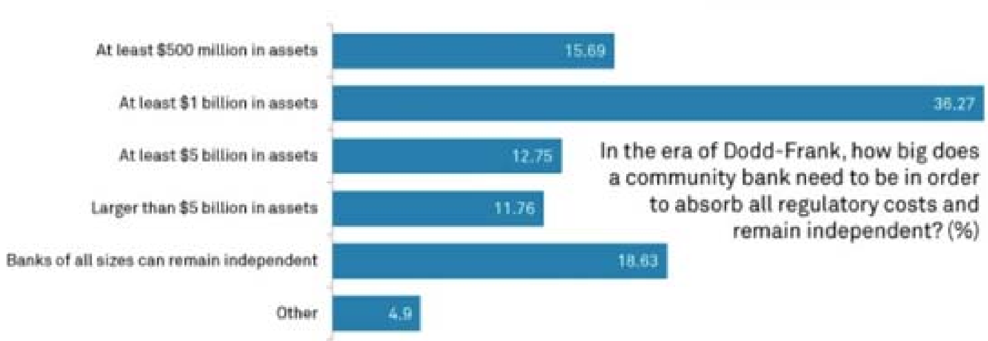
Aside from explicit regulatory costs associated with enhanced prudential standards, arbitrary asset thresholds have created regulatory arbitrage for banks falling below these thresholds and, more importantly, penalized growth, forcing companies to manage below these regulatory thresholds. Only two institutions, *CIT Group (NYSE: CIT)* and *New York Community Bancorp (NYSE: NYCB)*, temporarily broke above $50 billion in total assets since the passage of the *DFA* in 2010. While *CIT Group*[5] *(NYSE: CIT)* had been subject to *CCAR* since 2016, both institutions have successfully managed their balance sheets below the statutory threshold in the current period.

This has inevitably impacted growth and merger opportunities with banks slightly below $50 billion hesitant to subject themselves to heightened regulatory scrutiny accompanied by the increased costs of annual *CCAR* stress tests, liquidity rules, living wills and restrictions on shareholder payouts. Raising these hurdles releases a new pool of acquirers, namely large regional banks that will benefit from mergers, as they sit between bigger banks with scale and community banks competing with lower fees and improved technological services coupled with better customer service. For many of these banks, growth through M&A will be a welcome alternative to organic growth.

The $1 billion threshold would be raised to $3 billion in the *Small Bank Holding Company Policy Statement*, which could also spur more M&A within this group. Eighty-eight percent of the targets and 50% of the buyers since 2010 were below $1 billion, making this space the most active in M&A. Also, more than a third of respondents surveyed by *S&P Global Market Intelligence* believe at least $1 billion in assets is needed to succeed in the current environment, which serves as another catalyst for this space. In our opinion, raising the *Small Bank Holding Company* threshold from $1 billion to $3 billion allows more community banks to benefit from higher levels of subordinated debt for mergers. This enables an additional 300 small BHCs to support growth with higher levels of lower cost debt and hybrid capital.

[5] *CIT Group* completed its merger with *OneWest Bank* in 2015.

Chart 10: 36% Believe Banks Would Need to Be At Least $1 Billion In Assets to Be Profitable in The Current Regulatory Environment



Source: S&P Global Market Intelligence

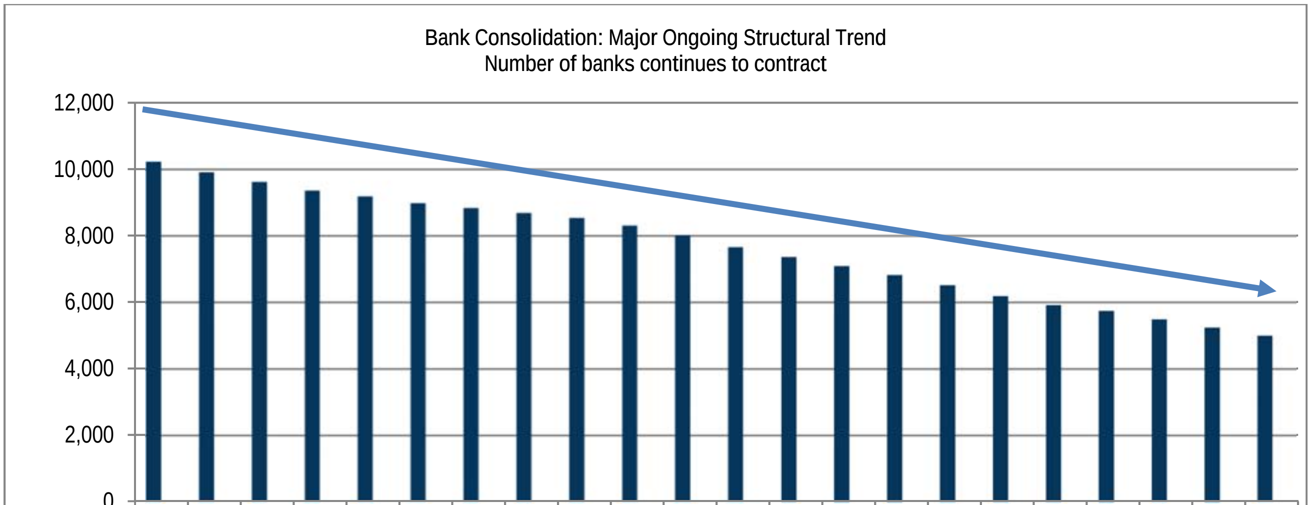
Upcoming regulatory relief will slow the pace of increase in compliance costs, but the overall impact likely will persist. Many of the costs have already been built into the banks' core systems and any savings are expected to be diverted to investment in cybersecurity. This will benefit our consolidation thesis.

Per the *S&P Global Market Intelligence* survey, many banks continue to anticipate further consolidation among lenders. Nearly 40% of respondents said that over the next 12 months, challenges tied to *DFA* are either "very likely" or "somewhat likely" to influence their institution to consider entering into a merger transaction. *DFA* legislation is a major consideration for any merger deal that is reviewed. The 1990s was the last wave of consolidation in the banking space prior to the crisis.

Research finds that regulatory changes are important drivers of takeover waves, but takeover activity is also present in economic recoveries coinciding with periods of rapid credit expansion. Regulatory relief geared toward growth and credit expansion will only extend the consolidation trend, as banks build scale to compete with other banks, as well as a burgeoning space of nonbanks spurred by innovative technologies in finance.

Much like in the 1990s when M&A activity was unprecedented, both in deal value and volume, banks will look to consolidation for growth to remain competitive as rates rise and regulatory costs remain elevated (while not growing as quickly). The net result of this change will be increased ROE and thus higher capacity to pay sellers demanding higher valuations, given the better operating environment. Based on the long-term pace of consolidation, we expect to see the number of banks decline by more than 50% over the next 10 to 15 years.

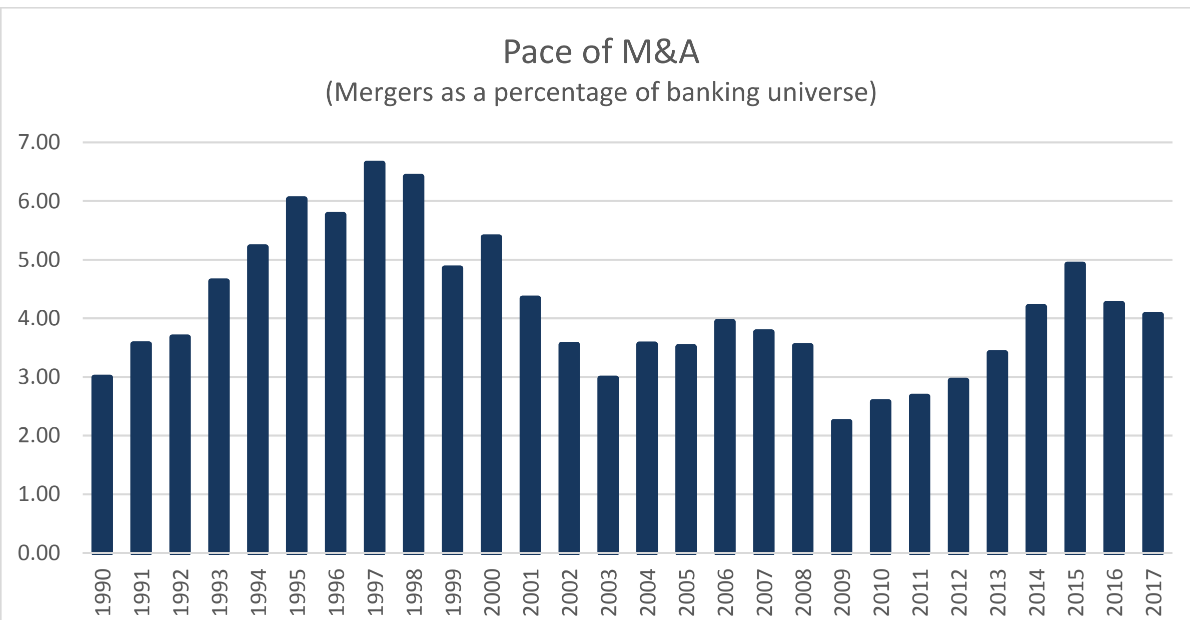
Chart 11: Long-Term Trends in Bank Consolidation



	1999A	2000A	2001A	2002A	2003A	2004A	2005A	2006A	2007A	2008A	2009A	2010A	2011A	2012A	2013A	2014A	2015A	2016A	2017A	2018E	2019E	2020E
Number	10,222	9,904	9,614	9,354	9,181	8,976	8,833	8,680	8,534	8,305	8,012	7,657	7,357	7,083	6,812	6,509	6,182	5,913	5,737	5,479	5,232	4,997
% Change		3.1%	2.9%	2.7%	1.8%	2.2%	1.6%	1.7%	1.7%	2.7%	3.5%	4.4%	3.9%	3.7%	3.8%	4.4%	5.0%	4.4%	4.0%	4.5%	4.5%	4.5%

Source: FJ Capital Management

Chart 12: Pace of Mergers & Acquisitions



Source: FJ Capital Management

Conclusion

We are excited about the recent spate of regulatory relief and the impact it will have on both profitability and the ongoing structural consolidation trend. The U.S. banking industry should continue to experience a shift in the regulatory pendulum toward a more pro-business environment that will be positive for banks and the overall economy. While these latest changes are not a panacea to undo the harmful effects of and the inefficiencies created by the *DFA* legislation, the need for increased asset scale will continue to create a favorable environment for M&A going forward. *FJ's Investment Team* projects that over the next 10 to 15 years, the consolidation trend will reduce the number of banking institutions from 5,700 to around 2,000.

About FJ Capital Management, LLC

FJ Capital Management, LLC is a fundamentally driven, SEC-Registered Investment Advisor firm founded in 2007 that analyzes and invests in public and privately traded U.S. community and regional banks through private investment vehicles. The firm utilizes proprietary fundamental research to uncover value disparities in the small- and mid-cap bank sector and seeks to take advantage of these disparities by building core positions with longer term holding periods. The firm also seeks to generate attractive, risk-adjusted investment returns by uncovering opportunities with identifiable, near-term catalysts. For more on *FJ Capital* or to further explore opportunities in the bank sector, please visit www.fjcapital.com or contact:

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