



# INVICTUS

## Bank Insights

### Finding and Keeping Community Bank Directors in the New Regulatory Environment

Community banks across the U.S. may be finding it hard to recruit and retain outside bank directors, the Federal Reserve notes in its **latest issue** of *Community Banking Connections*. But strong directors are more important now than ever, and banks must make sure they are providing the necessary training and education to ensure proper oversight, the article advises.

Banks must conduct periodic board assessments to review directors' responsibilities, determine the effectiveness of strategic planning and monitor policies and procedures. Such assessments can reveal important questions about "the engagement and contribution" of individual directors, the article notes.

The Federal Deposit Insurance Corp. has named 793 former directors and officers as defendants in **lawsuits** in connection with banks that have failed since the financial crisis. That means those directors could be found personally liable for mistakes banks made before they failed. And that has had a chilling effect on people who previously might have wanted to serve on bank boards.

In a survey last year, the **American Association of Bank Directors** found that 25 percent of banks that responded had lost either current directors or potential candidates because of fear of personal liability. The AABD also identified more than 800 provisions in guidance and regulations that placed obligations on board members.

"Before the recession, directors were often prominent businessmen with a non-bank view, who could add an outside perspective and facilitate lending in their marketplace," says Invictus CEO Kamal Mustafa. "That picture has changed. Because of both the legal and personal risk, directors must now understand banking, capital and the bank's risk profile. It's a clear-cut shift from board members that could create business to board members that can understand bank behavior."

Every prudential regulator has emphasized how important it is to get board members trained:

- **The FDIC's Director Resource Center** is continually being updated, with technical videos on topics ranging from troubled debt restructurings to appraisals and evaluations, as well as a series on rulemakings, fiduciary responsibilities and risk management best practices.
- **The Federal Reserve's Bank Directors Desktop** offers lessons for new directors, with quizzes to make sure they understand the topics.

#### Bank Director Responsibilities

The bank's board of directors is responsible for making sure the bank controls its risks and operates in a safe and sound manner. The board must identify, quantify and understand all risk. It also:

- Hires and retains competent management
- Establishes strategic plans
- Oversees business performance
- Makes sure the bank serves the community's credit needs

Source: **OCC, Detecting Red Flags in Board Reports**

- The Office of the Comptroller of the Currency conducts **workshops** for community bank directors across the country on compliance, credit risk, governance and essentials of being a new director.

"Essentially, a bank director now must keep the bank out of the ditch," notes former bank CEO Thomas Rideout, an Invictus executive adviser. "They must fully understand the bank's regulatory mandates and operating risks. Most critical is focusing on business perspective to assure policies and procedures are in place for safe and sound operations and regulatory compliance."

The *Community Banking Connections* article, written by Cynthia L. Course, the director of the Federal Reserve Bank of San Francisco, says that director candidates do not need to be experts in banking. The Fed, however, does **suggest** that proposed directors of de novo banks have "appropriate" community bank expertise. The Fed notes that the inclusion of directors from failed banks can be a red flag in a de novo application.

She acknowledged that "recruiting new bank directors may have been easier to do in the past than it is today." She said directors today "weigh the benefits against the potential burden or legal liability." ■

(See page 2 for tips from Course's article)

#### Inside this issue:

- Succession Planning a Key Risk (page 2)
- How to Recruit Candidates, Assess Personal Liability (page 2)
- Regulatory Capital Focus to Continue (page 3)
- Fed Reiterates Importance of Capital Planning (page 4)

## Building A Bank Board for Success

So how can banks recruit candidates? The Fed's Cynthia L. Course offers some advice for the nominating committee in her article, "**Recruiting and Retaining Bank Directors:**"

- Determine the skills and demographic profiles of your current directors, then compare them with the bank's strategic objectives and risk profile. Identify gaps and look for candidates to fill them.
- Sell potential director candidates on the benefits of membership, such as networking in the industry.
- Be willing to have honest discussions about the bank, and how the candidate can add value. Be sure, however, not to disclose confidential information, such as the bank's CAM-ELS composite, without written permission from regulators.
- Build a competitive compensation package.
- Assure candidates that they will receive proper training and liability insurance.

## How to Assess Personal Liability

AABD president David Baris, a Washington, D.C. bank lawyer, has conducted personal liability assessments for bank directors to minimize risk. He said in an October speech that bank directors should make sure that:

1. Board minutes are sufficient to support the decisions being made.
2. Board and committee reports are detailed and meaningful.
3. Written policies are realistic.

Directors should also:

1. Understand their D&O policies, including exclusions.
2. Avoid approving individual loans.
3. Make sure to avoid conflicts of interest and self-dealing.
4. Include indemnification provisions or liability limitations in bank articles or bylaws.

Once new directors join the bank, the board must work fast to make sure that directors are ready to do the job. Course again offers some pointers:

- Develop an orientation program that includes meetings with the head of each business line, other board members and key outsiders, such as bank lawyers, auditors and regulators.

- Make available exam and audit reports.
- Provide director training materials and opportunities, such as newsletters, retreats and trade group meetings.
- Be sure management is transparent about all aspects of the bank.
- Give accurate, timely and sufficient information to all board members so they can make informed decisions. ■

## Regulators say Lack of Management Succession Planning is 'Key Risk'

One of the key responsibilities for bank boards is hiring and retaining senior management. Yet management succession planning is a "growing issue for many banks" and a "key risk," the Office of the Comptroller of the Currency noted in its most recent semi-annual **risk perspective**.

Boards must incorporate succession planning into strategic planning, the OCC advises. The OCC says examiners will focus in 2015 on the "adequacy of strategic, capital, and succession planning processes in light of assumed risks and planned initiatives, assessing whether banks' plans are realistic and appropriate risk management processes are established and followed."

Indeed, many banks under enforcement orders have been told by regulators to not only increase board participation in the bank's activities, but to also put together a written management succession plan or identify future senior executives, according to a review of 2014 FDIC and OCC enforcement orders. The FDIC noted last year in **Supervisory Insights** that the lack of succession planning was a major element leading to Matters Requiring Board Attention during community bank exams.

In a workshop for community bank directors, the OCC recommends that bank boards have adequate management succession plans for CEOs, CFOs and even senior lending officers. Banks without succession plans could be ripe for takeovers. ■

### Adding Value to the Bank

An active director must attend meetings, request and review materials, ask questions, understand audits and exam reports, exercise independent judgment, enhance shareholder value, monitor and minimize risk, and ensure management accountability.

Source: FDIC Training Presentation



## THE CEO CORNER

### *Despite Political Talk, Regulatory Capital Focus to Continue*

By Vito Nardelli

Community and regional bank executives along with their board members should not be lulled into a false sense of security based on recent political changes in the nation's capital. Especially when it comes to bank capital.

Although it is safe to say that Congress will consider some modifications to the Dodd-Frank Act, it is safer to say that bank capital will continue to be paramount to legislators and more importantly, bank regulators. Indeed, the Office of the Controller of the Currency's semi-annual **risk perspective**, published last month, emphasizes that examiners will focus on community banks' capital planning processes in the coming year.

Let's review some recent events that demonstrate why bank capital has been and will continue to be sacred:

- Falling oil prices and their effect on bank energy portfolios.
- Lower grain prices' impact on return-per-acre calculations for agricultural bank loans.
- New Basel III liquidity requirements and their trickle-down effect on smaller banks.
- Global monetary action, such as The Swiss National Bank's uncapping the franc from the euro, which led to an international currency valuation cascade with potential ramifications on both the U.S. dollar and the economy.

Focusing on the domestic side of the equation, consider the inevitable shift in bank interest rates and its impact on interest rate risk. There's a potential for a drop in production due to a falling demand in exports caused by a stronger dollar, which could weaken economic recovery. Companies may see higher operating expenses driven by health care costs, regulatory expenses and the threat of a higher minimum wage and paid sick time. All of these concerns place banks and their customers at risk.

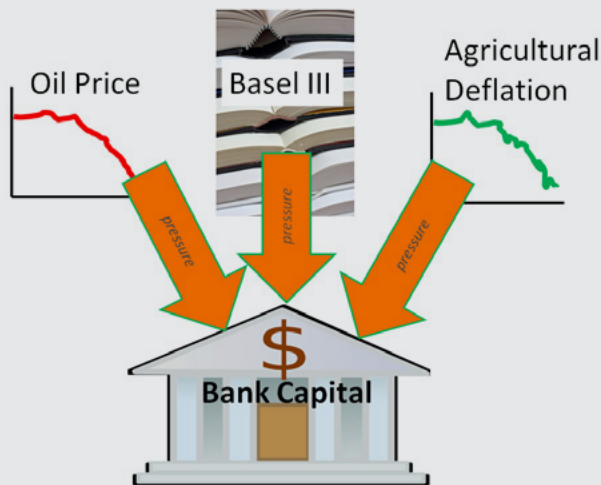
It should be evident that that these issues can—and will—put pressure on bank lending portfolios. How we in banking survive and grow in this ever-changing global environment, with all of its volatility, is as much about capital strength as any other singular component of our industry. Bank executives and their boards must continue to be laser-focused on their capital and the impact their strategic plan has on that capital. Let's not be fooled, capital still rules the day! ■

### About the Expert



*During his 30-year financial services career, Vito Nardelli has excelled at building and maintaining excellent relationships with regulators. He served as the President and COO of OceanFirst Financial Corp. and as President of OceanFirst Bank in New Jersey. Previously, Mr. Nardelli served as the Senior*

*Vice President and Retail Banking Director for Trust Company Bank, and held several leadership positions at First Union National Bank, including president of the Central New Jersey region. He has also served as Executive Director of the New Jersey Economic Development Authority in the 1990s, and was a Lieutenant Colonel in the United States Air Force Reserve. He received his BS and JD degrees from Fordham University and has an MBA in Executive Management from St. John's University.*



## Read Between the Lines

Each month *Bank Insights* reviews news from regulators and others to give perspective on regulatory challenges.

### Fed Reiterates Importance of Capital Planning



The Federal Reserve Bank of Atlanta has taken another look at why so many banks failed in Georgia and Florida during the crisis. One takeaway: “It is critically important for banks to engage in ongoing capital planning,” **writes** Michael Johnson, senior vice president, in *Community Banking Connections*. Johnson says that the key to avoiding bank failures in the future is for banks to implement “a sound, sustainable strategy and risk management practices.”

### FDIC Expands Definition of Brokered Deposits



Be sure to review the Federal Deposit Insurance Corp.’s recent updated **guidance** on brokered deposits, which appears to have broadened the definition of brokered deposits, while narrowing when banks can obtain relief from accepting them. Undercapitalized banks are prohibited from accepting brokered deposits, and significant brokered deposits can increase a bank’s insurance assessment. Bank lawyers say that banks with higher levels of brokered deposits often receive extra regulatory attention, such as mandates that they draft a liquidity plan to show how the bank would replace the brokered funds.

### Interest Rate Risk Remains Top Focus



After analyzing interest rate risk modeling at more than 1,500 community and mid-size banks, the OCC is reminding banks that they need to perform sensitivity analysis of Non-Maturity Deposit assumptions. “Testing the sensitivity of existing assumptions by applying subtle or significant variations to the repricing or decay rates may be used to analyze the potential impact on capital and earnings if depositors are less stable, or more price sensitive, than expected,” the OCC writes in the fall semi-annual **risk perspective**. “As appropriate, strategic planning should include consideration of potential asset-liability management strategies to minimize earnings volatility and capital exposure under different rate scenarios.”

The FDIC’s Winter issue of **Supervisory Insights** also focuses on interest rate risk, noting that exposure to changing interest rates is a risk faced by every community bank. (The February issue of *Bank Insights* will address this in more detail).

### New York State to Require Cybersecurity Exams

New York’s Department of Financial Services **announced** last month that all banks licensed in the state would now undergo cybersecurity exams. Regulators want to make sure that banks are incorporating cybersecurity into their corporate governance structures. Examiners will ask banks about resources devoted to cybersecurity issues and risk management, protections, testing, incident detection, management of third-parties and whether the bank has cybersecurity insurance coverage. Treasury Deputy Secretary Sarah Bloom Raskin, a former state banking regulator and Fed member, also **advised** bank executives and directors in Texas last month to consider purchasing cyber risk insurance. Qualifying for insurance can help banks assess their risk levels and identify tools and best practices the bank might be lacking.

### OCC Encourages Community Bank Collaboration



The OCC says in a new **paper** that community banks might want to pool or share resources to reduce costs and leverage expertise.

### Worth reading: Updated Handbooks

The OCC has updated four handbooks that apply to community banks. One is on **government securities**; another is about **litigation and legal matters**; a third is about **conflicts of interest**, and the fourth is about **retail nondeposit investment products**.

### Want to Buy a Troubled Bank?



The FDIC has created a new **webpage** to make it easier for healthy banks to bid on failing banks. The page includes FAQs, information about the marketing process, regulatory guidance, application links and even a video about loss sharing. The page allows bidders to update their profiles by including what state and asset size preference they want to buy. ■

## About Invictus

*Invictus Consulting Group’s bank analytics, strategic consulting, M&A and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. Bank clients have excellent results when using Invictus reports to defend their strategic plans and capital levels to regulators.*

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