

# ABABANK DIRECTORS BRIEFING

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## THE DIRECTOR'S JOB

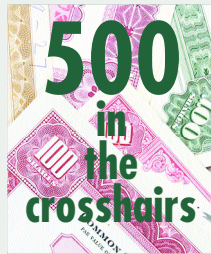
### "500 SHAREHOLDER ISSUE": NOW IT'S BOARD'S TURN TO DELIBERATE OVER PUBLIC OR PRIVATE QUESTION

For years, ABA and other banking interests worked to change the rules concerning the number of shareholders that triggered a bank's obligation to become a "reporting company"—one that must file public reports with the Securities and Exchange Commission, and, as a result, also fulfill other governance and securities compliance duties.

In the April newsletter, we reported that the JOBS Act, signed by the President, had at last made the long-pursued changes into law. In brief, the new law raised the threshold for becoming an SEC reporter to 2,000 shareholders of record, from 500. At the same time, the threshold below which a public bank or bank holding company could file to "deregister," taking itself out from under SEC registration and reporting, was raised to 1,200 shareholders of record, from 300. Other changes of potential interest to community banks have also been made by the new law.

#### IT'S YOUR TURN NOW

Now that the legislative work is over, the management and boards of public banking companies, as well as those companies that were nearing the threshold of becoming public companies, have the final law and pending SEC regulations, to consider. (The new registration and deregistration thresholds became effective immediately, and SEC has one year to revise its rules. However, some other aspects of the JOBS Act involving capital instruments and capital raising cannot be exercised until SEC



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## DEAR DIRECTOR:

### New Comptroller Says The Top Industry Challenge Now Is Operational Risk

Banking risk comes in many forms, the official number, and the labels, varying according to which regulatory agency your bank comes under. In the end, separating types of risk is a tool, a filter, for getting a better handle on overall risk, because often the surfacing of any one risk is like striking the head of a drum—the blow kind of reverberates all over.

But at any given time, a particular facet of risk may rank as the top aspect to watch, both for the regulator and for the banker.

*In a key speech, the new national bank and thrift regulator, Thomas Curry, Comptroller of the Currency, identified "operational risk" as the industry's top challenge.*

"It is currently at the top of the list of safety and soundness issues for the institutions we supervise," Curry said.

Curry noted that asset quality has been improving in recent years.

"But as the industry continues to heal from the credit and capital market challenges of the financial crisis, it is evident that another type of risk is gaining increasing prominence," Curry told the Exchequer Club, a group of financial services movers and shakers in Washington, in mid-May. That risk, Curry said, is "operational risk—generally defined as the risk of loss due to failures of people, processes, systems, and external events."

While the Comptroller directly oversees national banks and federal savings institutions, the Comptroller also sits on FDIC's Board, and the agency is part of the interagency Federal Financial Institutions Examination Council, the forum where many interagency

decisions and rules are crafted.

**Closer look at operational risk**  
Operational risk is a very broad category, perhaps because it touches many other risk issues. As Curry said:

"The risk of operational failure is embedded in every activity and product of an institution—from its processing, accounting, and information systems to the implementation of its credit risk management procedures. Managing operational risk requires banks and thrifts to control the straightforward things—like ensuring that legal documents are properly signed and contain accurate information—as well as the more multifaceted ones, like validating the inputs, assumptions, and algorithms in their risk models. Operational risk is heightened when these systems and procedures are most complex."

Just what an operational risk deficiency looks like depends on the matter being examined. Curry noted that recent controversial problems in mortgage servicing and foreclosures resulted from inadequate systems and controls.

The banks involved, said Curry, "did a poor job supervising both their own internal processes and the providers to which they outsourced some of these functions, and they are paying the price for their mistakes."

Curry added that operational risks loom when a bank has flawed risk assessment and risk management systems in place.

"For community institutions with credit concentrations, a flawed assessment of risk can lead to inadequate controls and insufficient risk

management systems,” said Curry. For the largest banks, such complex issues as “model risk,” the risk that those used for financial management are flawed, represent a key factor.

**Specific operational risks**

Bank boards, intended to play an oversight role, have to set the tone for risk management, yet they also need to avoid micromanagement. Yet board members should be aware of several specific operational risk concerns cited by Curry in his speech:

1. *Economizing too far or inappropriately.* Banks face higher and higher costs, as compliance burdens grow, with smaller incomes. Curry warned that “all institutions, regardless of size, must resist the temptation to under-invest in the systems and controls they need to prevent greater risk and larger losses in the future.”

2. *Trusting in third-party relationships without adequate vetting and controls.* Increasingly banks rely on partners for many aspects of their operations. Curry noted that outside processors present a risk of data breaches. Third-party marketing relationships could carry the seeds of unfair and deceptive consumer products and services. Curry made the point that farming out an activity done on the bank’s behalf does not remove the bank’s responsibility.

“Due diligence in identifying, measuring, and monitoring the risk from third-party relationships, and establishing mechanisms for controlling and continuously monitoring those risks, is thus an essential part of managing operational risk, which in turn affects its safety and soundness,” said Curry.

3. *Bank Secrecy Act and anti-money-laundering compliance came in for a specific mention.*

Operational and other risks combine in this area, Curry said.

“When things go wrong in those areas, not only is the integrity of the institution’s operations compromised, but national security and drug trafficking interdiction goals can be undermined.”

Curry concluded by underscoring his concern: “No issues loom larger today than operational risk in all its dimensions, the manner in which all risks interact, and the importance of managing those risks in an integrated fashion across the entire enterprise.”

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**ABA Value-Added Regulation Study: Permanent chills—and how to avoid them**

Does bank commercial lending run the risk of a longstanding slowdown? Specialists studying the current relationship between banks and their federal examiners for ABA warned of that likelihood in the course of their research.

“While there is some concern that bank examinations are holding banks back from lending today, there is a much greater worry among bankers that various aspects of the post-crisis regime of examination will permanently chill lending in the future—either by making it more expensive for borrowers, largely in the form of additional paperwork accompanying any loans, and higher required equity cushions—or denying loans to borrowers that many bankers believe would be sound but run substantial risk of regulatory criticism.”

Former Comptroller of the Currency John D. “Jerry” Hawke, Jr., now a partner at Arnold & Porter LLP, and Robert Litan, vice-president for research and policy at the Kauffman Foundation and a senior fellow at the Brookings Institution, wrote the recently released *Value-Added Bank Supervision: A Framework for Safely Fostering Economic Growth*.

The quote above, taken from it,

continues with this warning from the two authors:

“The potential negative impact on future lending is of special concern because it can slow the recovery in the intermediate term, and if sustained, could lower potential national economic growth over the longer run by raising the cost and reducing the availability of business lending. These impacts will be magnified to the extent they curtail bank lending to small and newer businesses, which historically have been a main driver of both job growth and cutting-edge innovation. In other words, we find that in dangerous ways distance has developed between the bank supervisory program and its value-added mission.”

The ABA-sponsored survey found that, post crisis:

- 49% of bankers surveyed said exam practices would “toughen underwriting standards permanently, as applied by the bank.”
- 48% agreed that examination shifts “would require borrowers to have more equity in their deals.”
- 48% reported that changing standards “would reduce their willingness to lend to customers that in the past they would have considered creditworthy.”

**What’s “valued added”?**

To some bank bashers, the thought that the nation’s economic health and the shape of its banks bear a relationship to each other may seem novel. But Litan and Hawke’s broader point is that regulatory supervision of banks means more than looking over banks’ shoulder every year or so.

The authors explain their concept that bank examinations should have a “value added” element by drawing an analogy, the annual medical checkup.

“It is useful to think of bank examiners as the financial equivalent of physicians,” they write.

# How much do busy bank directors **really** read?

What regulators **think** your directors read



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"Doctors conduct annual physical exams to assess a patient's health and to spot potential problems, and they frequently provide advice about how to sustain or improve health in the coming year."

"Examiners are experts who are specially trained to look beyond the numbers, seeking to determine whether the processes that banks use to gather deposits, extend loans, manage risk, and keep track of all of this information, and to ensure its security, are appropriate," they write. "... When conducted with the foregoing objectives in mind, bank examinations add value to banks just as annual physicals add value to patients."

The point, they write, is that if the bank is doing well and no significant changes are necessary, then the bank is better off for the exam. And an exam conducted as a value-added exercise should identify issues that a bank requiring something more needs to deal with.

"Banks that have significant weaknesses, including capital shortfalls or insufficient liquidity, must be told to shape up, in their own interest, and in the interest of other banks, which bear the cost of insuring their deposits in the event troubled banks fail," they state.

**Where's the value?**

The study found that since the crisis, bankers have not felt that examinations have been adding value. Many surveyed feel that examiners don't tailor their examinations to the bank being examined. The survey found 37% felt examiners adapted their work to the institution, while 42% only felt this was somewhat the case, and 21% felt that supervisors don't customize their examinations at all.

Litan and Hawke suggest eight steps that can help restore some equilibrium. Read them in ABA's full report, <http://tinyurl.com/valueaddedstudy>.

Sincerely,

*Steve Cocheo*

For *ABA Banking Journal*

finalizes implementing regulations. And some aspects of deregistration also hang on SEC action.)

For many public banks, there's no question that they will remain so. But for an estimated 500 community banking companies, deregistration now becomes a possibility. Further, banks that were hovering near the old borderline—sometimes having to engage in last-minute maneuvers to pull down their number of shareholders of record to avoid crossing the line—now have some breathing room.

"We were right there at the line, right at 500," a community bank CEO told us over lunch the other day. He sighed with visible relief in discussing the April news.

**NOT A SIMPLE DECISION**

"For community banks, it was a big hit," overall, said Jennifer McCain, of Maynard Cooper & Gale, PC. Under the old rules, community banks often faced a balancing act, attempting to raise capital without passing the threshold for becoming a public bank.

This issue involves a fair degree of detail and minutiae, once a decision has been reached. In late April, ABA presented a telephone briefing, "The New Deregistration Thresholds Under the JOBS Act: What Community Bankers Should Know." Experts, including McCain, participating in the program discussed many of the early details to be examined by banks considering taking advantage of the law. But they also spoke more strategically.

*A key point behind this section of the program concerned the role of a bank board as guardian of the interests of shareholders.*

No doubt, the costs of being an SEC reporting company can be significant, involving not only the direct duties but also those imposed by legislation such as the Sarbanes-Oxley Act. Years ago, when the effective dates of "SOX" approached, community banks that had eagerly sought the perceived prestige of being an SEC reporter frequently explored steps they could take to "go private" and get out from under the shadow of SOX. Some did so, some ran up against the federal limits that have

now been undone.

As explained by the speakers, the decision to deregister is not a simple one. It's nothing to decide as if the matter were nothing more than the approval of last month's minutes.

"The decision is a very important corporate move and should not be taken lightly," said speaker Robert Fleetwood, partner at Barack Ferrazzano Kirschbaum & Nagelberg LLP. "As you work through this, remember your duty of care."

Fleetwood noted that his firm has clients who, while having fewer than 1,200 shareholders, don't plan to deregister. He said that those companies' strategic plans call for growing their shareholder bases, and that they don't intend to contain their shareholder group to fewer than the new 2,000 holder limit, where registration would be required.

"There are a lot of nuances to consider here," said Fleetwood.

**KEY CONSIDERATIONS**

Among questions listed by Fleetwood and partner Sarah Bernstein:

- What impact could deregistration have on the company's stock price? Could no longer being a public company make the bank's shares less desirable, thus lowering the price and affecting existing holders?
- What effect could deregistration have on shareholders' liquidity?
- What impact could deregistration have on the perceptions of shareholders and others regarding the company's stance now and in the future?
- How might a clear decision to keep the shareholder base below the new 2,000 threshold affect willingness of local market makers to continue providing a means of trading shares? It was pointed out that some market-makers may have been doing so in anticipation that a bank would eventually go public. Market-makers may reconsider their participation.
- What impact would deregistration have on the company's ability to trade in the future? Companies that deregister would have to leave stock exchanges, for instance, though

Fleetwood pointed out that existing forums such as the "pink sheets" and newer, evolving markets for trading community bank shares provide, or could provide, a means of trading the stocks outside of traditional channels.

- What impact would deregistration, or the decision to avoid the new threshold, have on institutional investors who have a piece of the bank? Such investors may not care for stock that isn't going to be actively traded.
- What impact would deregistration have on employees and employment-related programs? Would going private affect existing options and other equity-based rewards programs? Could there be an effect on employee stock ownership programs?
- Could key employees' decision to remain with the bank be affected in some way by the decision to deregister?
- Could deregistration affect the prestige of the bank in its community? Could the wrong interpretation be put on deregistration?
- More strategically, if the bank's plans include making acquisitions in the future, a key "currency" for buying other institutions (other than failed or failing banks from the government) may be your bank's own shares. Could deregistering devalue that stock-as-currency?
- Could deregistering affect future ability to raise capital?
- How might deregistration have on the bank's insurance costs? Bernstein pointed out that directors' and officers' liability coverage might become cheaper if the bank deregistered.

The message, overall, was that the board that is reviewing the public-private question must take many factors into account. Deregistering the bank is a decision, said Bernstein, that must be made for the right reasons, not just for the sake of getting rid of some of the federal regulatory burden.

### VOICES BEYOND THE BOARD'S

Speakers said that while the board and management must consult carefully on this issue, it's not just their decision, in some cases.

For example, speaker Jennifer noted that a bank's state and federal regulators will expect to be consulted when the board is weighing an decision of this importance.

Various elements of the company may influence how the regulators feel about deregistration. A bank that has been scrutinized by examiners over capital may run into resistance.

And if a bank or its holding company is under a formal or informal enforcement action, that may also play a role in how regulators view a proposed deregistration.

### INTERESTS OF EXISTING SHAREHOLDERS

Existing shareholders can be part of the equation, as well. Speakers said that a bank that wishes to shrink its shareholder base to below 1,200, in order to deregister, will

have to take steps to slim down the base.

Stock purchases, stock splits, and other actions accomplish the mechanics, but some transactions may require shareholder approval, and Bernstein stated, can trigger rights for dissenting shareholders.

Some transactions may require the assistance of experts and demand a stock valuation. Disclosure of a bank's stock valuation may put data in the hands of hostile investors. What they could do with that data must be considered, Bernstein said.

Bernstein also said that where shareholders are being bought out, to shrink the shareholder base, laws beyond the JOBS Act must be considered. State law, in the form of statutes, governing court decisions, and state common law, may play a part.

Given all this, "it's important for the board to consider the appropriate price at which to make repurchases," for example, said McCain.

*An unexpected wrinkle affects savings and loan holding companies.* Due to a legislative oversight, such companies weren't covered by the JOBS Act. This oversight has to be fixed by corrective legislation, which is being pursued in Congress.

### OTHER FACETS TO WATCH

The program also looked at other aspects of the JOBS Act that may be helpful to community banks, in time. These won't be effective until SEC issues rules.

One matter concerns private placements. At present, issuers of private placements of securities cannot make general solicitations to attract potential investor in these private offerings. This could sometimes make it hard to get the word out that the local bank was looking for new investors.

The JOBS Act would allow issuers to promote private placements, using print, television, internet, and other advertising. An important restriction is that all purchasers would have to be "accredited investors." Briefly, as far as individual investors not connected to the institution, they would have to have a net worth, excluding their home, of \$1 million. (This can include the net worth of a spouse.) Or they would have to have income exceeding \$200,000 in each of the two most recent years, and reasonable expectation of similar income in the current year. (If a spouse's income is counted, the threshold rises to \$300,000.)

The JOBS Act includes additional new wrinkles intended to bring capital into all kinds of businesses.

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This article is a summary of a very complex program, and we recommend that any institution contemplating moves under the JOBS Act obtain a recording at [www.aba.com/teleweb/tb042512.htm](http://www.aba.com/teleweb/tb042512.htm) ABA members may also wish to contact Diana Preston, vice-president and senior counsel, and deputy general counsel of the ABA Securities Association, at [dpreston@aba.com](mailto:dpreston@aba.com)

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