

# Community Bank Director



From the ICBA Community Bank Director Program

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## IN WASHINGTON

### ICBA Secondary Market Plan Ensures Strong Voice for Community Banks

By Ann Grochala

As the debate over fundamentally reforming the secondary mortgage market has heated up, ICBA recently released its comprehensive plan on how reforms should proceed to ensure that community banks have open and equal access to the secondary market of the future. In a written statement for a House Financial Services Committee hearing, ICBA proposed restructuring Fannie Mae and Freddie Mac as cooperative entities owned by mortgage originators that purchase stock commensurate with their loan sales to the co-ops.

**ICBA's Plan.** The association's proposed capital structure is similar to the Federal Home Loan Banks' and provides a source of capital

that can be adjusted based on market conditions and the co-ops' risk profile and performance. The cooperative structure would ensure broad access and deter excessive risk taking. Members would have an incentive to transfer only soundly underwritten loans because any losses would adversely affect their capital investment.

The co-ops also would be governed on a one-company-one-vote basis, so large banks would not be allowed to dominate the system. This would ensure that all members enjoy open and equal access and benefits in terms and pricing, regardless of their origination volume. *continued on page 3*

## RISK MANAGEMENT

### OREO Development: Can Banks Turn Lemons Into Lemonade?

By John M. Jennings

With burdensome levels of other real estate owned (OREO) generated by foreclosures during the economic downturn, many banks are exploring alternatives for managing OREO to enhance recoveries. One alternative is improving or developing OREO.

To what extent is this allowed?

#### **For National Banks**

A national bank must dispose of OREO at the earliest time that prudent judgment dictates and within five years, unless an additional period of up to five years is granted by the OCC. While the National Bank Act allows for a five-year (or longer) holding period, a bank, along with its examiners and shareholders, will generally desire a much shorter holding period.

In general, a national bank may be permitted to spend funds to develop OREO to the extent

necessary for the bank to recover its investment, but it is not permitted to develop OREO for the purpose of real estate speculation or in an attempt to generate a profit. For example, for OREO that is a development or improvement project, a national bank may make advances to complete a project if the advances:

- are reasonably calculated to reduce any shortfall between the parcel's market value and the bank's recorded investment amount;
- are not made for the purpose of speculation in real estate; and
- are consistent with safe and sound banking practices.

A national bank subsidiary is generally subject to the OREO development restrictions that apply to the bank. Costs relating to property management—such as taxes, in-

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## **IN WASHINGTON**

# **ICBA Advocates Reforms To Prevent Additional Burdens**

**By Brian Cooney and Aaron Stetter**

**I**n recent congressional testimony, ICBA continued its campaign to prevent the Wall Street Reform Act from imposing disproportionate burdens on the nation's community banks and their customers. Testifying before a House Financial Services subcommittee, ICBA Immediate Past Chairman Jim MacPhee noted that while some pieces of the law benefit community banks, several provisions threaten to pose additional burdens on institutions already facing a harsh regulatory environment.

MacPhee again called on Congress stop the Federal Reserve's proposed rule to impose government price fixing of debit card interchange fees. He told the panel that an exemption for institutions with less than \$10 billion in assets and a two-tiered pricing system for large and small institutions will not work in the marketplace. "Not only are small issuers not carved out, they would be disadvantaged relative to large issuers, and a likely consequence of the Federal Reserve's proposed rule, if implemented, is further industry consolidation, higher fees and fewer choices for consumers," he said.

MacPhee also recommended that Congress ensure that prudential bank regulators have a greater role in developing Consumer Financial Protection Bureau regulations and that the new bureau continue to reach out to community banks as it develops new rules. He also said that regulators should not define "qualified residential mortgages" too narrowly, which could drive thousands of community banks and other lenders from the residential mortgage market.

Further, MacPhee said regulators should exempt portfolio loans held by banks with assets of less than \$10 billion from a new requirement that first-lien mortgage lenders establish escrow accounts for the payment of taxes and insurance. Among other recommendations, he also encouraged Congress to ensure that new regulations do not disadvantage community bankers' use of derivatives and to reintroduce the use of credit ratings, but authorize regulators to confirm the credit ratings when additional credit analysis is warranted.

While MacPhee discussed these and other recommendations on how to prevent additional burdens on community banks, he also expressed ICBA's support for provisions in the act that provide for tiered regulation of the banking industry, subject too-big-to-fail financial institutions to stricter regulatory standards, impose new regulations on the "shadow" banking industry and base the deposit-insurance assessment base on assets instead of deposits.

The Wall Street Reform Act was a landmark law for the financial services industry that continues to be debated by Congress and federal regulators. ICBA remains a part of that debate and will continue working with policymakers in the weeks, months and years to come. **I**

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## ***RISK MANAGEMENT*** from page 1

insurance, maintenance and normal repairs, and managerial fees—generally are permitted and do not require regulatory approval. The OCC has shed some light on the types of development expenditures that are permitted. For example, in response to a request from a national bank that proposed to spend funds on matters such as site preparation, streets, sewers, curbs, gutters, utilities, re-zoning and platting of land, the OCC responded with the following illustration ...

If an OREO property is vacant land upon which construction of 100 houses was planned, a national bank generally could not commence construction of the 100 houses. However, if construction had begun on some of the houses, a national bank probably may complete the construction of those homes that had been started and make improvements to the land that are reasonable and necessary to sell those homes.

If construction on only 10 houses had been started or completed by the borrower prior to foreclosure, the bank could not commence construction of the remaining 90 houses simply because they had been planned by the borrower.

In another instance, in which a national bank faced several serious consequences, such as frequent expenditures, possible legal liability and deterioration in the market value of the subject properties because the septic tank system was malfunctioning, the OCC permitted the installation of sewer lines to carry sewage from residential properties held by the bank as OREO.

As a related matter, a national bank may be permitted to expend additional funds to operate an establishment whose value depends substantially upon uninterrupted operation. For example, a national bank has been permitted to operate a theatre, a bowling alley, three bars, a grill, a steakhouse,

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**Risk Management.** To shield the co-ops from excessively risky mortgage lending, a limited scope of conservatively underwritten products would be eligible for sale to the co-ops. Fifteen- and 30-year fully amortizing mortgage loans that meet the definition of “qualified residential mortgage” and adjustable-rate mortgage loans that meet the QRM definition would be exempt from risk-retention requirements. Loans that fall outside of the QRM definition would require risk retention by the originator, and the additional risk to the co-ops would be priced accordingly. Further, the co-ops would be barred from operating in the primary market so that they would not unfairly compete with mortgage originators.

**Taxpayer Protection.** Additionally, a privately capitalized guarantee fund would insulate taxpayers. Co-op members and third-party guarantors would capitalize a fund to guarantee the mortgage-backed securities issued by the co-ops. Resources would be set aside in good times to prepare for challenging times, and the government would provide catastrophic loss protection, for which the co-ops would pay a premium. Though the co-ops would ultimately be backstopped by the government, private capital from members and private reinsurers would absorb all but catastrophic losses.

**Market Stability.** This guarantee, fully and explicitly priced into the guarantee fee and loan-level price, would provide credit assurances to investors and sustain robust liquidity even during periods of market stress. It also would enable the co-op securities to be exempt from Securities and Exchange Commission registration and trade in the “to-be-announced” forward market. Without the

TBA market, which allows lenders to sell loans forward before they are even originated and to hedge their interest rate risk during the rate “lock” period, the 30-year, fixed-rate loan as we know it would become a rarity.

**Sound Transition.** The infrastructure of Fannie Mae and Freddie Mac—including their personnel, systems and automated underwriting engines—would transfer easily to the new co-ops. This is an essential feature of the proposal as it would minimize disruption in the market and reduce the cost of the transition to the new system. Further, the government-sponsored enterprises’ outstanding debt and securitizations would retain the current guarantee.

**Strong Oversight.** Finally, the new co-ops would be subject to strong regulation and supervision by the Federal Housing Finance Agency. The agency would be responsible for setting and monitoring capital levels based on market conditions, portfolio performance and overall safety and soundness. The FHFA also would approve all new mortgage products purchased by the co-ops.

**Looking Ahead.** Community banks need a financially strong, impartial secondary market that provides equitable access and pricing to all lenders regardless of size or volume. While it is all but certain that private entities will succeed Fannie and Freddie, it remains to be seen what form those entities will take. ICBA is focused on ensuring that the reformed housing-finance system will not feature instruments of Wall Street, but rather an infrastructure that allows community banks and the largest institutions to be represented equally and that serves communities throughout the nation. ■

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## IN THE BOARDROOM

# Doing More with Less—An Imperative for Directors

By Rick Wemmers

Doing more with less, that new business imperative shouldn't be news to any community bank director. It is dramatically changing how organizations must do business today. Just look at what is happening to the U.S. Postal Service: Its branches and service are being reduced in places least expected. Who even thought this would so deeply affect such a long-insulated government institution?

With these changes comes a strong command for all board members to refocus and reevaluate the quality of leadership running their bank, and not just the president's leadership. Leadership improvement starts with the board and extends down the management chain, including department and branch managers. Like other organizations, community banks must accomplish more with fewer people, and the younger generation of employees must obtain different management skills than earlier business leaders.

Some bank boards are serving "at the will of the president" while other boards try to micromanage their bank's executives. For banks facing any degree of either example, now is the time to put personal emotions and idiosyncrasies aside and concentrate on working better together to ensure your board has something to manage in the future.

Your community bank's board and top-level executives should candidly review the quality of leadership talent running the bank now and that which will do so in the future. This should not be a popularity, ego or emotional discussion. To avoid boardroom conflicts, consider ob-

taining outside professional assessments of your bank's leadership and board team. After an outside assessment, meet and discuss who it shows has the skills to best manage current and future challenges. Those challenges include managing new technology, meeting new competition from afar, developing young employees for future management careers and dealing with many new regulations.

The leadership assessment should answer questions such as these:

- Is the bank's management proactive or reactive?
- Is there a clear strategic plan (which doesn't simply mean a new budget)?
- Are leaders anticipating and preparing for different local and national change scenarios?
- Can the bank handle increased regulatory costs?
- Is there a clear and implementable management succession plan in place?
- Is the bank prepared to operate with fewer employees?

If your board can't openly discuss these questions then bring in an outside facilitator to help. There is nothing to fear and everything to gain from professional leadership assessments. They should better prepare your community bank to prosper in the future.

Please make the subject of leadership, and preparing to do more with less, a part of your next board meeting. Every director should be willing and open to discussing this issue. ■

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### **RISK MANAGEMENT** from page 2

a convention hall and a motel which it acquired through foreclosure until a subsequent sale could be arranged.

If the sum of a development or improvement project's estimated cost and the bank's current recorded investment amount (including any unpaid prior liens on the property) exceeds 10 percent of the bank's capital and surplus, a national bank must provide a 30-day advance notice before implementing the project. Unless informed otherwise, the bank may implement such a proposed project, subject to any conditions imposed by the OCC.

#### **For State Banks**

Most states have "wild card" statutes that permit banks chartered in that state to engage in all activities permissible for national banks, although a state bank should examine the law of its particular state. The FDIC generally prohib-

its an insured state bank from engaging in activities that are not permissible for a national bank. Accordingly, the OREO development limitations applicable to national banks generally also apply to state banks.

In general, the more the lemons have been peeled and squeezed before a bank takes possession of the property, the more likely it is that regulators will view completion of the lemonade as non-speculative and likely to enhance the bank's recovery, and so the transaction would be permissible.

Whether a bank's specific proposed development or improvement of OREO is desirable, permissible or subject to a regulatory advance notice requirement will depend on the particular facts and circumstances, which should be evaluated by the bank together with its regulatory counsel. ■

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## **MANAGEMENT**

### **So Who is Running Your Bank?**

**By Michael Guglielmo**

2011 is emerging as another year of turmoil and uncertainty. Fatigue and burnout over financial, accounting and regulatory burdens still weigh on many financial institutions. Contributing to the angst are inconsistent interpretations and application of new accounting rules and regulatory pronouncements. Further, many banks are still experiencing credit risk challenges, an excessive build up of cash, limited investment opportunity, lackluster loan demand and an overabundance of non-maturity deposits whose future retention is questionable.

Working actively with hundreds of organizations, our firm sees a broad spectrum of regulatory and strategic issues facing banks this year. In unwavering terms, times have changed and the consequences of not being prepared are too severe. Management teams and boards of directors must become comfortable answering tough questions from examiners with “I’ll get back to you tomorrow.” If they are sufficiently versed in the new regulatory guidance, they also should “push back” on recommendations that are truly not required.

Many community banks are investing valuable time and money trying to cover items identified in their last exams that are not required by regulatory guidance, but also have little, if any, utility. Most of those banks are inadequately prepared and, therefore, can do little to head off unfortunate outcomes.

Community banks that navigate these challenges do so through a combination of key initiatives:

- ongoing development of an ALCO discipline that has at its core a focused, proactive decision-making process backed by more robust modeling, supportable assumptions, “what-if” strategy simulation and stress-testing practices;
- a commitment to broadening the knowledge of the board through formal education and training programs;
- greater emphasis on documentation (policies, procedures and paperwork); and
- preparing for an upcoming exam by playing devil’s advocate and anticipating the “tough questions.”

For banks that don’t invest the time and money in these initiatives, more regulatory scrutiny is in their future. Instead, be proactive and show examiners that your bank’s ALCO and board have a firm understanding of the entire asset-liability management process; that the results are used in your bank’s strategy discussions; and that your bank is comfortable with its risk profile under stressed/extreme scenarios.

Can your community bank do this? If it can, then the answer to “who is running your bank?” is simple—you are. ■

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## **BANK COUNSEL**

### **Board Duties When Considering a Merger**

**By Len Rubin**

Most financial industry analysts expect that the number of U.S. financial institutions will materially decline over the next several years. They cite the increased costs associated with regulatory compliance, need for additional capital and large inventories of distressed assets as the principal reasons that some smaller banks may find it hard to remain independent, and why many of them will have to sell or find a merger partner.

For directors considering a possible bank merger or other business combination, to satisfy the board’s fiduciary duties, it is important to understand the process the board (either the bank board or, if applicable, the holding company (BHC)) needs to follow from start to finish. There are many important issues other than price to consider before, during and after a merger. Here is a brief outline of the typical merger decision process.

#### **Board Actions**

A bank should first engage an investment banking firm to provide financial advisory and investment banking services in connection with a potential transaction, and counsel experienced in bank mergers and acquisitions should advise the board and investment banker throughout the process.

*Investment banker duties.* The investment banker will meet with special counsel and a specially appointed committee to provide an overview of the bank merger and acquisition market and to discuss reasonable expectations for a transaction, including the price at which a transaction could occur in today’s market. The investment banker will also discuss with the committee the bank’s projected value under various scenarios if it were to continue as an independent entity.

The discussions may occur over the course of more than one meeting and, ultimately, the committee and the board will need to decide whether proceeding with a transaction would be better for the long-term enhancement of shareholder value.

The investment banker will prepare and deliver to the board a list of potential merger part-

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ner candidates and will conduct preliminary due diligence on the candidates and the bank. He will also prepare a set of materials, including a confidential information memorandum, for use in soliciting the candidates.

Each candidate must enter into a confidentiality agreement before engaging in discussions regarding a potential transaction. The board must approve both the form and substance of the confidentiality agreement before requesting that the potential merger partner sign the agreement.

The confidentiality agreement should include a covenant not to recruit the bank's employees or customers. The investment banker will provide certain information about the bank to each candidate that it is authorized to contact and with whom it has an executed confidentiality agreement.

The investment banker will likely recommend to the bank whether to focus on only one or two candidates, or whether to conduct an auction at which a number of candidates may bid on the bank, or whether the bank should pursue some other alternative. If the investment banker identifies one or more candidates and if discussions with those companies progress far enough, those companies will likely engage legal counsel and a loan review firm to assist with their due diligence, including meeting with bank senior management and the full board of directors.

The bank's special counsel should be present at these meetings and will interact directly with the candidate's counsel and senior management. It is common at this stage for the amount of due diligence conducted by the candidate to be limited. Should the discussions progress further toward a likely transaction, the candidate would complete a more thorough due diligence.

*Letter of Intent.* Ultimately, if satisfactory progress is made, the candidate will deliver to the bank a proposed letter of intent in which it would offer to acquire/merge with the bank or bank holding company. The letter of intent would include a nonbinding proposal to acquire/merge with the bank/BHC, subject to due diligence and other conditions. The letter would reflect the general business terms of the transaction. The special counsel and investment banker will review the letter and advise the board on the proposed terms and on an appropriate response.

If the merger committee has not already up-

dated the full board of directors on the merger negotiations with the candidate, it will typically do so at this point. The committee has a duty to report to the full board of directors any opportunities that it concludes rise to the level of a genuine opportunity for the bank/BHC, together with the committee's recommendation, if any, regarding a response.

If the committee (or the board) does not find the potential candidate's offer attractive enough, it is not under any obligation to go forward with the transaction and may choose not to respond to the proposed offer. The board has the authority to terminate negotiations with a candidate at any stage throughout this process. However, if the board finds the candidate's offer attractive enough, the committee and bank special counsel will negotiate the terms of the letter of intent. The proposed transaction would typically remain confidential at this stage. It would not be disclosed publicly, and knowledge of the transaction would be strictly limited to a need-to-know basis within the bank/BHC.

*Due diligence/Merger Agreement.* If a satisfactory letter of intent is executed, the candidate will typically complete its due diligence at that point. If the candidate had not yet engaged legal counsel or a loan review firm to assist with this process, it will do so at this time. The bank/BHC with its special counsel will negotiate and document a merger agreement and other related agreements with the candidate, usually including lock-up and non-compete agreements for directors and new employment and non-compete agreements for senior management.

The bank/BHC will discuss approval of the merger agreement at a board meeting, and both the bank's/BHC's special counsel and investment banker will attend. Special counsel will summarize the legal terms of the transaction, and the investment banker will discuss the financial terms of the transaction and its fairness opinion.

If approved by both the bank/BHC and the candidate, the merger agreement will be executed by both parties and the investment banker will issue its fairness opinion on the transaction. The first public announcement of the transaction is made at this time.

After execution of the merger agreement, the bank/BHC will seek shareholder and regulatory approval for the transaction. This typically takes three to four months. ■

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