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EDITORIAL: 212-620-7219 SCOCHEO@SBPUB.COM
CIRCULATION: 800-895-4389 JEBERLY@SB-REB.COM

THE DIRECTOR'S JOB

EXPLORING MYTHS, HOLES, AND EXCLUSIONS ABOUT DIRECTOR'S AND OFFICER'S LIABILITY COVERAGE

The exposure of bankers and board members to liability has rarely been greater. Regulatory ratings can plummet unexpectedly these days, and accounting policies can undo profits and capital. Shareholders get angrier faster. While few bank board-management teams need worry about failure, and the strong possibility of an FDIC lawsuit in the wake of that, the risk of financial penalties haunts bank leaders even when failure is not an issue. The Dodd-Frank Act, in many ways, lurks, its long-term impact on the industry still an unknown.

Hundreds of listeners to a recent webinar sponsored by *ABA Banking Journal* and Zurich in North America, a major directors and officers liability insurance carrier, were asked if they felt adequately protected from liability. *While 59% said yes, a shocking 41% said no.*

PROTECTION: MORE THAN INSURANCE

A key point that came out during the speakers' discussion was that while it's unthinkable to not have adequate coverage, that is a solution for when all else has failed, not a first-line defense.

"D&O is perhaps seen as a safety net," said Chris Taylor, head of Zurich in North America's financial institutions group. "But it is a back-end device. It is not something that relinquishes you of any duty or responsibility to do the right thing along the way."

Putting it more directly, Taylor warned, "While it's an *honor* to be selected to be a board member, it's definitely not an *honorary*

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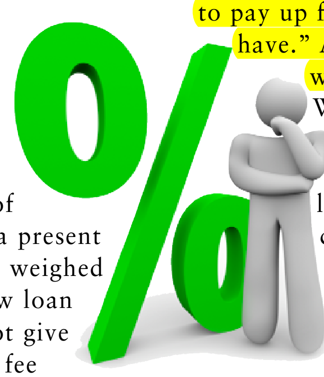
DEAR DIRECTOR:

Dodd-Frank's Interest On Business Checking Arrives At An Odd Time For Many Community Banks

It's not often that the reversal of a banking law going back to the Great Depression draws a low-key response from the banking industry.

But a combination of factors results in most community banks not making the oncoming repeal of restrictions on paying explicit interest on business demand deposits a priority.



Among the factors: Dodd-Frank overload; an overflowing plate of higher-priority tasks; a present abundance of deposits weighed against widespread low loan demand; an urge to not give up increasingly scarce fee income; an environment of ultra-low interest rates; and questions about the technical details. Add an interesting deposit insurance twist and you get something of an exhausted yawn in many quarters about the July 21 change.

Quiet on the checking front

Mind you, Dodd-Frank and the Federal Reserve's proposed regulatory revisions don't force this on banks. It's *optional*.

"We will be restructuring and repricing all of our business checking account products this fall and will probably create the business checking with interest product at that time," says Wyoming community banker Richard Chenoweth, at $146 million-assets Rawlings National Bank. Chenoweth says the bank has had no demand for the product from customers. "There are plenty of other, larger fish to fry, in dealing with this difficult economy," he explains.

"Most of the banks that I'm talking to think of this as a nonevent," says bank asset-liability management consultant George Darling. "The last thing most banks need right now is deposits. There's no loan demand. And they don't want to pay up for money they already have." Adds Darling: "Nobody wants to be first."

While Dodd-Frank lifts the restriction by statute on **July 21**, a year after the law's enactment, most community bankers interviewed continue to study the matter. They say virtually no one—neither big bank nor community bank—has tipped their hand or tried to get out in front of the pack. (ABA and others have pointed out to the Federal Reserve and FDIC that there are many technical issues involved and have asked for more time for banks.)

Indeed, "we are watching the market like hawks, but they are sitting quiet on this one," says Dan Geller, executive vice-president of Market Rates Insight, a firm that tracks financial institutions deposit pricing.

Typical comments:

• "We're looking at the options that are open to us," says Frank Sorrentino, chairman and CEO, $602 million-assets North Jersey Community Bank, Englewood Cliffs. "But right now, I'm not so sure anybody cares, because interest rates are near 0%."

• "I would have preferred that they didn't change the rules," says Rheo Brouillard, president and CEO, $915.2 million-assets Savings Institute Bank & Trust, Willimantic,

Give banks more time to prepare, ABA tells Fed, FDIC

In detailed comment letters, ABA and The Clearinghouse took both a short-term operational viewpoint and a long-term strategic viewpoint, in anticipation of the return of higher rates. A key excerpt from the May 16 letter to the Federal Reserve:

"Due to the repeal of Regulation Q, banks choosing to offer interest-bearing demand deposits will have an operational burden to develop new deposit products, update contracts and disclosures, educate customers, and, depending on the applicable FDIC insurance levels, move a substantial volume of customers' funds into new deposit products. From a compliance perspective, banks need clarity on the treatment of new interest-bearing demand deposit accounts, including hybrid interest products, and, very importantly, guidance on how to record interest-bearing demand deposits on quarterly bank reports."

Read more: *www.aba.com/Members+Only/Regulatory/gr_PaymentDemDepositInt2011.htm*

Conn. "It has the potential to change the interest expense side. These have been good low-cost deposits for some time."

• "Credit unions here in Oregon pay interest on business deposits and we have complained about our inability to compete with them," says Portland banker Ann Marie Mehlum, president and CEO, $117.6 million-assets Summit Bank, Eugene. "That said, it will take a good deal of our management bandwidth to evaluate this and devise the best implementation strategy. We will not be ready in July."

Deposit insurance angle

Adding some uncertainty is deposit insurance, in the mid-term. Until the end of 2012, businesses have *unlimited* insurance on noninterest-bearing demand deposits. Under Dodd-Frank, if they opt for interest-bearing accounts, they only receive the now-standard $250,000 coverage.

But in the short term, some bankers have more certainty. For example, Charles Brown, chairman and CEO at $148.6 million-assets Insignia Bank, Fla., believes most large business account holders will tend to prefer full insurance, rather than receiving interest.

Exceptions to "*dis*-interest"

While many banks would just as soon this issue be punted forward—maybe even permanently—there are some positives seen by some.

A key one concerns sweep accounts. When market rates were much higher, "sweep" accounts were born. Broadly, the idea was that the deposits in sterile checking accounts were minimized by sweeping excess funds out of them and into interest-bearing arrangements. A very common arrangement was sweeping funds into repurchase agreements, or "repos" for short. Essentially, a bank sold securities from its portfolio to the business depositor, temporarily. The investment instrument secured the arrangement and the depositor received interest for the short-term investment.

Business customer interest in such arrangements has varied, and in many of the banks interviewed, customers with larger balances tended to use them. In some institutions the process was automated, in others a cumbersome manual routine had to be followed.

Now, for those banks that have had customers in sweeps, life will be simpler, *eventually*. They will be able to deliver interest without sweeps, and their investment portfolios, the source of the "repos," will no longer be encumbered. Darling knows of one large community bank where 50% conversion out of sweeps would free up $300 million in securities.

Some banks have seen less customer interest in sweep programs in the low-rate environment of recent times.

But for those who still have substantial participation in sweeps, a side benefit of the shift will be the return of the deposits to the bank. Though many institutions sit flush with cash right now, that won't necessarily continue to be the case.

Potential competitive impact?

Consultant George Darling is skeptical about anyone who hopes only to get deposits, pointing out that credit is what many firms want, and they'll change banks to get loans and move their deposits at their new lender's request.

"I don't think a lot of companies are going to move their relationships just to get interest on demand deposit accounts," says Darling.

There's common agreement among bankers interviewed that a big reason they are relatively calm about this aspect of Dodd-Frank is the low-rate environment. When the return on an account is measured in basis points, rather than percentage points, it's not exactly the stuff that quickens your pulse.

But those who take a longer view think more will be going on.

"It will be a new paradigm," says analyst Dan Geller. "It is hard to gauge how it will evolve. Definitely, competition will intensify."

There is also a minority viewpoint, in specialized situations.

Some community savings banks, only recently entering the business banking arena, see the change as an *opportunity*—a chance to attract new customers for all services with interest on checking as an introduction.

In Vermont, for instance, Dan Yates, president and CEO of $185.7 million-assets Brattleboro Savings and Loan Association, notes that the thrift is the only banking institution that is still headquartered in its part of the state. This is driving a decision to expand activities.

Interest on business checking "is

a great opportunity for us," done carefully, says Yates.

"One school of thought is, if you are going to do it, this is the time, with interest rates where they are," says Yates. However, he adds, "there is the question, what do we do when rates *rise*?"

At present, even though the bank has plenty of deposits, Yates notes that a shift to business checking could be a boon for the traditionally consumer-focused company. Even if Brattleboro were to pay 20 basis points on business checking, he points out, its average cost of funds currently is 199 basis points—nearly *ten times* the cost of the business deposits.

"That doesn't sound bad," says Yates. "But again, that's *today*." The future rate policies of the Federal Reserve remain an unknown.

Pricing interest-bearing accounts

Market Rates Insight's Geller, who studies pricing trends, notes that there is no historical data to go on. With interest on business checking being banned in the 1930s—indeed, until the nationwide advent of NOW account in the 1980s, interest on any transaction account from a bank was barred—"we're looking at 80 years when no interest was paid on business checking," says Geller.

What evolved instead was the "**earnings credit**," a form of quasi-interest that was computed to give customers a return for interest-free use of their funds.

Those banks that used this approach, in a process generically referred to as "analysis," offset the quasi-interest against the various fees charged for processing items, etc. Larger banks tended to have more sophisticated analysis programs, but a significant number of community banks use some form of the practice.

"Congress seems to think there's a free ride, a free lunch, here," says

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position. You need to be fully engaged."

"Prevention is better than the cure," said speaker Kathleen Murphy, an industry expert and currently president and CEO of the Maryland Bankers Association.

The greatest general form of prevention, said speaker Jeff Gerrish, attorney and consultant at Gerrish McCreary Smith, comes down to this: *"Do your job."*

The speakers spent much time on what board members can do to perform their roles better and to minimize risk, and you can hear that, *free and on demand*, at *www.ababj.com/bjzurichdando*. However, a big part of having any kind of insurance is peace of mind. And in the D&O area, that begins with understanding what the coverage really means, and what it doesn't.

"GETTING" WHAT YOU'VE GOT

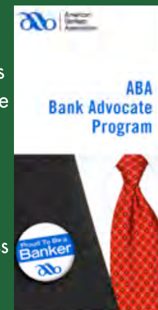
At Bank Midwest, a $628.7 million-assets bank in Spirit Lake, Iowa, the first board meeting of the year includes an insurance review. The directors have an impartial expert present an analysis of not only D&O insurance, but all other forms of insurance that the bank maintains, said speaker Mary Ellen Domeier, a board member and former bank chairman.

"It's an opportune time for directors to satisfy themselves that the extent of coverage, the types of coverage, and the provider of the coverage are sufficient," said Domeier.

D&O policies are highly specialized packages and Taylor recommended that a bank shopping around for new coverage engage the assistance of a specialized broker or other expert, rather than flying solo. D&O deserves "a deeper dive," he said, and he warned against dealing with either a broker or a carrier that merely "dabbles" in D&O.

Taylor said it can be especially helpful to engage a third-party expert—"someone without any skin in the game"—to evaluate the board's protective coverage. With no stake in the purchase decision, an expert can determine the board's risk tolerance and weigh adequacy of

Talk to Washington



Bank board members can now help out ABA's grassroots lobbying through the new ABA Bank Advocate Program. The mission: "To make sure that no Member of Congress can say, 'I didn't hear from my bankers'," says ABA. Learn more at *www.aba.com/grassroots/bankadvocate.htm*

coverage in light of that attitude.

Every bank has its own circumstances, risk profile, business plan, and other characteristics that make it different from another. Domeier pointed out that these can evolve, based on new developments at the bank—such as a merger or acquisition. As a result, the institution's D&O needs may also be a moving target. This underscores the importance of regular review.

MYTHS ABOUT COVERAGE

Whether a board is new to D&O or full of longtimers, it is possible that there are misunderstandings about what the policy covers. Indeed, speakers noted that there are myths about D&O. Among them:

1. *"All policies are created equal."*

"While there are some core principles at play, the policies are quite individualized," according to Taylor of Zurich. Because banks can be so different, as described earlier, Taylor says there is no "rubber stamp" D&O coverage. This isn't like insuring your house.

2. *"You don't have to read your exclusions, because they are standard on all policies."*

This is not only wrong, but somewhat backwards, said Taylor. First off, exclusions not only can, but do, differ from one policy to another, though there may be common ones. Second, according to Taylor, is the point that exclusions shouldn't be the first focus of a discussion about a policy.

"You don't go in and say, 'Okay, what are you *not* going to do for me?' " explains Taylor. The appropriate way to buy D&O is to begin by

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knowing what the bank wants and needs. Then look for that coverage. *Then* consider exclusions.

3. *"Those policy limits are all there to cover the directors and officers."*

That's not the case. "Remember, the directors and officers are there to advise and protect the bank, and to help run a business from a strategic and approval standpoint," Taylor explained. "And part of that duty is to see that the bank entity itself is covered."

Because elements of the *bank's* protection come out of the D&O policy, board members will find that typically the policy limits protecting them can be eroded by protection of the bank. "The limits are there to protect the entity and to protect the people," said Taylor, "but there's only so much water in that well." This becomes a consideration when determining how much total coverage to arrange for, then.

4. *"Excess 'Side A DIC' coverage is only for big banks."* Without going too far into the weeds, this describes coverage that comes in when other policy limits have been exhausted, to add protection for directors and officers. "This prevents the erosion of limits and we've seen many community bank take excess Side A coverage," said Taylor.

NEGOTIATING YOUR COVERAGE

Speakers noted that policies are negotiable, though the bank's perceived strength and regulatory status will determine how much room for bargaining there will be.

Taylor said banks fall into three categories right now:

• *"Banks in fantastic shape still find a competitive marketplace."*

• *"Those with a blip on the radar screen, it depends."* Those with a bit of trouble may pay a bit more for coverage or may qualify for lower policy limits. "And they may have a lot more conversation with their carrier before they can, in fact, secure coverage," said Taylor.

• *"The worse case scenario."* Taylor said covering a bank and board where there is a regulatory order is trickier. "It's like having a patient with a major illness, who is trying to get healthy going forward," he said. "You're trying to have someone provide life insurance along the way while they do that."

ARE YOUR COVERED FOR "CMPS"?

Civil Money Penalties, or CMPs, are monetary assessments against the bank, the board, officers, or all of the above. While the regulators assess them, they likely have nothing to do with a failure. That doesn't mean they aren't costly.

"Those penalties can be issued for any violation of law, rule, or regulation," explained Jeff Gerrish. He noted that there are approximately 1,500 formal enforcement actions in place. "Most of which I would venture to say have not been fully complied with, which could be the basis for civil money penalties," said Gerrish. The attorney believes that failure to comply will be the biggest source of future CMPs, a break with past causes.

Gerrish noted that FDIC Part 359, in the Code of Federal Regulations, has some limitations on what a bank can indemnify a board member for (which includes buying insurance that covers them in those regards). Perusing that, and the policy itself, will indicate whether the board member is covered for various types of CMPs. In some cases a director can purchase their *own* coverage for certain CMPs.

Gerrish offered this general advice for avoiding CMPs and other liabilities: Pay attention.

Said Gerrish: "Don't ignore regulatory warnings. Don't ignore warnings from your auditors. Make sure that, if you rely on your management team as a defense, that it has corrected problems pointed out by a third party."

We'll present more from this event in the future.

N.J.'s Frank Sorrentino. "But you can't keep chopping away at banks' profitability. " In reaction, as community banks address it, there will be a rethinking and repricing of business checking services.

Connecticut's Rheo Brouillard says his bank will give business depositors a choice, most likely: earnings credits or explicit interest, but not both. Customers will be asked to decide which way they want to be paid.

"Mind you, if they get interest, they are going to pay service charges," says Brouillard. He says his bank would aim to make the transition as neutral as possible.

While most reported that no bank was showing its cards, some think they see some patterns in Bank of America's behavior that indicate it may be looking at some push here. B of A was among leaders in the large bank sector who radically changed their approach to overdraft fees on consumer deposits while other institutions watched Washington.

Community bankers suggest that business customers tempted by a large bank's attempt to win them away may want to look closely at the overall pricing before they leap.

Says Robert Chapman, president and CEO at $862.2 million-assets United Bancorp, Tecumseh, Mich.: "Whatever they see, they'll need to peel the onion back to see what's really transpiring."

Sincerely,

Steve Cocheo

for ABA Banking Journal

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