Evolving Director Role

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Peter G. Weinstock
Hunton & Williams LLP
1445 Ross Avenue, #3700
Dallas, Texas 75202
(214) 468-3395
pweinstock@hunton.com

PRACTICES

Banking and Finance
Financial Institutions Corporate and Regulatory
Fair Lending
Consumer Financial Compliance and Litigation

CONTACT

pweinstock@hunton.com
1445 Ross Avenue, #3700
Dallas, TX 75202
p 214.468.3395
f 214.740.7182

EDUCATION

JD, Duke University School of Law, 1985

BA, State University of New York, 1982

BAR ADMISSIONS

Texas

Peter's practice focuses on corporate and regulatory representation of a wide range of financial institution franchises.

Peter's practice focuses on corporate and regulatory representation of small to large regional and national financial institution franchises. During the past several years, Peter has devoted substantial time to regulatory, law enforcement and internal investigations of financial institutions. He is Co-Practice Group Leader of the Financial Institutions Section. He has counseled institutions on more than 150 M&A transactions, as well as provided representation on securities offerings and capital planning.

Relevant Experience

Representation includes:

- lead counsel in merger of equals creating a $13 billion bank;
- lead counsel on the North American Corporate Deal of the Year (Middle Market) – The M&A Atlas Awards – for Cascade Bancorp, Inc.'s successful topping bid to acquire Home Federal Bancorp, Inc., a NASDAQ-listed bank;
- Finance Monthly Deal Maker of the Year Award 2014 – Cascade Bancorp, Inc.'s successful community bank topping bid in connection with Cascade's agreement to acquire Home Federal Bancorp;
- more M&A transactions than any firm over the last 15 years (according to *SNL Financial*, December 2015);
- number 1 in 2013 with 19 M&A transactions and in 2014 with 20 M&A transactions (according to *SNL Financial*);
- hundreds of capital offerings;
- hundreds of fair lending, CMPs, and other enforcement actions;
- testimony before Panel of the House Judiciary Committee regarding Operation "Choke Point" in July 2014; and
- myriad compliance issues before all of the federal bank regulatory authorities, including the CFPB; and negotiations of administrative actions.

For the last 20 years, he has served as co-editor of ICBA's Newsletter, "SUBCHAPTER S: THE NEXT GENERATION." He is the author of numerous articles in law and banking publications. His article, "Acquisitions of Failed Banks – Present Risk and Opportunity," was voted the second best article appearing in The Risk Managers Association Journal of 2011. He has spoken at over 200 banking conferences and seminars, including for over the last 12 years, ICBA's annual conference. Mr. Weinstock is listed in Chambers USA "Leaders in Their Field" for banking.

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Best Practices in the Boardroom

Best Practices in the Boardroom

- Board responsibilities (the “Top 10”):
  - Determine future strategic focus. Test key assumptions in management proposals. Set “risk appetite” associated with objectives
  - Oversight of company’s business affairs and compliance with strategic plan (variances)
  - Establish policies – filling in the “risk tolerances”
  - Oversee internal controls and compliance with laws and regulations (CMS)

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Best Practices in the Boardroom (cont'd)

- Risk oversight
- Monitor financial reporting
- Set the tone for ethical business conduct
- Approve hiring and firing of executive officers and arrange for management succession
- Board composition
- Contribute to the bank's economic success

Shareholder Rights: Dominant Theme of Corporate Governance

- Personal responsibility for internal controls under SARBOX
- ISS rejection of change in control defenses and staggered boards
- SEC requirements such as “say on pay”
- Elimination of “golden parachute” excise tax gross-ups and single triggers
- More performance-based compensation

Activism is Exploding and Trickling Down

By the numbers:

- The number of proxy fights highest since tracking began in 2001[1]
- Over $200 billion in activist private equity funds
- In 2015, 46 proxy fights resulted in a board seat
- No one set response (no more these are “corporate raiders”)

Outside of banking:

- Dow/DuPont
- eBay spin-off of PayPal

Within banking:

- Activist pressures for sales are not a new development in banking
- Board seats: Trian Partners representative added to BNY Mellon board
- Basswood Capital Management pressured Astoria to sell

[1] According to Factset.

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H&W Experience in Last Quarter of 2015

- $150 million asset bank – proxy fight/T.O.
- $250 million asset bank – proxy fight/T.O./TRO
- $500 million bank holding company – proxy fight
- $800 million family bank sold in split vote
- Lawsuit by private equity against management team
- Merger of equals $5 billion and $8 billion banks with interloper

What do the first five have in common?

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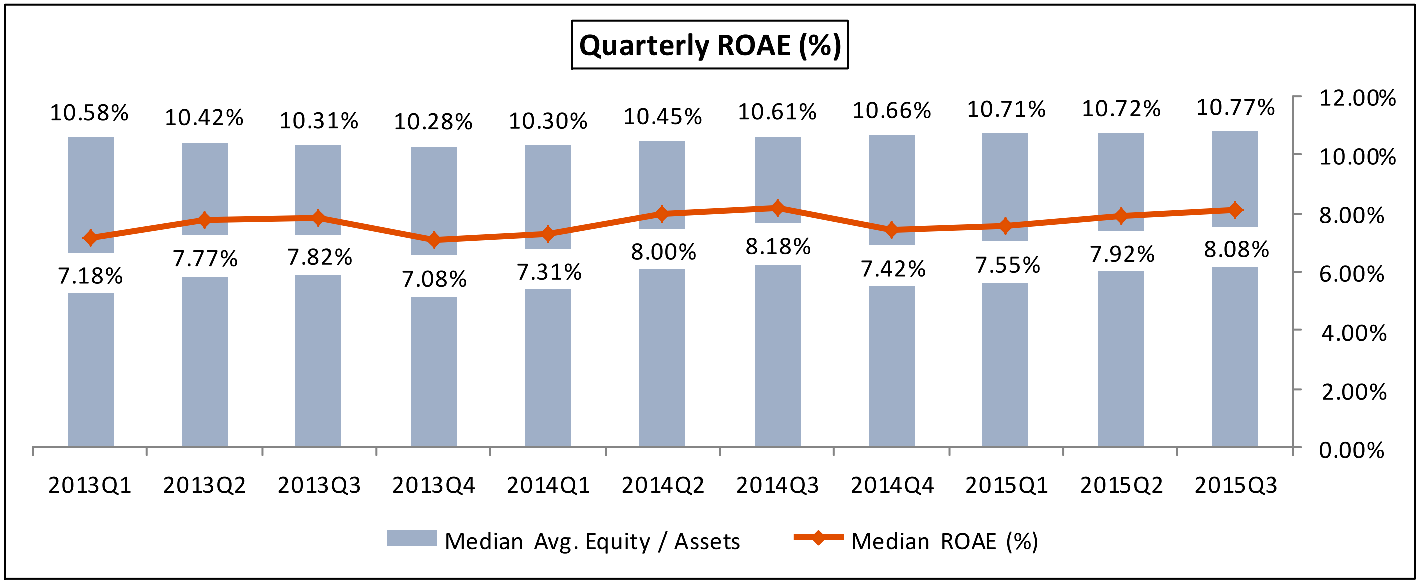
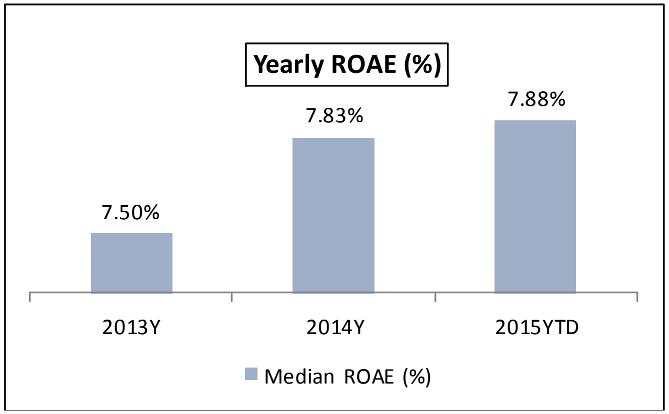
Expectations for Strategic Plans

- Key for independence is growth in earnings
  - Evaluate quality of earnings growth
  - Get behind the “noise”
  - Consider one-trick ponies – fee income, cost savings, etc.
- Approximately ½ of publicly traded banks saw declining earnings in 2013 (some made up the difference with bond gains, negative ALLL provisions and cost cutting)
- The new normal ROE? SNL Financial estimated that for 2013, “core” net income (excluding non-recurring revenue and expenses) increased 8%. The ROAE for 2013 was 7.5%.
- For banks under $10 billion in total assets, ROEs were 7.83% through 2014 according to SNL[1]
- Through 9/30/15 for banks under $10 billion in total assets, ROEs were 7.88% according to SNL[1]

[1] This percentage does not correct for noncore income or expenses.

Community Bank Return on Average Equity





- Median values are derived from a nationwide population of 5,929 regulated depositories with total assets under $10 billion.

Source: SNL Financial

New Standards for Bank Performance

- So, maybe 8% ROE <u>in</u> <u>this</u> <u>interest</u> <u>rate</u>/economic environment is enough
- Between 1991 and 2006, ROEs exceeded the inflation rate by 10% on average (less than 7% for 2013 through 9/30/15)

What to do?

- Nothing – we already chin the bar on 8% ROE
- Nothing – when we clean up our problems, we will chin the bar
- Change the strategic plan because 7-8% is not acceptable – the board determines what it believes is appropriate return for the risk
- Change the strategic plan because the bank is not generating a return that is 10% above the rate of inflation
- Nothing – we are Subchapter S and we are clipping coupons

Fiduciary duty is to the hypothetical long-term investor who has no need for current liquidity.

Warren Buffett: "I believe in running the company for shareholders that are going to stay, rather than the ones that are going to leave."

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Strategic Plan

- Decision to "just say no" is a fiduciary decision. It must be:
  - Well informed
  - Based on strategic plan
  - Supported by projections

- Key to strategic plan:
  - Plan should consider short- and long-term interests
  - Analyze the data (historical and prospective)
  - True road map for asset growth based on reasonable assumptions
  - Risk appetite
  - Subchapter S
  - High stock price/value is best takeover defense
  - Assistance from investment banker?

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Strategic Plan and Unsolicited Offers

Advance Planning is key. With Advance Planning:

- Board does not have to present offer to shareholders
- Board can authorize management to “Just Say No” to an unsolicited offer
- Management must instruct or notify the board of inquiries
- Key is strategic plan
  - Plan should consider short- and long-term interests
  - Analyze the data (historical and prospective)
  - True road map for asset growth based on reasonable assumptions
  - Risk appetite
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Where to Start?

What to do?

- Eliminate marginally profitable operations, e.g., trust
- Rigorous analysis of what bank does well – core competencies
- Assessment of existing activities:
  - Capital charge
  - Acceptable allocation of liquidity? COFs
  - Standalone P&L
    - Assignment of overhead bugaboo
    - Alignment of compensation/incentives
  - Core function? Distraction?
  - Contingencies/regulatory risk:
    - Quantifiable?
  - Strong mitigants available, e.g., stress testing
  - Avoid “Tandonizing” the business

Transformative Plans

- Advance while others retreat:
  - Mortgage lending
  - Auto lending
  - Consumer
- Support appropriate long-term investment and prudent risk taking
- Organic loan growth and “lift outs” (noncompete/ nonsolicitation)
- Lines of business:
  - Factoring
  - Equipment leasing

Transformative Plans (cont'd)

- Problem banks
- MOEs/strategic combinations – "who's in your 5?"
- Branch purchases
- Joint ventures and earnouts
- Matched parts:
  - PacWest/Capital Source
- Repurchase shares

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Preparing to be a Purchaser

- Why M&A?
  - Cost of funds has dropped to the bottom
  - Cost cutting, including simplifying operations/rationalizing branch networks, has reached its limit
  - Easing standards to grow echoes 2005/2006 activity
  - Compliance, IT and employee costs continue to climb
  - Headwinds from interest rate environment, anemic loan growth and competition continue
  - Focus has shifted to growth
  - Legacy asset issues are no longer the fundamental concern for buyers
  - M&A offers a way to use cost savings to grow eps on a risk-adjusted basis

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For Potential Buyers – What To Do?

- Strategic plan/M&A roadmap
- Capital plan
- Regulatory buy-in even if current administrative action
- Address compliance issues
- Executive planning sessions/team buy-in
- Conducive culture
- Team in place, especially diligence and integration
- Stock authorized

Pillars of Compliance Management Systems ("CMS")

- Board oversight
- Policies and procedures (strategic plan with tolerances)
- Due Diligence
- Risk Assessments
- Compliance officer
- Training
- Monitoring/testing
- Contracts
- Complaint policy

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Risk Profile

Goal is to take action on emerging risks before they hit financial statements.

Risk – potential that events will have an adverse (read in "material") effect on current or projected financial statements, including liquidity.

Risk Category	Quantity of Risk (Low, Moderate, High)[1]	Quality of Risk Management (Weak, Satisfactory, Strong)[2] [OCC adds Insufficient][3]	Aggregate Level of Risk (Low, Moderate, High)[4]	Direction of Risk (Increasing, Stable, Decreasing)
Credit				
Interest Rate				
Liquidity				
Price				
Operational				
Compliance				
Strategic (Key Risk)				
Reputation				

1 Amount of risk assumed in the business.
2 Are systems capable of identifying, measuring, monitoring, controlling the amount of risk?
3 "Insufficient" designation may be applied to Audit or Internal Controls.
4 Current risk.

NOTE: Risk assessments indicated in bold or *italic* type reflect a change since the last assessment.

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Civil Money Penalty Issues

- HMDA data/LAR
- Flood insurance
- UDAAP
- Fair lending issues
- BSA/AML
- RESPA
- Third-party risk
- SCRA

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The Board's Role – Enterprise Risk Management ("ERM")

- Smaller banks – ERM 1.0
  - Strategic plan and tolerances
  - Stress testing
  - Interest rate risk management
  - Credit review and ALLL methodology
  - Capital plans and triggers

The Board's Role –ERM (cont'd)

- Larger banks $700 Million - $1+ billion banks – ERM 2.0
  - ERM 1.0 and add:
    - Integration of risks
    - CRO?
    - Management risk committee?
    - Board risk committee?
    - Key risk indicators and leading risk indicators
    - Dashboard and reporting to board

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The Board's Role –ERM (cont'd)

- Large banks – $10+ billion – ERM 3.0
  - ERM 2.0 add:
    - Board risk committee requirement
    - Management risk committees and departments
    - Consistent use of modeling
    - Anticipate needs/triggers
    - Bernanke "madness of model proliferation"

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Best Practices in the Boardroom

- Baseline Requirements:
  - Best Practices: Majority of directors are non-management/independent
  - Board and committees should be active and, if needed, have access to (and funding for) outside experts
  - Reserve most board time for strategy, performance and risk oversight
  - Independent directors should meet in regular executive sessions – non-banker chairman, chair of the executive committee or “lead director”

Best Practices in the Boardroom (cont’d)

- Board packages delivered in advance of meetings
- Board should establish audit and compensation committees comprised of independent directors
- Conduct annual self-evaluations
- Establish training (and orientation programs) for new directors
- React to red flags!

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Sources of Red Flags

- Pre-examination information request
- Examination report narrative
- MRAs; MRIA; MRBAs
- Exit interviews
- Regulatory visits
- Policy exceptions
- Management reporting: risk, variances to plan, etc.
- External audit
- Internal audit and compliance reports
- Outside reviews, e.g., interest risk, credit administration, etc.
- Comparison to peer group (UBPR and otherwise)

Sources of Red Flags (cont'd)

- Key ratios/numbers:
  - Asset quality
  - Concentrations
  - Reserves by type of credit
  - Noncore funding dependency ratio
  - Real estate value appreciation
  - Commodity price appreciation
  - Loan to deposit and loan to assets
  - Out-of-market loans to total loans
  - Loan participations
  - Return on capital by business unit
  - Growth rate

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Sources of Red Flags (cont'd)

- For problem banks add:
  - OREO to classified assets
  - Performing nonperformers to classified assets
  - Classified assets seasoning

- Growth, ALLL, concentrations, funding and capital – where is the bank running hot?

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Best Practices in the Boardroom (cont'd)

- Expectations for Directors:
  - Establish expectations for board members at the outset
  - Learn as much about the company and the bank as possible and stay informed
  - Review agendas and related materials before each meeting
  - Attend and participate in all board and committee meetings
  - Respond promptly in critical situations
  - Ask probing questions and expect clear and responsive answers
  - May rely on information and reports from officers and advisors, but reliance must be prudent
  - Move beyond oversight role to find ways to add strategic value – "ride hard for the home team." How are you adding <u>economic</u> value to justify your economic cost?
  - Maintain confidentiality

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Confidential Information

- The duty of confidentiality is extremely important
- The board, acting as an entire group, is the only party that can authorize the disclosure of confidential information. The entire board can delegate such authority, in whole or in part – typically to the bank CEO
- The code of conduct limits disclosure of confidential information. All information regarding the bank's "customers, employees, strategic plans, operating business plans, product offerings, or any other proprietary information is confidential"
- "In no case shall confidential information regarding board decision-making be divulged to persons outside of the board of directors – including family, friends and associates, any third parties, and bank staff who have no need to possess such information." Again, the board determines what is "confidential information"

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Conflicts of Interest (cont'd)

- Duty of loyalty:
  - Corporate opportunities belong to company or the bank
  - Procedure:
    - Disclosure to board
    - Board determinations whether to:
      - Pursue or waive opportunity
      - Allow disclosure of information
  - "Under no circumstances shall any individual take advantage of his or her position with the bank to obtain credit, solicit or accept financial or monetary benefits or, in any way, influence the decisions of the bank or its customers for personal financial gain."

Why Be A Director?

The Top 7:

- Give back to the community (“community bank”)
- Enhance the growth of small businesses in the market
- Prestige/standing
- Access to information
- Training/enhance your intellectual capital
- Keep an eye on your investment
- Board compensation

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Closing Insights and Observations

- Strategic plans are not just for the binders on the shelf
- Oversight – not management
- Expectations for directors does not mean be adversarial with management
- Working with management does allow for a close relationship – encourages transparency
- Maintain collegiality of the board and its committees – allows for efficiency
- Healthy skepticism does not mean object to all change

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Closing Insights and Observations (cont'd)

- Do not focus on fighting the last war to the exclusion of the existing one
- Expectation is directors' actions need to be "above reproach"
- Increased regulatory scrutiny of corporate governance, tighter examinations and more frequent remedial actions
- Increased supervisory focus on risk management, compliance and internal controls
- In a nutshell, the job is about risk oversight and strategic planning – do not get caught up in the minutiae

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