

# ABABANK DIRECTORS BRIEFING

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## THE DIRECTOR'S JOB

### PERIOD OF TURMOIL MARKS OPPORTUNITY TO REVISIT, REVIEW, AND REVISE BOARD PRACTICES

A wise man once said, "No trouble, no progress." That would make current times one of the best shots ever to learn about directorship—whether you signed up for that, or not.

Describing current conditions as a "perfect storm," the law firm of Wachtell, Lipton, Rosen & Katz recently issued a white paper titled "Some Thoughts for Boards of Directors in 2009."

In the introduction, the authors state that "the task for boards is not simply to go into crisis mode in order to deal with current issues, but rather to take a more holistic, long-term approach to reassessing their proper role and functioning."

The paper, by Martin Lipton, Steven A. Rosenblum, and Karessa L. Cain, runs for 20 tightly printed pages of sound advice, some aimed at boards of very large companies. But there is much that's helpful to boards of smaller banks. You can find the paper at [www.wlrk.com/docs/ThoughtsForDirectors2009.pdf](http://www.wlrk.com/docs/ThoughtsForDirectors2009.pdf). Some key points:

**1. Remember the need for confidentiality.** The duty of confidentiality, always important, rises to the level of "critical" in times like these. The authors remind directors that "a board should function as a collegial body, and directors should respect the confidentiality of all discussions that take place in the boardroom. Moreover, directors generally owe a broad legal duty of confidentiality to the corporation with respect to information they learn about the corporation in the course of their duties."

Also important: The authors point out

**THE DIRECTOR'S JOB** continues on p. 3

## DEAR DIRECTOR:

### ABA Economic Panel Puts Chips On Stimulus And Fed Easing, Sees Growth Tip-Toeing Back

In mid-January the ABA Economic Advisory Committee's members put their heads together and decided that grim times remain on the docket. But they saw the faintest glimmering of hope ahead.

The group, consisting of top economists from banks around the country, said that the economy remains in the grip of a severe recession that will likely turn out to be the longest since World War II.

#### A dark gray first half

The ABA group meets twice a year, and the outlook from its first 2009 gathering held little good news.

"Conditions have deteriorated considerably since the committee met in June [2008]," said Bruce Kasman, committee chair and chief economist for J.P. Morgan Chase, New York. "With consumption contracting and job losses intensifying, it is unlikely that the picture will brighten soon."

Elaborating, Kasman said "we are in the midst of an unusually synchronized global recession and U.S. growth is being hurt by the deterioration of economic conditions in all of our major trading partners."

Such a fragile situation faces the risk of additional factors that can push things down further. If consumers continue to retrench, the committee said, there will be further weakening in demand for goods and services. And the committee pointed out that exports, which formerly helped bolster the U.S. economy, continue to decline.

The economists' consensus was that the U.S. economy fell in the fourth quarter of 2008 at the sharpest rate seen in nearly three decades. The group concluded that the downturn will continue through the first half of the year.

Unemployment will rise to 8.5% over the course of the year, the group predicted, which would be the highest level seen since 1983.

#### Credit picture mixed

Most panel members giving their predictions for credit quality expected further deterioration in both consumer and commercial credit over the next six months.

Regarding credit availability, the economists' views were more of a mix. On the consumer side, econo-

**"With consumption contracting and job losses intensifying, it is unlikely that the picture will brighten soon"**

mists tended to foresee no change in availability, with nearly the same number expecting some improvement. On the business side, economists were as likely to see availability

improving as they were to see it remaining the same or falling off.

#### Outlook for Fed action

Kasman said that the committee, which typically meets with representatives of the Federal Reserve Board at each gathering, expects that with unemployment rising and inflation under control, that the Fed will concentrate on promoting economic growth and financial stability throughout 2009.

"The committee foresees no change in the current federal funds target rate and expects further

**“Financial market stress should ebb and private sector access to credit should improve”**

grams,” ABA’s official statement said of the overall consensus view. “As a result, financial market stress should ebb and private sector access to credit should improve.”

The nation’s lenders face a balancing act on the credit side.

“Banks are paying close attention to credit quality, but continue to provide funding for credit-worthy households and firms,” Kasman said. “Treasury’s capital injections have helped.” The committee noted that while banks continue to be careful with credit in the current environment, that their loan portfolios have actually grown.

The capital injections, under the TARP Capital Purchase Program, remain controversial, with members of Congress angry about the perception that the capital investments not turning into loans. Much of the anger was directed at larger banks, the first to be able to avail themselves of TARP capital, with Subchapter S banks, accounting for about a third of the industry, only recently being given a TARP program to apply through.

[You may have seen a late January *Wall Street Journal* front-page article claiming that fourth-quarter lending by the nation’s largest banks declined in the fourth quarter. The *Journal’s* methodology has been questioned by at least one noted bank analyst, who says his calculations indicate lending was up.]

In January the House passed a symbolic bill disapproving of further TARP funding—symbolic because the Senate had already, effectively, released the second half of the TARP program’s \$700 billion to the Treasury Department at the

expansion of the Fed’s lending and asset-purchase pro-

behest of both the outgoing and incoming Administrations. Speculation remains that more such funding will be proposed. In late January President Obama hinted that this might happen. How such funds would be used remains a matter of speculation.

**Mortgage picture: a blend**

The new Administration has already pledged to spend as much as \$100 billion of the \$350 billion second half of TARP for foreclosure relief.

The ABA economists addressed the mortgage markets in their statement. Their consensus view is that 30-year fixed mortgage rates will remain below 5% for several months. However, the group also expects to see home prices continue to fall. And it projects continuing increases in mortgage delinquencies.

Specifically regarding mortgages, Kasman had this to say: “A surge of refinancing is already underway, and lower home prices and interest rates will gradually support an increase in home sales.” Because of this, the committee thinks the extended falloff in housing starts will end around the middle of 2009.

**The glimmer of hope**

Taken as a whole, not a grand picture. However, the committee held out a bit of hope.

Kasman stated that: “Implementation of a substantial stimulus package, combined with continued monetary ease by the Federal Reserve should bring the economy out of recession before the end of the year.”

The committee expects to see economic growth return later in 2009.

At press time, the Obama Administration and congressional Democrats and Republicans continued to tussle over the nature, shape, and size of the economic stimulus package. Much controversy exists over how quickly the package’s

measures will influence the economy. The White House continued to hope that the package would be signed into law by mid-February.



In the midst of the grim outlook, later January saw a wave of headlines holding out the possibility of “nationalizing” the banking system. Bank stock analyst Richard Bove of Ladenburg Thalmann skewered this idea in a Jan. 21 report titled: “The Banks Will Never Be Nationalized: This Idea Reflects the Current Hysteria and Makes No Sense.”

Perspective is a terribly important commodity in times like these, and Bove, who is no Pollyanna, made this point:

“True, there are a great many bad loans in the banking system.

However, how many are there? The data from the FDIC, based on third quarter numbers, provides figures that are shockingly low relative to conventional wisdom. Even if one assumes that the banks are about to see these numbers triple, they are well within the bounds of what can be absorbed, if history is any judge.”



**Regulators advise care with remote capture service**

Remote deposit capture service, one of the hottest business-side services to come to community banking in years, is also fraught with risks that they must safeguard against.

“RDC [remote deposit capture] should be viewed as a new delivery system, and not simply as a new service,” banking regulators stated in “Risk Management of Remote Deposit Capture,” a mid-January advisory from the interagency Federal Financial Institutions Examination Council.

The agencies see four types of risk in remote capture: legal, compli-

ance, reputational, and operational.

Remote capture service, as used in the announcement, refers to the scanning of checks at business banking customers' location by company staff.

The scanned images travel over the internet to the company's bank, or its payment processing vendor.

The electronic files may continue to travel and be processed solely in electronic form—either as exchanged images or converted to electronic payment instructions for use in the automated clearinghouse system, or they may be turned into printouts of the captured check images where an institution must process checks in physical form. The format hinges on the capabilities of the banks along the route in which the check travels.

While RDC has been a hot business banking product over the last few years, some institutions have started extending service to consumer customers as well. Typically, scanned checks remain with the company or individual depositing them.

The regulators advise that boards or management, depending on the size of the institution, should assess the risks of its approach to remote capture.

This risk assessment may include not only risks seen internally, but at customer locations and at any third-party processors used by the bank. *This latter point is in keeping with an emphasis by regulators in recent years on the role played by third parties in providing banking services.*

While many of the bank's functional areas—ranging from Information Technology to Deposit Operations to Compliance and Legal—may be involved in the risk assessment, the regulators said, "the board and senior management are ultimately responsible for safe and sound operations, including RDC products and services."

While RDC technology is relatively new, many of the potential risks are familiar ones in new forms—fraud,

that keeping secrets is important to the *individual* board member, "since directors can be responsible for any misleading statements that are attributable to them." The authors point out that the director who blabs may not even realize that they don't know all pertinent facts, and mess up.

Thus, they continue, unless a director has been asked by the CEO or the whole board to talk to outsiders on bank business, the best practice is to respect the CEO's role as chief spokesperson for the company.

**2. Minutes grow ever more important.** "Increasingly," the authors state, "courts and regulators have raised questions about the amount and scope of attention that was spent on a matter when the minutes did not adequately support the recollection of the directors as to what transpired."

This surely applies to all board and committee meetings, the authors state, but may also be important concerning "executive sessions." The latter are board meetings where management is not present, by design, to encourage frank discussion.

"Depending on the matters considered at executive sessions," the firm advises, "it may be appropriate to have summary minutes or in some cases very extensive or even verbatim minutes of such sessions."

**3. Look hard at your D&O policy.** This is a good time, if you haven't done it already, to review what your policy provides. "D&O policies are not strictly form documents," the firm notes, "and can be negotiated." It may be that your policy doesn't include coverages you thought it did. And it may be that your policy draws on the same finite pool of coverage for the corporation as it does for individual board members. And know that no D&O policy provides unlimited coverage. They all "top out."

**4. Don't confuse risk management and risk management oversight.** The

## April 8 marks 2009 ABA director briefing debut

The ABA's "Boards and Strategic Planning In A Challenging Environment" telephone briefing is set for April 8, from 2-3:30 PM Eastern Time. The briefing is presented by ABA's America's Community Bankers Council in cooperation with ABA Bank Directors Briefing newsletter. For more information, e-mail [tleiva@aba.com](mailto:tleiva@aba.com)

The 2009 season also includes: "Regulatory Update for the Board," July 8; "Directors and Regulators: Understanding the Examination and Enforcement Process," Sept. 23; and "The New Basics of Asset/Liability Management for Directors," Dec. 9.

authors draw a good, bright line between these functions: "The board's role is one of informed oversight rather than direct management of risk. The board cannot and should not be involved in the day-to-day risk management activities. Directors should instead satisfy themselves that the risk management processes designed and implemented by executives and risk managers are adapted to the board's corporate strategy and are functioning as directed..."

The authors also make the point that too much avoidance of risk can be as bad for a company as too much risk taking.

**5. Maintain perspective on executive compensation.** Nowadays, among angry shareholders and especially in the context of banks that have accepted government TARP Capital Purchase Program funds, "executive compensation" is a pair of dirty words. However, Lipton, Rosenblum, and Cain stress that directors must remember that while executive compensation shouldn't encourage excessive risk-taking, it must be sufficient to ensure that the bank attracts and holds onto good leaders.

**6. Remember the need for collegiality.** The authors stress the importance of a team spirit in several places, notably in board makeup and CEO succession planning. "In large measure," they write, "the fate of each of the board and the CEO is in the hands of the other."

Regarding board composition, boardroom independence has been emphasized almost to a fault. The authors state that, while of necessity observing legal and exchange requirements, that the board not lose

**THE DIRECTOR'S JOB** continues on p. 4

sight "of the importance of the sort of board dynamic that can most effectively lead to a well-functioning board and an effective partnership between the board and senior management."

We note that it is true that the concept of a "team of rivals" has been talked up in recent months, as the Obama Administration has somewhat emulated the approach to Cabinet selection made famous in the Doris Kearns Goodwin book of that name, concerning President Lincoln's cabinet.

However, the authors point out that a related concept—perhaps expressed as a "team of strangers"—may not fit corporate governance: "The concept of directors as remote strangers and the board as the agency for the discipline of management, rather than as an advisor to management in setting the strategic course of the corporation, is contrary to all prior experience and will not lead to better performance."

A strong boardroom, the authors state, is peopled instead by "directors who possess sufficient character and integrity to allow them to make judgments that are unbiased by personal considerations."

Regarding CEO succession, the authors suggest that: "A proven, qualified internal candidate, who is intimately familiar with the corporation's business and culture, is frequently the best choice."

**7. Beware short-term thinking, even now.** Especially among public companies anxious to please shareholders and analysts, much planning in recent years had emphasized short-term gains. Yet now that solutions must be found, the short-term remains a trap. "An unduly narrow focus on short-term issues risks repeating some of the very mistakes that contributed to the current market turmoil," the trio states. "... a strong, impartial board is best situated to resist pressures for short-term gains and balance competing interests to promote long-term value."

**DEAR DIRECTOR** (CONT'D.)

customer information security, privacy, money laundering, and more.

The agencies' announcement makes it clear that the regulators don't see any "one size fits all" risk management working here.

The approach the bank will take depends on the nature of its operations; the nature, size, and scope of its RDC customers' use of the service; and the types of suppliers and vendors used to provide the service.

Due diligence review of outside parties, including any outside vendors used, is expected. Institutions offering remote capture will be expected to use contracts and customer agreements relating to the service that will help mitigate the bank's risks. Again, regulators discourage cookie cutter approaches, preferring that contracts and agreements address the specific program.

Many community banks introduced remote capture conservatively, offering it first to their most-trusted customers. Other institutions have offered RDC more broadly, from the start.

The regulators' parting advice is this: "As with other financial services, RDC may not be appropriate for all customers or for all financial institutions."

Also, this: "The general principles of RDC risk management discussed here are also applicable to financial institutions' internal deployment [of RDC] and other forms of electronic deposit delivery systems (e.g., mobile banking and automated clearing house conversions.)"

Sincerely,  
**Steve Cocheo**  
for *ABA Banking Journal*

**An Audit Committee chairman discusses this key committee's role**

Last December ABA's America's Community Bankers Council presented a director telephone briefing entitled, "Effective Board Committees: The Audit Committee and Beyond." During the program Robert F. Coleman, director and chairman of the Audit Committee at Chicago's Private Bancorp, Inc., and head of his own law firm, spoke about the role of this key board body. Some highlights:

- *Demonstrating independent oversight.* "Over the next several years, I anticipate a substantial increase in regulatory actions and shareholder litigation over the decisions made by management, and the failures of boards of directors and audit committees to effectively oversee management's actions," said Coleman. "An effective defense to these lawsuits is provided when directors can demonstrate that they have exercised an informed business judgment."

Elaborating, Coleman said that this means that the directors are not passively accepting the judgments of management. "We are probing, drilling down, and testing management's assertions and the conclusions that management reaches, before we exercise our judgment," he explained.

- *Reexamine audit committee practices periodically.* Audit Committees can become creatures of habit, Coleman warned, and can fall into a routine.

"Many times we find a committee doesn't review and refine its practices and procedures until something goes wrong," said Coleman. "Now is the time to evaluate the way that your Audit Committee goes about its business. Let's not wait until it's too late."

- *Don't confuse Audit Committee oversight with management authority.* A combination of regulatory expectations, increasing stress on corporate governance, and the duties for public banks' boards under the Sarbanes-Oxley Act have confused this issue. "The Audit Committee should not mistake its oversight responsibility for the day-to-day responsibility of management to manage the bank's business," he said.

To order CDs of this briefing, go to [www.aba.com/teleweb/tb121008.htm](http://www.aba.com/teleweb/tb121008.htm)

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