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FINANCIAL INSTITUTIONS DEVELOPMENTS

Key Trends in Financial Institutions M&A and Governance

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2013 was a year of continuing challenges and opportunities for U.S. banks. The low-interest rate environment continued to challenge the ability of banks to lend profitably. Already burdensome regulatory demands grew weightier with expanded Dodd-Frank stress testing and the finalization of the Volcker Rule, among other things. More than ever before, the responsibility of directors of financial institutions for regulatory compliance and bank safety and soundness is broadening, highlighted most recently by the OCC's steps to formalize its program of supervisory "heightened expectations" for larger banks and their directors. Against this backdrop, the banking industry saw steady and creative deal activity, with a pronounced concentration among community banks.

As has been the case throughout the history of the industry, strong and thriving regional banks are being created and enhanced through thoughtful acquisitions. With rivals sidelined by their own regulatory or business issues, or hesitant to act amid concerns about gauging contingent liabilities and deal execution risks, firms such as Umpqua, PacWest, First Financial and Sterling Bancorp struck transformative mergers that created instant value for their shareholders. Strong existing regional players such as Huntington, MB Financial, Old National and Prosperity also added to their lengthy tallies of successful deals by selectively enhancing their franchises.

In the midst of these great opportunities, it is more important than ever that bank directors continue to focus on strategic planning even while they understandably wrestle with growing supervisory demands. Deals, done carefully and with the proper attention to due diligence, integration and risk management, can help achieve regulatory objectives. Depending on the deal, these may include, among many others, enhancing and diversifying earnings and liquidity, acquiring strong management and director talent, improving the range of products and services offered to customers and the community and improving systems and compliance functions.

Below we summarize some recent developments in financial institutions M&A and corporate governance with key repercussions for the ability of institutions to navigate an environment more than ever replete with both great challenges and great opportunities.

I. Trends in Financial Institutions M&A in 2013

Community Bank Consolidation

Dust from the financial crisis continued to gradually settle in 2013, but through the clearing haze a new group of community banking leaders can be seen taking shape. Business conditions are improving, but remain challenging. Changes in technology and delivery channels are accelerating. The supervisory environment is strict and, potentially more problematic, regulatory standards are dynamic and, sometimes, less than predictable. Market valuations for many banks remain short of the historical pre-crisis range of 2 to 2.5 times book value, but have risen to the point where a clearly growing number of institutions are considering the possibility of selling. In short, the environment creates a good opportunity for bold, innovative and disciplined managers to separate themselves from the herd. In important respects, this is being accomplished through mergers and acquisition activity.

As noted in our previous reports, M&A activity has concentrated among community banks. The largest banks continue to be sidelined by a regulatory environment that discourages the big from getting bigger, at least through acquisition. “Enhanced” prudential supervision—the panoply of Dodd-Frank initiatives ranging across higher capital requirements, stress tests, more rigorous capital planning, liquidity planning, living wills and stringent expectations about compliance—is not only preoccupying many larger institutions but trickling down to smaller institutions. Technology and compliance costs are rising. Enforcement actions remain plentiful, and even when they don’t explicitly encourage banks to seek a buyer, the effect of the increased compliance burden can be the same. Banks have made great strides in repairing balance sheets and are adapting to the new business environment, but there remains a clear need to strengthen earnings by increasing scale and taking out rising costs. In addition, smaller banks see that greater size, and the greater array of product offerings that comes with it, may be necessary as larger competitors with more relationships with clients can be more competitive on pricing core lending products.

The result has been consolidation gradually building across the industry. The trend is clearly no tidal wave—financial institution M&A constituted only about 5 percent of U.S. M&A in 2013; it was more than 25 percent in 2003. But it is nonetheless unmistakable, is addressing compelling economic forces and could gather considerable strength when economic recovery accelerates. One important and noteworthy difference that began to

emerge in 2013 is the growing incidence of strategic mergers between two strong institutions, after a period in which many deals involved the acquisition of targets weighed down with substantial regulatory or business issues.

Among the strong and well-run community banks, consolidators have emerged; the process of forming the great banking franchises of the next decades is well under way. Leading examples of transformative transactions include SCBT doubling its size to become a dominant South Carolina franchise through merging with First Financial; Sterling Financial of Spokane joining forces with Umpqua Holdings in a \$2 billion deal to form a major Pacific Northwest institution; and, in the largest bank deal of 2013, PacWest in a \$2.4 billion merger that combined its strong regional deposit franchise with the national lending business of CapitalSource to create a new California powerhouse. Similar themes were at work in MB Financial's announced \$640 million acquisition of Taylor Capital Group, another transaction in which a strong local branch/deposit franchise was joined with a company with not only local presence but also national lending businesses.

These deals illustrate the major themes running through current deal activity. Combinations are smart; they have a clear and compelling strategic purpose and, often, are transformative. In several cases, adept deposit aggregators seeking to generate assets joined with strong asset generators in search of efficient funding. And, despite concerns about the regulatory environment, the deal activity shows that it is indeed possible to be a successful serial acquiror. Many of the crop of currently active acquirors are repeat players in M&A—as were both Umpqua and PacWest—and have demonstrated the discipline and skill to seamlessly integrate acquisition targets and deliver the anticipated financial results. F.N.B. Corp. has announced three acquisitions in less than a year. Although Prosperity Bancshares is paying over 2.5 times tangible book value for FVNB, the market reacted positively, given Prosperity's acquisition experience and track record of delivering promised cost savings. Experience in doing systems conversions and integrations quickly and efficiently has also become an important differentiator among acquirors.

Mergers of Equals

Several of the most important deals, such as the Umpqua/Sterling transaction, have navigated the tricky shoals necessary for banks of similar sizes and aspirations to come together in all-stock “mergers of equals.” This construct often allows pricing to be relatively disciplined and makes more likely a positive market reception of the deal for both buyer and seller. Other examples from the past year include the mergers of Rockville Financial and United Financial and of Provident New York Bancorp and Sterling Bancorp; in both cases the combined company will be run by one company's CEO and will take the other

company's name. Also notable is Union First Market Bancshares' announced \$445 million all-stock merger with StellarOne, anticipated to create the fifth-largest branch network in Virginia. Through these deals, sizable new community banking competitors, the next generation of important regional players, are being formed.

While all-stock transactions have been prominent among the notable deals of 2013, part-stock, part-cash transactions are also alive and well as acquirors seek to use merger transactions to fine-tune their capital strategies while keeping the stock portion of the transaction tax-free. For example, the MB Financial/Taylor Capital transaction features an approximately 80 percent/20 percent mix of stock and cash. The presence of significant private equity investment in selling companies is often a predictor of notable cash consideration in a deal, although the Umpqua/Sterling transaction indicates that, for the right strategically compelling combination, deals with private-equity-backed targets can get done with stock consideration predominating.

Obstacles to M&A Activity; Navigation Strategies

To be sure, obstacles and challenges to dealmaking remain. Buyers continue to be highly selective about choosing merger partners, and those who contemplate a program of ongoing acquisitions are loath to make a misstep. The pricing on offer, as a general matter, remains relatively disciplined. Absent appropriate planning, contingent liabilities can be an obstacle to dealmaking. And several significant deals have been delayed due to significant supervisory issues arising with one of the parties. In addition to M&T's proposed acquisition of Hudson City, timetables needed to be extended due to regulatory reasons for United Bancshares' acquisition of Virginia Commerce and for Mercantile Bank's purchase of Firstbank. Customers' Bancorp, which had increased its assets several times over through successive acquisitions in recent years, saw two announced deals terminated in 2013, reportedly over regulatory-related delays or issues. For acquirors involved in the CCAR stress testing and capital planning cycle, the timing of the processing and approval of regulatory applications may be influenced by the timetables of those processes.

Given an evident heightened sensitivity to supervisory issues from regulators and a heightened propensity for issues to be referred to regulators in Washington rather than resolved solely in the applicable regional office, it has become more difficult, and more crucial than ever, to get an accurate (if informal) read on regulatory receptiveness before a deal is announced. Potential acquirors should expect greater pre-signing consultation with regulators and should expect to be required to provide more rigorous and refined information than in the past. Detailed pro forma information about the deal, as well as associated business plans, is important for pre-signing meetings with regulators. Pro forma capital should

reflect consideration not just of numerical regulatory thresholds but where the institution will stand relative to its peers and consideration of performance under stress. Acquirors should also expect potential targets to have a great deal of interest in the acquiror's discussions with regulators and the response. Perhaps most importantly, institutions planning to be in the acquisition business must look at regulatory relations as a sustainable strategic advantage and give them the appropriate priority, with the CEO taking a personal interest and significant role in building the regulatory goodwill and reputation that will facilitate the realization of strategic plans.

As noted, some transactions are taking longer due to supervisory issues, while others experience some delays because of potential antitrust issues or protests by community groups. The merger of United Bancshares and Virginia Commerce, announced in January 2013, did not receive regulatory approval until December 2013. The transaction attracted protests from community groups and it appears that regulators are now giving community group objections a more receptive hearing and taking more time to consider them and the response of the applicant. With the relative paucity of big deals, smaller transactions appear to be more frequently attracting protests. Thus, another very important area for acquirors to have nailed down is their CRA track record, their relationships with community groups and consumer compliance generally. Beyond such issues, even some transactions without evident supervisory issues or protests may now require long periods, up to approximately nine months, to get approval.

Still, when the opportunities are compelling, even larger banks are not dissuaded from moving forward to make key acquisitions. Additional examples in 2013 included \$56 billion Huntington Bancshares' announced acquisition of Camco Financial (following Huntington's acquisition of Dearborn-based Fidelity Bank announced in 2012) and \$22 billion Cullen/Frost's announced acquisition of WNB Bancshares, giving Cullen/Frost access to the booming oil and gas activity of Texas' Permian Basin. Another prominent recent example is BB&T's announced acquisition of 21 Texas branches and \$1.2 billion in deposits from Citi, giving BB&T an enhanced presence in Texas markets.

And despite the heightened regulatory environment and the delay experienced in a significant portion of transactions, numerous deals are getting approved in a timely manner, in many cases within 60 days after an application is filed.

Mutual due diligence, before a deal is signed, of regulatory and other key issues such as contingent liabilities, is critical and more essential than ever. Contractual provisions dealing with regulatory approval, such as what the parties will and won't be required to do to obtain regulatory approval, must be appropriately calibrated to reflect the particular

parties to the deal. Deals that are strategic winners if closed in four months will generally continue to be winners even if they take somewhat longer to get done. At the same time, parties do need to consider the possibility of an extended review period and insure that there is an understanding about interim operations of the target bank, compensation and other key issues if a longer period is needed, so that the economic expectations of the parties are not disrupted by any delay. Companies that plan for acquisitions to hold a key place in their strategies need to enhance their compliance programs so that their “normal” level of regulatory fitness achieves the “decathlon” level required today to be an active acquiror. Outstanding supervisory issues, such as existing enforcement actions or “matters requiring attention,” should be lifted or resolved. Ongoing conversions from prior deals, if any, should be completed. With more emphasis on capital planning and stress testing, as well as IT systems, controls and operational risk, institutions of all sizes will likely be expected to analyze acquisitions consistent with these expectations and be prepared to give regulators comfort that such considerations have been thoroughly considered.

At the same time, regulatory issues such as enforcement actions can create opportunities for attractive deals, particularly as their conclusions draw near. Companies that are coming to the end of the process of meeting the requirements of an enforcement action can be in a good position to undertake a transaction. Camco Financial, for example, exited its consent order with the FDIC shortly after announcing its deal to be acquired by Huntington. Indiana’s Old National announced a proposed acquisition of Tower Bancorp in September 2013 and three months later announced the termination of its BSA/AML-related consent order with the OCC. Similarly, issues surrounding significant contingent liabilities do not necessarily represent a showstopper for otherwise attractive transactions. As discussed in our prior memorandum, contractual devices such as contingent value rights can help limit an acquiror’s exposure to particular uncertainties, while offering upside to the target’s shareholders.

Regulatory changes are driving transactions in other ways. Some of the sellers of 2013, Taylor Capital for example, were continuing TARP participants. The Volcker Rule, which became final in late 2013, has driven a spate of business divestitures even before becoming effective. Major institutions have participated in divestitures, with J.P. Morgan Chase announcing that it would look to sell its physical commodities business and Bank of America continuing to selectively divest branch locations in 2013. Much divestiture activity is driven by tightened regulation—including higher capital expectations and enhanced common capital requirements in particular—as a way of mitigating the stockholder dilution associated with issuing additional common equity. Susquehanna Bancshares recently closed a sale-leaseback transaction involving approximately 30 branches, in part to free up

regulatory capital to increase lending capacity by disposing of assets with a 100 percent risk weighting. Overseas regulatory issues also continue to impact the U.S. market. An important example during 2013 was the nearly \$900 million sale of City National Bank of Florida to Chilean Banco de Credito, as Latin American banks continue to deepen their involvement in the important Miami market. In this case, City National's owner, Spain's Bankia, had received state aid and was required to divest the bank pursuant to a regulatory recapitalization agreement. New regulations that would require the U.S. holding companies of overseas banks to carry additional capital may also spur further M&A activity.

Deal Litigation

As transaction activity has concentrated among community banks, an unfortunate side effect has been that shareholder litigation over deals, formerly more likely to feature in larger transactions, has become commonplace in community bank deals. Nearly every announcement involving a publicly-traded seller quickly attracts a shareholder class action complaint and often several of them (a recent report indicated that the average transaction attracts six complaints from various plaintiffs and jurisdictions).

In most cases, these lawsuits have no legal merit—but they need to be taken seriously and, given their ubiquity, planned for from the outset. Plaintiffs' counsel bringing these suits will try to time their activities, including seeking a hearing for an injunction blocking forward progress of the deal, so as to exert as much pressure as possible on the merger parties.

As legal developments in the case law around such litigation have tended to limit the fees that plaintiffs' attorneys can obtain as part of settlements involving merely curative proxy disclosure, there is now more pressure from these firms to include other types of concessions in settlements, including changes to breakup fees, standstill protections or perhaps even deal consideration. And when a transaction has been negotiated on an arm's-length basis and there is no basis for a breach of the duty of loyalty by a director or officer of a party, plaintiffs' firms will look elsewhere for some colorable claim of this kind, including past relationships between the parties and their financial advisors. The increasing trend toward multiple competing litigations brought by plaintiffs in different jurisdictions can sometimes complicate reaching a global settlement, and several public companies have considered "exclusive forum" bylaws in the hope of easing the expense and burden created by such multijurisdictional litigation.

While such litigation will generally not threaten ultimate consummation of a deal, it should be anticipated and some basic preparation with transaction counsel ahead of time

can go a long way towards insuring that any such litigation can be disposed of on a reasonable basis, including through cost-effective settlement.

II. Bank Regulatory Developments and the Directors' Evolving Role

Overview

The responsibilities of directors of banks and their holding companies differ in important ways from those of directors of other enterprises. With developments in the wake of the financial crisis, including the enactment of the Dodd-Frank Act and the raft of rules, issued and to be issued, required in its wake, as well as the implementation of the Basel III framework, the role of the financial institution director is becoming more demanding and challenging than ever. Enhanced responsibilities for directors are coming from numerous new banking regulations but are perhaps most plainly exemplified by the OCC's recent proposal of a regulation to formalize its program of supervisory "heightened expectations" for larger banks and their directors.

Directors remain responsible for overseeing management's efforts to run the business profitably for the benefit of stockholders. Beyond that, the compliance oversight responsibilities of financial institution directors have increased substantially. There are not only new formal regulatory requirements, but a new level of expectations from bank supervisors in their traditional examination role. It is important for directors to understand that, as regulatory pressure has increased, supervisors are in essence looking to directors to help them carry out their regulatory mandates. These expectations are not limited to the "tone at the top," but comprehend a more involved, active and inquiring level of oversight.

Absent careful calibration, the pressure on financial institution directors to be monitors can come into tension with their traditional, and legally important, role of corporate fiduciary and strategic partner and advisor to management. This latter role is an essential component of continuing to attract capital into the financial services industry and retaining a premier role in the global financial order. Any new and enhanced responsibilities must somehow continue to make room for vigorous "animal spirits."

Traditional Duties of Financial Institution Directors

The legal duties of directors generally apply as well to financial institution directors. These duties stem from corporate and bank chartering statutes under state and Federal law, other elements of Federal law (e.g., the Sarbanes-Oxley Act), judicial decisions interpreting those statutes, SEC and PCAOB rules, stock exchange listing requirements and company and bank charters. The views of investors and investor advocates influence practices and customs on boards of directors. At its core, a director's role is one of oversight, not

management. Generally, it is limited to overseeing management’s conduct of the business of the company, including regularly reviewing the financial performance of the company with management. Directors are called upon to become directly involved only in decisions of high significance to the company, including, for example, the hiring, firing and compensation of the Chief Executive Officer and potentially other key executive officers, raising capital, distributing profits to stockholders and strategic transactions, such as mergers and major divestitures. When crises arise that implicate the conduct of senior management officials, it may sometimes be appropriate for directors to step in to manage the response and investigation. In making these and other business decisions, directors of an institution must satisfy fundamental fiduciary duties of care, good faith and loyalty to that institution.

A publicly traded company is required to have a board with a majority of directors who are “independent” of the management of the company, as well as audit, compensation and nominating committees, comprised of such independent directors, performing key oversight functions. Over time, the key board standing committees have accumulated greater responsibility, so that committee membership has become ever more demanding in terms of the commitment of time, the expected level of active involvement for a director and the expertise required to carry out the role. Independence is important in other ways as well; under the law relating to fiduciary duties, it is advisable in situations involving certain conflicts of interest for “disinterested” directors to take the lead or even the sole role in addressing those issues. More recently, the OCC has proposed rules that would formally require at least two directors at the bank (as opposed to holding company) level who are independent of management. While this is in line with the prevailing regulatory encouragement of subsidiary bank boards to more closely reflect the composition of the public company parent board, rather than being composed mainly of management employees, there is a new emphasis in the OCC’s proposed rules on overlapping directors considering separately the safety and soundness of the subsidiary bank as distinct from the parent holding company.

In addition, through the evolution of the bank examination process, bank regulators have traditionally been more prescriptive as to the particular duties of directors—including requiring an assessment of bank management. Banking organizations have long been expected to adopt formal, board-approved policies and procedures for:

- Lending standards
- Allowance for loan losses
- Liquidity management
- Asset management

- Capital planning
- Internal and external audit
- Compliance with banking regulations (such as community reinvestment, Bank Secrecy Act and anti-money laundering matters)
- Information technology
- Insider transactions and conflicts of interest
- Compensation

Moreover, supervisors expect directors to bear ultimate responsibility for:

- Selection and oversight of senior management
- Compliance with applicable laws and regulations, and with supervisory actions whether formal or informal
- Safe and sound operation
- Adequacy of the organization's capitalization, asset quality, earnings, liquidity and sensitivity to market risk
- Communicating risk tolerance limits to management and overseeing the establishment of risk control mechanisms reflecting that risk tolerance
- Effective internal audit and control functions
- Responding to reports of examination and overseeing prompt action to correct deficiencies
- Adequacy of efforts to serve the convenience and needs of the community

The Enhanced Role of the Board

For financial institutions, the pressure to expand the monitoring role of the board has been especially ascendant. With a broadly held view that the difficulties in the financial crisis arose from institutions taking on excessive risk without sufficient oversight, it is not surprising that the board's monitoring role would be subject to heightened scrutiny. This is reflected in a variety of specific formal requirements directed at boards under the Dodd-Frank Act, as well as in a distinct shift in supervisory expectations, proposed regulations formalizing those heightened expectations, and a more rigorous enforcement environment.

Many Dodd-Frank requirements specifically require the involvement and approval of the board of directors:

- *Standalone Risk Committees.* Each publicly traded bank holding company with assets of at least \$10 billion, and publicly traded nonbank financial company supervised by the Federal Reserve, now must establish a stand-alone, board-level, risk committee. The risk committee is responsible for overseeing enterprise-wide risk management practices and, among other things, must include at least one risk management expert experienced in dealing with risk exposures of large, complex firms.
- *Stress-testing Oversight.* At banking organizations with assets of \$10 billion or more, directors must review and approve stress testing policies and procedures at least annually, but potentially more frequently if economic or company conditions warrant. Directors must also consider the results of the stress test in the normal course of business, and see to it that they are factored into the company's capital planning, assessment of capital adequacy and risk management practices.
- *Assessment of Capital Adequacy.* For bank holding companies and other covered firms with assets of at least \$50 billion, the board (or a committee) must at least annually, prior to submission to the Federal Reserve of the annual capital plan, review the "robustness" of the company's process for assessing capital adequacy, ensure that any deficiencies are appropriately remediated and approve the company's capital plan.
- *Liquidity Planning Responsibilities.* Under the Federal Reserve's proposed rule to implement Dodd-Frank's Section 165 requirement for stricter prudential standards for \$50 billion and larger institutions, directors would be required to oversee liquidity risk management processes and must review and approve senior management's liquidity risk management strategies, policies and procedures. The board would be required to establish the company's liquidity risk tolerance at least once a year, review at least every six months whether the company is managed in accordance with the established tolerance and review and approve the company's contingency funding plan at least annually.
- *Basel III Implementation.* For banking organizations with assets of \$250 billion or more (or on-balance sheet foreign exposure of \$10 billion or more), as well as others that elect to use Basel III "advanced approaches," the board must approve the company's Basel III implementation plan. Additionally, directors must:
 - Annually review the controls supporting the company's "advanced systems" (including systems for measuring and managing operational risk)
 - Annually receive a report from internal audit on the controls supporting systems to measure market risk

- Approve a policy addressing how the company determines the disclosures required by Basel III, including associated controls and procedures
- *Approval of Living Wills.* Directors of \$50 billion and greater asset companies are required to approve the initial resolution plan submitted by the company and each annual resolution plan.
- *Volcker Rule Compliance.* The Volcker Rule requires that banking companies with \$50 billion or more in assets (or, when fully phased in, \$10 billion or more in “trading assets and liabilities”) establish an “enhanced compliance program” to ensure compliance with the rule. The program must meet minimum standards and incorporate written policies and procedures, internal controls, management framework, independent testing, training and recordkeeping. The board of directors is very much front and center in these Volcker Rule compliance programs. It is responsible for setting and communicating an appropriate culture of compliance. It is charged with ensuring that appropriate compliance policies are in place and that management is appropriately qualified and motivated. The board must approve a written compliance program and review its effectiveness, and must also be informed of any material weakness or significant deficiency discovered. The board is also mandated to have the “appropriate authority,” “access” and “appropriate resources” to effectively oversee Volcker Rule compliance.
- *BSA/AML Compliance.* In recent years, supervisors have focused with increasing intensity on compliance with the Bank Secrecy Act and anti-money laundering regulations, and supervisory and enforcement actions in this area have been particularly noteworthy for their number and severity. In some cases, cease and desist orders and civil money penalties have been entered against individual bank directors. As a practical matter, directors are now required to engage directly to understand in greater detail the workings of a company’s BSA/AML programs and to oversee their effective functioning.
- *Oversight of Outside Vendors.* Under recent guidance, the OCC is mandating that national banks implement processes to manage third party relationships that involve critical activities (including significant bank functions, such as payments, clearing, settlements and custody) or significant shared services (such as information technology) or other activities that could cause a bank to face significant risk if the third party fails to meet expectations, could have significant customer impacts or for which an alternative external or internal solution would have a “major impact.” The OCC guidance requires that boards:
 - Approve the bank’s policies that govern the third party risk management process, and identify “critical activities”

- Approve management plans for use of third parties in critical activities
- Review due diligence results and management recommendations to use third parties in critical activities
- Approve contracts with third parties that involve critical activities
- Review management’s ongoing monitoring of third-party relationships involving critical activities, and ensure that management responds appropriately when the results indicate significantly deteriorating performance, changing risks or material issues
- Review periodic independent reviews of the third-party risk management process.
- *Consumer Financial Protection.* Under guidance from the Consumer Financial Protection Bureau, boards are expected to adopt clear statements of policy on consumer compliance (as to the organization itself and its external service providers) and to oversee a compliance audit program addressing all applicable federal consumer finance laws. Consequently, directors should be familiar with significant developments in this dynamic area (for example, qualified mortgage standards and ability to repay, fair lending, collections practices and indirect lending).

Evolving Supervisory Expectations for Directors Involvement in Risk Management

While regulators will acknowledge that directors must focus on the financial health and performance of the organization and provide strategic business oversight for the benefit of the institution and its shareholders, they are nonetheless increasingly expecting directors to devote substantial time to, and demonstrate subject-matter expertise in, overseeing detailed aspects of the organization’s affairs linked to safety and soundness. This is true both in areas—such as capital planning and risk management—that have always required board engagement, as well as in areas that have traditionally been primarily allocated to management.

These heightened safety and soundness expectations were brought home most recently when the OCC released a proposed rule on new risk-management standards for larger (\$50 billion and up) banks, a formalization of the “heightened expectations program” the OCC has up until now been applying through the examination and supervision process. (The OCC also may apply the guidelines to smaller institutions it determines are highly complex or otherwise present heightened risk.) The OCC intends for the program to strengthen governance and risk management practices of large national banks, and is in line with earlier statements by the Comptroller that, as to internal controls and audit functions, “satisfactory” ratings are no longer sufficient.

It is noteworthy that the OCC's proposed rule goes beyond prescribing conduct for the board as a whole. It focuses on individual directors, expressly stating that "each member" of a bank board has a duty to oversee compliance with safe and sound banking practices.

Clearly, supervisors now expect directors to actively engage in compliance-related decisions and processes and to exhibit sufficient independence, knowledge and organization to effectively challenge management, and the OCC's proposed rule would explicitly formalize these expectations. It would require that boards ensure an effective risk governance framework and actively oversee management, exercising "sound, independent judgment," providing a "credible challenge to management" and "questioning, challenging and, when necessary, opposing" proposed actions that would violate the bank's risk appetite and threaten safety and soundness. Regulators expect that if directors lack necessary information to test management assumptions, they will proactively obtain appropriate information and education, and the OCC rule includes proposed requirements for ongoing director training and self-assessment.

The OCC's proposed rule requires that subject bank boards include at least two independent directors to help promote independent oversight of bank management. While the OCC's proposed rules would generally only apply to larger or more complex national banks, in the current environment any board that does not demonstrate sufficient engagement, resources and independence risks being criticized as unable to effectively challenge management.

Other regulators may follow suit. As reflected in the OCC's proposed rule, in addition to participating in the development of the banking organization's strategic plan and understanding its risk profile, the boards of banking organizations are increasingly expected to oversee the crafting of policies and procedures necessary to effect the strategic plan and mitigate potential risk, and to more closely monitor implementation of risk management programs to ensure ongoing compliance and to oversee whether management personnel are in place to execute the goals of the banking organization.

Meeting the heightened expectations requires a careful balance that provides for rigorous attention to compliance matters but avoids pulling directors into a morass of detail that may detract focus from core strategic and oversight responsibilities. Those boards that succeed in the challenging task of balancing their many and increasing supervisory demands without losing sight of their all-important strategic planning role will best position their institutions to succeed and grow over the long term.

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As the financial services business continues to emerge from the financial crisis and its economic consequences, major changes are continuing that present financial institutions with both significant challenges and possibly once-in-a-lifetime opportunities to participate in the reshaping of an industry. The rapidly evolving business environment, technological change and escalating supervisory demands on institutions, their managers and their boards of directors are creating an environment where canny strategy and excellent execution can make more of a competitive difference than ever. As the active participants continue to build on their successes and more institutions see the opportunity to enter the fray, we expect in the coming year to see many more examples of this dynamic playing out.