

Discussion Memo

New Challenges for Bank Directors

October 30, 2007

The following observations are based on personal participation in hundreds of bank board meetings during the past thirty years as a bank executive, board member or board advisor. It is hoped this memo will help provide bank regulators with additional insight concerning current governance and oversight challenges from the viewpoint of bank directors.

The objective of this memo is not to debate the merits of bank regulation, but rather to discuss the risk of potential unintended consequences that may be created by existing accounting and bank regulations as banks re-enter a period of deteriorating asset quality.

- **Significant Increase in Community Banks**

During the past fifteen years over 1,800 new bank charters have been approved and, as illustrated on the attached exhibit, even though the total number of financial institutions has decreased by 38% from 13,853 to 8,615, the number of community banks (\$100M to \$1B) has increased by 31% - with over 850 more community banks. The AABD's primary focus is education for the board members of these community banks.

- **Board Members (CEO's & Examiners) Entering 'Uncharted' Territory**

Community banks have experienced fifteen years of solid earnings based on real estate related loan growth. Most community bank board members are local business people with little, if any, prior experience serving on the board of a highly regulated financial institution and very often do not fully comprehend the ongoing requirements of the position. Few of these new community bank board members have experience in dealing with significant asset quality issues. In addition, few CEO's and bank examiners have experience in dealing with significant loan problems and declining real estate loan values in their current capacities.

- **Regulatory Emphasis on Compliance**

Monthly board agendas have become increasingly compliance oriented (BSA, CRA, HMDA, FASB, GAAP, SOX, EPA, EEOC, IRS, etc) as a result of regulatory emphasis on technical compliance matters. Compliance has tended to 'crowd out' strategic board discussions relating to customers, credit, controls, etc. Every regulatory agency (not just bank regulators) wants to hold the board accountable for oversight and compliance with an ever increasing number of regulations.

- **Changing Credit Market Conditions**

Credit problems surfacing in the residential mortgage markets and declining home values are well publicized.

Commercial real estate could also enter a period of declining values if the decline in capitalization rates (from 10% to 6%) reported by the Federal Reserve is reversed. An increase in investor capitalization rates to recognize increased risk will obviously decrease both appraised and market values.

This memo is not intended as a prediction of industry-wide problems but rather is intended to serve as a discussion of potential risks when credit problems occur at individual banks.

- **Changes in Accounting**

Changes in accounting rules during the past decade have created much confusion and frustration inside bank board rooms and with bank shareholders;

- ✓ **Loan Loss Reserve Adequacy**

CPA firms (following FASB & GAAP) have focused on the industry's recent good experience to establish (lower) reserve levels.

Bank regulators continued to focus on 'adequate' reserves creating RAP – GAAP confusion for bank directors.

As a practical matter, bank reserves have been computed based on complex historical formulas that may not fully reflect future conditions and reserves will need significant additions when loan losses increase (reducing earnings & capital).

- ✓ **Fair Value Accounting**

This accounting concept impacts a number of areas (including loan values) and requires detailed (confusing) audit committee and boardroom explanations that may tend to 'crowd out' other issues. Fair value accounting is another example of increasingly complex accounting standards challenging the boards, audit committees and management of community banks. Most important, such fair value estimates may not reflect future market values.

- **Key Risks > When a Bank gets in Trouble**

- ✓ **Bank & Holding Company Financial Risk** > Issues related to additional provisions to cover an increase in bad loans, potential deposit withdrawals, reduced earnings, dividend restrictions, borrowing covenants and capital requirements all require board action.
- ✓ **Board Risk** > Difficult to retain or recruit experienced qualified board members. Board fees don't compensate for risk to personal financial statements. Problems frequently exist because boards were not fully informed by (prior) management.
- ✓ **Management Risk** > Boards (and regulators) seek qualified and experienced leadership to replace existing management. However, it's very difficult for boards to identify and recruit qualified and *experienced* management to a troubled institution.

Board Role Expands > Very difficult period; more meetings, special committees, consultants retained and an interim CEO (board member or existing manager) must be identified and approved to provide temporary leadership, etc.

Recruiting Risks > New CEO faces substantial unknown risks!

Personal Reputation Risk > Why move from a secure job to a troubled bank?

Personal Financial Risk > Compensation, investment, Section 405

Personal Regulatory Risk > Must resign prior to regulatory approval.

Management Risk > Who can the new CEO recruit to help?

- ✓ **Bank Reputation Risk** > Publication of C&D becomes the basis for articles in local press leading to potential deposit withdrawals and liquidity risk.
- ✓ **Bank Liquidity Risk**

Insured deposits have declined as a source of bank funding.
 Bank risks large deposit withdrawals due to bad publicity.
 Regulatory policy may prohibit renewal of broker (insured) CDS.
Consequence > Bank forced to sell good assets that further reduces earnings.
- ✓ **Holding Company Liquidity Risk**

Increased capital leverage due to issuance of trust preferred securities has increased the need for bank dividends to service holding company debt.

Deferral of trust preferred dividends is not a 'market friendly' alternative and deferral by numerous banks will likely add to current problems in the trust preferred markets for community banks and restrict future additions to bank capital.

Consequence > The elimination of bank dividends may force a bank holding company to issue (if possible) new equity capital at the worst possible time to service debt.
- ✓ **Increased Deposit Insurance Premium**

Risk rated deposit insurance creates a significant hurdle for new management.
 Changing a CAMELS rating from a 2 (10 BP) to a 4 (28 BP) increases the premium by \$900 thousand annually for a \$500 million deposit institution.

Consequence > The risk rated system penalizes the new management hired to solve the problem – not prior management that created the problem.
- ✓ **Increased Regulatory Reporting**

The increase in regulatory reporting required by a MOU or C&D requires an enormous amount of board and management time and significantly increases legal and accounting costs.

Consequence > Management and board time that could be devoted to solving problems is consumed with filing paperwork – a significant new burden.

Conclusion

The above observations are based on personal experience and do not necessarily reflect the views of the AABD or its individual members. Obviously, other bank directors may feel other issues are more important or differ with some of the preceding observations.

In any event, each of the preceding issues underlines the need for continuing board education which is the primary goal of the AABD.

Respectfully submitted,

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 American Association of Bank Directors

Financial Institution Statistical Data

FDIC: 12/31/1992 & 6/30/2007

Financial Institutions	<u>1992</u>	<u>2007*</u>	<u>Change</u>
All Institutions	13,853	8,615	- 5,238
Commercial Banks	11,463	7,350	- 4,113
Under \$100 M	8,292	3,197	- 5,095
\$100M to \$1B	2,791	3,649	+ 858
\$1B to \$10B	329	413	+ 84
\$10B +	51	91	+ 40
Savings Institutions	2,390	1,265	- 1,125
\$100M to \$1B	1,094	721	- 373

Bank Statistics (\$100M to \$1B):

% of Assets			
Net Loans	56%	69%	+ 13%
Real Estate Loans	32%	52%	+ 20%
Deposits	86%	81%	- 5%
Insured Deposits	72%	58%	- 14%
Core Capital (Leverage)	8.1%	9.9%	+ 1.8%
Loan Loss Reserves/Loans	1.91%	1.24%	- .67%

Bank Statistics (\$1B to \$10B):

Real Estate Loans	25%	48%	+ 23%
Insured Deposits	55%	44%	- 11%
Core Capital (Leverage)	7.2%	9.2%	+ 2.0%
Loan Loss Reserves/Loans	2.77%	1.30%	- 1.47%

Observations:

- ✓ Significant increase in community banks.
- ✓ Significant increase in real estate related credit > increased credit risk.
- ✓ Decrease in Loan Loss Reserves > less ability to absorb losses.
- ✓ Decrease in insured (core) deposits > increased liquidity risk.
- ✓ Trends are very similar for both \$100M to \$1B and \$1B to \$10B banks.