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Presentation by:

Keith A. Clark, Esquire

Shumaker Williams, P.C.

Legal and Business Counsel

P. O. Box 88, Harrisburg, PA 17108

Phone: 717.763.1121/Fax: 717.763.7419

Website: www.shumakerwilliams.com

Email: clark@shumakerwilliams.com

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Towson
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901Dulaney Valley Rd
Suite 610
Towson, MD 21204
Phone: 410.825.5223

York
1 E. Market Street
York, PA 17401
Phone: 717.848.5135

A Primer on the Basics of How to be an Effective and Fiduciarally Responsible Board Member

or

"The Relationship Between Management and Bank Directors – A Source of Opportunity, Anxiety or Neither"

The Cultural Crisis in Banking

Article by Raoul D. Edwards, Editor, United States Banker, October 1983

"Culture" defined:

The integrated pattern of values, human behavior and action that drives the organization.

Problem: The world needs banking but it does not need banks.

Problem: Defining the industry.

The challenge: The culture which the bank and thrift have lived under for the past 50 years is the wrong culture for the next 50, because the world has changed, the market has changed, competition has changed, and the social charge has changed – and the financial services provider must also change and adapt a new and appropriate culture, if it is to succeed, to prosper and to survive.

The "Depression" mentality: regulatory – legislative – driven institutions more concerned with safety and shelter from undue competition.

The "old" banking culture:

a. The banking industry culture was pronouncedly "internalized". It was inner-directed, with practices and procedures designed to satisfy internal needs for safety, order and the next visit of the state or Federal examiner.

b. As a consequence it was heavily bureaucratic, existing for the sake of the paperwork, which must be “perfect”. Layers of safety valves were built, in the form of layers of management supervision.

c. **Safety, prudence – these are good words, they became be-all and end-all words.**

d. Banks were not price or product oriented. Both price and product were designed in Washington and in the state capital. Interest rate levels were low – and, above all, no one else wanted the market.

e. Thus, banks became order takers – the attitude was "you come to me." Customer was not necessarily "king". Professionals (and even the junior clerk) in a bank felt he was a "professional" – sometimes trading that status for a lower paycheck "did not sell".

The changing environment: the shape of the change mandates the shape of the culture needed to deal with the changes and face the future.

CHANGE!

During the last 40 years, every fundamental of the banking industry has changed.

Change – government:

1. Shift from stressing safety and soundness to open and free access of customers to the financial system.

2. Elimination of design of price and product by the government.

3. Dismantling of government-mandated specialization of financial institutions.

Change – Environment:

1. Economic cycles: volatile interest rate environment.
2. Shift of industrial base from the United States to imports from overseas; increase in the exporting of our financial services. Converging to a service-based economy and cash-flow lending.
3. A world economy.

Change – Technology:

1. The expansion of time and space.
2. The broadening of once-scarce services to the masses.
3. Instant communication and expected reaction.

Change:

The "New" Customer – less loyal, more demanding, more mobile and more affluent.

The Employee

- **5 generations with different values and expectations.**
- **Much more mobile.**

The Shareholder – primary interest – current return on investments.

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Change – The new competition: the crowning blow.

1. A different "culture": the new competition will not imitate banking – they bring to the market a different approach.

2. Examples: the insurance industry, the investment industry, Sears.

a. They advertise, they sell, they call, and they reward for success.

b. They do not limit to a single sale; they sell the existing customer over and over again.

<u>The Required Action</u>: change of culture

a. Change from an internalized to an externalized environment.

b. Change from a bureaucratic to a flexible and highly innovative system, one which adapts to change as it occurs.

c. Change to the development of middle management which manages, at the same time that the clerical levels receive far greater challenge to manage their own activities.

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d. Change from "you come to me" to "I sell you, wherever you want to deal with me". (Adds a heavy stress on being market driven, which means market-tested products designed to satisfy market needs, not internal desires or technological capability. Which means, also, selling technology, not imposing it).

e. Finally, salesmanship, salesmanship, salesmanship – Importance of cross-selling.

To change a culture, you must change the framework within which the culture exists, including the required management systems:

- **a. Strategic business planning;**
- **b. Financial management/planning;**
- **c. Marketing management/planning;**
- **d. Human Resource management/ succession/planning; and**
- **e. Technology management/planning.**

The Board of Directors

"Governance is Governance" (Not Management)

Difference Between being an Institutional Director and an Entrepreneurial Owner of a Closely Held Business

- Process
- Knowledge
- 3rd Party Oversight

Understanding Motivation for Becoming a Bank Director

- Prestige
- Networking and Marketing
- Community Service
- Compensation

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Understanding Motivation for Becoming a Bank Director

Cont.

- **Help Shareholders make a Reasonable Return on their Investment**
- **Keep Management from making Bad Loans and from following Unsound Business Practices**
- **Investment in the Bank and the Community**
- **Want to Make a Contribution to the Bank and the Community**

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Any Institution Which Has An All-Powerful Chairperson And A Weak CEO Is An Institution In Trouble!

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Any Institution Which Has An All-Powerful CEO And A Weak Chairperson Is An Institution In Trouble!

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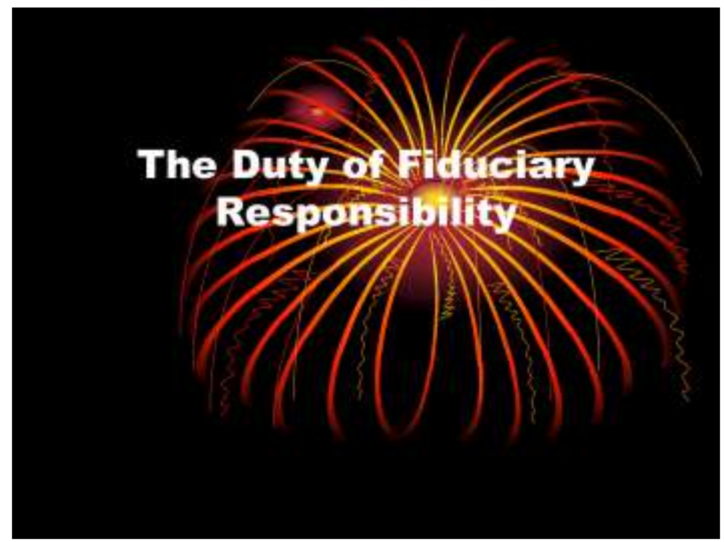
Update on Corporate Governance & Fiduciary Responsibilities



Source: Drew *et al.* (2006)

A Negative Approach – What a Director Should Not Do

Directors are harmful if they:

- **Micromanage and constantly remind the CEO that he or she is a "hired hand."**
- **Are overly influenced by their primary jobs outside the bank - as in, "At my organization we do things this way . . ."**
- **Form cliques on the board and hold official meetings without the CEO.**
- **Try to influence raises and promotions, and constantly try to get extra compensation - in health benefits or travel, for example - for their own services.**

A Negative Approach – What a Director Should Not Do

Cont.

Poor Directors are incapable of:

- **Making a decision.**
- **Dealing with troublesome colleagues.**
- **Helping the CEO do a better job, by giving constructive criticism.**
- **Working as team members with senior management, jointly setting priorities (and sticking to them) without getting bogged down in petty details.**
- **Conducting a meaningful CEO evaluation.**

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Have You Done Your Homework?

Review of Key Governance Documents and Information, Including:

- Has the Institution Done its Homework?
  - Due Diligence re: Necessary Talent (Matrix Approach)
  - Are the Expectations of the Institution Clear to a Prospective Director
- Confidentiality of Boardroom
- Attendance at Board Meetings:
  - Expectation
  - In person v. conference telephone call
- Directors' Orientation

Have You Done Your Homework?

Review of Key Governance Documents and Information, Including:

Cont.

- Annual Directors' Self-Evaluation
- Strategic Plan
- Structure: Bank/Holding Company/Affiliates
- Articles of Incorporation and Amendments thereto
- Bylaws
- Policies
- Code of Conduct/Code of Ethics/Conflicts of Interest

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Have You Done Your Homework?

Review of Key Governance Documents and Information, Including:

Cont.

- Employment Manual
- Three Year's Call Reports
- Three Year's Proxy Statements and Annual Reports
- Regulatory Reports
- Briefing by CFO on Financial Statement Format, Content and Tax Issues, Key Rates

Have You Done Your Homework?

Review of Key Governance Documents and Information, Including:

Cont.

- “How does the institution make a profit?”
- Committees:
  - Service Expectation
  - Unique Independent Nature of Certain Committees (e.g. Audit and Personnel Committees)
- Trade Association Affiliations of Organization and Activity Therein

Have You Done Your Homework?

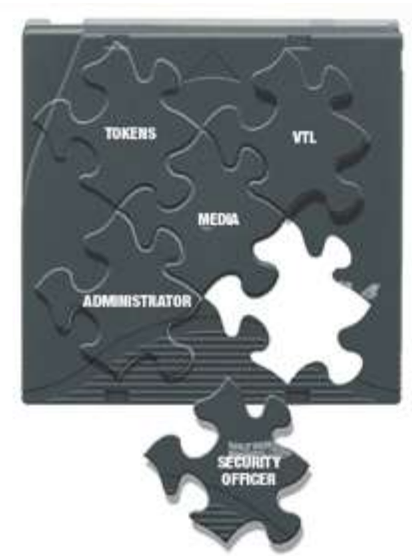
Review of Key Governance Documents and Information, Including:

Cont.

- “Expectations with Respect to Continuing Education and Sources
  - Internal
  - External
- Political Action Committee Contributions
- Director’s Fees
- D&O Insurance

I. Fiduciary Duty of Directors and Trustees

- Select competent executive officers
- Effectively supervise the banking institution’s operations
- Adopt and follow sound policies and objectives
- Avoid self-serving practices and conflicts of interest
- Keep informed of bank’s condition and management policies
- Maintain reasonable capitalization
- Observe banking laws, rulings, and regulations



I. Fiduciary Duty of Directors and Trustees *(Cont.)*

- Ensure that bank has beneficial influence on economy of local community
- Ensure management corrects any deficiencies at the bank
- Internal, Audit Committee, External Auditors, Bank Examiners
- Duty of Care
- Duty of Loyalty
- Maintain Confidentiality
- Disclose Properly to Shareholders

II. Board Responsibilities

- Strategic Planning; Ensuring and Monitoring Implementation by Management
- Business Plan
- Budgeting
- Capital Planning
- Select and retain competent management
- Review CEO performance at least annually
- Determine compensation of executive officers (how, who decides)
  - Employment Contracts

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II. Board Responsibilities *(Cont.)*

- Organizational Structure Adequacy should be evaluated annually
  - Executive Committee
  - Audit Committee
  - Fiduciary Audit Committee
  - Loan Committee
  - Asset/Liability Management Committee
  - Risk Management Committee
  - Fiduciary Committee
  - Compensation Committee
  - Nominating Committee

II. Board Responsibilities *(Cont.)*

- Oversee banking business performance
  - Trust But Verify
- Remain knowledgeable in key areas
  - Asset Quality
  - Liquidity
  - Interest Rate Risk
  - New Products and Services
  - Noninterest earnings (fee income)
  - Off balance sheet items
  - Dividends
  - Comparative position relative to peers

II. Board Responsibilities *(Cont.)*

- Meet credit needs of community served by bank
  - Community Reinvestment Act
- Compliance with laws, regulations, safe and sound banking practices
- Regulation O – Lending to Insiders Restrictions
- Avoid even the perception of insider abuse
- Comply with stock trading blackout periods

II. Board Responsibilities *(Cont.)*

- Constituency Mindfulness
  - – Community
  - – Customers
  - – Shareholders
  - – Senior Management – Trust But Verify
  - – Employees
  - – Regulators

II. Board Responsibilities *(Cont.)*

- Annual Meetings of Shareholders
  - Procedures in Advance of Meeting
  - Nominations of Directors
  - Proxy Disclosure
  - Proxy Mailings
  - Nominations; Vote
  - Shareholder Relations

II. Board Responsibilities *(Cont.)*

- Directors Meetings
  - Quorum
  - Regular Attendance and Participation
- Relationship with Regulatory Agencies
  - Ensure Management handles this well.
  - CAMELS 1, 2 – No Problem
  - Enforcement Situations (Board Resolution, MOU, Orders)
- Stay Educated.
- Responsibilities Vary Depending on Situation – Challenge, Opportunity.

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III. Fiduciary Duty of Directors/Trustees under the Law

- State Law
  - Standard of Care
  - Business Judgment Rule
- Business Corporation Law Standards
  - Holding Companies
  - Banking Institutions

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IV. More Fiduciary Duty under the Law: Disclosure, Disclosure, Disclosure

- Disclosure to Shareholders under the Law
- Securities Exchange Act of 1934
  - Companies with more than $10 million in assets whose securities are held by more than 500 owners must file annual and other periodic reports.
  - Disclosure in materials used to solicit shareholders' votes in annual or special meetings held for the election of directors and the approval of other corporate action.

IV. More Fiduciary Duty under the Law: Disclosure, Disclosure, Disclosure *(Cont.)*

- Proxy materials, must be filed with the Commission in advance of any solicitation to ensure compliance with the disclosure rules.
- Solicitations, whether by management or shareholder groups, must disclose all important facts concerning the issues on which holders are asked to vote.
  - Example: Tender Offers - anyone seeking to acquire more than 5 percent of a company's securities by direct purchase or tender offer is viewed as attempting to gain control of the company. Disclosure to shareholders is required, similar to proxy type of disclosure.

IV. More Fiduciary Duty under the Law: Disclosure, Disclosure, Disclosure *(Cont.)*

- Insider Trading Prohibited
  - Insider trading is illegal when a person trades a security while in possession of material nonpublic information in violation of a duty to withhold the information or refrain from trading.
  - Directors and Executive Management must not trade their banking institution securities during a blackout period.
- Director Trading must be reported (SEC Forms 3, 4, 5).
- Other Reporting: Annual Reports (10-K), Quarterly Reports (10-Q), Major Recent Items (8-K).

IV. More Fiduciary Duty under the Law: Disclosure, Disclosure, Disclosure *(Cont.)*

- Sarbanes-Oxley Act of 2002
- Mandated reforms to enhance corporate responsibility, enhance financial disclosures, and combat corporate and accounting fraud.
- Created the "Public Company Accounting Oversight Board," also known as the PCAOB, to oversee the activities of the auditing profession.
- Management Assessment of Internal Controls is required (Section 404 of SOX).

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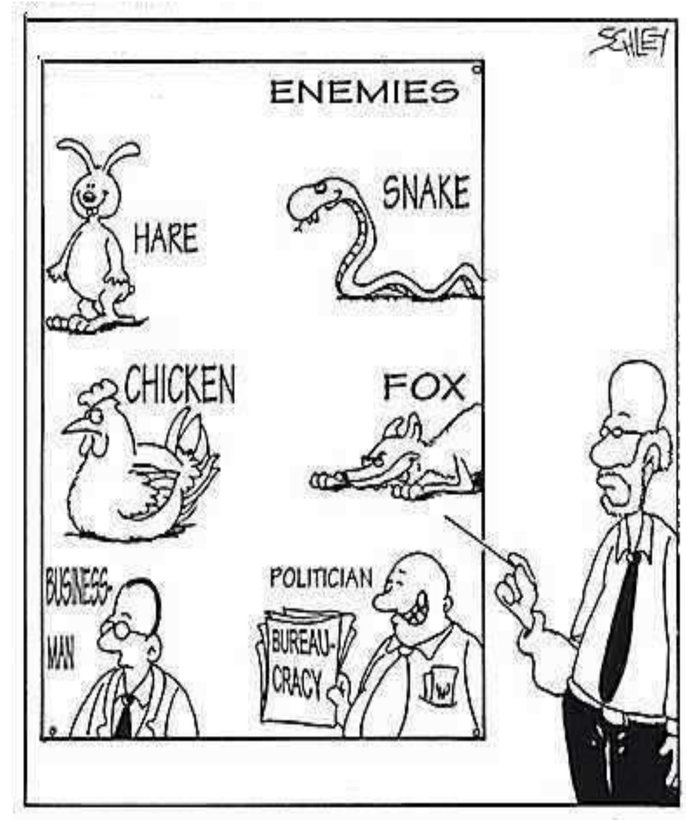
IV. More Fiduciary Duty under the Law: Disclosure, Disclosure, Disclosure *(Cont.)*

- CEO/CFO Periodic Certifications of accurate financial information.
  - Directors should monitor, inquire, evaluate information.
- Audit Committee – Independent Directors
- Audit Committee – Financial Expert Director
- Whistleblower Complaints Procedure – Audit Committee.
- Investigate and File SARs Promptly

V. Responsibilities of Board in a Merger Scenario



VI. Protection for Board Members

- Articles and Bylaws – Indemnification Provisions
- Directors and Officers Liability Insurance
- Regulatory Compliance
- Avoid Conflicts of Interest – Recuse Yourself When Appropriate
- File Appropriate Reports on Time with Full Proper Disclosure
- Maintain Confidentiality

VII. Recommendations for Board Action

- Strategic Planning
- Communication with Executive Management
- Evaluate Your Board
- Evaluate Senior Management
- Keep an Eye on the Financials
- Listen to Your Audit Committee
- Keep Whistleblower Function Strong
- Be Responsive to Regulators

VII. Recommendations for Board Action *(Cont.)*

- Disclosure to Shareholders Remains Important
  - – Say on Pay
  - – Annual Proxy Statements
  - – Timely Report Filings (SEC registered companies)
- Evaluate Yourself as a Director / Trustee
  - – Strengths, Weaknesses
  - – How You Can Contribute

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VII. Recommendations for Board Action *(Cont.)*

- Embrace Change by Becoming Educated About It
  - Because the Banking Industry Is in the Midst of Major Change
- Capital is King
  - Major focus to regulators.
  - Staying in front of the curve.
  - Don't Wait Too Long to Raise It in this Regulatory Environment
- Evaluate How Best to Survive and Thrive – Then Implement
  - Strengths, Weaknesses, Opportunities, Threats (SWOT) Analysis
  - Staying Independent vs. Other Alternatives.

Special Issues

- **Acquisition Issues – the Role of the Board and the CEO**
- **Dealing with a Seriously Critical Examination**
- **Properly Handling Insider Information**

Special Issues

Cont.

- **Directors Competing with:**
  - **Bank Customers**
  - **the Bank**
- **Selecting a New Board Member**
- **Disciplining a Director**

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The Future Value of Financial Institutions **or** Strategies for Remaining Independent

- Location
- Earnings Prospects
- Customer Networks
- Non-interest Revenue Realization and Potential
- "Uniqueness" - Commodity vs. Differentiation
- "Meeting the Needs of Its Market"
- Deposit Generation

The Future Value of Financial Institutions **or** Strategies for Remaining Independent

Cont.

- Increasing Fee Incomes
- Margin Analysis
- Overhead Control
- The Current Banking Climate
- Financial Strategies for Continued Independence
- Governance Strategies for Continued Independence

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Clark's C's of Board Service

- CEO – Coordination
- Change
- Character Counts
- Civility
- Commitment
  - Loyalty
  - Promotion and Sales
- Common Sense
- Communication
- Consensus
- Conservatism
- Continuing Education
- Compliance