The New Normal of Community Banking: Key Ingredients to Survive and Thrive

2012 Banking Institute
UNC School of Law Center for Banking and Finance March 29, 2012

Robert L. Davis
Executive Vice President, Corporate Counsel & Secretary
First Financial Holdings, Inc.

Paul M. Aguggia
Paul S. Pilecki
Kilpatrick Townsend & Stockton LLP

Scott M. Polakoff
Executive Managing Director
FinPro, Inc.
# Table of Contents

I. Overview of Key Regulatory Actions Implementing Dodd-Frank Act  

II. Corporate Governance and Strategic Planning Considerations for Thrifts and Community Banks
Key Regulatory Actions
Implementing Dodd-Frank Act
Federal and State Savings Associations – Examination and supervision of federal savings associations was transferred to Office of Comptroller of the Currency (“OCC”) and OCC now has rulemaking authority over all savings associations, federal and state.

- OCC issued regulations governing savings associations, both federal and state, in July 2011.
- Regulations substantially track prior OTS regulations.
- FDIC assumed OTS supervisory powers over state chartered savings associations.

State Savings Banks – State chartered commercial and savings banks continue to be supervised by the Federal Deposit Insurance Corporation (“FDIC”), or the Federal Reserve Board (“FRB”) depending on member bank status.
S&L Holding Companies

On July 21, 2011, the FRB took over from OTS as the federal regulator for all savings and loan holding companies, including federal and state mutual holding companies, and their non-depository subsidiaries:

- Includes supervision, examination and enforcement authority over S&L holding companies and non-depository subsidiaries
- FRB also has rulemaking authority for affiliate transactions, insider lending and anti-tying restrictions as to savings associations and savings and loan holding companies
- FRB Notice of Intent (April 15, 2011) – application of its consolidated supervisory program to SLHCs
- FRB Interim Final Rule (August 12, 2011) – adopted interim final rules to apply to all savings and loan holding companies and federal mutual holding companies
  - Imposes BHC control standards and policies on SLHCs
Capital Requirements

- A financial holding company must be well capitalized and well managed as a condition of engaging in expanded financial activities.

- The FRB is authorized to issue regulations imposing capital requirements on bank holding companies. The FRB is required to “seek” to make such requirements countercyclical allowing for decreases in requirements during times of economic contraction.

- Collins Amendment. The banking agencies are required to set capital requirements for insured institutions and holding companies with the existing minimum capital ratios applicable to depository institutions serving as a floor.
Source of Financial Strength

A holding company is required to serve as a source of financial strength, i.e., the ability to provide financial assistance in the event of the financial distress of the insured institution, to an insured institution subsidiary.
Risk Committees and Stress Tests

➢ Publicly traded bank holding companies with $10 billion or more in assets will be required to have a risk committee of the board of directors; the FRB may require publicly traded bank holding companies with less than $10 billion in assets to have a risk committee (Rules must take effect not later than October 21, 2013)

➢ A risk committee will be responsible for the oversight of the enterprise-wide risk management practices of the bank holding company and include the number of independent directors as the FRB may determine appropriate, based on the nature of operations, size of assets, and other appropriate criteria related to the bank holding company; and include at least one risk management expert having experience in identifying, assessing, and managing risk exposures of large, complex firms

➢ A nonbank financial company supervised by the FRB and a bank holding company with more than $50 billion of assets will be required to conduct semiannual stress tests. All other financial companies that have total consolidated assets of more than $10 billion and are regulated by a primary Federal financial regulatory agency must conduct annual stress tests and publish the results
Excessive Compensation

- Banking agencies proposed a rule on April 14, 2011 that would establish guidance on excessive compensation
  - Applies to financial institutions with assets greater than $1 billion
  - Requires board approval of policies and procedures governing compensation
Bureau of Consumer Financial Protection

- The CFPB is established as an independent entity within the Federal Reserve to regulate the offering and provision of consumer financial products or services under the federal consumer financial laws.

- Examination and supervisory authority over banks with assets of $10 billion or more and their affiliates.

- Banking agencies will continue to examine and supervise compliance with federal consumer financial laws with respect to banks with assets of $10 billion or less, subject to coordination with the CFPB.

- The FRB does not have authority over the actions of the CFPB or the personnel of the CFPB.

- The CFPB is authorized to employ attorneys, compliance examiners, compliance supervision analysts, economists, statisticians, and other employees as may be deemed necessary to conduct the business of the CFPB.
Update on Regulatory Actions Implementing Dodd-Frank

Other Issues of Note

- The most publicized provisions of Dodd-Frank only affect the largest banks, including enhanced capital and risk management requirements for systemically important institutions and the shift in the cost of the insurance fund toward large banks.

- But many of the effects of the Act will be felt by community banks, including:
  - Compliance requirements for small business lending will increase when new HDMA-style reporting requirements become effective.
  - Advisory and service relationships with municipalities may cause the bank to be deemed a “municipal advisor” subject SEC rules and registration.
  - Checking account relationships will change to recover costs associated with providing debit cards as debit interchange fees fall, even though small banks are exempt from the rule.
  - Directive that federal agencies modify their regulations to remove references to credit ratings as standards for determining creditworthiness results in more independent analysis for the banks in terms of categorizing assets for capital purposes and evaluating debt securities for investment.
Trends in Corporate Governance and Executive Compensation
Corporate Governance

Best Practices

- Proactive Board
- Oversight by Board of Directors, Not Day-to-Day Management
- Composition and Structure of Board
- Annual Self-Assessment
Corporate Governance

Best Practices (cont’d)

- Annual Review of Board and Committee Charters
- Separation of Chairman and CEO/Lead Director
- Succession Planning
- Risk Management
- Strategic Planning
Proactive Board/Board Oversight

- Board is responsible for establishing controls, procedures and suitable metrics to ensure any strategy the Bank undertakes is properly implemented.

- Board oversees and sets policies but should not be involved in day-to-day management.

- With increased scrutiny from regulators in the wake of the financial crisis, directors are expected to challenge management and to question the direction management is taking.

- Banking regulators will review as part of the examination process Board review and approval of policies, procedures and strategic plan of Bank.

- Regulators expect directors to understand the Bank’s risk appetite, internal controls and strategy.
Board of Directors Annual Self-Assessment

- Conduct an annual self-assessment of the board of directors and of each committee of the board to review the overall operation and effectiveness of the board and its committees

- Review the results of the assessment and make changes as needed
Corporate Governance

Separation of Chairman and Chief Executive Officer/Lead Director

- Not required by Dodd-Frank; but disclosure is required for public companies as to whether and why the roles are split

- Majority of Institutional Shareholders support separating the positions

- In the community banking industry, role of chairman and CEO are not typically split and lead directors are not typical
Corporate Governance

Succession Planning

- Adopt a management succession plan
- Review succession plan on regular basis
Risk Management

- Identify potential events that could affect the Bank – and manage risks to be within the appetite of the institution, in order to provide a good basis to believe the institution’s objections will be achieved within risk parameters.

- Align risk management with objectives and long term goals, not only to mitigate risk, but also to aid in success.

- Recent regulatory efforts force Boards to address risk and develop greater codification of strategic thinking about risk.

- Not enough to manage risk on “case-by-case” basis, need greater codification of strategic thinking about risk – must be able to explain it.
Strategic Planning

- Have clear strategies and a well-defined business plan

- Short term business plans translate long-term goals into specific measurable targets. Management is often in the best position to formulate these plans

- Include strategies to meet unanticipated operational contingencies to control strategic risk

- Contingency plan should forecast how departure from a business plan or a major operational loss could affect customer services or bank resources

- Value of Projections – one to three years the norm; beyond three years the value of the projections diminish
Increased Scrutiny of Executive Compensation

- Congress
  - Dodd-Frank

- Administration
  - TARP Regulations

- Financial Regulators
  - Incentive Compensation Guidance

- Securities and Exchange Commission
  - Expansion of Compensation and Corporate Governance Disclosure
  - Shareholder Advisory Services
  - RiskMetrics Group – Governance Policies

- Others
  - Media Sources/Investor Groups/Unions
Examples of Increased Scrutiny of Executive Compensation

- The structure of executive compensation has failed
- Tying compensation to performance
- Clawbacks
- Aligning the interests of executives and directors with those of shareholders
- Avoiding incentives to take unnecessary and excessive risks
- Independence and stronger corporate governance
- Say-on-Pay
- Increased disclosure (transparency)
Financial Institutions Excessive Compensation Rules
(Joint Statement)

Dodd-Frank Act Requirements – Incentive-Based Compensation

- Requires enhanced disclosure of incentive-based compensation arrangements by financial institutions and prohibits any type of incentive-based compensation that encourages inappropriate risk by providing excessive compensation, or has the potential to cause material financial loss to the institution

- Agencies to issue rules to implement provisions of Act. Proposed rule was issued by the banking agencies in March 2010. No final rule at this time
Financial Institutions Excessive Compensation Rules
(Joint Statement)

Interagency Joint Proposed Regulation – Incentive-Based Compensation

Would prohibit a covered financial institution from offering incentive-based compensation arrangements that encourage covered persons to expose the institution to inappropriate risks by providing covered persons with excessive compensation or that could lead to material financial loss.

- Covered Financial Institution: national banks, state banks, federal thrifts, state thrifts, bank and thrift holding companies, credit unions, broker-dealers and investment advisors and certain GSEs, in each case with consolidated assets of $1 billion or more.

- Covered Person: any executive officer, employee, director or principal shareholder of a covered financial institution. Executive officer is defined to include the president, CEO, executive chairman, COO, CFO, CIO, chief legal officer, chief lending officer, chief risk officer or head of a major business line.
Financial Institutions Excessive Compensation Rules
(Joint Statement)

Interagency Joint Proposed Regulation (cont’d)

- Would impose additional requirements on larger covered institutions (those with $50 billion or more in assets) relating to the deferral of incentive-based compensation for executive officers and review and approval of incentive-based compensation for those covered persons who have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital or overall risk tolerance.

- Would require all covered financial institutions to provide certain information to their federal regulator with respect to their incentive-based compensation arrangements for covered persons.

- Would require all covered financial institutions to maintain policies and procedures appropriate to their size, complexity and use of incentive-based compensation to help ensure compliance with these requirements and prohibitions.
Interagency Joint Proposed Regulation (cont’d)

- Requires the standards implemented by the agencies under the proposed rule to be consistent with the key principles established for incentive compensation in the Interagency Guidance on Sound Incentive Compensation Policies (adopted in June 2010) for purposes of determining whether an incentive-based compensation program may encourage inappropriate risk-taking by the covered financial institution.

- An incentive-based compensation arrangement would not comply with these standards unless it:
  - Balances risks and rewards;
  - Is compatible with “effective controls and risk management”; and
  - Is supported by “strong corporate governance.”
Strategic Planning Considerations
Strategic Planning Considerations

- Maintain Status Quo
- Charter Alternatives
- M&A Challenges
Maintain Status Quo
Strategic Planning Considerations

Advantages of Status Quo

- Operate under same set of regulations and policies for bank and holding company

- Regulated and supervised by same regulatory staff
  - Have a working relationship with regulatory staff

- No immediate change in day-to-day activities
Charter Alternatives
## Strategic Planning Considerations

<table>
<thead>
<tr>
<th>Charter Type</th>
<th>Bank Regulator</th>
<th>Holding Company Regulator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Thrift</td>
<td>OCC</td>
<td>Fed</td>
</tr>
<tr>
<td>State Savings Bank</td>
<td>FDIC (or Fed) and State</td>
<td>Fed</td>
</tr>
<tr>
<td>State Commercial Bank</td>
<td>FDIC (or Fed) and State</td>
<td>Fed</td>
</tr>
<tr>
<td>National Bank</td>
<td>OCC</td>
<td>Fed</td>
</tr>
</tbody>
</table>
Strategic Planning Considerations

Lost Advantages of the Federal Thrift Charter:

- Separate thrift regulator
- Dealing with single regulator at both Bank and holding company level
- Broad Federal preemption
- Interstate branching
- No holding company capital requirements
- Unrestricted holding company activities (lost with Gramm-Leach-Bliley)
Continued Benefits of Federal Thrift Charter:

- Continued dealings with OTS staff and examiners (albeit under OCC supervision)
- Continue to be governed by Home Owners’ Loan Act (albeit as interpreted by the OCC)
- Creation of Deputy Comptroller position at the OCC for savings association shows dedication to thrifts
- No changes required to governance documents
- “If it ain’t broke, don’t fix it”
- Enjoy Federal preemption (although more limited after Dodd-Frank)
Advantages of State Charter:

- Lower regulatory fees
- No QTL Test
- Potential for broader lending authority
- Not an “orphaned” charter
- More localized regulator
Strategic Planning Considerations

Disadvantages of State Charter:

- New examination staff
- Immediate loss of federal preemption
- Immediate bank holding company treatment, rather than phase-in applicable to thrifts
Advantages of National Bank Charter:

- No QTL Test
- Broader lending authority
  - No limit on nonresidential real estate lending, compared to 400% of capital for federal thrifts
- Have specific division devoted to regulation of community banks
- Bank charter generally associated with more complex or “bank-like” balance sheet
- Banks historically have traded at premium to thrifts
- Enjoy Federal preemption (although more limited after Dodd-Frank)
Strategic Planning Considerations

Disadvantages of National Bank Charter:

- New examination staff with reputation for stricter requirements
- Immediate bank holding company treatment, rather than phase-in applicable to thrifts
Charter Conversion Case Study: First Federal Savings and Loan Association of Charleston (“First Federal”):

- First Financial Holdings (Nasdaq: FFCH), the Charleston, South Carolina holding company for First Federal, is a $3.1 billion bank holding company providing financial services to individuals and businesses throughout coastal South Carolina, as well as the Florence, Columbia, and upstate regions of South Carolina and Burlington, and Wilmington, North Carolina.

- First Federal is the largest commercial bank headquartered in the Charleston, South Carolina metropolitan area and the third largest commercial bank headquartered in South Carolina based on asset size.
Case Study (cont’d)

- Filed charter conversion application in July 2011 with the SC Office of the Commissioner of Banks. Application included:
  - A plan of conversion which detailed any material changes in First Federal’s business plan, as well as any effects of the conversion on business locations, directors, officers, savings and deposit accounts, assets and property, liabilities, creditor claims, legal proceedings, liquidation accounts, and stock certificate
  - New Articles of Incorporation and Bylaws
  - Brief summary of First Federal and First Financial and additional information regarding the purpose of the charter conversion, a summary of the plan of conversion, capital ratios, nonbanking activities, and subsidiaries
Case Study (cont’d)

 Also in July 2011, First Federal filed an application (Form 2083) with the Federal Reserve to become a member of the Federal Reserve System upon completion of the charter conversion

 Form 2083 requests information such as: a description of any plans to raise Tier 1 or Tier 2 capital; a list of the Bank’s and the Company’s principals and certain information with regard to each; a description of any changes in management; a discussion of management’s plans for the Bank; and additional managerial information.

 Received approval for the charter conversion from South Carolina in December 2012, subject to approval of the FRB to become a bank holding company

 First Financial submits bank holding company application on FR Y-3 in December 2011
Case Study (continued)

- Prior to filing a Form FR Y-3 for review, the Federal Reserve expects the Company to contact their regional Federal Reserve Bank and first submit a pre-filing copy of Form FR Y-3. The pre-filing copy will allow the Federal Reserve to review and discuss with the Company any comments it has with regard to the application. After the Federal Reserve has had an opportunity to review the application, it will recommend when the application should be filed.

- The information requested in Form FR Y-3 includes specific questions regarding: information on the proposed transaction; financial and managerial information; competition; and the convenience and needs of affected communities

- Delegated vs. non-delegated
Case Study (cont’d)

- Charter conversion, including Fed membership and bank holding company status, accomplished in February 2012

Primary reason for conversion:
- Following Dodd-Frank and the elimination of the OTS, commercial bank charter more closely aligned with First Federal’s strategic plan
M&A Challenges
Strategic Planning Considerations

Getting a Deal Done: Shareholder and Regulatory Concerns

- Reasons for lack of M&A activity:
  - Depressed stock price of target and acquirer
  - Difficult to proceed when selling at the bottom
  - For acquirers, a lower price means less buying power
  - Due diligence has become more difficult and more important
    - Getting comfortable with the risks and pricing the transaction appropriately
  - Regulators looking more closely at pro forma capital levels and overall risk
    - Is there too much concentration of risk in a particular area?
    - Do you have the resources to handle the risk of an acquisition?
Strategic Planning Considerations

Getting a Deal Done: Shareholder and Regulatory Concerns

- Advice given these difficulties:
  - Pre-due diligence for acquirers
    - Conduct preliminary financial due diligence to see what a pro forma balance sheet and income statement might look like
    - Discuss the potential deal with regulators
    - Get the advice of lawyers, bankers and other professionals to determine if the deal makes sense financially and whether it's likely to receive regulatory approval
  - For targets, do not get too concerned with price
    - If you are not going to get top dollar for your institution, does that matter if you are taking stock in what might be a better company combined?
    - It's not going to get easier to get these deals done, so if you get too hung up on price, you may lose potential acquirers
Strategic Planning Considerations

Getting a Deal Done: Shareholder and Regulatory Concerns

- Role of Shareholder Activists:
  - Activists are going to be concerned about bad acquisitions
    - Overly dilutive on a book value basis and not picking up enough earnings
    - Unacceptable risks from an operational and organizational standpoint
    - “Stick to what you know”
  - For targets, activists generally want to see an exit strategy, especially for smaller banks with limited liquidity
    - If you are not going to get top dollar for your institution, does that matter if you are taking stock in what might be a better company combined?

- Advice for dealing with shareholder activists
  - Don’t ignore them
  - Get advice about what you can say in a meeting or in public reports that share elements of your strategy
  - Activists want to know management and the board are focused and understand their concerns
Strategic Planning Considerations

Getting a Deal Done: Shareholder and Regulatory Concerns

➢ Regulatory Issues:

➢ Approaching regulators about an acquisition

➢ Have an open dialogue about your business plan

➢ Regulators will often give helpful guidance in that they view prudent consolidation as a positive if it reduces risk to the system
Paul M. Aguggia  
Kilpatrick Townsend & Stockton LLP  
Suite 900 | 607 14th Street, NW | Washington, DC 20005  
office 202.508.5812 | cell 301.717.7717 | fax 202.204.5630  
paguggia@kilpatricktownsend.com

Paul S. Pilecki  
Kilpatrick Townsend & Stockton LLP  
Suite 900 | 607 14th Street, NW | Washington, DC 20005  
office 202.824.1415 | cell 202.258.3185 | fax 202.585.0022  
ppilecki@kilpatricktownsend.com