FINANCIAL SERVICES

Community Banks... A Way To Win (in the New Regulatory Environment)

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Keynote Address of Christopher C. Gallagher before the Directors & Managing Officers Conference of the New Jersey League of Community Banks, Forsgate Country Club, Monroe Township, New Jersey.

(Some Text in Outline Form)

Most of us are familiar with the premise of "Survivor," the TV show in which teams compete while they face various new challenges. During the series, the survivors are required to vote team members "off the island." It's pretty horrifying, since it appears to bring out the worst in everyone. Nevertheless, it resonates because it depicts a ruthless Darwinian environment in which only the strong can survive. At times business can seem that way.

In some ways, the show resembles community banking today. Only the strong survive–or do they?

Darwin taught us that survival comes not from strength, but from ADAPTATION.

In the last 10 years more than 6,000 community banks have gone "off the island." Today, however, the community bankers and directors here are survivors in every way. You should be proud of it. BUT if you want to remain on the island, the key word is ADAPT.

- You have resisted the temptation of the buyout.
- You must fight smash-mouth competition.
- You have remained committed to your own unique blend of community service and relevance, staying competitive with larger regional brethren whose size has enabled them to offer more products and services and whose enhanced underwriting models allow them to cherry-pick more of your loans than ever.

- You have held your own against newly aggressive credit unions pumped up with the financial steroids of tax subsidies.

- According to the FDIC and other recent reports, you are thriving.

But, there are signs that your confidence is not as strong as your recent ROA and ROE's would suggest. Grant Thornton Survey (No. 12 – 2005) of community bankers taken within the past year show:

Public Bankers

WHAT IS IMPORTANT			HOW CONFIDENT
1	93%	Retaining deposits	62%
2	92%	Attracting new business customers	53%
3	85%	Developing new sources of revenue	33%

These numbers confirm that within the community banking family, continued success is a growing concern.

Think of how David Letterman might put it—a community banker "Top Ten."

You know you're in trouble as a community banker when . . .

10. The open door of that huge safe in back of the lobby now serves as a coat rack.

9. During a recent power blackout your secretary was able to go right on typing.

8. One of your 3 tellers is using a walker, another wears Red Cross shoes, and the third is reading a yellow and black training manual entitled "Arithmetic for Dummies."

7. The toaster in the employee lunchroom has your bank's name on it.

6. The Board Chairman's 18 great-grandchildren have pushed your Girl Scout cookie budget through the roof.

5. Your employee training program now includes CPR.

4. You have only 311 passbook customers left.

3. The average age of your core depositors is twice your own.

Hey, that's NOT the way Letterman does it. These things get less funny as we go along…

This Top Ten gets worse, not better.

2. How about the Fleet Bank down the street just became Bank of America.

Finally,

1. Your cost of regulatory compliance is now greater than your net interest margin.

Whoa—wait a minute! That's not funny at all. But–is it true? Is it close to true? Is this where the survey's internal malaise originates?

In fact, compliance costs for some community banks is approaching 20% of non-interest expense, and climbing. Efficiency ratios are moving into the 70's?

I have worked with community banks for years and, like most of you, have heard before that the sky is falling. But these days, I am hearing it more than ever. Even the Regulators are saying it.

OCC's Julie Williams – ICBA Speech 3/11/05 –quotes.....

> "Economists can point to the succession of studies showing that, while compliance costs represent a serious burden for all banks, those costs take a particularly heavy toll at community banks, which don't enjoy the economies of scale available to their larger counterparts. We should all come to the same conclusion: regulatory burden relief, especially for community banks, should be a national priority."

And again,

> "The burden of regulatory compliance requirements represents a serious drain on the resources of community banks and a meaningful factor for the future viability of community banking franchises. We need to recognize this as a real issue with ramifications for the fabric of our financial system; it's not just rhetoric."

Why?—Community banks are important, she says.

So talk about <u>survival</u> is louder these days even among regulators who traditionally never said such things. But how can community banks survive if the cost of being regulated exceeds the benefits of being in business?

Julie Williams' words are echoed by the FDIC, in its study on "The Future of Banking." Most recently it released, "Community Banks: Their Recent Past, Current Performance, and Future Prospects."

Its Executive Summary ends with the following paragraph:

> "Community banks do face challenges. The number of community banks is likely to decline in the years ahead. Many community bankers state that it is difficult to both find and retain qualified employees. Competition with nonbank competitors, including credit unions, will continue. The fixed costs of regulatory requirements fall more heavily on community banks than on larger ones. Regulatory burdens could, therefore, have a significant negative effect on community banks' future prospects. Nevertheless, the evidence from the recent past about community banks' market presence, industry share, and earnings performance, coupled with the continued creation of new community banks, points strongly to community banks being a viable business in the future."

I have spent the last 35 years fighting to keep them strong—to give them the options they need to put together the unique blend of products and services that each will need to match the needs of its community. America's Main Street needs the specialized focus on community building and economic development that constitutes the community banks' reason for operating.

They do make the tough loans. They still offer the inefficient services many folks need to stay plugged in, or get plugged in. Most important—they do so because their business model is tied to and based upon the overall success of the area in which they are located. They give to the community they serve. They do not just take whatever they can.

But if the costs of compliance are now approaching the benefits of staying in business—it may be time to put on your helmets—because for many—the sky is falling. Because when compressed margins and lost customers is a marketing issue, you have a fighting chance. But when the business model itself is failing because of factors beyond your control, you have reason to be concerned.

So will this storm of burdensome regulation blow over? I believe it will NOT, but I also believe that you can weather this storm and maybe in the end even win out over your larger bank competitors and your credit union tormentors.

Indeed the good news is—the solution is up to you. It is within your control.
And the bad news is—the solution is up to you. It is within your control.

Before I offer solutions, we need to better understand the new regulatory emphasis.

Today I will focus on 3 of its key elements, and then you yourselves decide whether you think this storm will blow over.

Today's issues remind us all again of something we learned in the late 80's and early 90's. It is never good for banks to be on the political front burner. Everyone likes "my bank," but banking in general—no way! When populism rises, banks are often resented and bankers had better duck.

With respect to each of these 3 developments, there is:

- An external event or events,
- Then a political reaction,
- Then a regulator response, and finally
- An impact on banking.

I. 2002 Sarbanes-Oxley (SarbOx)

1. The Event – The Fall of the Untouchables

Enron's Ken Lay – Kozlowski at Tyco –
Bernie Ebbers—Frank Raines at Fannie Mae
AIG's Hank Greenburg—maybe evenWarren Buffet.

This is Elliot Spitzer being Elliot Ness

America's Untouchables have created a political revulsion with accounting shenanigans.

2. Congress Reacts

Sarbanes-Oxley—

House 423 – 3
Senate 99 – 0

A vote like that designed to get the electorate's attention also gets a regulator's attention.

SarbOx is aimed at SEC 34 Registrants with 500 or more shareholders.

As you all know, it incorporated internal controls validation procedures that had already been instituted by FDICIA's Section 36.

3. Regulators are examining with new emphasis on financial reporting. Bank management must verify the effectiveness of their internal financial controls. Not just to protect shareholders, but to reliably inform, and thus protect examiners—the regulators. Regulator "protection" is important because at exam time regulator fear quickly translates into tougher oversight.

And let's not forget Congress. Now they have someone to blame. CEO's and their boards can now be held accountable. The Sergeant Shultz defense, "I know nothing," won't work any more. Ken Lay is the last to use it. Congress wants regulators to nail corporate CEOs who play with the numbers. SarbOx makes them responsible for the effectiveness of their own internal controls.

But SarbOx also brought in The Accountants, who had been trying for years to limit their liability by keeping their audit function narrow. Sec. 404 says they must validate what management has validated. They are now on the hook as well, but in return for more liability, they got a cash bonanza. Reliable estimates are $40 billion in new money transferred to accountants, with SarbOx. We know some is being spent on lawyers to write engagement letters that transfer it all back to you. But a lot goes into their pockets.

Where does it all end? This reminds me of the Paul Nadler story (re a bank that spent $300,000 on accounting one year, didn't use an accountant the next year, explaining that it had no idea how it was doing this year, but knew it was $300,000 better off than it would be if it did).

This is <u>not</u> going to blow over. It is here to stay—<u>especially for banking</u>.

Nor should it— <u>Especially for banking</u>.

Why? Because it involves <u>trust</u> and TRUST is the one key differentiating factor for banks in the financial services world. Loss of "trust" means non-banking competition wins. Note the ascension of reputation risk in examiner reviews now. That is where the Trust factor <u>plays</u> in, and CAMELS is where it <u>plugs</u> in.

Only a week or so ago, <u>Fannie Mae</u> was told by OFHEO that more flack is coming—even after the removal of Frank Raines.

<u>The AIG</u> story is compelling drama—and it is nowhere near over.

<u>Citigroup</u> was told last week by the Fed that it cannot make more acquisitions.

<u>Bank of America</u> is getting hit as well.

All of these financial service companies' difficulties were based upon what the regulators deem "<u>inadequate internal controls,</u>" so the <u>Congressional</u> response to these issues has been hardened into law by its overwhelming vote. The <u>Regulators</u> are enforcing the law zealously.

What does this mean for the <u>Banks</u>? Well, the banks are trying to adjust to the cost—and, since the problem isn't going away, the real question is can they adapt?

Sarbanes-Oxley imposes <u>self policing</u> duties to establish financial controls.

1. Independent accounting to make financial reporting more reliable.

2. Independently monitored management to avoid conflict, creating checks and balances to ensure honesty.

3. Codes of ethics and best practices

4. Governance structures that ensure effective compliance.

These can be accomplished "within the walls."

What is gone? Listen up CEOs. Strong internal controls require different governance. <u>Singular responsibility and control is out.</u> (OIG-FDIC) Pyramidic structures are the least trusted. Combining financial and audit operations in one person is NOT ALLOWED.

THE CEO's JOB NOW IS TO HAVE A SYSTEM THAT IS LOOKING OVER HIS OR HER OWN SHOULDER.

Now must have

- Checks and balances built in.
- Structures and systems that will Prevent

OR

Detect and correct in timely fashion:

- All non-compliant conduct.
- Any potential misrepresentation.
- Before there is real loss.

Independently monitored internal financial controls WILL BE APPLIED TO EVERYONE.

This is not new. Coupled with FDICIA, it is the SAME STANDARD AS FDICIA. But examiner emphasis is new and independent verification has significantly raised the cost of financial controls.

SarbOx applies to all banks even those under $500,000. Notwithstanding John Reich's episode with

[TELL THE STORY—"Have them call me."]

John Reich letter *[explain]*

Read it

> "There has been some confusion about the application of the Act to small non-publicly traded institutions both among bankers and in some cases among regulators. My recent statements on the subject were designed to clarify that the Act does not apply to nonpublic institutions—regardless of their size. Having said all that, I recognize that the Act does contain provisions that may make sense for institutions of all sizes. Certain provisions of the Act actually mirror existing policy guidance related to corporate governance that the FDIC and other banking agencies have issued. These small institutions should realize that (1) although the corporate governance practices set forth in the Act are not mandatory, (2) consideration of these practices should be considered, given their size, complexity and risk profile. However, (3) an institution that reasonably determines that it will not implement these provisions should not be forced to do so. My invitation to contact my office to report any incident to the contrary still stands."

This sounds to me like it applies. At a recent panel in New Hampshire, Vice Chairman Reich concluded that it would apply unless you had a good reason for not applying it. Why does it apply to banks all banks? Because trust doesn't begin or end at $500,000 in assets. Moreover,

any banks' loss of trust is a significant reputational risk. The FDIC does not have two examiner training systems. The reputation risk concern applies to all.

Later I will explain how smaller banks should comply and how that compliance can provide a leg up on the competition.

II. Significant Event #2 (And we're a long way from Letterman now.)

9/11 2001

Congressional Reaction

- USA PATRIOT ACT
- CIP's
- BSA
- AML
- SARS, etc.

They aimed squarely at the banks because of terrorist financing. It takes money to do these things. Will this emphasis last? Remember. . . ANOTHER STRIKE IS INEVITABLE. Inevitable strikes create their own political dynamic. It's called CYA.

Elected officials. . .

1. Need to have taken action.
2. Need to find someone else to blame.
3. The intelligence agencies they oversee got it wrong, and they can be tolerant with them. (It makes you wonder what the CIA and FBI have on these guys.) They get a "Report" but we get regulatory programs with "ZERO TOLERANCE." This is regularly denied by regulators, but is still being felt by bankers.

Politicians say, "We must nip terrorism in the bud." The banks are near at hand and already regulated—and without the cost of government funding.

In Afghanistan
Mullah Nasrudin story

Lost coin—over there—why look here?

"The light is better here."

Bank regulators feel the heat. We have bank regulations in place. The light is better here.

Halawi

Can't trace it.

Hellawe!

Remember as a kid when you shouted the cry of the lost "Hellawe Tribe," "Where the hell are we?"

We are highly regulated. Government has a handle on us. So the focus is on the banks. FinCEN and the bank regulators almost had this BSA problem settled when Riggs came along. Back on the front page—that was the end of that discussion and BSA focus was aimed back at the banks. As one examiner told me, our exams this year about about three things: B – S – A.

Bankers, do the math. Where W is "Watch": BSA + CYA = WYA

The fact is near zero tolerance is imposed because Congress knows that "stuff happens"—but so do bankers. No one is perfect.

This WON'T GO AWAY and maybe it shouldn't. Mohammad Atta entered the air transportation system in Portland, Maine. Any hole, however small, is still a hole. They are not able to protect the grid any other way. Banks, like power stations, are plugged into the financial grid. That's what you tell your customers. If we cannot lower this river of regulation, then we must raise the bridge of compliance.

III. Now the third element—one more subtle but also continuing and unrelenting.

The era of big government is over even if we are threatened. So, reduce the size of government. Use the technology where you can and transfer the cost to the regulated.

Here's how it works—

Beginning in 1996 (with final adjustments in 2003), the FDIC began a new way of examining—top down; risk focused.

Compliance risk profile

John Jackman Summer of 2004
Supervisory Insights
First edition.

Here's what it means.

- Systemic analysis

- Self-policing

- Analysis of system

- If a clock strikes 13, the whole “system” is bad.

“Risk based” to “Risk Free”

FDIC Reasons

- Less time—more efficient
- High Tech

- Workforce Downsizing.

Yes there are fewer examiners? So don’t forget human nature. Risk based to whom?—to the examiners—that’s who.

Is it possible that

Finding nothing wrong doesn’t lead to job security?

Focus on your system is efficient.

Missing holes in your system can harm job security.

So naturally we have zealous examiners who are looking for systemic problems.

So tough risk-based examination is here to stay.

So when Congress has acted to. . .

1. Tighten homeland security by taking measures to detect and prevent terrorist attacks before they are launched,

   And to

2. Restore trust in the reliability of the financial reporting systems that underlie investment, no single sources of control,

   And to

3. Transfer these responsibilities to the regulated institutions themselves to provide for early detection, prevention, and correction,

And to

4. Ensure that these transferred responsibilities are carried out effectively,

5. And these measures merged well with the new examination process. . .

You get what I call SARBOX SYNDROME.

SarbOx Syndrome is produced by a confluence of megatrends that all point in the same direction. A storm that will NOT go away.

My Definition—

> "Congressionally driven intensification of supervisory oversight by transferring regulatory responsibility and accountability to the regulated entity;
>
> Then ensuring its effectiveness by requiring the implementation of internal and external control systems designed to detect and prevent problems from occurring before they happen;
>
> By making more persons responsible for the system's success, including bank directors, external auditors, and of course regulators."

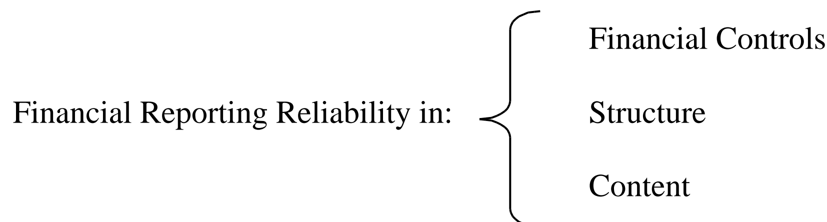
Since these new areas of regulatory concern require the installation of systems to prevent problems before they happen, and thus

Go right to the heart of the bank's management and control, the new approach must be applied through appropriate corporate governance.

So to the venerable duet of compliance, and safety and soundness two new pillars were added to the regulatory kit bag:

Homeland Security

And Fail Safe System



A new risk-based, risk free system. The new examination process seeks not just compliance—not just the absence of infraction, but the presence of a structured system that ensures

And write this down—This is now the job of Directors as well as operational management. Effective compliance is now a part of the management and the directors' fiduciary responsibility.

(But more on that later.)

IV. The new regulatory emphasis is a significant and substantial change.

To drill down deeper, the key word is "effective." For a system to be effective it must be:

- Immune from tampering.
- Must have independent monitoring
- Financial and audit operations must be separated
- No person can be in a position to conceal errors or irregularities

And there must be

- Independent conduits to the Board of Directors. Clear Communication.

This sounds like "heresy," which is why some CEO's do not want to hear this and some directors don't want to do this. For CEOs, it is inefficient. For Directors, it means more work and more liability. Yet this is what must be done.

All banks must ensure effective compliance. What is meant by effective compliance in this new paradigm? There are answers in Washington.

Herd—Group Think

Stuff waiting on the Shelf

Internal Controls? All say the same thing.

US Sentencing Guidelines for Organizations (USSGO) lay it out.

(Read them on the disk.)

Can you prove it? Is proof documented?

In today's climate, community banks may seem to have only two choices.

1) Sell out; or

2) Downsize Products and Services

BUT, I believe and contend there is a third choice – ADAPT – And that choice is available if community banks act now.

By ADAPT I do not mean urging your compliance professionals to do a better job, and hiring more vendors. This New Paradigm calls for a different response. Given today's competitive environment, multiple layers of compliance and vendors are now cost prohibitive.

The adaptation must be your own. This may sound more like revolution than evolution. You need integrated systems—to prevent or detect and cure failures in compliance before they happen—built into your management game plan with:

1. Top-Down Accountability

2. With more than one control point

3. And the leader is not the compliance officer.

4. Team trainers influence but do not design or implement the game plan.

You need to go on offense with integrated internal controls. They are the key to community bank survival because not having them leads to their external imposition by MOU or consent decrees. (This is one in the disk.) Besides, sound management requires internal controls. Why not combine them all? (Financial Compliance Operations) Why not create your own enterprise-wide risk management system?

Okay, what are internal controls? Where do I find them? Where do I start? COSO Treadway etc. (explain)

Turning to COSO for a definition, we find "internal control" defined as:

> ". . . a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
>
> - Effectiveness and efficiency of operations
> - Reliability of financial reporting

- Compliance with applicable laws and regulations

Internal controls are not merely accounting or even internal accounting procedures, although both play a role. Their essentials include traditional management objectives and oversight. They are not an isolated project. They are dynamic and continuing. Board and senior management must be aware, involved, active and committed to its operative components on a continuing basis.

- Internal control is a *process*. It is a means to an end, not an end in itself. The end is to survive and thrive

<u>Quick Outline</u>

(more on the disk)

1. <u>Control Environment</u> (Tone at the Top)

This critical component, often referred to as "tone at the top," provides the structure and discipline that supports all the others. Its elements include:

- The ethics and competence of the people in the organization
- Can't just talk the talk

Tone at the top is not just caring a lot. I hear it all the time, so do the regulators.

It involves. . .

- Management's operating style, and how it assigns authority and responsibility.
- Board involvement <u>and</u> direction, and most important,
- Board and senior management's continuous commitment to a culture of effective compliance. They must walk the walk

So with your compliance and financial people in the room, at the outset you do. . .

2. <u>Risk Assessment</u>

- Establishment of objectives
- Identification and analysis of risks that threaten those objectives
- Analysis of relevant risks created by changing conditions

- Risk Appetite

- Risk Tolerance

3. Control Activities (To Address The Risk)

   - Policies and procedures established to ensure that identified risks are addressed and management directives are followed throughout the organization, such as verifications, approvals, authorizations, security of assets, etc., including devices to identify and respond to material internal or external change.

4. Information and Communication

   - Identification, capture and communication of pertinent information in a form that enables people to carry out their responsibilities within the necessary time frame, that informs directors and senior management, and that enables informed oversight,

   - Data preparation, retention and security,

   - Training and awareness.

5. Monitoring

   - Ongoing assessment of system quality controls and their performance.

But beware of turning this entire process over to an accounting firm. COSO is an accountant's idea of Internal Control. You are running a business. Indeed, it is easy to see why the COSO framework alone cannot do the trick. It was drafted and is updated by the accounting industry. It is designed in part to support their external audits. It reflects their viewpoint—which is financial controls. Its terms are reflected in FDICIA's obligations and again in Sarbanes-Oxley. Its framework is a good starting point, but you cannot end there.

COSO fails to give enough attention to the operational controls that motivate management. For leaders concerned with profit and loss, functional efficiencies, planning, response to opportunities, asset valuation and leverage ratios, COSO alone comes up short. More must be added to the mix—if controls are to be effective AS MANAGEMENT TOOLS.

COSO provides a foundation for accountants to demand written evidence of internal control compliance, and it still focuses on liability mitigating metrics which enable accountants to take solid positions without fear of liability which, as I said, is already limited by self-serving engagement letters.

The problem is that strict adherence to COSO can require two sets of compliance controls resulting in the layering of costs and internal procedures that militates against efficiency and sound management. What is called for is enterprise-wide, integrated risk management within a framework of internal controls that defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Good management requires solid risk assessment and effective controls require not more than simply putting financial controls in place. That is why strict SarbOx and FDICIA compliance with financial controls requirements can get you into compliance, but also into financial trouble—through excess cost, wasted emphasis, and total dependence on your accountants.

You need to make the effort now to create a system that integrates within a strong corporate governance structure risk management, financial controls and operation controls in one efficiently functioning plan—a system that ensures—NOT JUST effective compliance in financial reporting, but also with respect to effective management.

Think of internal controls as a three-legged stool. One leg, reflecting COSO's accounting emphasis, is financial controls. Another is regulatory compliance, including BSA and the rest of the compliance alphabet soup. The third leg, however, is your business plan, the operations program for attaining the economic value objectives for which the bank was founded. This is the leg most cherished by management.

All three legs must now equally support the seat. They must work together in integrated efficiency. Sitting on it are your CAMELS, management, and Board of Directors. If any one leg collapses, the entire stool goes with it. Get them working in concert, THEN SELL IT TO YOUR REGULATOR. Sales is still a key role for the senior management team.

An internal controls solution is easier to explain than to execute. But I can tell you this—the smaller you are the easier it is to combine compliance and financial controls with management controls. Compliance may be hard, but integration is easier with 20 employees than with 200, or 2000.

The integration of Internal Controls is the only plausible solution to the regulatory burden now faced by community banks. Board and senior management must grasp and implement a framework of internal controls that successfully integrates bank operating goals and objectives with regulatory compliance and financial accounting requirements.

Such integration is the only way to efficiently and thus economically satisfy regulator cravings for credibility and the bank's continuing commitment to the program. They are the only way to support external audits and, most important, they are the only available outlet for management's need to accomplish all of this while pursuing and attaining enterprise goals and objectives in creating value for shareholders and other stakeholders. Such integration, therefore, is required both for compliance and for economic efficiency. That, coupled with the continued watchfulness of Board and Senior Management, will make it "effective."

So CEOs—it's up to you. Adaptation—not size and strength—is the way to survive.

Last summer Fed Governor Susan Bies spoke in Chicago to community bankers about Corporate Governance and Risk Management. As you read her speech (it's on the disk):

- Keep in mind that between FDICIA and SarbOx , the best practices bar has been raised.
- Keep in mind that systemic regulatory review look for systemic internal controls.
- Keep in mind that a system that doesn't work or, worse, doesn't exist at all will result in the imposition of an examiner's system on your bank in an MOU or consent decree.
- Keep in mind that once they find a weakness anywhere, they expect to find it everywhere (and so do their superiors).

Ms. Bies reminds us of all of these issues. She outlines how early concern with FDICIA Sec. 112, which required management report on internal controls and auditor attestation, has now been delegated down in the organization.

But risks change with changes in condition, products, competition, employees, etc. Change is the only constant.

She says:

"Any institution that views corporate governance as merely a compliance exercise is missing the mark."

"I challenge you to consider the corporate governance structure appropriate to your bank's unique business strategy and scale as an investment in terms of the avoidance of the costs of poor internal controls."

Ms. Bies has said a mouthful. Read her piece. It's on the disk. And take her advice.

This is also very important FOR DIRECTORS. There is a new focus on them.

1. (Regulators understand how to get the attention of senior management.)

2. "Tone at the top" means at the VERY top.

That impact is NOW. CEOs MUST ADDRESS THIS NOW.

Directors & Trustees

Under the OLD WAY, the role of Community Bank Directors was to:

- Develop external business

- Be Representatives

    Of Shareholders (large one)

    Of community (elder and respected)

    Of other constituents (business, sources of business)

There were almost never picked for internal value, such as

- Banking know-how
- Management skills
- Accounting prowess
- Knowledge of legal or regulatory issues.

Why?--that's the way it was, and besides they might get in the way of a CEO's unfettered discretion.

N ose
I n
F ingers
O ut

CEO's must understand that there is a regulatory laser aimed at your Boards of Directors. And its not just the Regulators. There is a legal basis for all of this. Class action attorneys are waiting. Failure to comply presents substantial risk to the institution.

Caremark Decision

- No protection under business judgment rule for failure to comply where failures is a significant risk of harm.
- Fiduciary duty to effective compliance where failure to do so poses a substantial risk to the organization.

Do the directors exercise independent review, and are they provided with information so as to exercise it?

T.J. Hooper Standards case

Sarbanes-Oxley has become the new standard

- Internal controls
- "Effective Compliance"
- Standards for Clear Communication
- Independent Monitoring

FOR DIRECTORS

1. Must have established standards and procedures for prevention and detection of (undesirable) conduct.
2. Must be knowledgeable regarding the CONTENT AND OPERATION of the compliance program.
3. There can be no conflict within the system of controls.
4. You need communication that imparts training and education to stay current.

ALL SPEAK SAME LANGUAGE

5. You need periodic evaluation of systems and operational changes.
6. You need direct and secure conduits to monitoring personnel including the Board of Directors.
7. You need incentives for compliance provided to encourage rather than discourage compliance.
8. Once noncompliant conduct is detected, it is effectively corrected.

(USSGO)

Perfection is not required, but any non-compliant activity will trigger intense review as to whether . . .

"the corporation's directors exercise independent review over proposed corporate actions rather than unquestioningly ratifying officers' recommendations; are the directors provided with information sufficient to enable the exercise of independent judgment, are internal audit functions conducted at a level sufficient to ensure their independence and accuracy; and have the directors established an information and reporting system in the organization reasonably designed to provide management and the board of directors with timely and accurate information

sufficient to allow them to reach an informed decision regarding the organization's compliance with the law."[1]

This is how the DOJ reads their requirements. Washington Group-Think reflects it. Is this how your Board operates? The Regulators are saying it too. OCC says the Board shall ensure that the bank has processes, personnel and control systems (programs) to ensure implementation of and adherence to the program developed to accomplish their role.

And for smaller institutions, some outside audit expenses can be saved. Build-in the dual monitoring system. A strong Board can help the CEO do his compliance duty without as much expense for outside audits.

"Partnership"

Most Important

- Won't have to pay for so many independent audits.
- Much of the new cost can be made up by an informed and independent Board of Directors.
- Think beyond Liability – Beyond the ugly exit meeting

Following are Not Defenses to Board Laxity

1. Good Faith
2. The guy has lots of time so we put him on the audit committee.
3. We all thought he would be deceased by now.
4. He owns a lot of equity in the bank and he buys dinner.
5. She is the only woman we could find. (Just try that one!)
6. I can't get anyone else to serve.

Examiners have heard them all.

[1] Memorandum from Larry D. Thompson (Former Deputy U.S. AG) to Heads of Department Components and United States Attorneys, dated January 20, 2003, and attached Principles of Federal Prosecution of Business Organizations, p. 11. Available at: http://www.usdoj.gov/dag/cftf/business_organizations.pdf

Therefore, if they must be involved in bank management, why not USE THEM? They will say they don't want the responsibility. They cannot learn.

Remember that Grant Thornton survey I talked about at the beginning of these remarks. It also shows that the number one reason for public banks to go private is the burden and cost of complying with the new regulations. For community banks, audit and documentation fees are up for more than 90% of them, but bless than 40% of them have increased their costs of retaining and education board members. They can and must do it.

V. <u>How do we change the board or its capacities?</u>

1. The entire Board doesn't have to be responsible. Use committees—but leave no holes.

   A) Audit committee must be independent and have knowledge of content and operations of the system.

   B) <u>Short Term</u> – Divide into Committees

   C) <u>Long Term</u> – Change the people.

      <u>Educate</u>

      Associations can help here, but the weave is critical.

      <u>Explain</u>

      - How is the knowledge applied?
      - How is access furnished?

D) General education is not enough.

   They must know:

   - How your compliance programs weave into your "game plan" and its adjustment processes.

   And

   - How your institution's unique plan operates.

The internal controls plan must be crafted at the highest level of Board and senior bank management. Constructed properly, the legal compliance and SarbOx issues fall into place. With the help of your compliance and accounting professionals, they can be integrated with the operational plan.

It becomes your own unique game plan. Then it must be implemented through the Board Committee on Audit and Governance, with periodic review and reporting. When the examiners arrive and ask for your system, give them your integrated plan that includes:

- Financial controls
- Compliance controls, and
- Operating controls

Operating together in a balance that enables you to have the benefits of continued operation outweighs the costs.

To get this in proper equilibrium, you may need to right size:

- To grow larger or smaller,
- To curtail certain products or services, or add them
- You may need to add to your board's makeup and training.
- You may need to find accountants and legal support that is willing to serve the bank you want to be, not the bank they want you to be.

This is a collaborative effort that once begun will move you efficiency ratios down, your cost of compliance down, and increase your survival rate going forward. But when it works…you get to remain "on the island." Because it is this integrated, unified control program—your game plan—that enables bank management to efficiently comply in the new regulatory framework and at the same time achieve a proper balance between compliance costs and stakeholder value objectives.

I will be the first to admit it won't be easy. Change is hard especially when it is outside of your individual comfort zone. "Getting there is clearly <u>not</u> half the fun," but bank management must get there because bank management can only run its business of banking within a framework of the increased regulation. Doing it separately, in layers, results in unacceptable layering of costs, and worse, the imposition by examiners of their own version of integrated internal controls, ultimately forcing that bank out of business. You can do it. Don't blame the regulators. They are only doing their job. Your job is to sell that unique plan to your regulators as being the right plan, the plan that works for your unique institution.

So don't wait for this compliance storm to blow over. The regulators are doing their best – listen to their advice, but if you must leave the island, leave it on your "own steam." Don't get pushed off by the costs of compliance. Make the new regulation work for you not against you.

If only you will take the initiative now, you can survive and thrive.

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