The

Chairman's Forum

Opening the door to new ideas

Newsletter

Gerrish Smith Tuck, Consultants and Attorneys

April 2017

Lately, there have been a number of different headlines and stories in various banking publications that in one way or the other relate to the Chairman's role and the Board of Directors' duties and obligations. In this month's edition of *The Chairman's Forum Newsletter*, we take a look at some of these recent headlines and current events and distill the lessons that can be learned from them and the ways that you can continue to lead your organization in a positive direction.

Some of these may be situations to avoid, while others may be things to watch out for as your organization continues to grow and prosper, but we hope that all provide useful insight. If any of these raise questions or concerns for you, please feel free to reach out to us to discuss them further.

In addition, we look forward to seeing a number of you this week at the sold-out Community Bank Mergers and Acquisitions Conference in Chicago that our firm is hosting along with the ICBA. For those of you who are unable to attend, but would like more information about the current merger and acquisition environment or ways to maintain your independence, please do not hesitate to contact us.

Happy Reading!

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Chairman's Summary

- Learning lessons from Wells Fargo.
- Learning from Wells Fargo Part II.
- Splitting the role of Chairman and CEO - revisited.
- Lessons for regulators.

Lessons From Wells Fargo

The recent difficulties Wells Fargo has experienced stemming from the phony account scandal certainly serves as a learning point for Chairmen and directors alike. Recently, one of the proxy advisory firms advised Wells' stockholders to vote against 12 of the 15 directors at the annual stockholders' meeting. As you might suspect, Wells Fargo was not too happy with that recommendation stating that the proxy firm had failed to take into account the company's ongoing efforts to strengthen oversight and rebuild customer trust. Wells argued that the firm did not take into account the "active engagement" of the Board with the substantial actions it had taken following the scandal to strengthen oversight and increase accountability. But from a community banking standpoint, Wells' argument would seem to hold little credibility.

It would seem the proxy advisory firm, perhaps correctly so, does not particularly care about the remedial actions the Board attempted to take after the fact, but, rather, is arguing that the Board of Directors was not actively engaged on the front-end and was not exercising enough due diligence and oversight to know what was going on at the bank to prevent the types of activities that occurred. Considering the market value lost in Wells' shares as a result of the scandal, as Chairman of the Board consider whether the Chairman of Wells and the other directors might have some financial liability and responsibility for the diminution in value from the alleged failure of appropriate controls and procedures, oversight and active engagement.

From a community bank standpoint, it certainly continues to point out the need for the Chairman of the Board to insist upon active participation, active engagement and some knowledge of the actions of the organization to know what is going on at the bank or otherwise to find board members who will be actively engaged. This is not to say, for example, that if a community bank has an embezzlement or a theft, the board is strictly liable for preventing such activities, but if there was a systemic problem in your organization where multiple loan officers were creating dozens of fake loans, then certainly the directors might have some liability for the systemic problems. The directors are not afforded the luxury of sticking their heads in the sand or being disengaged and then, when a problem occurs, argue that directors should not be held liable (or in Wells' case should not be voted out of office by stockholders) because they have attempted to take after-the-fact steps to try to prevent the problems from happening again. Directors must be actively involved at the outset.

Wells Fargo Part II

Another couple of lessons can be learned from the Wells Fargo situation in the areas of incentive compensation. A recent headline stated that the Wells Fargo scandal was placing incentive compensation practices under greater scrutiny. Therefore, consider as Chairman of the Board and directors what obligation the board has to ensure that the organization's entire compensation structure (salaries, bonuses and incentive compensation programs) is appropriate and drives overall stockholder value without placing undue pressure on the wrong types of performance. If there is one thing the Wells Fargo scandal should teach us, it is that incentive compensation programs work.

It may not be a shocking revelation to you, but apparently when employees are going to receive additional compensation for meeting certain sales goals, work-related benchmarks or other criteria, the employees generally do seem to perform at a level that achieves the organizational results in order to receive greater cash compensation. In the Wells' situation, employees who met sales goals for creating new accounts received more incentives. So, guess what? Many new accounts were opened. Therefore, the incentive compensation program worked. The only problem was that over two million phony accounts were created.

Apparently, there was nothing in the incentive compensation program that actually required real customers to open real accounts in order for the incentives to be achieved. There just needed to be accounts opened. So, shouldn't the Board of Directors consider the types of performance that are desired to be achieved and compare that with the type of incentive compensation program developed and to ask the difficult questions of whether there is any type of activity being engaged in to achieve the stated incentives that either puts the bank at greater risk, has the potential for driving behavior that is not desired or otherwise could cause reputational damage to the organization or harm in other areas where the bottom-line profitability may only be short-lived. Don't you think someone on the Wells Fargo board now wishes they had asked a few more questions about the incentive compensation program? Or, ask yourself, do you think the Wells Fargo Board of Directors even knew there was an incentive compensation program tied to opening new accounts. Rest assured, if the Wells Fargo scandal is causing regulators to scrutinize incentive compensation programs more closely, that will surely trickle down to community banks as well.

Splitting the Roles of Chairman and CEO – Revisited

There continues to be talk in corporate governance circles of the appropriateness of splitting the roles of Chairman and CEO. A recent headline indicated that advocates of splitting those roles are gaining ground in the fight. Would anyone venture to guess what one of the "clean-up" steps was that Wells Fargo took in the wake of its scandal? That's right, they decided to permanently split the roles of Chairman and CEO. It would seem, if there was a logical reason not to do that prior to the scandal, that nothing about the scandal should have changed their mind on that, but, obviously, they must have thought it created some type of public relations benefit, helped support the price of the shares or had other benefits.

Similarly, some of the other largest financial institutions, including Bank of America and U. S. Bancorp, dealt with stockholder proposals to separate the jobs with the proposals also demanding that the Chairman meet the definition of an "independent director". So, in addition to splitting the roles, that also means that the Chairman is supposed to bring a truly outside perspective by not holding a large block of shares, not having any type of management position at the bank, not having affiliations that would prevent him or her from being deemed independent, etc. However, in each circumstance, the organizations recommended that stockholders vote against the proposals. The arguments by a company against that kind of proposal generally take the form of the following from one such bank who said "imposing an inflexible rule regarding the Chairman's position could disrupt or impede governance of the company as well as the board's internal working relationships and decision-making process". You can sort out for yourself what that means, but might we suggest that if there is no one currently serving on the Board of Directors who could fill the Chairman's role other than the current CEO, then perhaps a revisitation of the board composition is appropriate.

For community banks, we have continued to believe that the practical realities indicate that maintaining one individual serving in both roles really poses no significant risks or problems. However, when that occurs, as a best practice for corporate governance, we continue to believe that the board should also appoint an additional individual as a lead outside director.

Lessons for Regulators

It is said that the regulators also learned some lessons from the Wells Fargo situation. As a result of what has been described as a postmortem review of regulatory practices relating to examinations of Wells Fargo before their problems erupted, there were several problems found in the regulatory process and that does not bode well for the trickle down nature of future regulatory exams to other banks and community banks in particular.

A couple of critical points about some of the commentary on the OCC's exam practices with Wells Fargo indicate that the agency missed opportunities to perform comprehensive analysis and take more timely action. That is a fancy way of saying the OCC, upon finding problems, did not punish or regulate the bank harsh enough and soon enough. You can guess what the effect will be on future examinations of banks at all levels.

Similarly, there was an indication that the examiners were not effective in supervising reputational risks of the bank. So, recommendations have been that examiners need to also look at the "systemic nature of a bank's culture and practices". From our standpoint, that has many practical implication problems if that type of review is applied on a small bank basis. How are you going to feel about your friendly local examiner considering all the tangible items that go into your CAMELS ratings (and, of course, some of the intangibles for the management component) and now, on top of that, also letting you and the board know that, in their opinion, the bank's "culture and practices" might create systemic risks at the bank. It doesn't seem too big of a stretch to foresee that argument being made by a gung-ho regulator against a community bank with an argument that, because it is a closely held organization where the primary owner also happens to be the Chairman and CEO, he or she is so dominant at the bank that it creates systemic problems because of the nature of the bank's culture and practices. How would you argue against that finding in a regulatory exam? It certainly is a call for the Chairman and the other board members to continue to be on their guard for these types of nuances that could be coming in the future.

Meeting Adjourned

So, as we conclude this *Chairman's Forum Newsletter*, it occurs to us that perhaps it is not the most inspiring newsletter we have ever sent out and it focuses on a number of potential problems, concerns and questions. But as we are riding the tide of renewed optimism that the economy and the markets seem to be expecting from a bank operational standpoint, we need to continue to temper that renewed enthusiasm with a healthy dose of reality that we are still going to see scrutiny by the regulators in perhaps new and different ways than we have in the recent past as asset quality has now improved. So, continue to be on your guard, continue to lead your organizations, continue to be mindful of corporate governance obligations and your organization will continue to reap the benefits of the positive economic developments that are happening.

Until next time,

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