AA|BD The American Association of Bank Directors

National Capital Office
1250 24th Street NW, Suite 700
Washington, DC 20037
(202) 463-4888
www.aabd.org

STATEMENT

OF

DAVID BARIS

PRESIDENT, AMERICAN ASSOCIATION OF BANK DIRECTORS

BEFORE THE

UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

ON

"REGULATORY RELIEF FOR COMMUNITY BANKS AND CREDIT UNIONS"

WASHINGTON, D.C.

FEBRUARY 12, 2015

Mr. Chairman, Ranking Member Brown and members of the Committee - thank you for the opportunity to submit this statement for the hearing record. The subject of the hearing is an important one. Community banks provide essential and unique banking services throughout the United States.

Founded in 1989, the non-profit American Association of Bank Directors is the only trade group in the United States solely devoted to bank directors and their information, education, and advocacy needs. The Institute for Bank Director Education was established in 1993 as the educational arm of AABD. Its purpose is to act as a clearinghouse for education programs designed for bank and savings institution directors that support the nationally recognized Bank Director Certification Program.

The community banking model is under attack. Despite recent improvement in their financial condition and results, community banks continue to face unprecedented challenges from an overreaching compliance regimen, competitive pressures, the overhang from the Great Recession, and historically lower margins.

The state of community banks cannot be fully evaluated without considering the state of community bank boards of directors.

They are overburdened, at undue risk of personal liability, and often underpaid for the risks and obligations that they assume. The banking industry is losing good bank directors and

director candidates from fear of personal liability and the burdens they undertake as directors We know of bank boards that have changed their behavior to become more risk averse, to a point where qualified borrowers may not qualify for loans or where the board is unwilling to offer new products or services needed by their communities.

Regulatory burdens

At a time when the viability of the community banking model is being widely questioned, it is more important than ever for the board of directors to focus on strategic and capital planning and enterprise risk management.

That is difficult to do in light of the extraordinary burdens placed on bank boards of directors by the federal banking agencies.

AABD has identified more than 800 provisions in federal banking statutes, regulations and regulatory "guidance" that impose obligations on bank boards and board committees. AABD has collated these provisions in the *Bank Director Regulatory Burden Report, 2014 Edition.*

Many of these requirements are management in character for which the board of directors is unsuited to fulfill, not having the training and experience required for that role.

These obligations establish no priorities. All are treated equally. The essential roles of the board of directors to help set strategy and risk management systems and controls will often be lost in the morass.

At least for directors of large institutions, there are normally resources available to support the board to meet its obligations. Not so for many community banks.

Many of the obligations imposed on bank boards of directors are created through regulatory "guidance" or "guidelines", which generally are not adopted through rule making procedures required under APA. Yet, in the world of banking supervision, written guidance is often considered as important to bank examiners as rules or regulations, and they apply them during examinations as if they were rules. Conscientious bank directors will want their banks to meet the guidelines and will spend time and resources in order to accomplish that. As such, these guidelines are indistinguishable from other burdens on bank directors created by a formally adopted rule.

That is the reason why the federal banking agencies should evaluate guidelines as part of their decennial review under EGRPRA as if the guidelines were rules. This was one of the recommendations that AABD made in its comment letter dated September 2, 2014.

But, so far, the agencies have not acknowledged that they will review bank regulatory guidelines that affect bank directors and their institutions.

None of the banking agency witnesses at your hearing on February 10, 2015 addressed regulatory relief for bank boards of directors. But bank boards cannot be separated in any logical way from the banks themselves in terms of the need for regulatory relief.

Among our recommendations to the federal banking agencies are the following:

- An agency evaluation of existing regulations and written guidance specifying bank director responsibilities to determine the overall burden on bank directors; eliminate unnecessary and duplicative requirements and requirements that are management in character or where the burden outweighs the benefits from such regulation or guidance; and organize the requirements so that they are easily retrievable and usable;
- Incorporation into the agencies' procedures a requirement that they will thoroughly consider the impact of proposed regulations and guidance on the burdens on bank directors, including their cumulative effects, and not add to the burdens unless the benefits of the proposed rule or guidance clearly outweigh the burdens;
- Proposal and adoption of a rule by the agencies that clarifies that bank boards of directors may delegate management duties to management and rely reasonably on management to perform such duties without incurring personal liability; and
- As part of the decennial review, a proposal by the agencies in the Federal Register that opens public comment to all current regulations and guidance that impose obligations on bank boards of directors or their committees to determine which ones are necessary or unduly burdensome.

We urge the Committee to evaluate, through oversight hearings and investigation, the aggregate effect federal banking agency actions are having on the duties and responsibilities of bank directors.

The agencies have been through the decennial review process once before, in 2006 and the two years that preceded that year. AABD's review of the 2006 effort concluded that it was an unsatisfactory and flawed process and result from the perspective of bank boards of directors. Numerous regulations and regulatory "guidance" that were unnecessary or unduly burdensome were ignored and have remained on the books ever since. Many regulatory burdens have been added since 2006.

In its September 2, 2014 comment letter, AABD urged the Agencies this time to take steps to avoid the mistakes made in the 2006 process.

AABD's *Bank Director Regulatory Burden Report* pointed out that the limited scope of the 2006 review was a factor in the failure to address or remedy the regulatory burdens imposed on bank directors. The agencies gave notice and invited public comment on a very limited, prescribed set of regulations that included only four regulations directly burdening bank directors. A more inclusive public notice process might have engendered a dialogue that could have opened up discussions of the numerous unnecessary or excessively burdensome regulations and regulatory guidance that impose obligations on bank boards of directors.

On July 31, 2007, the FFIEC and its constituent federal banking agencies published the 69-page Joint Report to Congress on EGRPRA, detailing the Agencies' fulfillment of EGRPRA. The Joint Report highlighted some of the comments that the Agencies received during the notice and comment period. Some commentators recommended that the Agencies conduct a study of examination reports to evaluate whether examiners were appropriately distinguishing management from board obligations in their examination findings, conclusions, and recommendations. Commentators also suggested that the agencies review existing regulations that examiners rely on to support their prescriptions that directors undertake more managerial-type responsibilities. However, the Joint Report simply informed Congress that the agencies received comments relating to the burdens on bank directors, without reference to the actions taken in response to the comments.

Given this history, it is important for the agencies to state clearly in a future Notice that regulatory burdens on bank boards of directors and their committees are considered burdens on the banks themselves. This arguably is a truism but necessary nonetheless to be reflected in a future Notice so that commenters will know that the agencies are interested in receiving comments on the regulatory burdens facing bank boards of directors and their committees. It goes without saying that bank boards are integral to the safe and sound operation of those institutions.

The duties and responsibilities of bank directors flowing from all these sources are numerous, burdensome, overwhelming, frustrating, sometimes conflicting, and often unnecessary.

A recent example of troublesome responsibilities informally imposed by the federal banking agencies relates to the placing of responsibility on boards to establish the appropriate culture. While we believe that this is a responsibility of the board and management, we also believe that clear and specific criteria need to be established before examiners begin to take "culture" into account in determining the management component in CAMELS ratings.

The numerous duties and responsibilities imposed on bank directors divert the time and attention of bank board of directors and board committees away from the essential role they should play- meeting their fiduciary duties of care and loyalty by overseeing (NOT managing) the institution. Bank directors should be focused on establishing a prudent risk management system, monitoring adherence to that system, establishing and overseeing the strategic plan of the bank and overseeing the performance and compensation of management. Instead bank boards have become overwhelmed with compliance and regulatory matters, so much so that compliance and bank regulatory requirements have become a major line of business replete with administrative minutia and duties falling on the board that rightly should be left to bank management or in some instances dispensed with entirely.

Further, imposing management-like responsibilities on bank directors also confuses and misaligns the appropriate roles of the board of directors and management. Board members typically are not professional bankers. They are not loan officers, financial analysts, or bank regulatory experts - - they are doctors, teachers, attorneys, businesspersons and investors. They

typically are not bank professionals and should not be expected to perform management functions. Instead of performing professional management-like responsibilities, the board of directors should be tasked with hiring and supervising individuals that can competently manage the banking institution. The ability of bank boards to delegate management functions to management to rely reasonably on them should be, but has not been, a clearly articulated and accepted facet of bank regulation and supervision.

Finally, the accumulation of so many duties and responsibilities from so many various regulatory sources in a manner that often is overlapping, duplicative and sometimes resulting in the inappropriate imposition of management-like minutia, especially when coupled with the increasing focus of enforcement and liability, negatively impacts the willingness of qualified individuals to serve as bank directors. This is not a consequence that is good for the health of the nation's banking system or the nation's economy. For community banks, the effects are magnified.

Personal liability risks

All bank directors face the possibility of heightened risk of personal liability from a number of sources. We believe that these risks impact on the willingness of community banks to be competitive in their market and qualified persons to serve on their boards.

Regulatory relief should include relief from undue personal liability.

The most significant source of liability since 2007 is that of directors of failed banks being sued by the FDIC as receiver.

Virtually of the banks that have failed since 2007 have been community banks. In a substantial number of bank failures, bank directors have been sued by the FDIC or the FDIC has authorized suit against them.

The heart of most of the suits is the fact that the board or loan committee of the board approved a small number of large loans, the losses from which contributed to the failure of the institution. This is a peculiarly community bank issue because generally speaking, it is only community bank directors, not large bank directors, who approve individual loans. Larger institutions typically view the underwriting and approval of loans as being a management function.

For community bank directors, their involvement is based on pressure from examiners to be involved in the underwriting process and the fact that many community bank directors will know or know of the customer or applicant, which allows them to play potentially a useful role in the review process. But no federal law or regulation requires board or board committee approval of loans other than certain insider loans.

By doing more than is legally required, community bank directors may be assuming greater risk of personal liability if their institution fails.

While AABD has advised many bank boards to stop approving loans, most continue to do so. The question remains whether they are willing to approve loans to credit worthy borrowers where some risk of repayment exists or continue to limit, as many banks continue to do, to make loans only to the strongest borrowers. We also know from a recent survey reported to the Committee that many community banks are staying clear from offering new products and services that might be needed by their communities out of fear that either the bank or its board may be subject to liability or regulatory criticism.

The following are some of the factors that AABD believes contribute to the fear of personal liability that motivates community bank director resignations and others to reject offers to serve as community bank directors. For many of those who remain, they will increasingly guide their community banks to avoid even reasonable risk involved in providing credit and other banking services to those in their community. It is within the power of the federal banking agencies and/or Congress to eliminate or mitigate many of these factors.

FDIC suits grounded in simple, not gross negligence

Despite the FDIC's written policy of not approving suits against directors of failed banks unless it has determined that they committed gross negligence, the FDIC's complaints often assert simple negligence, even in states which, in the view of AABD, have adopted a gross negligence standard.

Always being blamed for bank failures

Invariably, the Inspectors General of the FDIC, Fed and Treasury, in their Material Loss Reviews, point the finger at bank boards for having contributed to the failure of their banks. See AABD Report on Material Loss Reviews dated January 29, 2013. Bank directors now know that if their bank fails, they will be blamed, regardless of the facts and circumstances.

Outdated FDIC policy on bank director responsibilities

The FDIC bases its decision whether to sue directors of failed banks on an old (1992) and outdated policy statement that ignores the right of bank directors to rely reasonably on the work and opinions of bank management and advisors and that applies a simple negligence standard even though most states apply a gross negligence standard.

Enforcement authority that allows imposition of liability without culpability

For several decades, the federal banking agencies have had the authority to impose civil money penalties on directors without having to prove that the directors did anything wrong. All it takes is that the Bank violate a law or regulation or engage in an unsafe or unsound banking practice and the director "participate" in the violation or practice, whether knowingly or unknowingly. The director can meet his or her fiduciary duties but that would not matter.

Over the past seven years, directors have seen a huge uptick in enforcement actions against banks and insiders, including directors. They are feeling more vulnerable, for good

reason. The Reports of Examination routinely warn boards of directors that they are susceptible to civil money penalties for the slightest infraction.

Demands by examiners for the net worth of bank directors

AABD has received reports that during examinations, bank examiners will require directors to provide them their net worth or recent tax returns, even if they are not borrowers from their bank. This is a highly offensive request that violates basic principles of privacy and can only intimidate directors for no reason. The in terrorem effect on bank directors is not measurable.

Restrictions on bank directors' right to preserve records for legal defense purposes and defend themselves for official actions

In 2012, the FDIC issued a financial institution letter that suggests that bank directors are not entitled to access to bank records for the purpose of defending their official actions as directors. No other corporate directors are so restricted. The agencies also sometimes bar bank directors in receipt of a 15-day letter or notice of other enforcement action from having their attorneys have access to reports of examination that are necessary to defend the action.

Limitations on directors insuring against risk of civil money penalties

After the FDIC adopted a rule in 1993 barring banks from paying premiums for insurance to cover civil money penalties imposed on bank directors, a number of carriers offered an endorsement to banks' D&O insurance that would allow directors to pay the premium directly to the carrier for such insurance. The FDIC did not object to that practice until only three years ago, concluding that so long as the coverage was part of the bank D&O policy, it was prohibited by the rule even though the directors paid for the insurance.

Difficulty obtaining D&O insurance to cover regulatory risks

As a result of the FDIC's aggressive suits against bank directors and officers over the past few years, the insurance carriers have refused to cover regulatory risks for an increasing number of banks.

Barring insurance that would cover costs defending directors against agency administrative actions

The FDIC's 1993 rule referred to above also bars insurance from covering defense costs incurred by bank directors in an agency enforcement proceeding if the director ultimately loses the case or if the case is settled. The directors may be covered, depending on the policy, for defense costs prior to formal notices being issued by the agencies, but once the notice is served, the directors run the substantial risk that they will either lose or settle the case, which happens in most enforcement proceedings. This FDIC rule makes it exceedingly difficult for bank directors to defend themselves against an enforcement action through the administrative process, thus depriving them of due process protections afforded to them in law.

Forcing restitution through administrative means

In 2005, AABD issued a report questioning the appropriateness of the federal banking agencies to force a director or officer to make restitution through administrative means rather than through a court of law. This is another potential threat to bank directors and remains a concern of AABD and its members.

Authority to use deep pocket subpoenas to obtain personal financial statements and tax returns

The FDIC has the authority and has used that authority to subpoena personal financial statements from former directors of failed banks without first going to a court of law to prove that the need to review the financial statements was justified. Private parties that are considering law suits don't have that authority.

Community bank director resignations

The continuing regulatory burdens facing community bank directors and the heightened risk of personal liability have taken their toll on community bank boards. The loss of qualified bank directors should be of concern to the Committee and the federal banking agencies and could have negative effects on the success of certain community banks.

24.5% of bank respondents to a survey conducted by AABD last year advised AABD that at least one of the following had occurred during the past five years:

- Director resigned citing fear of personal liability
- Director candidate refused offer to become director because of fear of personal liability and/or
- Director refused to serve on Board Loan Committee or resigned from that committee because of fear of personal liability.

The AABD survey results are disheartening to those who advocate, as AABD does, for a strong bank board that is able to attract and retain the best people possible to serve as bank directors,

It may very well be that many bank boards of directors continue to consist of highly capable directors. However, attrition caused by personal liability fears is of concern and can be relatively easily rectified by appropriate actions taken by the federal banking agencies and the U.S. Congress.

Summary

Community banks face formidable challenges. So do their boards of directors. The federal banking agencies should take steps to provide regulatory relief to bank directors by minimizing their regulatory burdens and undue risk of personal liability. The Committee should play an important role in overseeing the federal banking agencies' rules, guidance and policies

that make it more difficult for qualified persons to serve as community bank directors and to accept reasonable risks in order for their community banks to survive and succeed in continuing to serve their communities.