

Community Bank Director



From the ICBA Community Bank Director Program

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IN WASHINGTON

Third Credit CARD Act Regulation Is Significant

By Karen Thomas

For the third time in 12 months, the Federal Reserve Board proposed a set of new consumer credit card regulations to implement the Credit Card Accountability, Responsibility and Disclosure Act of 2009 (Credit CARD Act). The Fed's latest proposed rules, to amend Regulation Z (Truth in Lending), would regulate late-payment and other penalty fees on credit cards and require credit card issuers to reconsider increases in interest rates.

Last July, the Federal Reserve Board issued a credit card rule implementing Regulation Z amendments that went into effect last Aug. 20. In January, the board issued a rule implementing other amendments that went into effect Feb. 22. The board was expected to approve its final penalty-fee rules in late May or in June.

These newest proposed rules, issued in March and scheduled to take effect Aug. 22, could considerably affect the pricing, competitiveness and profitability of community bank credit card

programs. Among other things, the penalty-fee rules would ...

- prohibit credit card issuers from charging penalty fees (including late-payment fees and fees for exceeding the credit limit) that exceed the dollar amount associated with the consumer's violation of the account terms. For example, card issuers would no longer be permitted to charge a \$39 fee when a consumer is late making a \$20 minimum payment,
- ban inactivity fees, such as fees based on the consumer's failure to use the account to make new purchases,
- prevent issuers from charging multiple penalty fees based on a single late payment or other violation of the account terms,
- require card issuers to inform consumers of the reasons for increases in rates and
- require issuers that have increased rates since Jan. 1, 2009, to evaluate whether the reasons for the increase have changed and, if appropriate, to reduce the rate.

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REGULATION

Fair Lending Risk Assessment

Fair Lending Act issues and the Home Mortgage Disclosure Act were at the top of every bank's agenda earlier this decade, but the Department of Justice's last major consent order for unfair mortgage-lending practices was in 2007. The federal government's next focus on discriminatory practices could turn to loan modifications or collection efforts on troubled loans, activities that are just beginning to face legal and regulatory scrutiny.

For those reasons, your bank should adopt policies and practices that would avoid any potential charges of discrimination in these areas.

Are you absolutely sure your bank offers loan modifications to minority borrowers as frequently as to nonminorities or to female borrowers as regularly as to male borrowers? Are your bank's foreclosure rates higher for whites or for minorities? What about for females or males?

Your board should consider these questions. Federal banking examiners could expect directors to have this information at their fingertips, and if you don't, examiners could pull data from your bank's loan files and request that the board explain any questionable lending patterns.

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REGULATION

Major Agency Actions in April

April was a busy month for prominent regulatory actions for community banks. The federal financial-regulatory agencies tackled three proposed or adopted policies that could significantly affect community banks and their position in the financial-services marketplace.

Correspondent concentrations. Federal regulators issued guidance on expectations for banks in identifying, monitoring and managing correspondent concentration risks between financial institutions (defined as exposure equal to or exceeding 25 percent of total risk-based capital). The policy statement states that institutions should develop plans for managing correspondent concentration risks, including ensuring that the terms for credit or funding transactions conform to sound practices and avoid potential conflicts of interest.

Consistent with recommendations in an ICBA comment letter filed in February, the agencies will not include loan participations purchased without recourse in the concentration calculation. They also clarified that the referenced credit and funding thresholds are not firm limits but indicators of concentration risk with a correspondent.

Liquidity-risk management. The federal banking agencies issued new guidance on managing funding and liquidity risks. Adding to a policy statement issued in

2008, the guidance emphasizes the importance of cash-flow projections, diversified funding sources, holding liquid assets in reserve and having a well-developed contingency funding plan approved by the board of directors. Such plans should account for limitations on brokered and high-rate deposits, and they should be appropriate for the bank's complexity, risk profile and scope of operations. Community banks boards should comprehensively review their funding and risk management plans.

Reserve requirements. The Federal Reserve Board approved amendments to Regulation D (Reserve Requirements of Depository Institutions) authorizing term deposits for institutions eligible to earn interest on their balances at Federal Reserve banks. Term deposits will be offered through a term deposit facility.

In a February comment letter, ICBA expressed concerns that the proposal could alter successful and longstanding correspondent banking relationships that community banks have, particularly those with the bankers' banks.

While the Fed had not issued specific guidelines at press time, the rule notes that smaller financial institutions will have the opportunity to participate. More information from the Fed should be available soon, and ICBA will continue to work to minimize any negative effect the requirements have on community banks. ■

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In April, ICBA submitted a comment letter voicing concerns about these latest proposed regulations. ICBA recommended several important changes to the proposed rule, and asked the Fed to remember that while greater regulatory protection is needed from some of the largest credit card issuers, community banks are common-sense lenders that offer credit cards on fair terms. The association also said penalty fees are legitimately used to deter consumers from becoming delinquent on their accounts, so the final rules should not undermine the overall beneficial purpose of those fees.

In particular, the Fed's proposed rule stated that a creditor may not impose a penalty fee unless the dollar amount of the fee is based on one of the following: (1) the total costs incurred by the creditor, (2) deterrence of violations by cardholders or (3) a safe harbor established by the Federal Reserve.

ICBA supported the safe-harbor option that would allow creditors to impose a dollar amount per violation, if the safe-harbor amount were not less than \$25 per penalty, as this option would be easier for community banks to comply with. However, ICBA stated it does not support any limitations on individual penalty fees that can be imposed on customers for violations of the account terms.

ICBA also provided extensive comments on provisions relating to the reevaluation of rate increases for consumers, requesting that the Fed limit the proposed six-month review of credit card accounts where the rate has been increased since Jan. 1, 2009, to only those accounts not affected by the Credit CARD Act provisions that became effective Feb. 22—thereby limiting this review to rate increases that occurred from Jan. 1, 2009, to Feb. 22, 2010.

More broadly, ICBA urged the Fed to consider the compliance resources and staff of community banks when finalizing regulatory requirements and cautioned the Fed that excessive regulatory burdens from the credit card regulations may cause community banks to exit the credit card business altogether, resulting in fewer options for consumers and a greater concentration of the market share for larger issuers. That, of course, would defeat the very purpose of the Credit CARD Act.

The Fed was expected to issue final Credit CARD Act rules for credit card penalty fees in May or June. However, ICBA asked the agency to give community banks at least six months to implement the final rules, even if an extension is needed beyond the Aug. 22 deadline.

View ICBA's comment letter at icba.org, filed under Advocacy and Letters to Regulators. ■

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STRATEGIC PLANNING

Focus, Commitment and Leadership—Characteristics of Successful Strategic Planning

The first and arguably most important characteristic of a strategic plan is the identification of value, both present and future. This is closely followed by articulation of the strategies and tactics to reach this identified value. Being successful at this process requires focus, commitment and leadership.

Editor's Note: This is the first article in a three-part series in Community Bank Director on strategic planning. See the newsletter's July-August and September-October issues for the other articles in the series.

Focus. Documenting your community bank's objectives and expectations creates a firm foundation for staying focused. This should answer two questions: One, what does your board want to achieve as an institution through this process? Two, how will it gauge success?

This discussion should include your choice of facilitator. The choice of facilitator is often a board decision. Whom you choose, either internal or third party, is critical to the process. The facilitator's role is to lead, guide and challenge your group through varied subjects, issues and education. The chemistry between the two parties must be a top priority.

First, determine directors' and management teams' roles and expectations before, during and after the strategic-planning session. This should eliminate miscommunication and confusion and ensure that the document represents the desired goals and outcomes.

Commitment. Show commitment to strategic planning by laying out a concise and focused approach. Participants must be engaged completely in identifying future value and the steps to achieve it. Seeing the process through requires steadfast guidance to the objectives outlined. Participants' role is to not let the document sit on a shelf but to continually challenge themselves to look past the current environment to create value.

Leadership. Setting a strategy requires strong leadership. A strategic plan is only as good as the follow-through. A leader must guide the plan creation, lead the institution in implementing it and monitor its effectiveness through clearly defined benchmarks. This is not to say that the success or failure of the process lies with that individual. Rather, the leader's responsibility is to lead the group with consistency, integrity and accountability. ■

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STRATEGIC PLANNING

The Elements Of Strategic Planning

By Jeff Judy

Every community bank board of directors should incorporate these things into its strategic planning process.

- **A broader assessment of risk.** Potential threats are expanding quickly. A wide range of factors, the complete spectrum of threats, should define your notion of "risk."
- **Realistic estimation of needed resources.** Responses through processes, systems and people must realistically match key risks. New patterns of risk require new patterns of resource deployment.
- **Explicit plans for employee development.** Systems and processes cannot contain risk by themselves. People got us into this mess, so invest in your people to help your bank through this crisis and stay out of the next one.
- **New, thoughtful projections of your financial statements.** Evolving customer profiles and expectations are changing your balance sheet. Responding to potential threats affects operating costs. Expecting your financial statements to look pretty much like they always did will do nothing to help you evaluate how effectively your responses manage your risk profile.

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PRODUCTS AND SERVICES

Opportunities in Merchant-Funded Debit-Rewards Programs

By Julie Bohn and Molly Plozay

The economic downturn created notable changes in consumers' everyday spending habits. Consumers are abandoning credit cards for debit cards to make purchases and control spending. With more consumers using debit cards, it's not surprising that more are also using associated rewards programs.

According to a consumer study by First Data last year, participation in debit-card rewards programs is up significantly—reaching 45 percent of debit-card users, up 11 percentage points from 2008. By leveraging the growing importance of debit rewards, community banks have a great opportunity to increase customer satisfaction, influence spending behavior and strengthen customer bonds. However, consumers accustomed to robust credit-card rewards programs expect similarly lucrative rewards from debit-card programs.

Merchant-funded debit-card reward programs include these key characteristics:

- a merchant-funded component layered over a more traditional, bank-sponsored loyalty program,

- a diverse merchant network across “everyday spend” categories at national and local retailers with in-store offers as well as online merchants,
- marketing efforts and dollars that are focused on the most valuable customers,
- earnings acceleration that encourages consumers to use bank services more often to earn rewards faster through competitive offers and
- fulfillment options that allow consumers to select the rewards they earn and even save for future rewards.

Participating merchants gain valuable marketing opportunities through debit-card loyalty programs and receive card data about their marketing campaigns. Some programs blend ongoing offers with shorter-term campaigns to help cardholders accelerate earnings and keep the program fresh and relevant with periodic promotions. Reward options can range from off-the-shelf merchandise to travel, event tickets and other experiential gifts such as access to sold-out concerts or once-in-a-lifetime experiences.

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REGULATION *continued from page 1*

Remember that the Equal Credit Opportunity Act (ECOA) and Regulation B implementing the law state that “a creditor shall not discriminate” in any part of a credit transaction. That mandate covers the time from when the bank first advertises for a loan product to until a borrower has paid off a loan, potentially 30 years later. It covers loan collections, loan modifications and payment extensions on consumer loans.

Your board should periodically review the bank's loan data and address any patterns that could be construed to relate to the gender or race—or marital status, age, national origin, ethnicity or familial status—of loan applicants or approved borrowers.

What regulators look for. Your federal regulatory agency has general regulatory authority over your bank and monitors it for discriminatory practices. The ECOA requires federal banking regulatory agencies to refer matters to the Justice Department when there is reason to believe a creditor is engaged in a pattern or practice of discrimination that appears to violate the ECOA. The agencies also may refer to the Justice Department matters involving an individual incident of discrimination.

The bad news is that the regulatory agencies must refer possible evidence to the Justice Department or the Department of Housing and Urban Development

even when information is discovered through a lender's own self-evaluation. The good news is that voluntary identification and correction of violations disclosed this way will be a substantial mitigating factor in considering what further actions the Justice Department or your regulatory agency might take.

Fair-lending risk assessment. It's important for your bank to integrate an effective fair-lending risk-assessment program into its overall risk-management process. A fair-lending assessment program should examine all lending products and document how the bank identifies, measures, controls and monitors lending activities.

Remember the examiner's mindset. If it isn't documented, it wasn't done. The banking regulatory agencies are as concerned about whether your practices conform to your written loan policies and procedures as they are that you meet the letter of the law. So your bank should review and risk-rate its loan files for the 11 protected classes listed in the ECOA and the Fair Housing Act. It should also review agency guidance on the topic.

Regulators expect financial institutions to have a system in place to periodically compare the treatment of loan applicants and borrowers to identify differences and correct potential problems. Remember—if it has even the chance of being broken, regulators do will expect your bank to fix it. ■

BANK COUNSEL

Officers and Directors of Failed Banks At Risk of Personal Liability

By Len Rubin



Officers and directors of troubled financial institutions should pay serious and immediate attention to their risk of personal liability because the risk of failed-bank litigation is growing. The FDIC has begun issuing civil demand letters with subpoenas to officers and directors of institutions that failed in 2009. The agency clearly is gearing up to sue former board members and executives who it determines engaged in unsafe and unsound banking practices.

FDIC and other bank regulatory agencies also have initiated administrative enforcement proceedings against a failing institution's directors and officers seeking civil money penalties. However, there are actions that can be taken to minimize the risk of personal liability to the FDIC and to bank shareholders in the event of a bank failure.

The Claims. The officers and directors of a failing or failed bank are subject to scrutiny by several federal or state regulators, but the most likely threat of litigation is from the FDIC. When a federally insured bank is closed, the FDIC is appointed receiver. In that capacity, to recoup losses suffered by the bank, the FDIC has the authority, perhaps even a mandate, to pursue claims against the failed bank's officers and directors.

The liability of officers and directors is not based only on fraud or dishonesty. Officers and directors may be held liable for violations of bank policies and laws or regulations that resulted in safety and soundness violations; or failure to establish, monitor or follow proper underwriting procedures or heed warnings from regulators or advisers.

Liability may also result from approving, overseeing or permitting a strategy of unsupportable growth with in-

adequate management supervision of liquidity or capital, measured in hindsight. That was the basis of claims recently brought against officers and directors of a failed Florida bank. In that case, the FDIC alleged, among other things, that the officers and directors allowed option ARM mortgages to represent 70 percent of the bank's residential loan portfolio, 60 percent of its total loan portfolio and 575 percent of its capital, all of which resulted from "reckless, high-risk and limited scrutiny lending to fuel the bank's aggressive and rapid growth." Given the rapid growth of so many community banks in the last 10 years, it is likely the FDIC is considering pursuing similar cases against the officers and directors of other failed banks.

When Bank Failure Appears Imminent. The FDIC is much more likely to pursue claims against the officers and directors of a failed bank where it appears to the FDIC that the board was not actively engaged, that management or the board was in denial of the bank's troubles, or that the bank did not take appropriate action to respond to criticisms and concerns raised in regulatory exams.

While in many cases the claims against the officers and directors of a failed bank will be based on events that occurred several years earlier, the FDIC will be less likely to pursue claims against officers and directors who remain actively engaged and who continue trying to the end to save the bank. In fact, even if failure appears inevitable, the board and management should continue taking all the steps they can to save the bank—responding to exam criticisms, complying with enforcement actions, seeking to raise capital, and managing the bank's nonperforming assets. These steps should be documented in board minutes and in correspondence with regulators.

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PRODUCTS AND SERVICES *continued from page 4*

When implemented properly, merchant-funded debit-card loyalty programs can help banks meet their immediate business goals while creating a platform for promoting more profitable bank programs, products and services. These programs deserve careful consideration to capitalize on debit-card popularity, streamline loyalty-program execution and build profitable customer relationships. ■

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If the bank is on notice from the FDIC that failure is scheduled, or if such notice is expected soon, there are things that officers and directors should do to prepare themselves in the event of post-failure litigation:

1) Provide copies of relevant bank documents to special counsel to the board or another central source on behalf of all directors, such as the board chairman:

- Board minutes (documenting efforts to save the bank);
- Loan committee minutes;
- Board resolutions and corrective action plans;
- Documentation of compliance with regulatory criticisms;
- Copies of D&O policies;
- Correspondence with federal and state bank regulators;
- Records of all internal meetings attended; and
- Letters and e-mails exchanged with management, regulators and bank counsel.

2) Document efforts, especially board and committee meeting minutes, to solve problems or save the bank.

3) Resolve insider loans by payment or move to another bank.

4) Comply with "golden parachute" rules that prohibit severance payments to insiders of troubled banks.

5) Remove personal items from bank premises.

6) Engage independent special counsel for the board.

7) Review D&O policies for coverage limits and exclusions.

If the Bank Fails. As of the date of seizure, all communication with the FDIC must be regarded as adversarial and made in anticipation of litigation. At that point, regular bank counsel cannot advise bank officers and directors on any matter which might be adverse to the FDIC.

Therefore, it is important that the board retain independent special counsel prior to closure to, among other things, assist with FDIC interviews during the closing week-end. Selecting special counsel early in the process gives counsel time to review potential issues and be prepared for questions that may arise during the closing process.

After a bank's closure, counsel will assist officers and directors to avoid and mitigate personal liability claims from regulators and shareholders. If the bank has a holding company, bankruptcy counsel also should be engaged.

D&O Coverage. Typically, the FDIC will file a claim for 100 percent of available coverage under the bank's D&O policy on the day the bank is seized. Bank officers and directors through special counsel should immediately place D&O carriers on notice of claims and seek coverage determinations. ■

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