



Director's Perspective: WHAT NOW?

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WHAT NOW?

Bank balance sheets and earnings have been under stress for multiple quarters as the economy fights its way through one of the longest and deepest recessions since World War II. The reputations of banks and bankers have never faced more challenges as the issues surrounding bank capital levels, executive compensation, and risk management practices have become politicized and the subject of intense media scrutiny. Banks have begun failing again after a long period of sustained health, and stock prices in the banking sector have been extremely volatile. Even the long active bank merger and acquisition run has come to a screeching standstill, eliminating an exit strategy previously thought always available for a bank. No one predicted the duration or the severity of the distress banks have suffered in the 2008 and 2009 operating environment.

Since the recession officially began in late 2007, banks have recorded significant credit losses and liquidity has been stressed in unusual and severe ways. The steep drop in the housing market and the value of collateral supporting residential mortgage loans promoted a record number of foreclosures and asset write downs on direct loans and on securities backed by residential mortgages. For a time in the fall of 2008, banks were afraid to lend to banks and the overnight lending market contracted severely, putting strain on ordinary and normal course sources of liquidity. The Federal Reserve in an unusual move opened its discount window on a routine basis to banks, and banks used the window for liquidity needs without the stigma of the past. The credit markets tightened further and many banks determined not to lend, putting further strain on sources of liquidity relied on by small and large businesses alike. Uncertainty crept into and then embedded itself into commercial relationships and business plans were put on hold.

Fear seized the market and even the government's extraordinary measures to enhance liquidity in the marketplace, add large amounts of stimulus dollars, and promote lending through the TARP Capital Purchase Program ("CPP") did not seem to jar the economy and the banking sector out of a downward spiral. Waves of fear moved through the market as headlines in the major newspapers, seemingly daily, captured major negative economic news. Indeed the banking industry was a bellwether for measuring the health or weakness of the economy. The government's stress tests for large banks became a late breaking story, the latest potential issue to put further pressure on bank stock prices and consumer confidence, only to be proven less negative than expected when the actual results were released. The market was relieved and reacted favorably.

In late April and into May 2009, influential leaders in the U.S. government began talking optimistically about a market bottom and gradual upturn and bank stocks began to rise. Many banks that had accepted TARP CPP money began to motion a strong desire to return the funds by replacing it with fresh capital raised through the private capital markets. Confidence in the banking sector and among investors in the sector began to improve late in the second quarter of the year.

In light of the multi-quarter trauma in the banking industry and notwithstanding the faint signs of economic optimism, going into the second half of 2009 a bank board of directors should be asking the question: What now?

This column reflects on two conceptual issues that naturally flow from the disruption in the markets over the past 18 months — coping with change and fear — and it identifies specific priorities for managing a bank in what is and will be a new and different operating environment.

COPING WITH CHANGE

As the economy and banking industry begin to stabilize, management and boards of directors must stop reacting to crisis and start focusing on the future of the banking industry and how their financial institution can prosper going forward. The degree of economic disruption and government intervention we have experienced since late December 2007 means that the operating environment for banks in the future is likely to be dramatically different than the operating environment of the past. Basic examples abound, such as the evaporation of the collateralized debt obligation market, a return to stringent mortgage underwriting standards, and contingency funding plans that have been tested by real life experience.

As stability returns, boards would do well to return to a strategic planning process, not so much to challenge bits and pieces of the strategic plan on the bank's shelf or make minor modifications to it but rather to question whether the plan needs to be wholly revamped. The strategic review needs to be led by management as it envisions the opportunities and risks presented by the new operating environment.

The starting point is to envision the type of financial institution that will thrive and prosper five years from now and define its core attributes. The success of the large financial service conglomerate model, envisioned after repeal of the Glass-Steagall Act, is now in doubt as many large banks that embraced housing a multitude of financial services under one roof have been weakened by that diversification and the model's viability is now in question. Conversely, single purpose entities, such as mortgage banking companies, have also proven unsustainable in many instances. There can be many correct answers to the question regarding the optimal financial institution of the future and different and reasonable perspectives will emerge when the question is

discussed in board rooms. But the question needs to be asked.

Once the best views on the banking business model of the future are identified, a board next must consider whether its institution's strategy and tactics will drive the bank in the direction of that future successful business model. This analysis calls for a realistic assessment of the organization's current strategy and tactics and whether any of those need to change to ensure enhancement of stockholder value over the long term and the proper tradeoff between risk and return.

Those institutions that seriously consider the need for change, even dramatic change, in the way they pursue business will benefit from the proactive approach. Those that take a wait and see attitude will continue to be reactive, missing opportunities as the world continues to evolve around them.

COPING WITH FEAR

What can management teams and boards of directors learn from the prolonged period of fear that has permeated the economy and the banking industry? There are four important lessons.

First, good advance planning can mitigate fear and act as a circuit breaker to a downward spiral based on uncertainty. There is no substitute for preparation as a natural way to manage through periods of fear and trepidation. Institutions that had thoughtful and tested contingency funding plans, capital plans and heat maps to track the status of enterprise risks were no doubt better able to manage the fear that gripped the banking industry during the severe economic downturn, seizure in the credit markets and large operating losses resulting from asset quality deterioration than those institutions with weak or ill conceived plans. While no plan is perfect in anticipating a series of adverse events and identifying logical action steps in a crisis, having a roadmap in hand that the management team and the board of directors have embraced

instills confidence and gives a sense of direction in turbulent times. For those bank executives who lived through the turmoil of the past year and a half, planning for future contingencies will have real meaning and, hopefully, the next generation of bankers will learn these lessons as they are passed down.

Second, teamwork is an effective tool to manage fearful tendencies. Working side by side with people you trust makes all the difference when the future becomes increasingly uncertain. It is judgment and collaboration in that kind of environment that takes over and controls decision making. Thus, team building within an organization is an essential tool for regulating fear when the environment deteriorates. Using a team approach to problem solving under stress and in an atypical operating environment helps avoid management paralysis that can set in if only one individual is tasked for addressing mission critical issues.

Third, communication has to be a top priority when fear sets in and the communication has to demonstrate a sense of realism. The volatility in the economy, equity markets and banking industry provoked fear among customers, employees, regulators and boards of directors. The successful banks communicated with their customers frequently and deliberately using the turmoil to deepen customer relationships. Customers needed to know their bank stood by them ready to help and provide a quality deposit outlet for cash that customers wanted to protect from the volatility of the equity and debt markets. Management teams used the prolonged crisis to enhance credibility with their employees and boards by explaining market developments and their effect on the institution. But successful communication in a crisis requires communicating realistic perspectives and pragmatic solutions.

Senior management that shows it is in touch with the new and painful reality builds trust and confidence despite daunting circumstances. Employees, regulators, and boards cannot expect

management to always have the perfect plan or solution to cope with a particular crisis or problem. But they do expect the management team to fully grasp the extent of the problem so an effective and thoughtful response can be implemented. Senior managers who are overly optimistic and detached put the enterprise at risk.

Fourth and finally, crisis management requires managing with a sense of urgency and decisiveness. Customers, employees, regulators, and boards want to see deliberate and swift action taken when exigent circumstances are presented. Fear can be attacked through decisive action. Decisive action based on prior contingency planning and solid teamwork can break the self-perpetuating fear cycle.

PRIORITIES FOR MANAGING IN THE FUTURE OPERATING ENVIRONMENT

Economic cycles roll up and down, and we can all take some comfort in the empirical predictability of the eventual upturn. We may already be in an upturn, though the complexion of this recovery may be different than the look of those that preceded it. In many respects, the economy in the fall of 2008 looked over the precipice of a grave and prolonged economic downturn and avoided the tipping point whether through luck or policy or a combination of the two. It is still too early to tell what the banking industry of the future may look like but it is virtually certain that it will look different than the industry of the past. To be successful, management teams will need to set clear priorities that recognize what the nation and the banking industry have been through and set a course for their enterprise to prosper and thrive in the new operating environment. Following are the seven priorities that boards of directors of banks should use to measure the performance of their management teams as the economy moves through its recovery stage and the banking industry of the future

becomes more apparent.

Managing the Regulatory Relationship

Board members should ask management probing questions about the kind of relationship management has with the bank's regulators. That relationship has never been more important. The regulators are preoccupied with bank failures, exam rating downgrades, enforcement actions, and identifying banks that need immediate financial support or reengineering to survive. Management should foster a close, proactive relationship with their regulators for several reasons in the environment of the future. Initiating regular contact with the bank regulators will give management crucial intelligence about the regulators' examination and compliance priorities that, in turn, can guide management's business priorities.

Another advantage of proactive outreach in this manner is it builds a relationship, should the institution face a difficult problem that risks the safety and soundness of the institution. The stronger the relationship is between management and regulator, the greater the likelihood of resolving regulatory problems informally. This heads off formal enforcement procedures that are a drain on leading the bank. Given the continuing distress in the banking sector, managing the expectations of the institution's regulators is valuable.

Planning for Capital and Liquidity

Directors must investigate management's plans for capital and liquidity. If the events of this last economic downturn teach us nothing else it is the value of good capital and liquidity planning and identifying contingency sources for both. Capital is a barometer of the bank's financial strength. Those institutions that can absorb unforeseen credit losses and seize strategic opportunities will enjoy a competitive advantage. The failures of

the equity and debt markets in the recent economic downturn to accommodate banks that needed to shore up their balance sheets provoked the implementation of the U.S. government's extraordinary TARP CPP and more government intervention in the banking industry. Performing periodic capital stressing, whether or not mandated by law or industry best practice, should be considered as it allows management and the board an opportunity to carefully examine the institution's need for capital in an extremely stressed operating environment.

Liquidity management will remain an issue for the foreseeable future. Last fall, customers made a "flight to quality." Special governmental deposit guarantees aided this flight and the guarantees changed the dynamics of the deposit relationship. As the economy adjusts, some of this cash will surely flow out of the banking sector as fast as it came in. Over time, government support of depositors will likely be reduced. All of these new realities need to be closely monitored and plans for dealing with these contingencies must be in place. The last crisis taught us the value of having a contingency liquidity plan, governance protocol, and experience using alternative liquidity sources. Given the prospects for more volatility in the future, all institutions should make a priority sourcing liquidity opportunities for the future.

Managing Human Resources

Directors must query the management team about matching the new reality with the quality of its workforce and plans for recruiting and keeping great people. Franchise value for banks is inherently linked to the quality of the institution's people. In the front office are producers, seasoned bankers and, depending on the business model, asset management professionals, brokers, and wealth management officers who have relationships with customers that drive bank revenue. Every successful bank has strong back office leadership as well to manage finance,

operations, IT, strategy, legal, human resources, marketing, and the other essential functions of a successful organization. Finding the best people and keeping the best people satisfied and motivated is critical to preserving the franchise and delivering long-term value for stock-holders. Market conditions since December 2007 have put strain on human resources in financial institutions large and small.

It has been a very difficult operating environment within organizations, given credit quality pressure, stress in the capital and liquidity markets that limit alternatives, earnings challenges, and U.S. governmental intervention in the banking industry. The relentless negative media coverage of the banking industry also affects morale and dampens optimism. Depressed financial performance among banks in 2008 and stricter U.S. government scrutiny, particularly for TARP CPP recipients, put downward pressure on executive compensation. Lower compensation, coupled with an extremely stressful operating environment, puts strain on human resources.

The economy will rebound and there will be a class of bank that not only survives but prospers. The institutions unhampered by executive compensation rules and limitations — such as foreign-owned banks — will have a financial advantage in recruiting the industry's most talented people. It will be important, therefore, for financial institutions to develop a human resources strategy that has as a goal retaining the organization's best people and creating opportunities to recruit the best people from other organizations.

The starting point in implementing a comprehensive human resources strategy is to start with a self-assessment. Leaders and managers must seek to understand their employees' needs, morale, and aspirations. They must also reassess whether their compensation programs are still effective in retaining and recruiting the best talent. But the HR strategy cannot exist in a

vacuum. It has to be tightly linked to the bank's business strategy so that employees understand the direction of the organization, buy into it, and see how the company's success is linked to their own financial success.

Relying on Great Operators

The difference between success and failure in business is razor thin and this is even more acute in banking. Banks need to be — simply put — extremely good operators in this environment where execution is what matters. Improving how the business is managed day to day should be a top priority for banks that strive for success. Excellence in execution requires excellent people, teams, and planning. Execution in this regard means driving optimal financial performance and operating performance. Indeed the two are interrelated. Having seasoned professionals who know how much to turn each “dial” on the control panel and when will separate the high performing banks from the others.

Since December 2007, the turbulence in the banking industry has proven again that successful banks have great management teams. The complexity of the market events of 2007, 2008, and 2009 and the unpredictability of the environment underscore that successful banks need great operators. Many significant issues in a bank are fundamentally interrelated and need to be managed with that awareness. For instance, capital and liquidity management pose intersecting issues. In addition, many seemingly innocuous business decisions can have financial accounting effects and need to be carefully weighed.

Whether a bank has great operators and whether they are working effectively together as a team can only be determined through some type of self-assessment. Some banks may be able to do this internally while others may need help from the outside. In this environment, directors who have not conducted such an assessment are asking for surprises. Do your current managers

have the experience to operate effectively? If not, fill in the gaps quickly and make sure key leaders can work effectively together toward achieving the institution's strategic and tactical goals. At a minimum, great operators manage the balance sheet and income statement, strategy, opportunities, and risks in a deliberate, cogent way to drive long-term stockholder value.

Managing Political Risk

Directors must raise their awareness about political risks. The banking industry has always been vulnerable to political risk as a highly regulated industry and one central to the economic well-being of the nation. From time to time the industry has suffered through periods of intense legislative scrutiny and lawmaking to remedy, for instance, consumer protection concerns, perceived problems with the scope and permissible activities of banks, and safety and soundness issues. But the legislative and governmental intervention in the banking industry in 2008 was unprecedented and creates political risk for institutions for the foreseeable future.

The reality is that until the banking industry is stabilized again and industry-wide profitability and capital levels return to more normal levels, the U.S. Congress and the Executive Branch will continue to exercise intense scrutiny of the industry's every move. There will likely be more legislation affecting banks that potentially can affect business plans and strategies. Being attentive to these developments is important. But is also important to manage the business with sensitivity for how corporate actions may be viewed by examiners and the public at-large. Like it or not, the industry is now and for the foreseeable future will be under great scrutiny. Political risk can come in the form of a senior government official making public demands on an institution or criticizing a particular type of corporate conduct. Thus directors much show extreme sensitivity to how corporate conduct may be perceived in public forums.

Anticipating Corporate Governance Reforms

Public company bank holding companies have special issues to address in the current environment, especially those who have benefited from U.S. government programs to restore health to the banking system. As an illustration of how political risk intersects with corporate governance, the Stimulus Act required public company bank holding companies who accepted TARP CPP proceeds to include in their proxy statement a non-binding advisory proposal on executive compensation practices, the so-called “say on pay” proposal. Corporate reform groups had been promoting this type of advisory proposal for years among all sorts of public companies, and the banking crisis created enough political momentum to make it a reality in the financial services industry.

Another issue that will continue to gain momentum is the separation of the CEO and chairman posts. The argument for separation is that the CEO manages the company and the chairman manages the board. Boards will need to determine whether it is time to get in front of this issue if the two positions remain vested in the same person.

Stockholders and the U.S. government expect better financial performance from the banking sector. Executive compensation issues, high risk banking practices and capital stress have put the banking industry in the spotlight on Capitol Hill, on Wall Street, and in the media. All of this will lead to more regulatory oversight of banks, and corporate reform groups will use it as an opportunity to promote their agenda, not only among public company bank holding companies but also among public companies generally.

Directors of public company bank holding companies should remain vigilant to developments in corporate governance. Expect investor interest in the banking sector to intensify in the months

ahead. There will be a higher degree of stockholder interest and activism toward banks and their boards. Do not be surprised if corporate reform groups seek even more corporate reform heading into the 2010 proxy season.

Reconciling Management and Board Strengths with the Strategy

The new reality of banking — whatever it turns out to be in the months and years ahead — requires the board to self-assess itself to determine whether the qualifications of the directorate match the strategy and complexity of the bank going forward. Likewise, the board of directors will need to evaluate whether the qualifications of the bank's management team reconcile well with the bank's strategy and tactics into the future. In a static state environment, institutions may not suffer meaningful financial and operational setbacks if routine self evaluations of human capital are deferred. Conversely, in a dynamic environment like the one immediately behind us and in front of us, having the right people in the right positions is fundamental to the success of the organization and making those determinations a continuous priority can make a difference between success and failure of the business.

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