

# LEGAL UPDATE

October 7, 2014

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## IMPROVING COMMUNITY BANK BOARD OF DIRECTORS MEETINGS

The challenges facing the members of boards of directors of banks in the United States continue to multiply. The Federal Deposit Insurance Corporation highlights this in its Pocket Guide for Directors: “The pace of change in financial institutions today makes it particularly important that directors commit adequate time to be informed participants in the affairs of their institution.” There is no reason to doubt the commitment of bank directors to both the stockholders they represent and the institutions they oversee. In light of this commitment on the part of directors, it is incumbent on bank management to use board meeting time to ensure that the directors are adequately informed participants in the affairs of the institution. Although they are required to monitor management performance, directors are not officers of the bank themselves. They rely on management to provide them with a full and unvarnished view of the bank and its operations. A plain recitation of facts and figures, however, is not enough. To truly benefit the directors, management must strive to explain *why* the bank is performing the way it does.

In privately-held community banks in particular, management’s monthly presentations to the board of directors appear geared toward reciting as many financial metrics as possible. Frequently a month-over-month or, particularly at the end

of a quarter, a year-over-year comparison of particular financial metrics is offered. In institutions with somewhat more sophisticated management, trend analyses are presented to indicate in which direction those metrics are moving relative to their history. Unfortunately, management presentations often end here. This forces privately-held community bank directors to sift through mountains of figures in attempt to tease out the story of *why* the bank is performing the way it is or, more specifically, *why* a trend is developing.

The issue is synthesis. The raw monthly performance metrics of a community bank are meaningless data points without a narrative that explains their interrelation and attempts to incorporate all of them into a coherent story. If directors do not know what internal and external factors are affecting the bank’s performance, they cannot fulfill their primary task of establishing policies to guide the bank in either the short-term or the long-term. In essence, community bank management should be looking to Item 303 of the U.S. Securities and Exchange Commission’s (“SEC”) Regulation S-K as a model for preparing their monthly presentations to directors.

Commonly referred to as Management’s Discussion and Analysis of Financial Condition (“MD&A”), Item 303 disclosure

is designed to provide the information “necessary to an understanding of [a company’s] financial condition, changes in financial condition and results of operations.”<sup>1</sup> As interpreted by the SEC, the MD&A requirements are intended to (i) provide a narrative explanation of a company’s financial statements that enables investors to see the company *through the eyes of management* and (ii) enhance the overall financial disclosure and *provide the context* within which financial information should be analyzed.<sup>2</sup> This synthesis of financial information by management is precisely what the boards of directors of community banks need to make the broad policy decisions with which they are charged.

This is not to suggest that management of a privately-held community bank should be working on monthly presentations that rise to the level expected of publicly-held companies that release financial statements only once per quarter. Instead, management should refer to SEC and industry guidance regarding MD&A for the purpose of enhancing its presentations to make them more useful to the directors. A few of the broader concepts underlying MD&A are easily applicable to privately-held community banks:

1. *Financial measures often tell only part of how a bank manages its business.* When preparing presentations for directors, management should disclose all key variables and other factors that

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<sup>1</sup> 17 C.F.R. § 229.303(a).

<sup>2</sup> SEC Interpretation: Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations

<sup>2</sup> SEC Interpretation: Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations (December 29, 2003).

management uses to manage the business. For banks, interest rates and economic growth rates and their anticipated trends are almost always the most important variables. But depending on a bank’s community and target demographics, the depth of Internet penetration in the customer base, for example, may have a direct correlation with customer engagement with the bank.

2. *The effectiveness of most presentations decreases with the accumulation of unnecessary detail or duplicative or uninformative disclosure that obscures material information.* For example, if there is a significant increase in the dollar volume of classified loans in the portfolio, but that increase is attributable primarily to one large credit that suffered a downgrade, discussion should focus on that particular credit. There is likely little need to walk through the entire classified loan portfolio. The presentation should include an explanation of that credit’s weaknesses and what is being done to address them. Management should also explain what the trend in classified loans would look like without the outsize influence of the single large-credit downgrade.
3. *Identifying the intermediate effects of trends, events, demands, commitments and uncertainties alone, without describing the reasons underlying these effects, may not provide sufficient insight for directors to see the bank’s business through the eyes of management.* As an example, if a bank’s financial statements reflect lower revenues resulting from a decline in new loan origination when compared to a prior period, management’s presentation should not only identify the decline in origination

volume, but also should analyze the reasons underlying the decline in originations. The analysis should reveal underlying causes of the matters described, including for example, if applicable, difficulties in clearing credits through the underwriting process, a decline in the marketability of a loan product, loss in competitive position and market share, or a combination of conditions.

In all instances, the goal of management's presentation to the board of directors should be to answer the singular question: why? Results do not speak for themselves. Absent an explanation that assimilates all of the bank's material performance metrics in a cohesive way, the board will be unable to re-allocate limited financial or managerial resources to address emerging needs in the institution.

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*This brief discussion is not comprehensive and is for general information purposes only. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Robert Lamonica at 212-326-0810, [rlamonica@pryorcashman.com](mailto:rlamonica@pryorcashman.com).*

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Robert Lamonica is a member of Pryor Cashman's Banking and Finance Group and Corporate Group, concentrating on mergers and acquisitions, financial institution regulatory matters and enforcement actions.

Robert has worked closely with state-chartered banks, national banks, thrifts and bank holding companies in managing regulatory compliance, conducting acquisitions and issuing securities. He regularly counsels financial institutions on compliance and enforcement matters involving federal and state regulatory agencies and has participated in the defense of directors and officers involved in regulatory liability actions.

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Robert is a 2007 graduate of Emory University School of Law, where he was a member of the Moot Court Society, and the Goizueta Business School, where he earned a Master of Business Administration.