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THE DIRECTOR'S JOB

DUCKING KEY DUTY OF MANAGEMENT SUCCESSION PLANNING IS LIKE PUTTING OFF WRITING YOUR WILL

At some point even the most successful CEO has to hand over the reins. A director asked consultant John Szold what he thought of leaders who stayed on by moving up to (theoretically) non-executive chairmanship.

Sometimes this works well, when the new chairman becomes "Mr. Outside," pursuing opportunities for the bank in the civic arena or in the industry, Szold said. But sometimes it's a very bad idea for the former CEO to hang around.

Szold: Succession is part of the board's job

Szold knows of one former CEO who stepped up to the chairman's job who just won't let go. So far this chairman has chewed through and fired three CEOs. "He's doing a *terrible* job," Szold told board members and bankers attending the ABA Directors' Forum at the recent Annual Convention.

Ultimately, the blame for such poor execution falls on the board, according to Szold, because succession planning ranks as one of the board's key duties. Szold, CEO of Planning for Succession, believes succession—and not just for the top job—should be on the board's agenda several times a year.

Planning means just that—talking about it, acting on the talk—in advance. "If you need a new CEO next week, you don't need a succession plan," quipped Szold. "You need to call 1-800-HEADHUNTER."

Szold asked for a show of hands: How many banks represented in the audience had a succession plan in place? About one-third of

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DEAR DIRECTOR:

New Exam Manual Adds Some Understanding Of Expanded "UDAAP" Regulatory Regime

Compliance has always been a challenge for boards. Bank regulation is a thick alphabet soup subject to periodic major fresh downloads and uncountable small shifts. The challenge won't get any easier.

The Dodd-Frank Act added an "A" to the long-standing "UDAP" enforcement standard, creating "UDAAP"—Unfair, Deceptive, and *Abusive* Acts and Practices. Now the Consumer Financial Protection Bureau has issued some guidance on what the new "A," for "Abusive," entails.

We last wrote about this in the July 2011 special report on Dodd-Frank's first anniversary. In mid-October, the Bureau issued its *Supervision and Examination Manual*. The manual includes an extensive section on UDAAP, including an entry on "Abusive."

UDAAP and compliance

Experts have warned that UDAAP, as expanded, will increasingly drive what regulators at traditional banking agencies and at the Bureau will be looking for when determining how well a bank complies with consumer protection laws. Particularly important to understand is that many of the laws and regulations banks have traditionally faced have dealt in hard and fast rules. This determined the shape and means used of compliance efforts.

UDAP, and now UDAAP, is "squishy." In a June cover story and accompanying podcast for *ABA Banking Journal*, consultants Jo Ann Barefoot and Lyn Farrell warned that UDAAP is "a de facto mandate to assure that all bank actions are 'fair' as well as compliant." (Read more at *http://tinyurl.com/udaappage*)

The writers, with Treliant Risk Advisors, elaborated: "Bank compliance functions are not designed to deliver unfailing fairness, especially against subjective standards and amidst relentless criticism

ABA-backed shareholder threshold bill passes House

We met two community bankers recently at an ABA gathering on opposite sides of a wall. The first, a bank in the area of $200 million in assets, has over 1,000 shareholders and thus falls under Securities and Exchange Commission reporting and other strictures, including the expensive Sarbanes-Oxley Act. The second bank, almost three times the other bank's asset size, has nearly 500 shareholders and the CEO vowed that he and his board will work to stay under that number.

The barrier that affects both is having 500 or more shareholders of record, subject of the September "The Director's Job" column. On Nov. 2, H.R. 1965 passed the full House. The legislation would raise the threshold—outdated for decades—to 2,000 holders. Bankers see this as especially important when regulators are demanding more capital.

A companion bill, S.556, has been introduced in the Senate. There is hope it will be "hot-lined"—put on a legislative express track for a Senate floor vote. That would bring some long-awaited relief to community banks now under SEC rules.

BY THE EDITORS OF ABA BANKING JOURNAL

from politicians, media, customers, and regulators."

In the new Bureau exam procedures manual, the agency reminds the reader that it has "rule-making authority and, with respect to entities within its jurisdiction, enforcement authority to prevent unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service."

The manual presents definitions of all the "classical" elements of UDAP, and also summarizes federal cases against institutions under each of those grounds. These sections are extensive and beyond what we can deal with here. However, the same section of the manual contains both the brief explanation of "Abusive" and also an illuminating discussion of the issue of consumer complaints.

What's "Abusive"?

An ongoing theme in the document is that multiple elements of UDAAP could be violated by the same action. But here is how the document speaks to what constitutes an "abusive act or practice":

"•Materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service or

"•Takes unreasonable advantage of—

"••A lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;

"••The inability of the consumer to protect its interests in selecting or using a consumer financial product or service; or

"••The reasonable reliance by the consumer on a covered person [institutions regulated by the Bureau] to act in the interests of the consumer."

Perspective from Raj Date

Additional perspective on the roots of this explanation of "Abusive" can be read in testimony recently given by Raj Date, special advisor to the Secretary of the Treasury for the Bureau. Date gave this on Nov. 2 in a hearing reflecting on the new entity's first 100 days of existence.

Date was speaking of the importance of clear disclosures to consumers and stated:

"A basic premise of an efficient, well-functioning market is that the buyer and the seller both understand the terms of the deal, and that buyers are able to make comparisons among products. But in the years leading up to the financial crisis and continuing through today, in many consumer financial markets, that was not the case.

"We saw the most egregious example of this in the mortgage industry during the housing bubble, when the fastest-growing mortgage products were some of the most complicated: hybrid ARMs, option ARMs, interest-only loans. The potential costs and risks of these mortgages were often not clearly understood. To properly calculate the costs and risks, borrowers needed sophisticated knowledge of things like rate caps and rate spreads. The result was that too many consumers ended up with mortgages they couldn't afford."

Importance of complaints

The same section of the new manual dwells at length on the issue of consumer complaints, both directly to an institution as well as to regulators; state attorneys general; the Bureau's own, new Consumer Response Center; private-sector agencies such as the Better Business Bureau; and even online consumer complaint websites.

"The presence of complaints alleging that consumers did not understand the terms of a product or service may be a red flag indicating that examiners should conduct a detailed review of the relevant practice," the manual states.

Bureau examiners are encouraged, as part of their examinations of large institutions, to search for potential UDAAP issues not only in complaint records and the companies' policies and procedures, but in records of complaints, in compliance audit reports, management reports, and in completed exam reports.

That's not all. Examiners are

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Do some of the developments out of the nation's capital get your blood moving, from time to time? *You don't have to be silent about it.* ABA offers board members two ways to take a direct role in telling elected leaders how they feel about the way Washington treats banks.

Summit. On March 19-21, 2012, ABA will hold its annual Government Relations Summit, which is open to bankers, bank board members, and state association executives only. Attendees hear from congressional, executive, and regulatory leaders, and time is set aside for visiting other leaders' offices to make banking's voice heard. The 2012 theme is "Talk to Power." For more information, visit *www.aba.com/Events/GRS.htm*

Advocate Program. Bank board members can help out ABA's grassroots lobbying through the ABA Bank Advocate Program. The mission: "To make sure that no Member of Congress can say, 'I didn't hear from my bankers'," says ABA. Learn more at *www.aba.com/grassroots/bankadvocate.htm*

also encouraged to review board minutes and the minutes of management committees, including those related to compliance. Board-level discussions of new product development is also mentioned.(Typically Bureau exams will only look at banking companies with more than $10 billion in assets, though it has backup authority to look at smaller institutions in tandem with traditional regulators. The latter are already known to be stepping up UDAAP-related work and will likely mine the same sources.)

How much does your board hear about consumer complaints? Do you receive bare-bones tallies of them or is some flavor of common problems brought to your attention?

At ABA's Regulatory Compliance Conference this year, speaker Paul Osborne, partner at Crowe Horwath LLP, warned:

"Consumer complaints could be indicative of a larger issue. Are you being proactive about managing and monitoring your complaint process? What are your customers telling you, good or bad? Don't wait for your regulators. The days of the [traditional] examination process, where you took your examination results, you fixed the issues, and you moved on, those days are gone. ... *Control your destiny*."

While Osborne was speaking to bankers, the advice, in an oversight sense, fits boards as well.

Resources to explore

• Read online coverage of the session Osborne spoke at *http://tinyrul.com/bjconsumercomplaints*

• Read an online *ABA BJ* "Pass the Aspirin," where bankers discuss how they handle customer complaints *http://tinyurl.com/unhappycustomers*

Sincerely,
Steve Cocheo
for *ABA Banking Journal*

those present raised their hands.

"Actually," said Szold, "that's a little *worse* than average."

TRICKY PROPOSITION

"Be clear on accountabilities," said Szold. "The board owns the responsibility for guiding the succession plan, and the CEO has to move it forward."

While succession in the executive ranks ultimately rests with the board, it's a joint project between current management and board members, Szold said. Much of implementation will fall to the current CEO, he said, "but we look for the board to be very visible and supportive throughout the process."

Succession can be a dicey process, especially under current industry and economic circumstances, even if a bank's board-management team has been diligent and tackled the challenge. We know of CEOs who stayed on past their original departure dates in this period because they didn't want to leave a damaged loan portfolio to their successor. And Szold noted that it's tempting for CEOs who have seen their personal portfolios decimated to express the desire to stick around longer, in hopes of rebuilding their retirement nest eggs. This is quite understandable, said Szold, but becomes a problem when an heir apparent was already identified and now faces the possibility of waiting longer to step up.

Another factor that makes planning for a transition difficult is that the board needs to have a firm sense of three points. One is where the bank is headed, strategically—this may dictate a change in the type of CEO, and the CEO's set of skills, from the leader the bank currently employs. Another is whether anyone answering the new "want list" of skills currently works for the bank. And then, there is the need to be brutally honest in assessing the bank's talent pool.

Szold spoke of a client bank where the CEO, 66 and with 42 years in banking, was asked by the board if there was a succession plan. This led to action.

A hard look was taken at the ages of the management team and the skills they had, with the matter rendered into a matrix. Talent in three areas—retail banking, commercial banking, and administration—was inventoried, and the board and management concluded:

No one on the management team had it all.

The COO, 55, had retail background and administrative skill, but no commercial banking experience. The CFO chiefly had administrative skill. And the head of lending knew retail banking and commercial banking, but wasn't strong in administrative talent.

Furthermore, of the team, four out of seven bankers, including the CEO, were already in their 60s. The COO was 55, but, again, lacked commercial banking experience.

At least the board and the team now had a firm handle on what the situation was. "Transparency and candor in program communications is critical," Szold said.

INSIDE OR OUTSIDE?

Of course, internal promotion isn't a given. A bank can hire executive talent. But each strategy has its pluses and minuses.

A board knows—or, if it doesn't, should immediately set about getting to know—potential internal candidates. Going with "family" means knowing them well, warts and all. And there are tools, such as personality inventory "tests"—a well-known one is the Myers-Briggs Type Indicator—that can help formalize that knowledge. Szold said he actually puts some stock in a person's astrological sign as an indicator.

In addition, Szold said, performance evaluation of the internal candidate can also help, demonstrating how well they handle current duties.

No internal selection is foolproof, but an outside selection can be twice as risky. Szold warned that external candidates who are selected come aboard with a "halo effect." But he added that the board and management don't know the banker's faults nor what skeletons may be in their closets.

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Outsiders also tend to paralyze an organization in the first 90 days on the job. Employees become cautious, and everyone's feeling each other out.

These are just some of the factors in the inside/outside choice. Szold presented the advantages and disadvantages of each, with his points including:

• *Inside candidate:*
Advantages: Continuity; easier negotiation; stability; no search fees; quick "ramp up"; high motivation to prove worth.
Disadvantages: Other insiders may lose motivation; an internal choice may not move easily in new directions; difficulties and expenses in keeping an heir apparent in the wings
• *Outside candidate:*
Advantages: Hire exactly what you want; shake things up; bring new business; inject new hope and excitement.
Disadvantages: Time and cost to search; cultural disruption; higher compensation; possible relocation issues.

CHOOSING MR. INSIDE

In Szold's case-study example, the client bank's board and CEO preferred to go with the COO, rather than an outsider.

The COO had some advantages, besides those of the typical internal candidate outlined above. A key one: He had a track record for grinding down costs. And he was known to be a perfectionist.

The COO also had some baggage, besides the lack of commercial experience and no exposure to large business customers. He tended to focus on short-term tactics, rather than strategy. And he was known to be a perfectionist.

That's not a typo: Szold listed perfectionism as *both* a plus and a minus. He sees that trait as a double-edged blade. To the COO's credit, while he was a perfectionist, he had 12 employees reporting directly to him and he was not known as a micro-manager.

BOLSTERING THE INSIDER

Did this bank do right, hiring inside? Szold said he might have looked outside, as well, for some comparison. "I'm not comfortable when there is a choice of one person," he explained, "because to me that's really no choice."

He told listeners that the board and CEO, recognizing the weaknesses, set up a plan for fixing them. A developmental program was set up to strengthen the COO's skills, and a reorganization was implemented to help the COO ease into the commercial banking role of the CEO's job.

Having gone through succession at the top, this prompted the board to look further down the organization chart.

THE REST OF THE BENCH

The bank has had assessments completed for the entire management team, ranking the bankers by current performance versus potential leadership. Szold pointed out that being a good lender doesn't make a banker a good manager of lenders, for example. He considers the ability to delegate to be a mark of potential leadership ability.

The assessments underscored two key groups:

• *Stars*—those with high potential and high current performance.

•*Contributors*—These people perform well. However, "they are often people who have plateaued," said Szold. "They are good performers but they aren't going any further."

The risk some banks run is that because they may be senior employees, they can act as "blockers"—employees whose seniority keeps more-talented people below them from advancing. This can keep strong internal candidates from bubbling up in the bank, and the bank that doesn't find a way to meet the aspirations of these employees risks losing them to better opportunities elsewhere.

One solution to this risk, Szold said, is having management implement projects that encourage up and comers to work across multiple areas of the bank. This draws out skills and displays talents.

WHAT ELSE CAN YOU DO?

The late Doug Austin, veteran board consultant, often stressed that the watchword for directors and trustees was "Noses in, fingers out!," out of respect for the line between oversight and management.

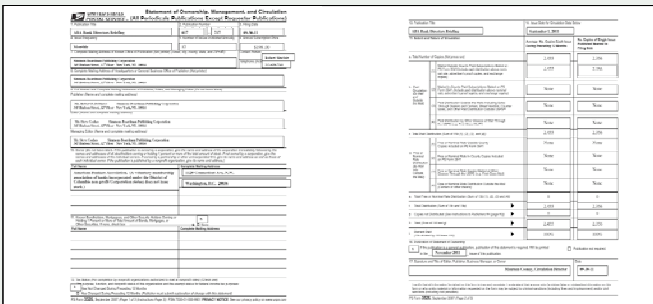
Szold stressed "noses in," specifically, get out of the boardroom enough to get to know people in the bank who have been identified as good performers with strong potential.

Some of this can be formalized by having a "bench strength dashboard." But Szold believes in personal involvement.

"You expect numbers on a balance sheet to be independently verified," said Szold. "So why would you take a report on human capital at face value?"

It's true that board members see members of the executive team in their regular meetings. But frequently that is limited to watching them make a 20-minute presentation a couple of times a year. That's pretty flimsy support for a potential CEO recommendation, someday.

"There are a lot of folks out there who give great PowerPoint presentations," said Szold. "But that doesn't make them great leaders."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What regulators *think* your directors read

What you *wish* your directors would read

What your directors *will* read.

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