FORTRESS PARTNERS
E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Scott McCallum & Jon Bruss
DATE: October 31, 2017
SUBJECT: **How Regulatory Overreach Stifles Community Bank Lending and Board Governance**

As community bank directors and investors, we've seen the regulatory pendulum swing way too far to the regulatory side of the scale weighing community banks down with burdensome regulations that impact how one runs and governs a community bank. To regular readers of our ***E*-Memo**, our commentary will probably not surprise you to see this from us.

Recently, a couple op/eds in *The Wall Street Journal* provide additional color on the topics of small business lending, regulatory burdens and board governance. The first one is dated yesterday, October 30, 2017, entitled "Some Banks Are Too Small to Succeed" by Joseph Ricketts (founder of TD Ameritrade) which discusses character-based lending to entrepreneurs and how regulation strangles such lending. The second one is dated August 29, 2017, entitled "Why Would Anyone Sane Be a Bank Director" by Thomas Vartanian (a practicing attorney and former general counsel of the Federal Home Loan Bank Board). That article is about the "rising dough" syndrome of regulation and the blurring roles of bank managements and boards, and the liability insurance fallout from failed banks.

Small Business Lending: The Ricketts article's main premise is spot-on as it pertains to the increased regulatory burden on community banks post-crisis, which has resulted in a "pull-back from character-based" lending to entrepreneurs, with a special concern for rural entrepreneurs and areas. We generally agree that regulatory burden has tamped down community bank lending to small businesses, regardless of how rural the borrower or market area.

We strongly believe that small business/character lending is at the very core of what community banks do: we build customer relationships with mutual trust over time. We think the proximity of the relationship manager is a critical attribute of that relationship, especially with borrowing customers.

Ricketts concludes: "With less regulation, community banks could devote a portion of their capital to small business lending that generates jobs, innovation and growth. There's an entire group of potential entrepreneurs whose ideas have yet to be unlocked."

Since bankers are in the business of renting (not selling) money, we fully recognize that this is not an all or nothing proposition. In fact, community banks need to have some compliance and non-revenue infrastructure "burdens", which are fundamental to running a safe and sound operation, especially to support sustainability and growth. We also believe that increased lending to small business not only fosters innovation but also entrepreneurialism. The benefit of such to community banks with lower compliance burdens would enhance efficiency, profitability and franchise value.

Community Bank Board Governance: The Vartanian article notes the typical reaction by Congress and regulators to "every financial crisis over four decades"—including the 2008 financial crisis—has sought to "improve bank regulation—which in practice has meant continuously increasing it. That has created a "rising dough" syndrome of regulation—a continuing expansion of regulatory obligations imposed on directors, and a corresponding expansion of the basis for lawsuits against them when their institutions fail."

In June Treasury concluded that "regulators' expectations may be crowding out critical board functions, blurring the responsibilities between directors and management" [albeit late]. And in August the Fed

"asked for comment on the elimination or amendment of redundant and ineffective director responsibilities including [*get this, bold-faced type ours*] **170 it identified in 27 different regulatory pronouncements**." If you hadn't gotten the drift of this article from its title, perhaps you now do.

According to Vartanian, the Fed now believes that "[b]oards that meet periodically cannot effectively undertake management's day-to-day operational responsibilities, or the oversight role of regulators." Furthermore, the Fed now "wants to improve corporate governance by having boards devote less time to satisfying supervisory expectations that to do not directly relate to their core responsibilities, and devoting more time to what really matters, such as establishing strategy and risk tolerance and holding senior management accountable."

That would truly be a breath of fresh air and, also facilitate a shift in focus to strategy, executive succession, shareholder value enhancement and senior management accountability—four worthy duties for community bank boards.

As for the impact of bank failures, Vartanian notes ". . .FDIC receivership suits against directors of failed banks have multiplied" with an increased focus on recouping losses, a noteworthy goal. This focus, however, has been driven by the availability of D&O insurance coverage and directors' personal financial means, "rather than whether directors made appropriate decisions. . ." Vartanian smartly posits "If directors believe they'll be sued in the event of failure no matter how they acted, why not throw a financial Hail Mary when failure looks likely? The FDIC should follow the Fed and Treasury leads and reevaluate its director and officer liability program."

Such a "recalibration of the regulatory demands on potential liabilities of bank directors would give tools, incentives and freedoms to be more effective overseers of the backbone of the U.S. economy and better avoid future financial crises."

Our Take on These Articles: *First* and foremost, bad loans still kill banks. So, elevated asset quality problems always deserve top priority for management teams and boards. *Second*, we believe just as more freedoms in small business lending should yield better outcomes for community bank management teams, boards and investors, a shift to a more strategically-focused board governance regime should strengthen performance, and likely better outcomes for management, directors and investors.

Finally, as an organization we believe "*the foundation of a strong, fee economy is a diverse and competitive banking system. We further believe interested, proactive shareholders promote efficiency and good performance, while fostering a healthy banking and economic system.*"

Happy Halloween…and may less ghoulish days be ahead for community bank management teams, boards and their investors!!

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