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Dodd-Frank and Its Impact on Mutual Institutions, Corporate Governance and Mutual-to-Mutual Business Combinations

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Who We Are

Luse Gorman Pomerenk & Schick is a Washington, D.C. based law firm specializing in:

- capital raising transactions
- mutual holding companies
- mutual-to-stock conversions
- secondary stock offerings
- mergers and acquisitions
- charter conversions
- executive and board compensation
- regulatory and enforcement matters
- corporate and securities law advice
- corporate governance

Our Accomplishments

- Counseled 100+ Mutual-to-Stock Conversions
- No. 1 Nationally Since 2001
- Counseled 100+ MHC Reorganizations
- No. 1 Nationally Since 1991
- Top 10 Mergers and Acquisitions Every Year Since 2001
(1st in 2009)

Overview

1. Regulatory Reform and Dodd Frank
2. Mutual Holding Company and Mutual-to-Stock Conversion Transactions
3. Corporate Governance
4. Mutual-to-Mutual Business Combinations

Regulatory Reform and Dodd-Frank

- Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (July 21, 2010, 2000+ pages)
- Effective Dates: 1 day to 5 years, most in 12-18 month range
- Regulatory Consolidation: 12-18 months, mid-summer 2011 likely
- Establishes 13 new agencies, offices and bureaus
- Requires 35 studies - will likely result in further rulemaking
- All financial institutions affected, larger institutions (\$50B+) more so

Regulatory Reform and Dodd-Frank

- Non-banks, mortgage companies and other financial service providers now become “regulated”
- Dodd-Frank only a “skeleton” of reforms – real impact will be felt after new rules are issued
- Many mandates and discretionary authority to write new rules, most new rules to come in next 6 months to 3 years
- Likely will not change how or where community banks do business but will increase costs of lending and deposit taking, increase compliance measures and require higher levels of capital
- Many “reforms” already here (through capital directives, MOUs and C&Ds, more scrutiny over business plans and compliance)

Effect on Community Banks

- Higher capital requirements
- Additional consumer disclosure and compliance procedures
- More active enforcement by state attorneys general
- Future revisions of conversion / MHC regulations
- New executive compensation regulations or standards
- Reduced federal bank charter choices
- More M&A deals as some smaller banks may want to merge

Change may not drastically alter products and services offered or geographic expansion considerations (unless over \$50B) but it will drive up costs to do business and reduce ability to grow without capital

Capital Requirements

- Regulators must establish minimum leverage and risk-based capital requirements for banks, holding companies and significant non-bank subsidiaries at no less than current levels

Timetable For Increased Capital Requirements:

- No deadline set
- Higher requirements already being imposed through examination and application process – most regulators want 8-10% (Tier 1) and 10-14% (Risk-based),
- Many expect higher requirements will come through adjustment of risk weightings and added activity risk components

Regulatory Consolidation

- Dodd-Frank eliminates OTS, merges it into OCC
- OTS authority over federal thrifts given to OCC
- OTS authority over state S&Ls given to FDIC
- OTS authority over SLHCs given to FRB
- Home Owners' Loan Act (HOLA) preserved - federal thrift charter and S&L holding company charters preserved (mutual and stock), dual banking system preserved (state charters still an option)
- Transfer Date: July 21, 2011, with one extension up to 6 months, OTS to be abolished within 90 days of Transfer Date

Revised Federal Bank Regulatory Structure

Bank Level:

OCC: Federal banks (commercial and savings)

FDIC: State commercial banks, savings banks, trust companies, state S&Ls

FRB: State chartered institutions that elect FRB as primary federal regulator

Holding Company Level:

FRB: All holding companies, including MHCs

Regulatory Consolidation

- OTS orders, determinations, regulations, agreements and interpretations are treated as if issued by OCC, FDIC or FRB (as applicable) and remain effective “until modified, terminated or superceded” by the OCC, FDIC and FRB
- Proposed OTS regulations remain proposed OCC, FDIC or FRB regulations
- OCC, FDIC and FRB must (by Transfer Date) “identify” regulations of the OTS that they will enforce and must publish that list in the Federal Register
- While HOLA has not been amended and general powers of thrifts and savings and loan holding companies have not been revised - OCC, FRB and FDIC now have an opportunity to revise all the regulations and policies of the OTS

Possible Effect on Mutuals

- OTS has been responsible for most mutual transactional developments (conversions, MHCs, mergers, second steps, stock funded foundation)
- OTS regulations are basis for state mutual/MHC regulations, OTS precedent provides interpretive guidance for states and FRB/FDIC
- FRB has no regulations for mutuals, effectively applies OTS regulations
- FDIC has limited regulations, effectively applies OTS regulations to state bank conversions
- OCC, FDIC, FRB will have opportunity to rewrite conversion and MHC rules. Previous rewrites have often been adverse and have raised questions about depositor ownership rights
- State mutual S&Ls and MHCs will be affected just like federal mutuals and MHCs

Focus (or Lack Thereof) on Mutuality

- Due to very small size of mutual segment of the industry (1% of all insured deposits), view toward mutuals is indifferent
- That is good and bad

Capital Raising Alternatives - Takeaways

General Observations:

- When you need capital to survive – you will NOT get it – whether in conversion or MHC or secondary offering
- No regulator is going to take the risk of giving a failing or distressed bank more time to raise capital
- Targets will not wait for a buyer to raise capital unless they have no other choice or you “pay up” for the financing contingency
- Higher regulatory capital requirements are already here through the examination process

Capital Raising Alternatives – Take-aways

- Market more favorable *for certain banks* to raise capital through stock conversion or secondary offerings
- Transaction / structuring options may change (not for better) with regulatory reform
- State chartered mutuals will be affected by elimination of OTS due to FRB and FDIC use of OTS rules
- Mutuals will survive BUT new federal regulator (OCC, FRB or FDIC) will have opportunity to rewrite regulations affecting mutuals

Current Market Conditions – Take-aways

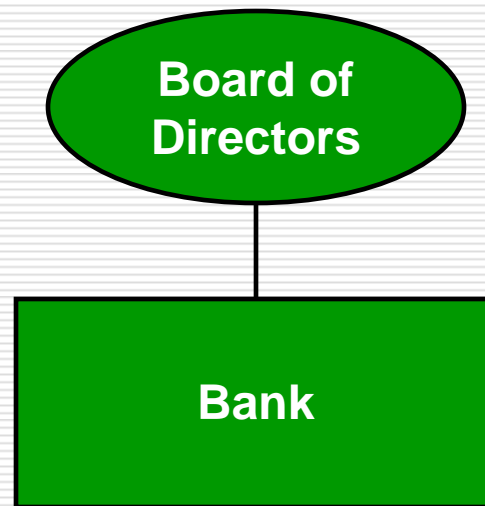
A Better Environment (For Some):

- Access to capital: will primarily depend on 1) asset quality, 2) size/liquidity, 3) market area
- Full conversions: much better market, driven by current low price to book values
- MHC offerings: difficult, unless a larger offering or there is significant board/management participation in the offering
- Trust Preferred/debt: non-existent market

A Mutual Board Should Periodically Review Its Corporate Alternatives

- Remain in traditional mutual structure
- “Private” Mutual Holding Company
- “Public” Mutual Holding Company
- Fully-Converted Stock Holding Company

Current Traditional Mutual Structure



Traditional Mutual Structure

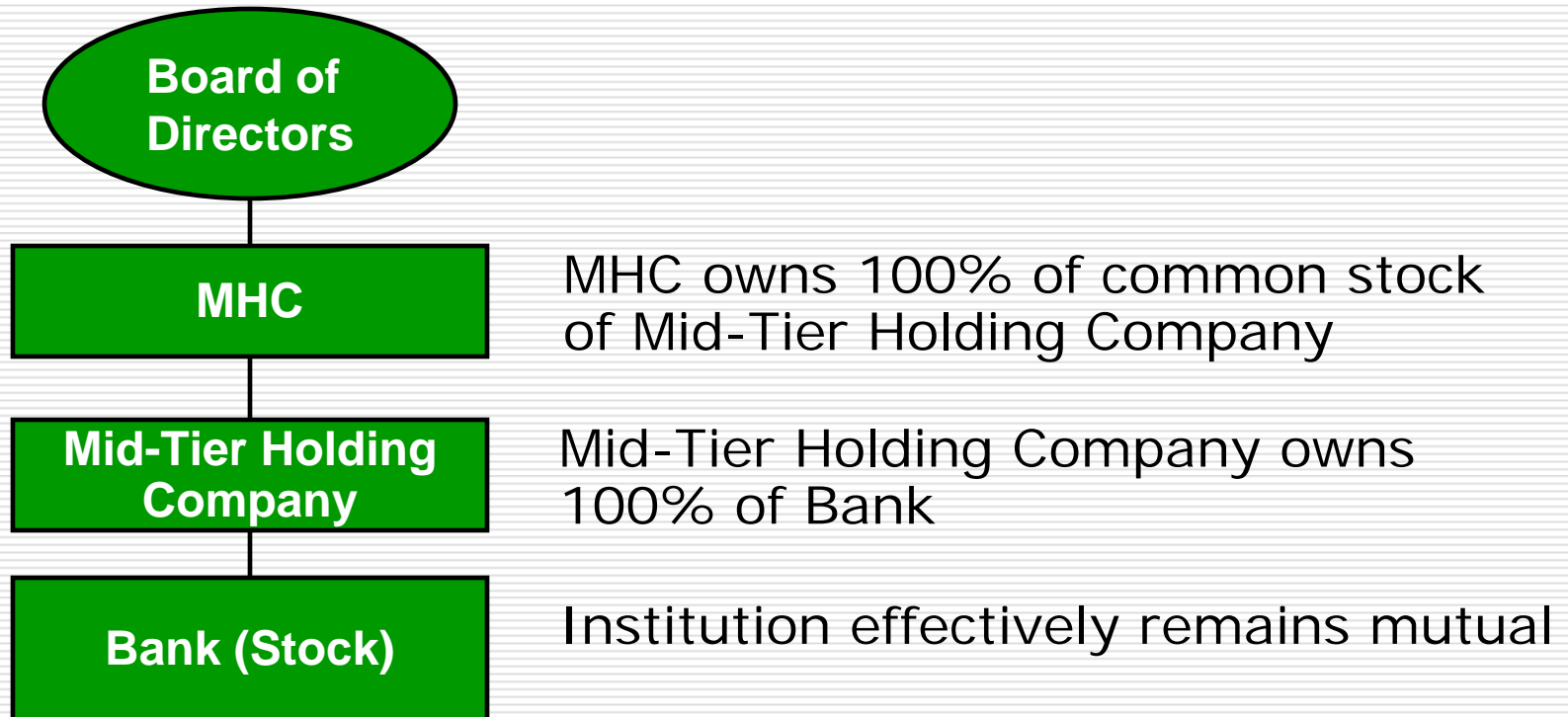
Advantages

- No stockholder pressures
- Secure and stable operating environment
- Complete autonomy, subject to regulatory oversight

Disadvantages

- Inability to raise capital
- Tendency toward complacency because no earnings pressure
- Uncertainty as to future of mutuality
- No “strength in numbers” (limited legislative and regulatory voice)
- No stock incentive plans for employees, management and directors

Private “Two-Tier” MHC



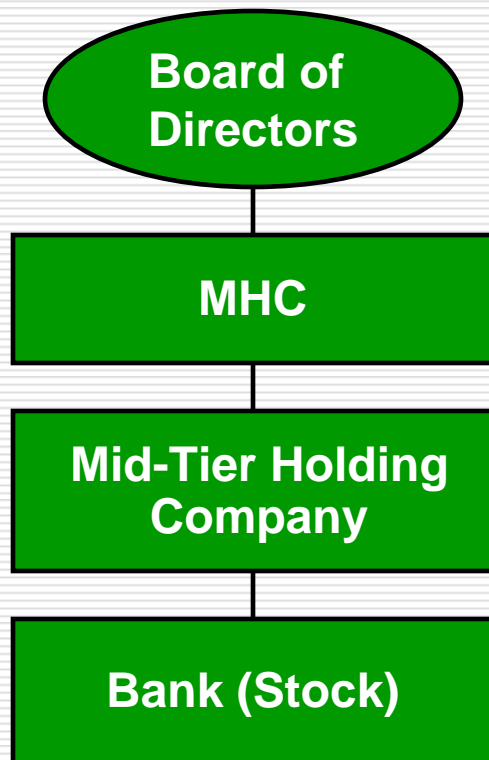
Private MHC - Advantages

- No stockholder pressures
- Secure and stable operating environment
- Complete autonomy, subject to regulatory oversight
- Get depositor vote out of the way
- Creates a mutual structure with more options and flexibility (including with regard to mergers)
- Can raise equity in the future

Private MHC - Disadvantages

- No capital raised
- Ownership still in question
- Limited growth opportunities
- No currency for acquisitions
- No stock incentive plans for employees, management and directors

Public "Two-Tier" MHC



MHC owns a *majority* of Mid-Tier
"Public" owns a *minority* of Mid-Tier



Mid-Tier owns 100% of Bank

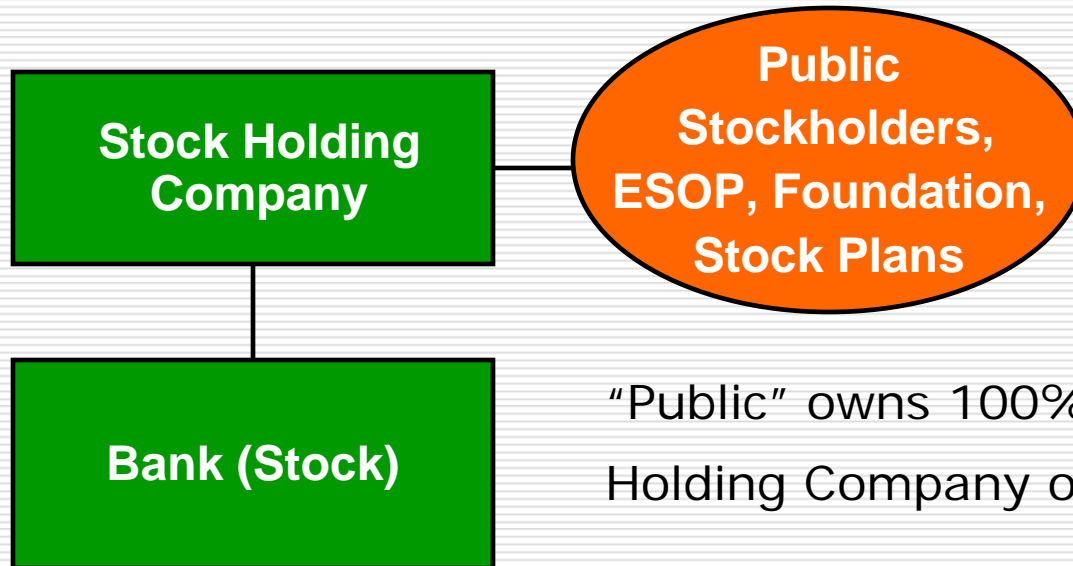
Public MHC - Advantages

- Improves capital position
- Control remains with MHC Board
- Easier transition to becoming a full public company
- Equity ownership for employees, management, directors
- Customers become owners with increased ties to bank
- Stock incentive plans for employees, management and directors

Public MHCs - Disadvantages

- Need to interface with stockholders
- More difficult to complete compared to a standard conversion
- Less liquidity compared to a standard conversion
- Fewer stock benefits compared to a standard conversion
- Regulatory risk in completing a second step
- Cost of being a public company (accounting, SEC, SOX)

Full Conversion



"Public" owns 100% of Holding Company
Holding Company owns 100% of Bank

Full Conversion - Advantages

- Maximizes capital raised
- Easier transaction to complete compared to MHC
- More liquidity in common stock
- Customers become owners with increased ties to bank
- No need to worry about regulatory risk or market for conversions or second steps
- In current market, may be only viable option for some mutuals desiring to raise capital
- Maximizes stock benefits for management, employees and directors

Full Conversion - Disadvantages

- Need to interface with stockholders
- No gradual transition to a public company
- Cost of being a public company (accounting, SEC, SOX)
- Potential loss of control through proxy contest

Full Conversion – Control Features

- Staggered terms for board of directors
- “Super-majority” vote to reduce or increase board
- Notice requirements for shareholder nominations / proposals
- Elimination of right of stockholders to call a special meetings
- Elimination of cumulative voting

- Board qualification requirements:
 - Residency requirements
 - Non-competitor requirements
 - “Bad Boy” provisions
 - “Strawman” prohibitions

Full Conversion – Control Features

- Perpetual 10% vote limitation - any individual, company or group acting in concert cannot vote more than 10% of company's outstanding common stock
- "Super-majority" vote to amend certificate of incorporation or bylaws
- Regulatory prohibitions on takeovers, minimum 3 years with optional 5 year provision
- Most effective control feature – significant stock ownership by officers, directors, employees, benefit plans, customers

Stock Offering Process

Stock sold in a regulated “priority” offering:

1. Eligible Account Holders
2. ESOP
3. Supplemental Eligible Account Holders
4. Other Members
5. Community

Stock Offering Process

Pricing of Stock Offered:

- All shares sold at same price per share (typically \$10.00)
- Independent appraisal determines amount/price and offering range – function of performance, peers, market and subscriptions
- Recent pricing – 45-58% Price/Book at maximum of offering range
- Compare to January 2008 – 80-86% Price/Book

Stock Offering Process

Pricing Examples:

Net Worth (Book Value):	\$10M	\$10M	\$10M
New Capital (Net Proceeds)	<u>\$10M</u>	<u>\$20M</u>	<u>\$30M</u>
New Total Net Worth:	\$20M	\$30M	\$40M
Price To Book:	10/20	20/30	30/40
	50%	66%	75%

Compare To Typical Price To Book: 100-120%

Stock Benefit Plans

Typical Stock Benefit Plans:

- ESOP – up to 8.0% of stock issued
- Stock Option Plan – 10.0% of stock issued
- Stock Award Plan – 4.0% of stock issued

Other Compensation and Benefit Plans:

- Employment/Change-in-Control Contracts
- Director Retirement/Deferral Plans
- 401(k) Plan Amendment to allow for stock purchases

Charitable Foundation

Regulations permit a savings bank to grant shares to a charitable foundation as part of a conversion or MHC stock offering, subject to the following requirements:

- Foundation must be included in stock issuance plan
- Depositors must approve foundation by a separate vote – majority of eligible votes
- For 5 years, one seat on foundation’s board must be reserved for an “independent” director from local community
- Maximum contribution is 8% of the offering (2% for the MHC)

Practical Governance Issues Facing Mutual Institutions

Responsibilities of a Mutual Board of Directors

- Boards of mutual institutions have fiduciary responsibilities to depositors, customers and some would argue, bank regulators
- The decisions of mutual boards are also protected under the so-called “business judgment rule.” That is, the decision of a board of directors should not be second-guessed by stockholders as long as the board exercised good faith and due care

Responsibilities of a Mutual Board of Directors

- A board has two duties: A duty of care and a duty of loyalty
 - Duty of care requires that the board act on an informed basis in making decisions
 - Duty of loyalty requires that individual board members not let their personal interests interfere with the interest of the institution

Responsibilities of a Mutual Board of Directors

While the courts and, in particular, the Delaware Chancery Court have a well established tradition of preserving and enforcing the business judgment rule in the face of stockholder lawsuits, the business judgment rule has not protected boards from actions by bank regulators

Mutual-to-Mutual Business Combinations

Considerations in Connection With a Business Combination

- Mutual institutions are facing greater challenges than ever before because of higher costs associated with the Dodd-Frank Act and rising operating costs generally
- As a result, a strategic combination with another mutual institution may be in the best long-term interest of the institution and its depositors and customers
- Mutual institutions can also acquire stock institutions
- Acquisition of a stock institution would likely not have the same financial advantages compared to acquisition of a mutual institution

Considerations in Connection With a Business Combination

Mutual boards have no obligation to merge with another institution (just as stock banks are under no legal obligation to sell even in the face of significant premium offers). However, they may want to consider a merger for the following reasons:

- Capital deficiency and mutuals need to carefully evaluate their capital needs and how to raise capital if ratios are deficient
- One challenge facing mutuals is how to remain relevant in an overwhelming stock environment and a consolidating market. High performing banks have all of the following:
 - Strong management
 - Engaged boards; and
 - A growth driven business plan

Considerations in Connection With a Business Combination

- Growth provides opportunity for new employees and strengthens the long-term management base of a bank
- But mutuals cannot grow without raising capital, since growth through retained earnings is likely to be slow and uneven
- All mutual boards should evaluate their business plan and capital needs with the following question in mind – What is our mission as a bank in our market area?
- Mutual banks that do not grow and change to accommodate customers needs will eventually become irrelevant

Advantages of a Business Combination

- Share costs and overhead, scale is more important today
- Expand branch locations and improve customer access – more offices, ATMs
- Improve operating efficiencies – economies of scale
 - Greater critical mass to support new services and technology/online banking
 - Greater capital/critical mass to support commercial lending and administration

Advantages of a Business Combination

- Increase capital position (depending on purchase accounting adjustments)
- Greater career opportunities for employees – improve retention and recruiting
- Good defense – block competitors from opportunities
- Decrease competitors
- Effective way into new markets

Potential Issues of a Business Combination

- “Social Issues” – compatibility of management, officer and board positions
- Different corporate cultures of combining banks
- Poor asset quality of merger partner – due diligence is required and more important today required
- Adverse regulatory issues facing either of the combining banks
- Integrating the two banks and their customer markets

Potential Issues of a Business Combination

- Loss of autonomy and control
- Rarely a merger of equals – one bank usually ends up on top
- Free transfer of target bank's capital to another mutual institution
- Employee dislocations

Deal Considerations – Social Issues

Principal Social Issues:

- Board and committee composition:
 - Combine boards based on equity, assets, income contribution
 - Separate boards
- CEO/key officer succession:
 - Who will be the CEO, CFO
 - Affected by retirement and succession plans
- Name of resulting bank and headquarters

Deal Considerations – Social Issues

- Branch closings and business line consolidations
- Combine or keep banks separate:
 - Understand costs of keeping separate banks
 - Consider concept of a “division” of acquiror
- Compensation and benefits:
 - Employee and directors plans and payments
 - Pre - and post merger arrangements

Deal Considerations – Social Issues

- Typical Compensation and Benefit Issues:
 - Compensation adjustments
 - New officer positions
 - Employment contracts for both banks(1-3 years, with change-in-control protection)
 - Change-in-control/severance payouts (1-3x payments)
 - Retirement plan enhancements (SERPs)
 - Post-merger consulting contracts
 - Merger transaction bonuses; stay bonuses
 - Post-merger phantom equity plans
 - Advisory/emeritus boards/board retirement plans
 - Agreements regarding participation in future stock plans

Practical Guides for Growing Your Community Bank and Maintaining Profitability

- Establish good corporate governance practices
 - Evaluate management and board members regularly
 - Engage an independent party to review board performance before the regulators require it
- Create a business plan that promotes responsible growth
 - New employees want to see opportunity, which requires growth
 - Customers like to see their bank growing and doing well

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