



# GOVERNANCE & RELATIONSHIP TO CURRENT ECONOMIC EVENTS

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# Economic “Moment”

- Inflation
  - Decreasing, but still building on last few years
- Deposits
  - Influx
  - Followed by outflow
  - Followed by rate competition
- Interest Rates
  - Decreasing credit appetite
- Credit Risk
  - Seemingly increased delinquency despite strong job market

# Differences From Prior “Moments”

- S&L
  - Inflation, Deregulation, Speculative Risks, Concentrations
  - Drive for profitability drove decisions past prior limits
- 2008 Financial Crisis
  - Mortgage driven, Assumption that housing prices would always rise
  - Assumption about risk led to over-concentration & extension
  - Drive for loan competition drove decisions to deeper credit risk

# Impacts

- Silicon Valley Bank
- Liquidity Crunch
  - Credit facilities necessary to calm markets
    - Low rate borrowing from the Fed
    - But no strings attached
  - Resulting arbitrage (borrowing to invest)
- Cash flow forecasts & models all fall apart
- Increased focus on Hedging



# Key Concepts

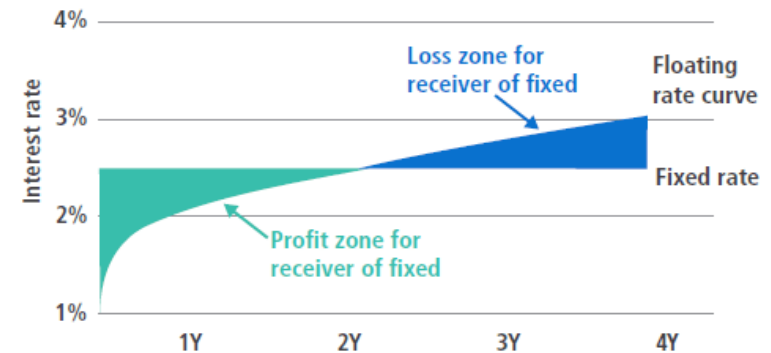
- Arbitrage: Buying and Selling an asset at the same time
  - (borrow at a low rate & invest at a higher rate)
- Contingency Funding: Borrowing or other cash capacity
  - (Over \$250 million in assets needs CLF or Fed under 741.12 as one)
  - Guaranteed Line
  - Repo / Repurchase
- Federal Reserve Discount Window
  - Operating Circular 10; borrowing from the Fed; collateralized
- Central Liquidity Facility (CLF)
  - NCUA run liquidity source
  - NCUA pitching as easier now



# Derivatives / Hedging

- Derivative:
  - Investment/security that acquires its value from something else
  - E.g., Rate Swap
- Hedge:
  - Offset losses in investments by taking an opposite position
- NCUA Regulations
  - Hedging treatment required
  - ISDA Agreements
  - Board Training
  - Regulator approval at lower CAMELS/Assets

A TYPICAL SWAP TRANSACTION AT INCEPTION

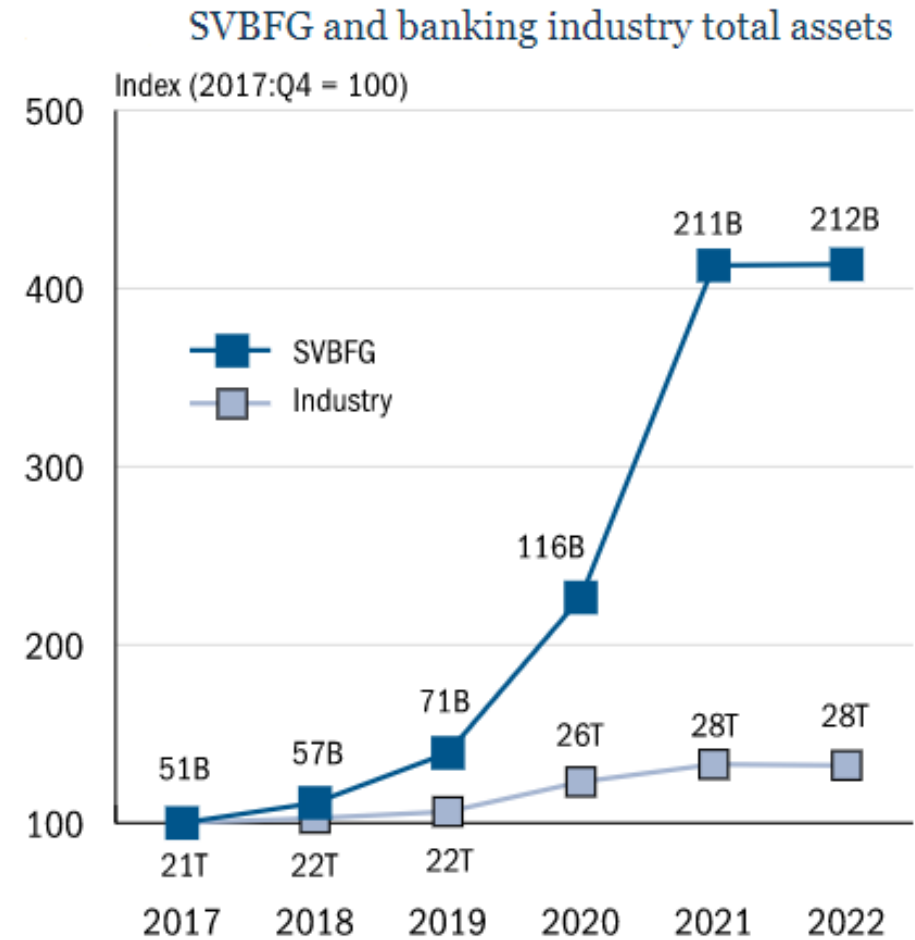


When an investor enters into a swap, the difference between the fixed rate payments and the expected future floating rate payments should be zero (the blue zone equals the green zone)

Source: PIMCO  
Sample for illustrative purposes only.

# What Happened at SVB?

Source: Board of Governors of the Federal Reserve System; Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank; April 28, 2023.



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Note: The key identifies lines in order from top to bottom. All values indexed to 100 at year-end 2017. Values are as of year-end. Values are in billions of dollars for SVBFG and in trillions of dollars for the industry. Industry aggregate includes all top-holder firms.

Source: FR Y-9C and Call Report.



# What Happened at SVB?

- Assumption of Continued Low Rate Environment
- ALM Mismatch
- Unwound hedges
- No Risk Officer, Lacking Risk Committee
- Concentration of Relationships
  - High uninsured deposits



# What Does This Have to do with Governance?

- “The system by which companies are directed and controlled.”
  - Cadbury Report, 1992
- “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”
  - Organization for Economic Co-operation and Development, Principles of Corporate Governance

**DOES YOUR BOARD  
UNDERSTAND YOUR BALANCE  
SHEET & STRATEGY?**



# Developments in Duties: Duty of Oversight

- Responsibility for Information Reporting Systems
  - Board and Management
  - Maintain systems & get information about highly regulated industry, key risk
  - Can't ignore red flags indicating wrongdoing
    - Know of the red flag; consciously fail to act; sustained, systematic, or striking failure
- Cases:
  - Blue Bell Ice Cream – No Board food safety committee or reports
  - Clovis Oncology – Red flags & failure to monitor compliance and safety
  - MacDonalds – “Party Atmosphere” known by HR; no report to Board
    - Oversight claims can extend to officers

# Important Implications

- Duty of Oversight is a Good Faith Concept
  - Failure to get information on or act as to red flags on critical operations
  - Not care problem, but seen as not approaching job in good faith
- Bad Faith Implications:
  - Business Judgment Rule
  - Indemnification
  - Insurance



# Application in Financial Institutions

The Upstate National  
Bank

OCC Order

Example Roadmap

(For Enforcement as  
well as Governance)

- Outline:
  - Hire competent management & oversee them
  - Board Governance Program
    - Written processes for decision-making & organization
  - Strategic Plan
  - Capital (& plan to attain targets)
  - Interest Rate Risk Management
  - Liquidity Risk Management
  - Books & Records
    - GAAP, Internal Controls, Reconciliation
    - Information reporting systems
  - Third Party Risk Management



# Specifics for Board / Management Relations

- Reporting & Information need to Include
  - What isn't getting done
  - How goals are not being met
  - Information on Audit Results
- Evaluations are Vital
  - Performance, expertise
  - Compensation & benefits
- Set Objectives & Strategy
  - In line with mission as framework
  - Setting objectives for overall risk profile & performance
- Understand Tradeoffs for Risk Appetite
- Governance Includes Committee & Information Reporting Design

# Specifics for Management

- See Something, Say Something
- Your Area, Your Problem
  - No pleading ignorance, culture, or orders
- Ensure Reporting Systems are Healthy





# What Does This NOT Mean?

- Board should not be Operational
  - Stay in strategy
  - But strategy requires information & oversight
- Board does not need All Information on All Things
  - Levels of detail varies with risk
  - Levels of detail & involvement also vary with trust
    - Why are they asking for more detail?



# CONTACT US



550 N. Brand Blvd., Ste. #550  
Glendale, CA 91203



tim.oppelt@swmlp.com  
bill.adler@swmlp.com



(818) 241-0103



<https://swmlp.com>



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