



MAINE BANKERS
Association

2011 DIRECTORS COLLEGE

BOARD GOVERNANCE: UNDERSTANDING BALANCE SHEET STRATEGY



Dave Thomas, President

October 21, 2011

Board of Directors Governance:

Responsibilities are to:

1. Understand and guide the strategic direction for the bank in managing risk (identify, measure, control, monitor risks)
2. Select and retain competent management
3. Establish business objectives and adopt supporting policies
4. Monitor operations
5. Oversee the bank's business performance
6. Ensure the bank fulfills its community mandate

Achieve this by:

1. Being independent and supportive
2. Staying informed and keeping perspective
3. Supporting and overseeing management

Do this through:

Establishing policies and procedures in areas such as:

1. Investments
2. Asset-liability management and funds management
3. Profit planning and budgeting
4. Capital planning
5. Internal controls
6. Compliance activities
7. Audit
8. Conflicts of interest
9. Code of ethics

Ensure ongoing monitoring with:

1. Appropriate reports to the board
2. Ongoing independent review when necessary and appropriate
3. Prioritize supervisory reports
4. Avoid conflict of interest and/or preferential transactions

Be aware of:

1. How the bank makes decisions
2. Monitors performance
3. The bank's operating environment

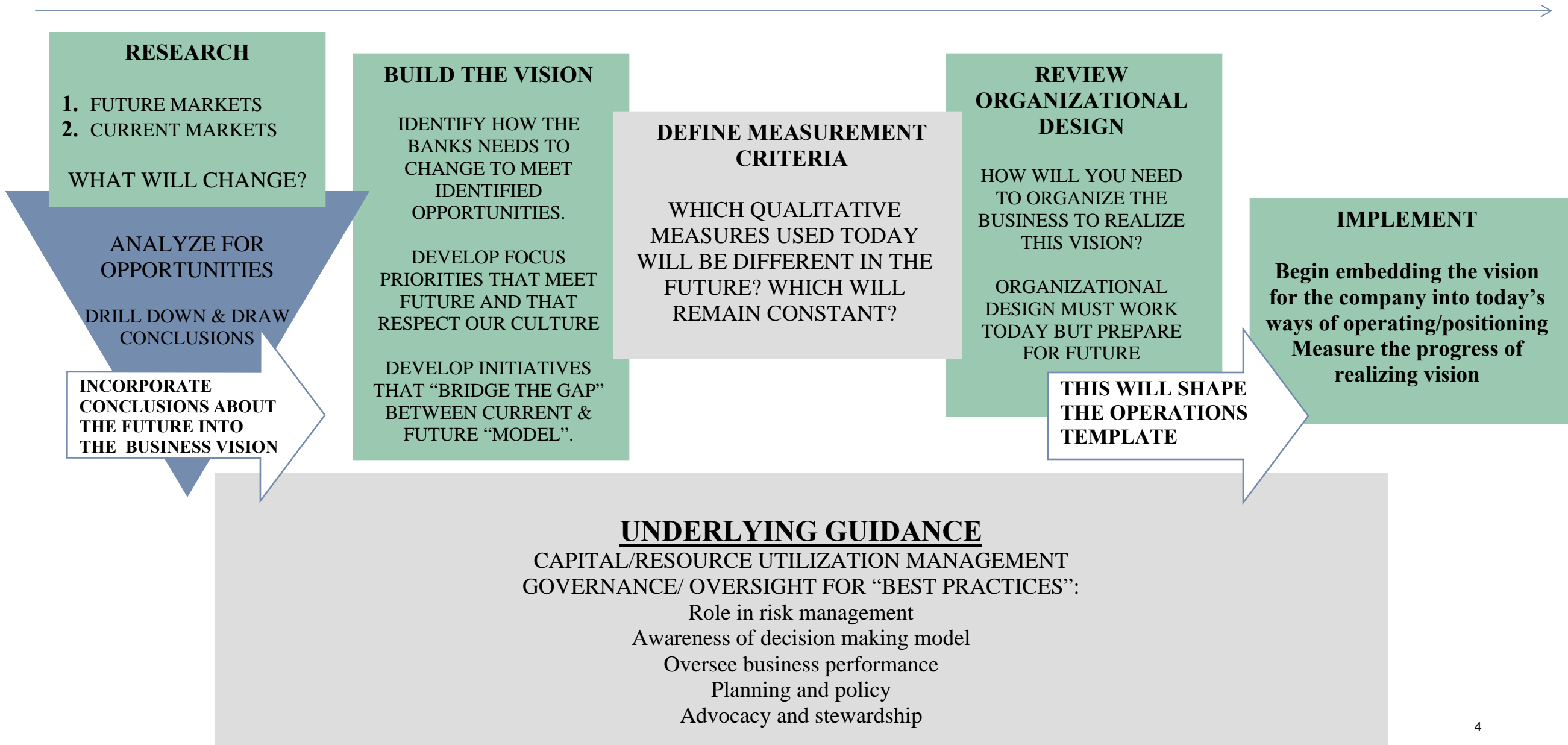


Key Points for Board Governance “Best Practices”

- Ask questions/Be informed
- Translate your experiences/knowledge into advice/counsel
 - Work “on” the business/ not “in” the business
 - Understand the “big picture”
 - Know the industry “language”
- “Support and guide” versus “compete and manage”

BOARD GOVERNANCE: UNDERSTANDING THE VISION FOR THE BANK

-an important element of Board Governance



The Bank's Strategic Plan Implementation Flowchart

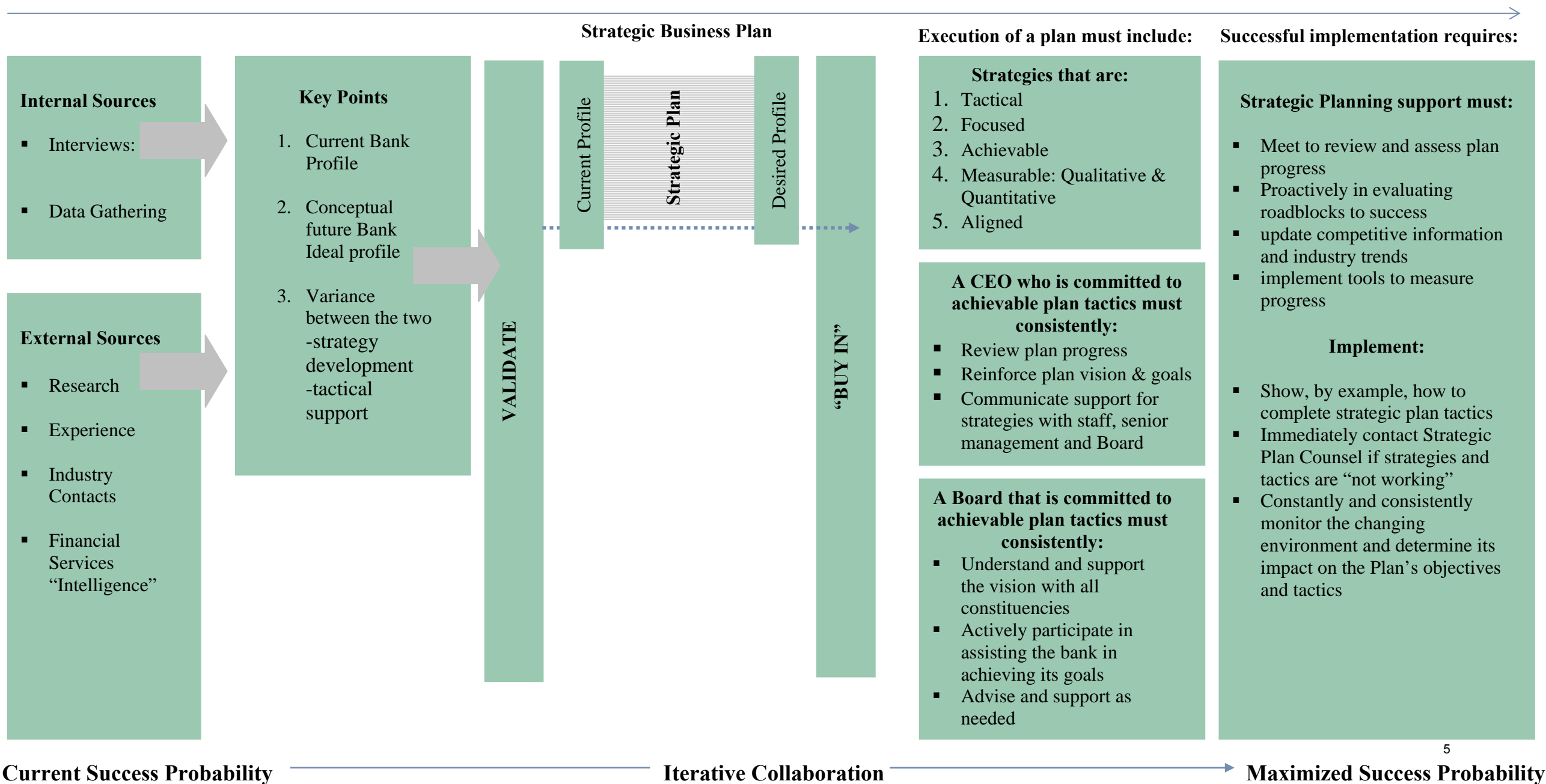
STEP 1: DISCOVER

STEP 2: ANALYZE

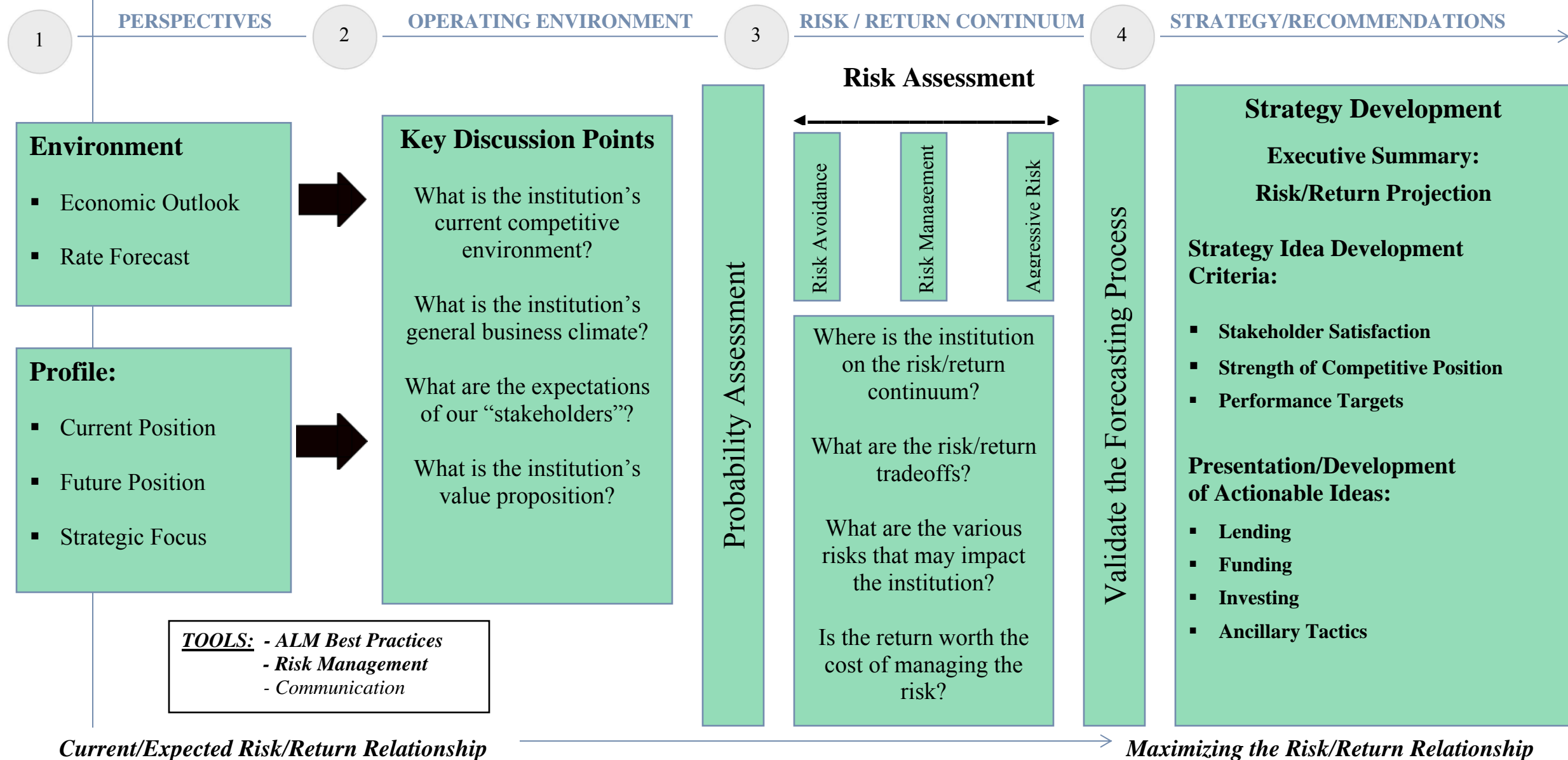
STEP 3: CREATE

STEP 4: IMPLEMENT

STEP 5: MONITOR



“Best Practices” Approach to Balance Sheet Management





Rate Environment

1. Current Economic Environment
2. Current Rate Environment
 - a. Shape
 - b. Height
3. Anticipated Rate Environment
 - a. Shape
 - b. Height
4. Rationale Underlying Anticipated Environment
 - a. How likely?
 - b. What could alter forecast?

Environment

- Economic Outlook
- Rate Forecast



EPG Perspectives

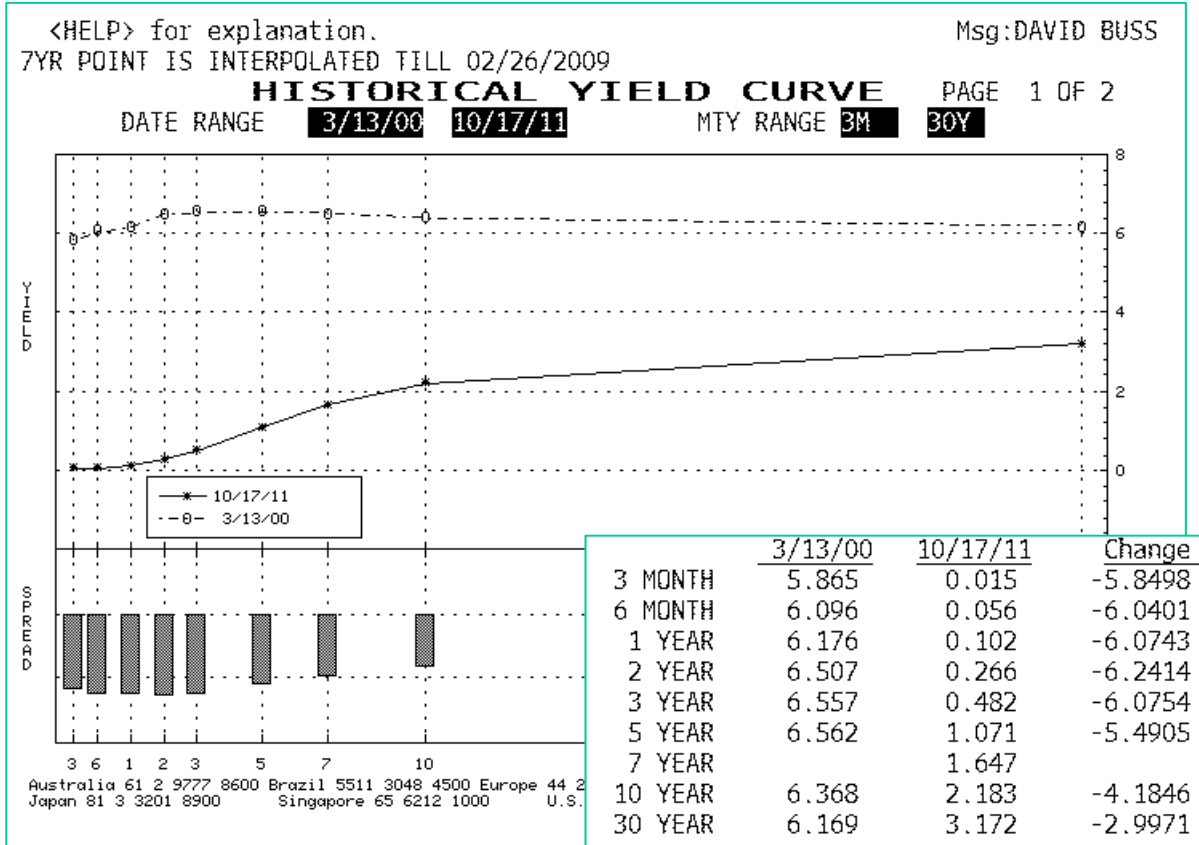
October 17, 2011

1. **GLOBAL:** Economic growth uncertainty and European debt woes abate as equities churn after dropping 15% from peaks. European leaders promise “meaningful” plan by month end to forestall looming debt crisis. Forecasts for US growth have shifted to 2% or significantly lower for the next 12 months. Risk of “no growth” high. US debt- limit/budget deal accord to limit future growth prospects.
2. **EMPLOYMENT:** Unemployment weekly claims hover near 400,000 and employers added 100,000 jobs in September. The unemployment rate held at 9.1%. Productivity collapse implies some job growth yet unemployment likely stuck above 9% next year.
3. **CONSUMER:** Consumer spending appears to be stabilizing somewhat in September. Consumers had proved extremely resilient during this recovery *although* limited income growth and diminished confidence is capping total consumer spending.
4. **HOUSING:** Residential and non-residential construction well below weakest levels compared to prior recoveries. Supply continues to exceed demand and prices move lower. “Shadow inventory” weighs on market. Negative near term impact on growth.
5. **ECONOMIC GROWTH:** Q2 GDP revised up slightly to 1.3% revisions going back to 2003 show recession was worse and recovery weaker than previously reported. Risks rise for growth to slow below 2% during second half as limited payroll growth and a weak housing market weigh on the economy. Confidence falters. Most likely growth to average 1%-2% with continued risks to the downside.
6. **INFLATION:** CPI at 3.8%; Core at 2%. Core inflation appears to have drifted to the Fed’s target of 2%. Headline inflation to converge on core.
7. **FED:** Fed continued to hold rates at “0” at September meeting. Announce plan to sell \$400bn in treasuries five years and under and purchase longer-term bonds. Fed focused on assuring recovery is sustained; attempting to “cap” long rates. Will reinvest agency bonds and MBS in same sector.

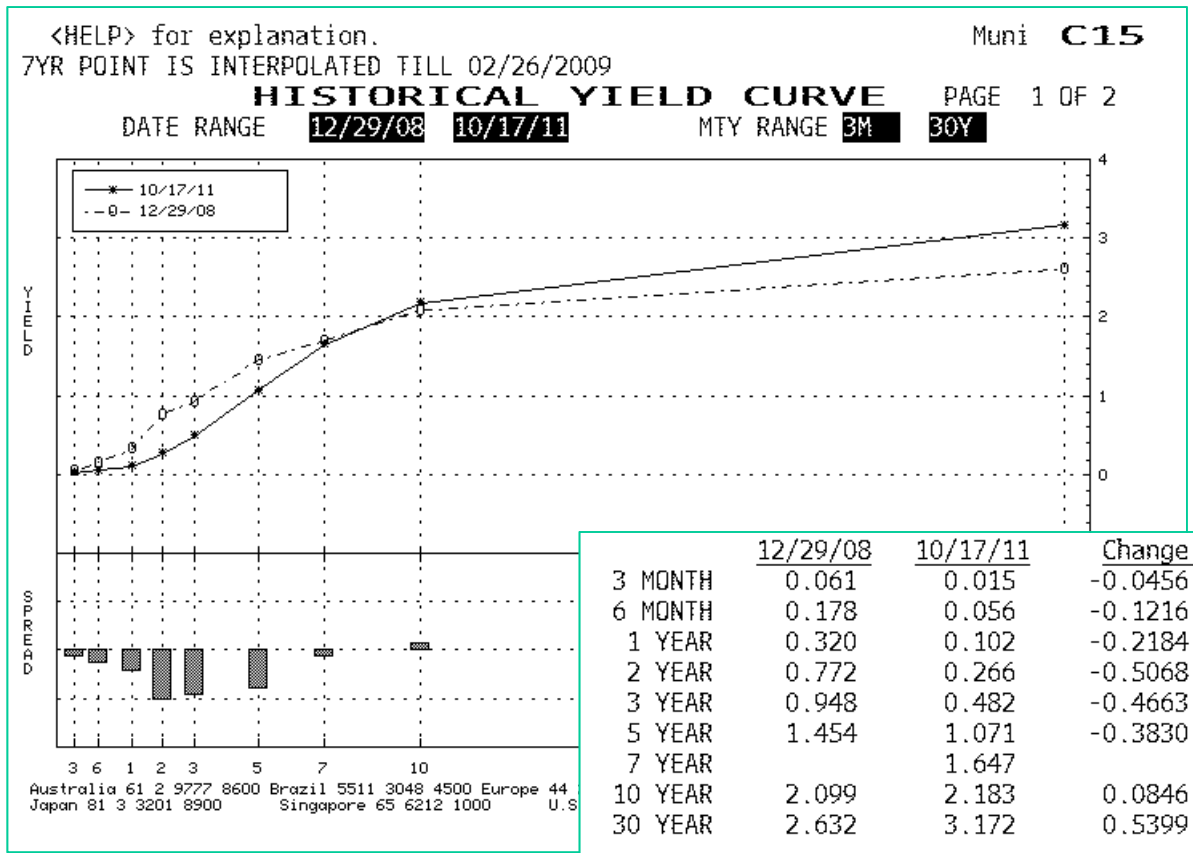
INTEREST RATES

1. **FED:** held short rates at (0-25bp) in September. Announce “Operation twist” to cap long rates. Two year commitment to unchanged fed funds rate will keep rates exceptionally low through mid-2013.
2. **YIELD CURVE:** averaging 255bp over past months; now closer to 190. The *10-year treasury* drops briefly to 1.70% on “operation twist” and on stock market flight to quality; now at 2.20%- the 2yr at ~30bp and 5yr at ~1.10%. Flattening of the yield curve and absolute yield drop put pressure on future NII.
3. **STRATEGY:** at middle of range near 2.2% with **10-yr now capped below 3 %**; get more aggressive at these levels focusing on cash flowing 10-20yr MBS and select 6 year bullets; barbell with MUNI 15-20yr which have cheapened versus treasuries (TEY 4.25-5%).

Historic Yield Curve: Recent High



Historic Yield Curve: Recent Low





Business Plan Summary

1. Confirmation of Business Plan Priorities (2 years)
2. Measurement Criteria
3. Goals
 - a. ROA
 - b. Assets
 - c. B/S Composition
 - d. ROE
 - e. Reach
4. Current Position
5. Expected Position (1 year)

Key Discussion Points:

What is the institution's current competitive environment?

What is the institution's general business climate?

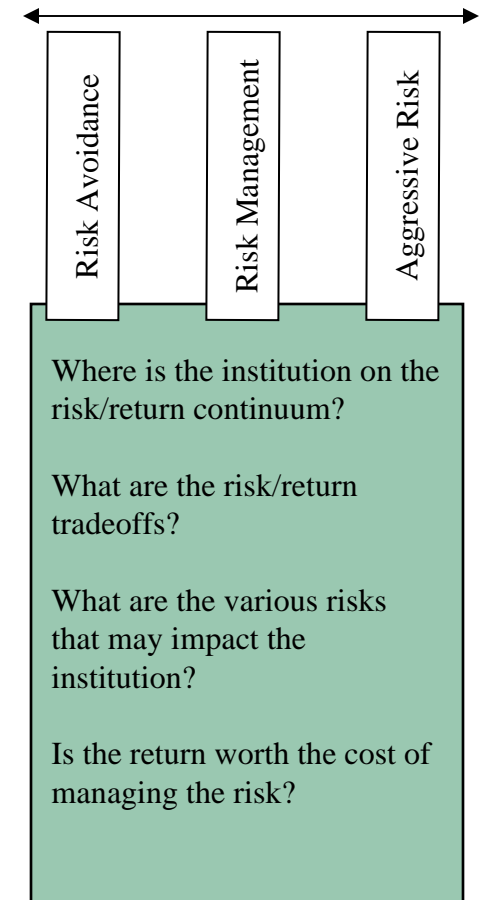
What are the expectations of our "stakeholders"?

What is the institution's value proposition?



Risk Management:

1. What are our current risk positions?
(risks in areas such as credit, interest rate, liquidity, price, transaction, compliance, strategic, reputation)
2. Are they acceptable?
 - a. Yes: Move to opportunity/profitability discussion
 - b. No: Need to develop and implement corrective measures and/or rationale for risk positions





Profitability/Strategy Development

1. Anticipated Profit Picture
2. Is there a variance that exists between projected and desired outlook?
3. Is this trade-off desired? Is it manufactured?
 - a. No: What are the strategies that can lead us to a trade-off more consistent with where we want to be?
 - 1.) Evaluate risk -vs.- return

Strategy Development

Executive Summary: Risk/Return Projection

Strategy/Idea Development Criteria:

- Stakeholder satisfaction
- Strength of competitive position
- Performance Targets

Presentation/Development of Actionable ideas

- Lending
- Funding
- Investing
- Ancillary tactics

Actionable Strategies

PREVENTATIVE

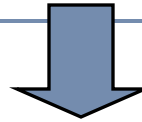
Obtaining an optimal risk/return profile is challenging. Once achieved, how do you maintain strong, consistent earnings? How do you prevent an earnings drop off or shift to unacceptable risk?

CORRECTIVE

How do you fix a problem in the most prudent manner?
Improve Earnings?
Lessen IRR?
Reduce Regulatory Pressure?

PROACTIVE

How to enhance performance:
Increase earnings
Leverage Capital
Introduce new products
Test pricing sensitivity



STRATEGY DEVELOPMENT CRITERIA:

Stakeholder Satisfaction

Strength of competitive position

Performance Targets

DEVELOPMENT OF ACTIONABLE IDEAS:

Lending

Funding

Investing

Ancillary tactics



Profitability/Strategy Development: Steps

1. First, ensure that, as part of ongoing business plan implementation, all other income/other expense opportunities have been fully exploited.
2. Identify target shortfall or expectation that these strategies will achieve in dollar terms.
3. Identify “non-negotiable” parameters to work within, including interest rate risk limits, capacity issues, market limits, capital, etc.
4. Prioritize the most attractive asset opportunities by coupon/income and duration available to you.
5. Prioritize the most accessible asset opportunities based on current market research.



Profitability/Strategy Development: Steps

6. Identify techniques that will be used for the coming period to acquire assets such as enhanced marketing initiatives, well priced loan calculation, participations, “build/buy/partner”, or buy whole loan product.
7. Calculate likely funding source beginning with retail (customer) and list in terms of cost and duration (see pricing calculator handout).
8. Identify available wholesale/alternative funding opportunities with similar duration.
9. Analyze the tradeoff between anticipated interest rate risk exposure and return as a result of achieving new business.
 - a. Confirm the optimal mix of new asset/funding and create tactics with committee to realize goal.



Funding Strategy Calculator

What are Appropriate Costs & Terms of New Funding?

PRODUCT NAME: _____

DATE: _____

NEW PRODUCT TERMS:

1) How much in New Funds? \$ 2) What interest rate on new funds? %
Initial expense of New product?
\$

MIGRATION IMPACT:

3) How much funds from existing products will shift to new product? \$ 4) Average cost of shifting funds? %
5) Cost differential (#2 - #4) %
Incremental migration expense of new product?
\$

TOTAL AMOUNT IN PROGRAM: \$

Total expense of new deposit program

\$

Total cost of new program

%

6) Equivalent FHLB Advance Bullet Term? _____ (Compare term to proposed new product for appropriateness)

7) Miscellaneous Notes: _____



Profitability/Strategy Development: Targeted New Business

1. Determine the likely assets that will be booked in the coming quarter:
 - a. Determine the mix of different products and the percent each product occupies;
 - b. Create a weighted average life/duration forecast for the identified asset mix;
 - c. Determine the weighted average coupon that the mix represents; and,
 - d. Apply the weighted average duration and coupon to the targeted net asset figure representing the expected new business for the quarter.

Note: A comprehensive quarterly asset/liability modeling discipline will help ensure that the iterative strategies undertaken will be aligned with and benchmarked against the institution's overall, comprehensive outlook from both a risk and return standpoint.



Current Investment Alternatives: Approximate Yield Calculations as of 10/17/11

The following presents general investment alternatives sorted by yield/maturity characteristics:

<u>Yield</u>	<u>Maturity</u>	<u>Security</u>	<u>Considerations / Risks</u>
4.25-5%	20 yr	AAA/AA municipals (Build America Bonds (Taxable)/BQ	Maturity/Credit
3.50%	15 yr	AAA long-term callable	Maturity/Price, Historic Low yield
2.75%	30 yr	AAA whole loan private CMO (not government backed/implied)	Potential credit losses
3.25%	30 yr	AAA Agency MBS	Extension risk-low yield
3.10%	10 yr	AAA Callable Agency (NC 1 yr)	Historic low yield
2.75%	20 yr	AAA Agency MBS	Cash flow assumptions
2.35%	15 yr	AAA Agency MBS	Cash flow assumptions
1.85%	10 yr	AAA Agency MBS	"Lower coupon"
1.60%	5 yr	AAA 5 year Callable	Low yield given structure
1.15%	30 yr	AAA 3/1 ARM GNMA	Only 1% annual cap
0.90%	3 yr	AAA 3/1 One-time Call	Low yield
1.30%	8 yr	AAA Agency Seasoned CMO	2-3 yr average life
1% / 1.50%	1 yr / 5 yr	AAA Callable Step-up	Call uncertainty
~60-75bp	30 yr / mthly	AAA Agency/GSE Floaters-CMO (reset to 1 mo. "libor" changes)	Long final, low spread
40-65bp	2-3 yr	AAA Agency Bullets	Low yield

The above listing represents current yields and/or spreads associated with alternative investments that meet current risk/return profile criteria/investment policy guidance. While these are not all alternatives that are recommended, they provide a broader view of available alternatives.



Profitability/Strategy Development: Targeted New Business

2. Determine the likely liability mix which will fund the anticipated assets for the that you are targeting for the coming quarter:
 - a. Determine actual mix of funding sources that will make up the overall funding;
 - b. Determine the weighted average life/duration of the funding mix; and,
 - c. Determine the weighted average cost/interest rate on the “basket” of funding.

Note: A comprehensive quarterly asset/liability modeling discipline will help ensure that the iterative strategies undertaken will be aligned with and benchmarked against the institution’s overall, comprehensive outlook from both a risk and return standpoint.

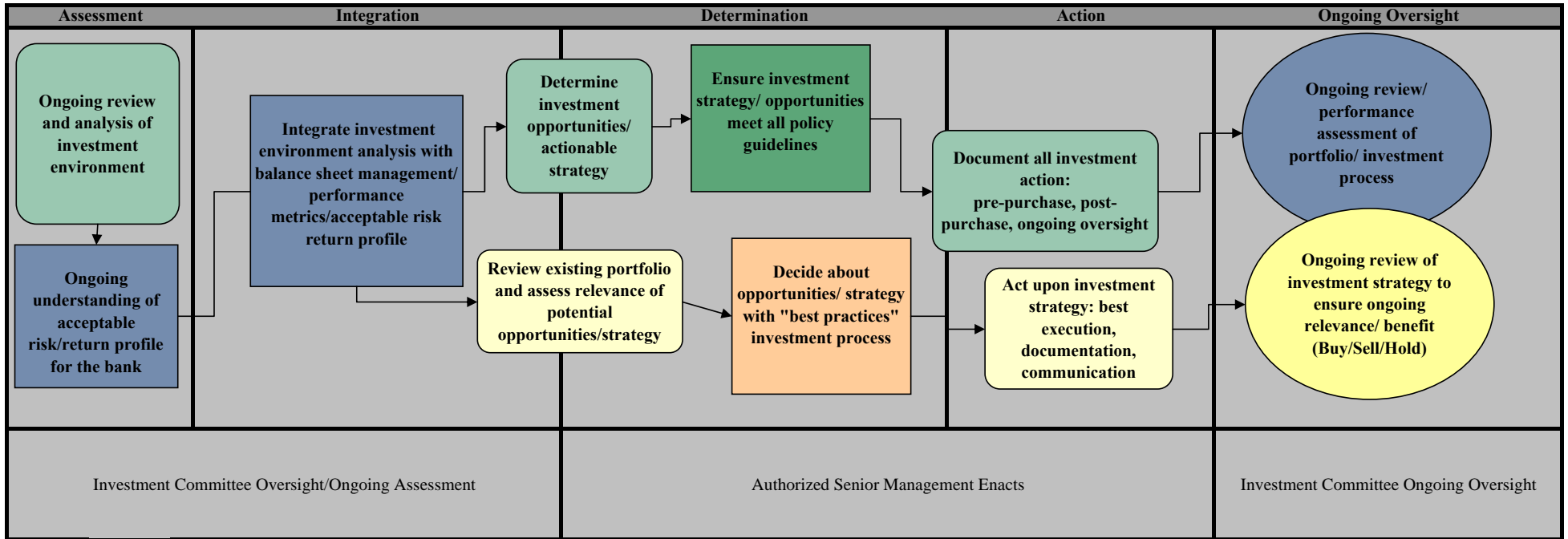


Profitability/Strategy Development: Targeted New Business

3. Understand the “spread to worst” and “most likely spread” based on the following discussion points:
 - a. Life of the asset mix and yield - the “basket” of assets forecasted next quarter
 - b. Project the number of times the funding will “roll”
 - c. The likely behavior in terms of how the funding could reprice

Note: A comprehensive quarterly asset/liability modeling discipline will help ensure that the iterative strategies undertaken will be aligned with and benchmarked against the institution’s overall, comprehensive outlook from both a risk and return standpoint.

BANK INVESTMENT "BEST PRACTICES" FLOWCHART



COMPONENT PRACTICES FOR INVESTMENT ACTIVITIES

Board Governance: INVESTMENT ACTIVITIES

SECTION I - Purpose and Contents		
General		
This section should give a brief overview outline of the policy formalized and accepted by the Board of Directors as well as a brief statement about the purpose of the investment activities. A listing of key aspects should be provided.		
Key elements the Policy Statement should stress are:	Compliant	Notes on How Compliance is Achieved
I.) Purpose and Contents		
II.) General Policy Statement		
III.) Structure of Accountability		
IV.) Securities and Derivatives (fasb 115)		
V.) Statement of Accounting Standards (fasb 133)		
VI.) Risk Management		
VII.) Acceptable Investment Practices		
VIII.) Unacceptable Investment Practices (fasb 115)		
IX.) Portfolio Diversification and Quality		
X.) Approved Securities Dealers		
XI.) Investment Authority		
XII.) Reg f Filing		
XIII.) Compliance With Regulatory and Accounting Principles		
XIV.) Investment Management Strategies		
XV.) Audit Policy		
XVI.) Staff Training		
XVII.) Retention of Documentation		
List Effective Date and Required Participation	Compliant	Notes on How Compliance is Achieved
1.) Effective date of the Policy		
2.) In general terms what segments of the organization are responsible		

COMPONENT PRACTICES FOR INVESTMENT ACTIVITIES

SECTION II - General Policy Statement		
This general summary of the Policy Statement should provide guidance and sound principles for the Banking Organization's Directors, Management and Staff for managing investment and derivative activity. It should clearly reinforce the importance of Board of Director oversight, Management supervision, the role of investments in the bank overall operations, as well as in general terms outline rules governing enforcement and exceptions.		
Key elements the General Policy Statement should stress are:	Compliant	Notes on How Compliance is Achieved
1.) Underscore the importance of Board of Director oversight and Management Supervision.		
2.) Reinforce and emphasis the requirement for effective Risk management.		
3.) Describe the Bank's primary business direction and the position investments plan in that plan.		
4.) A listing of the Primary Objectives of the Bank's Investment Strategy.		
5.) Overview outline of Management's essential responsibilities including:		
a.) Principal preservation		
b.) Defining cash flow		
c.) Necessary Credit information		
d.) Size and concentration of investments		
e.) The eligibility of investments as collateral for public deposits and borrowings		
f.) Marketability of investments		
6.) Enforcement		
a.) Who has responsibility and authority to make policy changes		
b.) Approval authority		
c.) Describe those who have primary enforcement responsibility		
d.) Reinforce the need to maintain current legal and regulatory requirements		
7.) Outline the methodology for making exceptions to the policy:		
a.) Exception requests must be to specific items		
b.) How they should be submitted		
c.) Approval process		
8.) Communicate the need for adequate risk management programs, measurement, monitoring, and control of these risks.		
9.) Reinforce that the failure to understand and adequately manage investment activity risks are unsafe and unsound practices.		

COMPONENT PRACTICES FOR INVESTMENT ACTIVITIES

Section III - Structure Of Accountability		
Board Oversight		
Board oversight is vital to effective investment risk management, and the board has very specific investment activity responsibilities. The board should:	Compliant	Notes on How Compliance is Achieved
1.) The board should adopt policies that establish guidelines for management and periodically review management's performance.		
2.) Approve broad goals and risk limits.		
3.) Adopt major investment and risk management policies.		
4.) Understand the approved investment activities.		
5.) Ensure competent investment management.		
6.) Periodically review management's investment activity.		
7.) Require management to demonstrate compliance with the board's goals and risk limits.		
8.) Mandate an independent review program and review its findings.		
General Management Oversight		
Management is responsible for daily oversight of all investment activity. Management should:	Compliant	Notes on How Compliance is Achieved
1.) Establish policies, procedures, and risk limits to achieve the board's goals.		
2.) Implement operational policies that establish a strong internal control environment.		
3.) Understand all approved investment activities and the related risks.		
4.) Identify, measure, monitor, and control investment activity risks.		
5.) Report investment activity and risks to the board.		
6.) Ensure that its staff is competent and adequately trained.		
7.) Adhere to securities broker/dealer selection policies.		
Other Board and Management Responsibilities		
A.) Investment Strategies	Compliant	Notes on How Compliance is Achieved
Management should employ reasonable investment strategies to achieve the board's portfolio objectives. Investment strategies should be based on and consistent with the following:		
1.) Management must understand the board's goals, applicable risk limits, and related instruments and markets.		
2.) Overall strategic goals.		
3.) Capital position.		
4.) Asset/liability structure.		
5.) Earnings composition.		
6.) Competitive market position.		

COMPONENT PRACTICES FOR INVESTMENT ACTIVITIES

B.) Delegation of Investment Authority	Compliant	Notes on How Compliance is Achieved
Investment authority may be delegated to a third party, with specific board approval. Management must understand every investment's risk, return, and cash flow characteristics. To conduct its independent analysis, management may rely on information and industry standard analysis tools provided by the broker/dealer, provided that:		
1.) The analysis uses reasonable calculation methods and assumptions.		
2.) Management understands the analysis and assumptions.		
3.) Management's investment decisions remain independent.		
Before delegating investment authority to a third party, management should thoroughly evaluate the third party's reputation, performance, creditworthiness, and regulatory background. Any third party arrangement should be governed by a formal written agreement encompassing the following:		
1.) Compensation.		
2.) Approved broker/dealers.		
3.) Investment goals.		
4.) Approved activities and investments.		
5.) Risk limits.		
6.) Risk and performance measurement.		
7.) Reporting requirements.		
8.) Settlement practices.		
9.) Independent review.		
10.) Requirement that all trade invoices, safekeeping receipts, and investment analyses are readily available to the bank.		

COMPONENT PRACTICES FOR INVESTMENT ACTIVITIES

C.) Program Periodic Evaluation		Compliant	Notes on How Compliance is Achieved
Periodically, the board and management should evaluate the risk management program to ensure that its investment activities reasonably meet the board's goals and the bank's strategic needs. The basis for these examinations should be as follows:			
Board Periodic Review Responsibilities		Compliant	Notes on How Compliance is Achieved
a.) Annual evaluations should be sufficient, quarterly (or more frequent) evaluation may be necessary.			
b.) The board should review management's reports, including an investment activity summary, portfolio risk and performance measures, and independent review findings to identify broad weaknesses and determine if			
(1.) Stated goals accurately represent the board's objectives.			
(2.) Risk limits properly reflect the board's risk tolerance.			
(3.) Risk limits reasonably protect the bank's safety and soundness.			
(4.) Management has appropriately pursued the board's goals.			
(5.) Internal controls remain adequate.			
(6.) Any new activities are warranted.			
(7.) Policies provide sufficient guidance for management.			
c.) The board should first consider the bank's current and expected condition, competitive environment, and strategic plans.			
(1.) Reassess its portfolio goals to ensure that they do not conflict with the overall strategic plan.			
(2.) When necessary, adjust its portfolio goals.			
d.) After evaluating its goals, the board should then affirm that the existing risk limits accurately reflect the board's risk tolerance. Then consider the following if necessary:			
1.) Consider either relaxing or tightening the risk limits placed on management			
2.) Review and discuss the effects of accepting increased or reduced risk			
3.) consider if increased or diminished risk would produce satisfactory returns.			
e.) Evaluate management's performance which should encompass the following:			
(1.) Management's success at achieving the board's goals.			
(2.) Adherence to policies and risk limits.			
(3.) Maintenance of an effective control environment.			
(4.) Determine the cause of any material deficiencies and obtain management's commitment to rectify those deficiencies.			
f.) Determine if any changes to its policies are warranted.			
Management Periodic Review Responsibilities		Compliant	Notes on How Compliance is Achieved
Management should review the portfolio management program frequently in more detail to identify both broad and specific weaknesses. Managements responsibilities include:			
a.) Measuring portfolio risk and performance.			
b.) Validating risk measurement systems' adequacy and accuracy.			
c.) Reporting portfolio activity and performance to the board.			
d.) Adjusting investment strategies to better achieve the board's goals.			
e.) Correcting policy and regulatory exceptions.			

COMPONENT PRACTICES FOR INVESTMENT ACTIVITIES

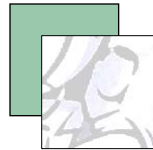
Board of Directors and Senior Management Oversight of Risk Management	Compliant	Notes on How Compliance is Achieved
The policy should clearly communicate that these individuals are aware of their responsibilities and adequately perform their roles in managing and overseeing the risks associated with nontrading activities involved with securities and derivative instruments.		
Board of Directors	Compliant	Notes on How Compliance is Achieved
1.) The Board should be required to approve overall significant risk strategies including securities and derivatives		
2.) Specifically the Board should:		
a.) Approve managerial oversight and articulate risk tolerances and exposure for securities and derivative activities		
b.) Monitor the performance and risk profile of the institution's investments		
c.) Be provided sufficiently detailed and timely information for understanding and assessing credit, market, and liquidity risks for the investments		
d.) Reviews should be conducted at least quarterly (more frequently involving significant positions for complex investments)		
e.) Provision made for the Board to periodically review:		
(1.) Institution's business strategies		
(2.) Significant risk management policies and procedures		
(3.) The institution's financial objectives and risk tolerances		
3.) Board minutes along with presentation materials and reports should communicate the board's adherence to these responsibilities		
4.) Board should promote dialog with management and others involved in investments for risk management process and exposure		
5.) Ensure the board has appropriate access to independent legal and professional resource advice on the securities and derivative holdings and strategies as well as to evaluate recommendations presented by management or investment advisors		
6.) Their knowledge as well as management's should be commensurate with the size and complexity of the portfolio investments		
Senior Management	Compliant	Notes on How Compliance is Achieved
1.) Senior management's major responsibilities are to ensure that adequate policies and procedures are maintained for conducting investment and end-user activities for long term and on a daily basis. Specifically they should:		
a.) Maintain clear lines of authority and responsibility for acquiring investment instruments		
b.) Managing risk		
c.) setting appropriate limits on risk taking		
d.) Creating systems for measuring risk		
e.) Provide systems for measuring risk		
f.) Setting standards for valuing positions and measuring performance		
g.) Establish effective internal controls as well as comprehensive risk reporting and risk management review		
2.) Management should demonstrate understanding of the institution risk profile		
3.) Create reports that provide adequate information for evaluating the sensitivity of investments to changes in credit quality, market prices and rates, liquidity positions and other key risk factors		
4.) Establish periodic review of risk procedures for safety and soundness continuity		
5.) Encourage and be involved in staff discussions about risk, risk measurement and reporting		
6.) Ensure sufficient depth in staff resources to management the risk process		
7.) Provide for sufficient back office and financial control resources to manage and control risk		

COMPONENT PRACTICES FOR INVESTMENT ACTIVITIES

SECTION - IV ACCEPTABLE INVESTMENT PRACTICES		
<p>The Board is responsible for adopting comprehensive written policies that clearly communicate their investment goals and risk tolerance. These policies should be tailored to the bank's needs, size and situation and In this section the following should be included in establishing the policies:</p>		
The Board's investment goals	Compliant	Notes on How Compliance is Achieved
a.) If investments are to be considered a secondary source of income this should be stated.		
b.) If the objective is for investments to be a major provider of income the expectations should be delineated and explained.		
c.) In addition to purpose, the Policy should articulate the risk limits and return goals.		
d.) Express the Board's earnings objective for the portfolio.		
e.) Portfolio performance targets should be described.		



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