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Comptroller of the Currency  
Administrator of National Banks

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THE ROLE  
OF A NATIONAL  
BANK DIRECTOR

THE  
**DIRECTOR'S**  
**BOOK**

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Office of the Comptroller of the Currency  
Washington, D.C.

March 1997

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THE DIRECTOR'S BOOK: THE ROLE OF THE  
NATIONAL BANK DIRECTOR

by the Office of the Comptroller of the Currency

March 1997

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# PREFACE

A bank's board of directors plays a critical role in the successful operation of the bank. The health of a bank depends on a strong, independent, and attentive board. Bank directors are ultimately responsible for the conduct of a bank's affairs. They also are accountable to the bank's shareholders as well as its depositors, regulators, and the communities served by the bank.

The Office of the Comptroller of the Currency (OCC), the agency responsible for regulating national banks, recognizes the challenges facing both current and future bank directors. The OCC is providing this book as an aid to help bank directors fulfill their duties in a prudent manner. It contains general concepts and standards for the safe and sound operation of a bank and summarizes various laws and regulations of which directors should be aware.

The first edition of *The Director's Book* was published in 1987. It received praise from the banking industry for providing reasoned guidance to bank directors. This edition updates that guidance to reflect legal and regulatory changes occurring since 1987 and also changes in the OCC's approach to supervising national banks. Directors should tailor the guidance in this book to reflect the size, scope of operations, and risk profile of the bank on whose board they serve.

The guidance in this book does not constitute a legal opinion that conduct consistent with it protects a director from liability. Conversely, conduct inconsistent with such guidance will not necessarily result in violation of the law and possible liability. Instead, directors are encouraged to review their responsibilities and conduct on an ongoing basis and to seek advice from counsel as necessary.



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# 1

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## THE BOARD OF DIRECTORS

IMPORTANCE OF THE BOARD  
BOARD COMPOSITION  
THE BOARD AND THE OCC  
THE BOARD'S ROLE IN RISK MANAGEMENT  
THE BOARD AND OTHER REGULATORS

### IMPORTANCE OF THE BOARD

A national bank, like other corporate organizations, has shareholders who elect a board of directors. A bank's board of directors oversees the management of the bank's activities. Directors must exercise reasonable care when guiding the bank's affairs and must consider the bank's interests before their own.

Bank directors face unique challenges because banks differ from other corporations. Although banks, like other corporations, use their capital to support their activities, most of the funds banks put at risk belong to others, primarily depositors. Banks loan and invest customers' deposits to earn a profit and a reasonable return to shareholders and to meet the credit needs of the community. Generating a return to the shareholders with depositors' funds creates the framework for determining the risks that a bank can prudently undertake. Properly managing risk to serve these interests is a critical challenge faced by the board and bank management.



Directors of a national bank are accountable not only to their shareholders and depositors but also to their regulators. Banks are regulated in part because Congress provides for federal insurance of deposits while also subjecting banks to regulatory oversight. The risks inherent in the business of banking, the safety net provided by deposit insurance, and the importance to the nation's economy of a safe and sound banking system make this oversight appropriate.

The long-term health of a bank depends on a strong, independent, and attentive board. A board sets the overall tone and direction of the bank and establishes guidelines on the nature and amount of risk the bank may take. The board oversees and supports management's efforts, reviews management's recommendations before approving or rejecting them, and makes sure that adequate controls and systems exist to identify and manage risks and address problems. In difficult economic times, an active, involved board can help a bank survive. During these times, the board must evaluate bank problems, take appropriate corrective actions, and, when necessary, keep the bank operating until the board ensures that effective management has been reestablished and the bank's problems have been resolved.

The board's familiarity with the bank's systems and controls, as well as the volume and complexity of the controls, should be appropriate to the bank's size, the nature and scope of its operations, and its risk profile. For example, the board of a smaller, noncomplex bank would not necessarily need to be as familiar with more sophisticated bank products (which are not offered by that bank) as would the board of a larger, more complex bank. Similarly, the issues that the board will become involved with at a bank will probably be dictated by the nature and scope of the bank's operations.

A board should evaluate its effectiveness periodically and determine whether or not it is taking the steps necessary to correct deficiencies. The board should review how well its committees are meeting their responsibilities. Bank counsel, auditors, or other advisors can often assist the board in these efforts. The bank's examiners will review how

well the board meets its responsibilities and will make recommendations for improvement if they find weaknesses.

A board should consider orientation programs for new directors. These programs should explain the operation of the bank and the banking industry, and clearly outline the responsibilities of board members both individually and as a group. Ongoing education programs that describe emerging industry developments, opportunities, and risks also are often helpful.

## BOARD COMPOSITION

A board's effectiveness depends in large part on how well its members work together to identify and address issues important to the bank's future. A national bank must have at least five, but no more than 25, directors. Within these limits a bank's board and its shareholders will establish the number in the bank's bylaws.

Membership on a bank's board gives a person a valuable opportunity to share his or her expertise with the bank, help the community, and advance professionally. The position is prestigious, identifying the incumbents as trusted and respected members of the communities in which the bank operates. At the same time, a well-respected individual's alliance with a bank may lend stature to the institution. Board membership is also an opportunity to contribute to the local economy's growth and development.

Typically, a board includes both individuals who are bank officers and/or employees (called "management" or "inside" directors) and "outside" directors who are neither officers nor employees of the bank. Outside directors bring with them experiences from their fields of expertise. These experiences provide perspective and objectivity when overseeing bank operations and evaluating management recommendations.

When searching for new bank directors, banks should seek individuals who will exercise independent judgment and who will actively

participate in decision making. The principal qualities of an effective bank director include strength of character, an inquiring and independent mind, practical wisdom, and sound judgment. Some boards establish additional criteria to supplement these attributes. These may include individual qualifications such as technical skills, career specialization, or specific backgrounds. Such criteria may change over time if, for example, the bank plans to offer new products or services or expand beyond current markets.

The board's nominating procedures can help it identify and retain qualified directors. Many banks nominate directors based on their independence, diversity, technical qualifications, and capabilities. Many directors are also selected because of their position in the community or their relationship to the bank (for example, a large shareholder).

Prospective directors should determine whether the bank's board actively oversees bank operations. If directors, including outside directors, are not encouraged to actively contribute and participate in board discussions, prospective directors should weigh this carefully against their prospective responsibilities and corresponding potential liabilities when deciding whether to serve.

In most cases individuals who are nominated as national bank directors can serve in that capacity immediately after they are approved in accordance with the bylaws. If the bank is not in compliance with minimum capital requirements, is in a troubled condition, or is in noncompliance with a directive to correct a problem promptly, however, the bank must file a notice with the OCC about proposed new directors before they can serve on the board. The OCC also may object to proposed directors of new banks during the first two years the bank is in business.

When prior notice is required, the OCC will conduct background checks and review these proposed directors. The OCC has 90 days to disapprove the nomination of a proposed new board member.

In summary, the qualifications of a candidate seeking to become a member of the board of directors of a national bank include:

- ❑ Basic knowledge of the banking industry, the financial regulatory system, and the laws and regulations that govern the operation of the institution.
- ❑ A willingness to put the interests of the bank ahead of personal interests.
- ❑ A willingness to avoid conflicts of interests.
- ❑ Knowledge of the communities served by the bank.
- ❑ Background, knowledge, and experience in business or another discipline to oversee the bank.
- ❑ A willingness and ability to commit the time necessary to prepare for and regularly attend board and committee meetings.

#### ADVISORY DIRECTORS

Some institutions supplement their boards with advisory directors, also known as associate directors, honorary directors, and directors emeriti. Advisory directors may serve the board, directly or indirectly, through an advisory board. These individuals provide information and advice but do not vote as part of the board.

A board with advisory directors generally brings a broader perspective to a bank. Advisory directors are often former directors of newly purchased banks and may represent a large constituency of customers or communities that are not otherwise represented on the board. A bank may use advisory directors in the following situations:

- ❑ When the operations of the bank are geographically dispersed and the board wants input from more segments of the communities served by the bank.

- ❑ When the board itself is small and the directors want direct involvement with a broader array of community leaders.
- ❑ To assist in business development.
- ❑ To gain access to special expertise to assist the board in its planning and decision making activities.
- ❑ To help identify likely candidates for future board openings.

Because of their limited role, advisory directors generally are not liable for board decisions. The facts and circumstances of a particular situation, however, as well as whether an advisory director functions in effect as a full director, are likely to determine whether an advisory director may have liability for individual decisions, including factors such as:

- ❑ Whether advisory directors were elected or appointed.
- ❑ How advisory directors are identified in corporate documents.
- ❑ How advisory directors participated in board meetings.
- ❑ Whether advisory directors had voting authority or exercised significant influence on the voting process.
- ❑ How advisory directors were compensated for attending board meetings.
- ❑ Whether the advisory director had a prior relationship with the bank.

An advisory director who in fact functions as a full director may be liable for board decisions in which he or she participated as if that person were a full director. Individuals cannot shield their actions from liability simply by inserting the word “advisory” in their title.

# THE BOARD AND THE OCC

## SUPERVISORY ACTIVITIES

The OCC supervises national banks by conducting on-site examinations and by performing off-site monitoring. These activities help determine the condition of individual banks and the overall stability of the national banking system. The frequency of OCC on-site examinations will be determined by the bank's size, complexity, risk profile, and condition. These on-site examinations are conducted either annually or up to every 24 months (unless the bank is experiencing problems, in which case it may be examined more frequently).

Examiners will meet with bank management during the examination to obtain information or to discuss issues. When the examination is complete, the examiners prepare a report of examination and conduct a meeting with the bank's board of directors (except for some smaller affiliates of large banks, in which case the meeting may be conducted with the lead bank's board) to discuss the results of the examination. Directors then generally review and sign the report of examination.

An environment in which examiners and board members openly and honestly communicate benefits a bank. OCC examiners and office personnel have experience with a broad range of banking activities and can provide independent, objective advice on safe and sound banking principles and compliance with laws and regulations.

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AN ENVIRONMENT IN WHICH  
EXAMINERS AND BOARD MEM-  
BERS OPENLY AND HONESTLY

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Board members are encouraged to meet with OCC examiners to discuss the condition of the bank and the results of the examination. Some boards have chosen to meet with OCC examiners without management's presence. Directors should pay close attention and review carefully any written communications from the OCC. They should ask questions and raise issues of concern. They also should

assure themselves that the bank completes any specific follow-up actions in a timely manner.

The activities of OCC examiners, however, do not diminish the board's responsibilities to oversee the management and operation of the bank. Directors are independently responsible for knowing the condition of the bank and should not rely on the examiners as their sole source of information to identify or correct problems. Instead, the board should look to its senior management, its auditors, and other outside experts to identify and correct any problems.

#### APPEALS PROCESS

If the board of directors of a national bank disagrees with an OCC finding occurring during OCC's supervisory process, it should feel free to take advantage of the OCC appeals process. The appeals process is designed to resolve disputes in a fair, expeditious, amicable, and informal manner. The OCC ombudsman, who directs this process, reports directly to the Comptroller of the Currency and has responsibilities outside of normal bank supervisory activities.

Functioning as an independent advisor and decision maker, the ombudsman can accept appeals from boards of directors or others related to examination ratings, the adequacy of loan loss reserve positions, and classifications of loans that are significant to an institution. The ombudsman may not accept appeals related to the appointment of receivers and conservators, preliminary examination conclusions communicated to a national bank before a final report of examination is issued, enforcement-related actions or decisions, formal and informal rulemakings pursuant to the Administrative Procedures Act, or requests for information filed under the Freedom of Information Act.

The boards of directors of national banks are encouraged to contact the ombudsman to discuss any agency policy, decision, or action that may subsequently be appealed. The ombudsman will attempt to reach agreement to a dispute before it develops into a formal appeal.

## COMPLIANCE WITH LAWS AND REGULATIONS

A board of directors should be aware that, in addition to its supervisory responsibilities, the OCC enforces banking laws and regulations that apply to national banks. For example, it enforces compliance with the legal lending limit, which restricts the amount a bank may lend to a single borrower (or to related borrowers that are financially interdependent) to prevent undue concentrations of credit. Other banking laws include restrictions on loans to insiders and transactions with affiliates. These laws are intended to prevent the misuse of a bank's resources by such persons or companies.

Other laws and regulations include those designed to protect consumers or to facilitate broader law enforcement efforts. For example, the OCC administers compliance with the Equal Credit Opportunity Act, a law that requires banks to make credit decisions without discriminating on the basis of certain enumerated factors. The OCC also assesses a bank's performance under the Community Reinvestment Act (CRA) when deciding whether to approve a bank's application to open branches or to merge with another bank. The OCC's law enforcement efforts include examining for, and enforcing compliance with, the Bank Secrecy Act, a law to deter money laundering.

## REGULATION OF PROBLEM BANKS

If the OCC believes a bank has significant weaknesses, it may conclude that the bank requires additional or special supervision. In such cases the OCC usually monitors the bank more frequently. The OCC will work with the board and bank management to determine necessary corrective action so that the bank can be managed in a safe and sound manner.

A problem bank often possesses one or more of the following deficiencies:

- ❑ Ineffective or dishonest management.



- ❑ Unwarranted loans to officers, directors, or stockholders.
- ❑ An inordinate amount of low-quality assets.
- ❑ Insufficient capital.
- ❑ Inadequate internal controls.
- ❑ Inadequate policies and procedures.
- ❑ Earnings or liquidity problems.
- ❑ Significant medium- and long-term interest rate risk exposure.
- ❑ Failure of the board or senior management to understand the activities conducted by the bank.

## THE BOARD'S ROLE IN RISK MANAGEMENT

The OCC recognizes that banking is a business of taking risks in order to earn profits. Risk levels, however, must be appropriately managed and controlled. Indeed, a bank's safety and soundness is contingent upon effectively identifying and managing its risk exposures.

To manage risk effectively, a bank must have an informed board of directors that guides the company's strategic direction for managing risk. A key component of strategic direction is establishing the organization's risk tolerance. The board should endorse this risk tolerance by approving policies that set standards for the nature and level of risk the bank is willing to assume. These policies may be either oral or written.

After the board has adopted the framework within which the bank's tolerance for risk is to operate, it must ensure that its guidance is

being adhered to throughout the bank. Well-designed monitoring systems are the best way for the board to hold management accountable for operating within established tolerance levels.

Capable management and appropriate staffing are critical to effective risk management. Bank management is responsible for the implementation, integrity, and maintenance of risk management systems. Management must:

- ❑ Keep the directors adequately informed.
- ❑ Implement the board-approved strategic direction.
- ❑ Develop policies, formal or informal, that define the institutions' risk tolerance and are compatible with the bank's strategic goals.
- ❑ Oversee the development and maintenance of management information systems to ensure that they are timely, accurate, and informative.
- ❑ Make sure that the board's strategic direction and risk tolerances are communicated and adhered to throughout the organization.

Because market conditions and bank structures vary, no single risk management system works for all banks. Each bank should develop its own risk management program tailored to its needs and circumstances. The sophistication of the risk management system will increase with the size, complexity, and geographic diversity of each bank. All sound risk management systems, however, have several common fundamentals. For example, bank staff responsible for implementing sound risk management systems should perform those duties independently of the bank's risk-taking activities. Regardless of the risk management program's design, it should include mechanisms for identifying, measuring, controlling, and monitoring risks:

- ❑ **Identifying.** Proper risk identification focuses on recognizing and understanding existing risks or risks that may arise from new business initiatives. Risk identification should be a continuous

process, and should occur at both the transaction and portfolio level.

- **Measuring.** Accurate and timely measurement of risks is a critical component of effective risk management. A bank that does not have a risk measurement system has limited ability to control or monitor risk levels. The sophistication of the risk measurement tools a bank uses should reflect the complexity and levels of risk it has assumed. Good risk measurement systems assess both individual transactions and portfolios. The bank should verify the integrity of the measurement tools it uses periodically.
- **Controlling.** The bank should establish and communicate risk limits through policies, standards, and/or procedures that define responsibility and authority. These control limits should be meaningful management tools that can be adjusted if conditions or risk tolerances change. The bank should have a process to authorize exceptions or changes to risk limits when they are warranted.
- **Monitoring.** Banks should monitor risk levels to ensure timely review of risk positions and limit or policy exceptions. Monitoring reports should be frequent, timely, accurate, and informative, and should be distributed to appropriate individuals for action when needed.

#### OCC SUPERVISION BY RISK PROGRAM

This overview of the OCC's supervision by risk program is included to provide boards of directors with a general description of the importance of risk management to banking. More detail on the supervision by risk program may be found in the "Bank Supervision Process" booklet of the *Comptroller's Handbook*.

The OCC's supervision of national banks is directed at identifying significant or emerging problems, in individual banks and the banking system, and ensuring that such problems are appropriately corrected. Because banking is essentially a business of accepting and

managing risk, that philosophy is centered on evaluating risks and risk management. The OCC applies that philosophy in all supervisory activities that it conducts, including safety and soundness, compliance, and fiduciary activities.

Supervision by risk consists of evaluating the quantity of risk exposure in a bank and determining the quality of risk management systems in place to control risk. The supervision by risk framework provides consistent definitions of risk, a structure for assessing these risks, and a more integrated use of risk assessment in the supervisory process.

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SUPERVISION BY RISK PLACES  
THE RESPONSIBILITY FOR CON-  
TROLLING RISKS WITH THE  
BOARD OF DIRECTORS AND

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Supervision by risk places the responsibility for controlling risks with the board of directors and management. The OCC assesses how well a bank manages its risks over time, rather than only assessing the condition at a single point in time. With supervision by risk, the OCC functions in more of an oversight than an audit role. Supervision by risk allows the OCC to supervise by concentrating on systemic risks and those institutions that pose the greatest risk to the banking system.

#### CATEGORIES OF RISK

Risk is the potential that events, expected or unanticipated, may have an adverse impact on the bank's capital and earnings. To achieve more comprehensive and efficient examinations of national banks, the OCC has defined nine categories of risk inherent in bank activities as the basis for its supervision and examination activities. These categories are not mutually exclusive, because any product or service may expose the bank to multiple risks. For analysis and discussion purposes, however, the OCC identifies and assesses the risks separately.

The following is a brief description of the nine risks. A more complete discussion of these risks as they apply to specific bank activities

is contained in the *Comptroller's Handbook*. The OCC does not require banks to adopt its risk management systems. Bank management and directors should, however, understand the nature of these risks and ensure that the bank's risk management systems adequately address all relevant risks.

- ❑ **Credit risk.** The risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise fail to perform as agreed. Credit risk is found in all activities where success depends on counterparty, issuer, or borrower performance.
- ❑ **Interest rate risk.** The risk to earnings or capital arising from movements in interest rates. Interest rate risk arises from differences between the timing of rate changes and the timing of cash flows (repricing risk); from changing rate relationships among different yield curves affecting bank activities (basis risk); from changing rate relationships across the spectrum of maturities (yield curve risk); and from interest-related options embedded in bank products (options risk).
- ❑ **Liquidity risk.** The risk to earnings or capital arising from a bank's inability to meet its obligations when they come due, without incurring unacceptable losses. Liquidity risk includes the inability to manage unplanned decreases or changes in funding sources. Liquidity risk also arises from the failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.
- ❑ **Price risk.** The risk to earnings or capital arising from changes in the value of portfolios of financial instruments. This risk arises from market-making, dealing, and position-taking activities in interest rate, foreign exchange, equity, and commodities markets.
- ❑ **Foreign exchange risk.** The risk to earnings or capital arising from movement of foreign exchange rates. This risk is found in

cross-border investing and operating activities. Market-making and position-taking in foreign currencies is price risk.

- ❑ **Transaction risk.** The risk to earnings or capital arising from problems with service or product delivery. This risk is a function of internal controls, information systems, employee integrity, and operating processes. Transaction risk exists in all products and services.
- ❑ **Compliance risk.** The risk to earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, or ethical standards. Compliance risk also arises in situations where the laws or rules governing certain bank products or activities of the bank's clients may be ambiguous or untested.
- ❑ **Strategic risk.** The risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve these goals, the resources deployed against these goals, and the quality of implementation.
- ❑ **Reputation risk.** The risk to earnings or capital arising from negative public opinion. Reputation risk affects the bank's ability to establish new relationships or services, or continue servicing existing relationships.

#### EVALUATING A BANK'S RISK MANAGEMENT SYSTEM

The board should ensure that bank management adequately identifies the risks associated with particular activities and has put in place systems and controls to manage that risk. When examiners assess a bank's risk management systems, they consider policies, processes, personnel, and control systems. A significant deficiency in one or more of these components constitutes a deficiency in risk management. All of these systems are important, but the sophistication of

each will vary depending upon the complexity of the bank. Noncomplex community banks normally have less formalized policies, processes, and control systems in place than do large banks.

**Policies** reflect the board's intent and commitment to pursuing desired results. They set standards and courses of action to pursue, implement, or enforce specific objectives. Good policies link with, and reflect, a bank's underlying mission, values, and principles. They also clarify the bank's tolerance for risk. Mechanisms should be in place to trigger a review of policies in the event that activities or tolerances change. Policies may be written or unwritten depending upon the effectiveness of management and the complexity of the area or bank. In any event, standards and responsibilities should be articulated clearly and adhered to in practice.

**Processes** are the procedures, programs, and practices that govern how a bank will pursue its objectives. Processes define how daily activities are carried out. Good processes are consistent with the underlying policies, are efficient, and include checks and balances.

**Personnel** are the staff and managers that execute or oversee performance of the processes. Good staff and managers are qualified, competent, and perform as expected. They understand the bank's mission, values, policies, and processes. Compensation programs should be designed to attract, develop, and retain qualified personnel.

**Control systems** are tools and information systems that bank managers use to measure performance, make decisions, and assess the effectiveness of existing processes. These feedback devices must be timely, accurate, and informative. They measure performance and assist in decision making.

When risks are excessive or not properly managed, the OCC will work with the board and bank management to determine necessary corrective action so that the bank can be managed in a safe and sound manner.

## THE BOARD AND OTHER REGULATORS

In addition to the OCC, boards of directors of national banks may have occasion to contact other federal bank regulatory agencies—the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation. The following table summarizes the primary and secondary supervisory responsibilities of the three bank regulatory agencies. It also illustrates that these agencies have jurisdictions that sometimes overlap. When this occurs, the agencies work together and share information to reduce burden to both the bank and the agencies.

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Banking Agency	Supervisory Responsibility
Office of the Comptroller of the Currency	National Banks (Primary) Federal Branches and Agencies of Foreign Banks (Primary)
Board of Governors of the Federal Reserve System	Bank Holding Companies (Primary) State Member Banks (Primary) National Banks (Secondary) Federal Branches and Agencies of Foreign Banks (Secondary)
Federal Deposit Insurance Corporation	State Nonmember Insured Banks (Primary) National Banks (Secondary) State Member Banks (Secondary) Insured Branches and Agencies of Foreign Banks (Secondary)

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Bank boards also should be aware that certain activities may be subject to securities, insurance, fiduciary, and disclosure laws and regulations promulgated by the Securities Exchange Commission (SEC), individual states, and other entities.

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# THE BOARD'S RESPONSIBILITIES

BE AWARE OF THE BANK'S OPERATING ENVIRONMENT  
HIRE AND RETAIN COMPETENT MANAGEMENT  
MAINTAIN AN APPROPRIATE BOARD STRUCTURE  
MONITOR OPERATIONS  
OVERSEE BUSINESS PERFORMANCE  
SERVE COMMUNITY CREDIT NEEDS

Although a board of directors does not guarantee the bank's success, it must oversee the bank's operations to ensure the bank operates in a safe and sound manner. The board must keep informed about the bank's operating environment, hire and retain competent management, and ensure that the bank has a risk management structure and process suitable for the bank's size and activities. The board also must oversee the bank's business performance and serve community credit needs. Problems arising from failures in any of these areas represent the board's failure to exercise properly its oversight responsibilities and can result in individual liability if a director has not acted as a reasonably prudent director would act in similar circumstances.

## BE AWARE OF THE BANK'S OPERATING ENVIRONMENT

Directors should understand generally both the bank's business environment and the legal and regulatory framework within which the

bank's activities operate. Rapid and ongoing changes in the financial services industry require directors to have this understanding to keep the bank healthy and competitive.

Laws and regulations governing banking effectively impose on bank directors a potential for personal liability. Because of the breadth and importance of these laws, directors should be generally familiar with them and should determine that the bank has appropriate policies and procedures in place to maintain compliance with them.

These laws and regulations subject the banking industry to comprehensive regulation. This regulatory scheme addresses, among other things:

- ❑ The markets a bank serves.
- ❑ Permissible products and services.
- ❑ Permissible investments.
- ❑ Dividend restrictions.
- ❑ Transactions with affiliates.
- ❑ Capital requirements.
- ❑ Geographic location.
- ❑ The limits of a bank's lending relationship with a single borrower.
- ❑ The bank's transactions with its directors and other insiders.

By working with management, directors can keep informed about industry trends or other matters. For example, they can participate in the following:

- ❑ Management presentations on bank activities and developments in the industry.

- ❑ Bank counsel briefings or reports on legislative and regulatory changes, pending litigation, and emerging compliance issues or other legal developments.
- ❑ Bank auditor briefings on major accounting or tax developments.

Other sources of expertise can keep the board up-to-date about issues and trends affecting the bank's operating environment. National trade associations, state bankers' groups, management consultants, correspondent banks, and other professionals can help a board identify and understand emerging problems in the industry and recommend solutions. Industry organizations, for example, offer information and training on legislative and regulatory changes, emerging compliance and risk issues, new products or services, technological advances, or problem areas. Bank regulatory agencies also provide general guidance on emerging issues.

#### MAINTAIN APPROPRIATE RELATIONSHIPS WITH THE PARENT HOLDING COMPANY AND BANK SUBSIDIARIES

The board of a bank that is part of a holding company often has a different operating environment from the board of an independent bank. A bank holding company can be a source of strength for its subsidiary banks. It also determines policies and performs key bank functions and the holding company's directors may oversee and review the role and responsibilities of a subsidiary bank's board of directors.

For its part, the primary duty of the subsidiary bank's board of directors is to protect the bank. It must review carefully holding company policies that affect the bank to ensure that they adequately serve the bank. The bank's board is responsible for either approving or recording its lack of approval of holding company directives that affect the bank, and then monitoring those directives. If the board is concerned that the holding company is engaging in practices that either may harm the bank or are otherwise inappropriate, it should

notify the holding company and discuss modifications. If the holding company board does not answer the bank's concerns, bank directors should dissent on the record and consider action to protect the bank. It should hire an independent legal counsel or accountant if it decides it is necessary. The board also may raise its concerns with bank supervisors.

A diversified bank holding company that has nonbank subsidiaries raises additional concerns that a bank board must consider. For example, the board of a holding company subsidiary bank should be aware of the activities and condition of its holding company affiliates. No bank operates in a vacuum, and an affiliate's unsafe and unsound activities could adversely affect the bank's reputation as well as its condition. Certain transactions with affiliates may not be in the best interests of the bank, and in some cases may be unlawful. These may include, for instance, unearned or excessive management or servicing fees charged by the holding company or its affiliates, pressure for excessive dividends, or requests that the bank purchase low-quality assets from affiliates (which are specifically prohibited).

The operating environment of a bank with subsidiaries raises other issues. The board at the bank level must oversee the subsidiaries and verify that effective controls are maintained. Representation on the subsidiary's board of directors is one way to be certain that the bank's board participates in policy making. The board should confirm that it has authority to audit operations and review findings of the subsidiary's own internal or external auditors.

## HIRE AND RETAIN COMPETENT MANAGEMENT

A profitable and sound bank usually is the result of talented and capable management. It has the ability to manage day-to-day operations to achieve the bank's performance goals. Such management has the industry expertise to help the board plan for the bank's future in a changing and competitive marketplace as well as generate new and innovative ideas for board consideration. It has the technical

expertise to design and administer the systems and controls necessary to carry out the bank's policies, to manage risks, and to ensure compliance with laws and regulations.

One of the board's fundamental responsibilities, therefore, is to select and retain competent management. When a bank hires a CEO, the board or a designated board committee should actively manage the selection process. Selection criteria should include integrity, technical competence, character, and experience in the financial services industry. The board's choice for a CEO should share the board's operating philosophy and vision for the bank to assure that mutual trust and a close working relationship are maintained.

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THE BOARD'S CHOICE FOR A  
CEO SHOULD SHARE THE  
BOARD'S OPERATING PHILOSOPHY AND VISION FOR THE

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The board should consider a formal performance appraisal process to supervise management's performance. Such a process helps to assure that periodic evaluations take place and demonstrates that the board is discharging its responsibility to supervise management. Performance appraisals should evaluate criteria relevant to each position, such as:

- ❑ The bank's record of complying with laws and regulations.
- ❑ Criticisms contained in audit and examination reports, and their resolution.
- ❑ Management's responsiveness to board directives, including compliance with board-approved policies.
- ❑ The timeliness, quality, and accuracy of management's recommendations and reports.
- ❑ Management's presentations to the board.

- The bank's business success, including business performance indicators such as actual versus projected performance, comparative bank performance, and peer group comparisons used by bank management.

Although the board probably will only review directly the performance of the CEO, it should consider requiring performance appraisals for all bank employees. That will help it have strategies to retain competent management and staff, including compensation and benefit packages. Although compensation and benefit packages should be appealing, they should contain reasonable terms and conditions and not discriminate against any individuals or groups. They must not be excessive or lead to material financial loss for the bank. While the board may want to consider the compensation and benefit packages of similarly situated banks, the board should tailor the compensation package to the bank's size, its financial condition, and the nature, scope, and complexities of its operation.

The board or a designated committee can monitor personnel turnover rates to evaluate whether the bank is retaining the expertise and human resources needed to fulfill its goals. The board also should verify that the bank has adequate training programs to support needed skill levels and to keep personnel up-to-date with developments in the financial services industry.

The board should develop a management succession policy to address the loss of the CEO and other key executives. This policy should identify critical positions and qualified potential, including interim replacements. If no individual in the bank is suitable, the succession policy should identify a temporary replacement (often a member of the board) who could serve until the board finds a successor. The board should review these contingency plans annually to determine if they remain workable.

If the board needs to dismiss a member of the bank's management for poor performance, dishonesty, conflicts of interest, or for other reasons and it fails to do so, this failure may represent a serious breach

of the board's responsibilities. Management employment contracts that explicitly state the board's statutory authority to remove a member of the bank's management can clarify the board's right to act.

## MAINTAIN AN APPROPRIATE BOARD STRUCTURE

The board must ensure that it has an organizational structure in place to keep it informed and to provide it with adequate support. The board should consider carefully the extent and nature of the demands that will be placed upon it and should identify areas that committees could appropriately address. Committees can handle matters that require detailed review or in-depth consideration. They may make decisions on the board's behalf or submit recommendations for its consideration, depending on their specific charter.

Committees also help directors get involved and give them important insights to help them oversee the activities of the bank. The often less formal atmosphere of committee meetings can encourage board members to consider thoroughly issues and help them better understand the activities of bank management. Overlapping committee memberships can help integrate board activities.

Each committee should have a clear statement of its mission, authority, responsibility, and duration. Committee charters help assure that important board functions are not neglected because of misunderstandings or incomplete delegations. Standing committees may address ongoing responsibilities. Ad hoc committees may handle special projects, allowing in-depth consideration of one-time issues.

Committees should report regularly to the full board. The full board is ultimately responsible for its, and each board committee's, decisions. The board must assure itself that the committee acted responsibly and its recommendations are reasonable.

The best committee structure for a bank depends on the bank's size and scope of operation, risk profile, the board's composition, and



individual directors' expertise. Board committees typically oversee the bank's risk management by ensuring that management has implemented:

- ❑ Sound policies and procedures, either written or unwritten.
- ❑ Accurate and reliable risk measurement systems.
- ❑ Timely and meaningful risk reporting processes.
- ❑ Effective risk controls such as policy limits, authorizations, and product approvals.

Only two committees are required by regulation. An audit committee is required for any bank with assets in excess of \$500 million and must be comprised entirely of outside directors. A trust audit committee is required for a bank with trust powers.

Some typical committees are described below. They are not necessarily the only committees a board should have. Conversely, some boards of directors will not have all of the committees summarized here.

#### EXECUTIVE COMMITTEE

An executive committee generally is authorized to act for the board in its absence. Large institutions and banks with large boards most commonly use executive committees. This committee usually handles matters requiring board review that arise between full board meetings. Executive committees can relieve the full board of detailed reviews of information and operational activities. Generally, all major functions of the bank will be subject to review and approval by the executive committee. The executive committee will coordinate the work of other board committees. An executive committee, however, probably will not have the authority to exercise all of the board's powers; for example, the full board generally reserves the right to execute extraordinary contracts such as mergers and acquisitions.

## AUDIT COMMITTEE

### MEMBERSHIP

An audit committee has a key function because it monitors bank management and staff compliance with board policies and with laws and regulations. Because it evaluates bank operations, whenever possible outside directors should serve on an audit committee. The audit committee of national banks with assets in excess of \$500 million generally is required to be made up entirely of outside directors unless the OCC determines that the bank has encountered hardships in recruiting and retaining outside directors to serve on the committee.

The audit committee of large banks must include members with banking or related financial expertise. The committee must have access to its own outside counsel and the audit committee may not include any large customers of the bank. In certain circumstances, these requirements may be met at the holding company level.

### DUTIES

The audit committee should supervise the audit function directly to verify that auditors, internal and external, are independent of bank management and are objective in their findings. It should work with these auditors to verify that the bank has comprehensive audit coverage. The committee should hire senior audit personnel, set compensation, review audit plans, and evaluate performance. It should seek to retain auditors who are fully qualified to audit the kinds of activities in which the bank engages. The committee also may meet with the bank's examiners as necessary, sometimes without management, to review reports and discuss findings. Finally, it should monitor management's efforts to correct deficiencies described in an audit or a regulatory examination.

In addition to traditional audit functions, the audit committee may be a vehicle for communicating risk management concerns to the full

board. The audit committee should ensure that risk management evaluation functions are independent, because the objective is to evaluate management's ability to manage risk within the policies established by the board of directors. As a result, many banks have a structure that requires risk management findings to be reported directly to the audit committee of the board. The audit committee may also be responsible for internal loan review.

#### LOAN COMMITTEE

A loan committee ensures that management's handling of credit risk complies with board decisions about acceptable levels of risk. It reviews the bank's lending policies and monitors the lending officers' compliance with such policies. It verifies that management follows appropriate procedures to recognize adverse trends, to identify problems in the loan portfolio early, to take corrective actions, and to maintain an adequate allowance for loan and lease losses. The loan committee also should determine that risk controls are in place governing compliance with loan-related or other applicable laws and regulations. In many banks, this committee also evaluates credit applications and helps make credit decisions, especially for credits involving large dollar amounts.

#### ASSET/LIABILITY MANAGEMENT COMMITTEE

An asset/liability management committee's primary responsibility is to oversee the bank's actions relating to interest rate risk and liquidity risks. The committee also may be responsible for overseeing controls to manage price, foreign exchange, and compliance risks.

Among other activities, this committee typically reviews interest rate risk exposures and approves management strategies for investment securities activities, derivatives transactions, deposit programs, and lending initiatives. It also evaluates the bank's liquidity position and considers the impact of anticipated changes on that position. Asset/liability management committees in more complex banks may approve trading strategies and review trading positions in securities,

derivatives, or foreign exchange. If the bank's broker-dealer business subjects the bank to the rules of the Municipal Securities Rulemaking Board or rules implementing the Government Securities Act, this committee also typically reviews compliance activities relating to these acts.

#### RISK MANAGEMENT COMMITTEE

At some banks, the traditional loan and asset/liability board committees have been replaced with a broader risk management committee responsible for overseeing all the bank's risk management activities. Such a committee structure promotes an integrated approach to evaluating and monitoring interrelated risks, especially in banks with complex activity and product mixes.

#### FIDUCIARY COMMITTEE

A national bank with trust powers generally establishes at least two fiduciary committees: one for policy deliberations, and one to oversee fiduciary audit functions. The policy committee, usually called the fiduciary or trust committee, oversees fiduciary activities to ensure that the board meets its responsibilities and the bank complies with the multitude of statutes and regulations governing these activities. This committee provides guidance on matters such as the types of fiduciary services offered, fiduciary investment practices, brokerage placement practices, retention of legal counsel, and appropriate fee structures. The committee also approves and oversees policies on the hiring of a staff competent to perform fiduciary activities. Finally, it takes all necessary steps to avoid conflicts of interest among the bank, its directors, officers, and employees, and the fiduciary interests of customers and beneficiaries.

A fiduciary audit committee, separate from the fiduciary committee, oversees the annual or continuous audits of the bank's fiduciary activities. It reviews controls for transaction, reputation, and compliance risks as they relate to fiduciary activities. All national banks with fiduciary powers must have a fiduciary audit committee, although this committee may be combined with another audit committee.

## COMPENSATION COMMITTEE

A compensation committee generally determines that the bank's compensation and benefit packages are suitable and do not provide excessive benefits or lead to material financial loss to the bank. Because of potential conflicts of interest, whenever possible only outside directors should serve on this committee. The committee generally approves or recommends to the board compensation packages or plans for senior management, directors, and employees. These compensation and benefit packages may include salaries, bonuses, vacations, termination benefits, profit-sharing plans, contributions to employee pension plans, stock option and stock purchase plans, and indemnification agreements. When reviewing these plans, the committee should consider the following issues:

- ❑ The combined value of all cash and noncash benefits provided to the individual.
- ❑ The compensation history of the individual and other individuals with comparable expertise at the institution.
- ❑ The financial condition of the institution.
- ❑ Comparable compensation practices at similar institutions, based upon factors such as asset size, geographic location, and the complexity of the bank's business activities.
- ❑ The projected total cost and benefit to the institution for postemployment benefits.
- ❑ Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the institution.

## NOMINATING COMMITTEE

A nominating committee generally recommends nominees for election as directors and may recommend a successor to a key senior management position when a position is vacant. This committee also may develop a management succession policy that specifies key senior management positions and qualified potential replacements. A larger bank may have a succession plan which addresses positions ranging from middle management to the CEO, while a smaller bank's plan may only address potential successors to the CEO. This committee also should appoint temporary replacements when key positions become vacant. (In smaller banks a member of the board is sometimes appointed as a temporary replacement.)

## MONITOR OPERATIONS

Although the board may depend on management's expertise to run the bank's daily operations, the board remains ultimately responsible for monitoring the bank's operations. The board can monitor the operations of the bank through management reports, but it must do more than merely accept and review these reports; it must be confident of their accuracy and reliability.

The board and bank management must work together to promote the bank's best interests. Both must understand that management works for the board—the board does not work for management. When management dictates the actions for the board to take, the board neither fulfills its responsibilities nor serves the institution well.

While they support each other, the board and management have their own distinct roles and responsibilities. The board should ascertain that lines of authority are clear and that management understands and carries out board policies and directives.

The board should ensure that management has incorporated a sound system of internal controls into the bank's daily operating procedures. Internal controls are designed to safeguard assets, ensure the accuracy

and reliability of data, ensure compliance with policies and laws and regulations, and promote management efficiency. Internal controls include basic precautions such as ensuring proper separation of duties—those responsible for physical custody of an asset should not also be responsible for accounting for it—and verifying accounting data.

#### AUDIT PROGRAM

A board can ascertain that it is meeting its oversight responsibilities through a comprehensive audit and control program. Generally, the audit program consists of both an internal audit and an external audit.

Federal regulation requires that the audit address certain specific areas. The internal audit should provide an ongoing focus on internal controls and periodic review of all aspects of bank operations. The internal audit should review compliance with approved policies, as well as applicable laws and regulations. Although the board should decide how frequently the internal audit function needs to review specific operations, areas suitable for more frequent scrutiny include those that present the greatest inherent risks or that have shown weaknesses in past reviews.

If the board or audit committee determines that an external audit is appropriate, it should select an external auditor experienced in the types of activities in which the bank engages. The value of the auditor's judgment depends to a large extent on the auditor's understanding of the issues being reviewed. For example, if a bank is considering expanding into swaps, futures, and options, the board should be certain that the auditor is qualified to assess resulting risks and management techniques.

#### FULL-SCOPE AUDIT

Many banks have chosen certified public accounting firms (CPAs) to conduct full-scope audits of their annual financial statements. This type of audit provides the board with an objective, third-party opin-

ion on the adequacy of management systems and accounting controls and the accuracy of financial information. In addition to the auditor's opinion regarding financial statements, the board should expect to receive a management letter and possibly other reports highlighting control or other weaknesses identified during the audit.

Federal regulation requires that an independent public accountant prepare an annual report and financial statement for banks with total assets greater than \$500 million, unless the bank is owned by a holding company that performs annual audits of its banks. The same regulation also requires that this audit address certain specific areas, such as insider activities. Regulations governing fiduciary activities also require audits of these activities in all national banks exercising trust powers. Full-scope audits may be required in newly chartered banks, banks subject to securities law regulations, and in some problem banks. Full-scope audits are strongly encouraged for all other banks.

Rather than hire outside CPAs, the directors of some banks have relied on their internal auditors or auditors from their holding company or a correspondent bank to perform their annual audit. The board should be certain that these auditors have the same independence as outside CPAs.

#### LIMITED-SCOPE AUDIT

Because a full-scope CPA audit can involve considerable expense in both time and money, some banks use limited-scope reviews. The board (or audit committee) and auditors should agree on the scope of work in advance. These reviews are not full financial audits and do not allow the auditor to render an opinion on the accuracy and completeness of the bank's financial statements. A typical review reports on the adequacy of internal controls and on the accuracy of certain financial information, but normally does not review the loan portfolio or the adequacy of the allowance for loan and lease losses. The board and the public, as a result, receive only limited assurance that the bank's reports accurately represent the bank's condition. Consequently, the board should balance the risks against any savings realized when deciding whether to use a limited-scope audit.



## ONGOING CONTROL PROGRAM

An ongoing control program helps the board to be confident that adequate control of operations has been established. Outside auditors can assist in this function, but many banks find that internal auditors provide an important resource already based within the bank. In such a program, auditors review and test whether the board's operating procedures have adequate controls that function properly and that comply with board policies and laws and regulations. Such auditors also often help management develop strategies to address problems.

Ongoing control programs may reduce the cost of an annual CPA audit. CPAs will evaluate the internal audit function as part of their audit. If they find it reliable, they may reduce the scope and, as a result, the cost of their review. The outside auditor's evaluation of the quality, reliability, and independence of the bank's internal audit function also provides the board with an informed opinion about the internal auditors' performance.

During its pre-examination planning, OCC examiners will review both the internal and external auditors' reports; they sometimes even review the auditors' workpapers or meet with the auditors. If the OCC deems this work reliable, the examiners generally will accept the conclusions drawn by the auditors and will reduce the amount of time spent in a given area of the bank.

## AUDITOR INDEPENDENCE

Regardless of how the board staffs its monitoring responsibilities—whether by external or internal auditors or a combination of the two—it is critical that the board (not management) control the selection, retention, evaluation, and compensation of those performing the audits or reviews. Auditors must have access to the board or its audit committee so that they can directly report their findings. The audit committee should review carefully the auditors' findings and bring

key issues to the full board's attention. The board should ask management to report periodically on its progress toward resolving problems raised by the audits, so the board can be sure that management is taking the necessary corrective actions. Failure to address identified problems undermines the value of the audit and breaches the board's responsibilities.

## COMPLIANCE ACTIVITIES

Many banks establish a separate compliance function headed by a compliance officer or committee. (Bank Secrecy Act regulations require a compliance program and the appointment of a compliance officer to oversee compliance with that act.) In some banks, the compliance program focuses mainly on consumer and antidiscrimination laws. In others, this program reviews a broader range of compliance concerns including legal lending limit, tax, and securities issues.

The board should actively demonstrate its support of the compliance program. Larger, more complex banks generally have more elaborate compliance programs than do smaller, less complex banks. The compliance officer or committee generally performs periodic compliance reviews, develops necessary systems and controls, assesses the impact of new laws and regulations on bank operations and procedures, and provides guidance on compliance issues as the bank develops new products. For example, a compliance officer may develop appropriate procedures for complying with the reporting and disclosure requirements of the Bank Secrecy Act, the consumer laws, and regulations governing bank securities dealer activities. Compliance officers also should provide appropriate training for bank employees on compliance issues.

## OVERSEE BUSINESS PERFORMANCE

Sound business performance is one of the board's primary objectives and responsibilities as well as a key indicator of management's success. A bank is in business to offer financial services to its community and to earn a return on its shareholders' investments. Consistently poor earnings performance affects this return and can hinder the bank's ability to generate capital to support growth.

Sound financial performance means more than simply how much the bank earned last quarter. Equally important is the quality of earnings over the long-term. Quality earnings result from sound fundamentals: good quality assets, stable funding sources, well-controlled expenses, sound funds management practices, and knowledge of markets served. When evaluating the quality of earnings, directors should understand the soundness of the bank's operations and the interrelationships among operating statistics. Directors should ensure, for instance, that the bank does not artificially inflate earnings by delaying charge-offs or inadequately providing for loan and lease losses. Auditors' reports and reports from the bank's independent loan review program will help when evaluating the reliability of management's figures.

A board should receive adequate financial data and analyses that can answer questions such as:

- ❑ Is management meeting the goals established in the planning process? If not, why not?
- ❑ Was the plan unrealistic because of the circumstances?
- ❑ Is the level of earnings consistent or erratic?
- ❑ Do earnings result from the implementation of planned bank strategies or from transactions designed to increase short-term earnings but also raising longer-term risk?

- ❑ Is the bank being adequately compensated for the risks it is taking in its various product lines and activities?
- ❑ Does the bank have sufficient capital to support its risk profile and business strategies?
- ❑ Are the reports accurate or do they reflect an incomplete evaluation of asset quality or expenses?

Management should provide the board with relevant and appropriate financial information to enable them to answer these questions. The board should identify what information and reports it wants to see and how frequently, and request that management provide it with such reports. The board will be in a better position to answer these questions if it receives reports highlighting key performance measures, trends, and anomalies rather than being deluged with large amounts of raw data. Key performance reports should enable the board to evaluate the amount of risk being taken, compliance with the board's risk tolerances, and the adequacy of the bank's risk management processes. The bank's management information systems should reflect these requirements and be able to provide up-to-date reports in a timely manner.

Useful reports are likely to include the following information: budgeted compared to actual performance; portfolio activity, including classified asset trends, significant loans, past dues and renewals; liquidity trends; off-balance sheet exposures, including derivatives activities; large depositor listings to determine volatile liabilities; and interest rate sensitivity reports.

When overseeing the bank's business performance, it is often useful for the board to compare results to those of the bank's peer group. The quarterly Uniform Bank Performance Report (UBPR), which is derived from call report data and is provided to each national bank, gives the board a comparison of the bank's performance with an identified peer group. Although deviations from peer group norms do not necessarily indicate problems, management should explain large dif-

ferences. Understanding the reasons for the differences will help the board determine where the bank's performance differs from its peers and whether or not there is a problem.

The board should realize, however, that peer group averages are not a benchmark, merely an analytical tool. There are no model ratios or numbers that guarantee success. The peer group data simply tells how banks of similar size and complexity are performing in certain areas of their operation. Peer group data do not necessarily reflect good or appropriate performance and may not reflect appropriate goals.

#### KEY MEASURES OF BUSINESS PERFORMANCE

Certain key financial ratios, although not all-inclusive, provide good insight into the performance of the bank and management. Some of these key ratios, which are available in the UBPR, include:

**Return on Average Assets (ROAA).** Net income divided by average assets. This is the primary profitability indicator and measures the bank's efficiency in using its assets to generate profits.

**Return on Equity (ROE).** Net income divided by equity capital. Investors use this ratio to measure the return on the shareholder's investment. This ratio is also important when calculating the bank's value to potential investors. From the shareholder's perspective, the higher the ROE the better. From the board's perspective, however, it should not seek an attractive ROE which is based on inadequate capital or unwarranted risk.

**Net Interest Margin (NIM).** Interest income less interest expense divided by average earning assets. This ratio reflects the traditional business of banking; i.e., the results of a bank's efforts to buy funds and reinvest them profitably.

**Net Noninterest Expense to Average Assets.** Total noninterest income less total noninterest expense divided by average assets. This ratio indicates the impact of all noninterest expenses (such as person-

nel, occupancy, or other costs) on the bank's earnings and can provide a measure of the bank's efficiency in generating earnings.

**Tier 1 Capital to Average Assets (Leverage Ratio).** This ratio indicates how much Tier 1 capital is available to support bank assets and future growth. (Tier 1 capital is common equity plus noncumulative perpetual preferred stock plus minority interests in unconsolidated subsidiaries less ineligible deferred tax assets and ineligible intangibles.) Capital provides a cushion against unexpected losses and promotes public confidence in the bank's condition. Confidence in the bank's condition is a critical factor in its ability to attract deposits and support further business. Thus, although regulatory guidelines establish minimum capital requirements that banks must meet, well-managed banks typically operate with more capital than these minimum requirements.

A declining capital-to-assets ratio is frequently an indication of large loan losses, rapid asset growth, or large dividend payouts. It also may reflect a loss of profitability because of factors such as the absence of cost controls, inadequate pricing, or a flawed business plan. The board should set as a goal the minimum leverage ratio for the bank (the ratio should, of course, be at least equal to regulatory requirements). The board should be alert to any declines in the ratio, and should determine the cause of any declines and take necessary action to be certain that adequate capital is maintained.

**Nonperforming Loans to Total Loans.** This ratio relates the level of nonperforming loans (loans that are past due at least 90 days, are in nonaccrual status, or have been renegotiated) to the total loan portfolio. A high level of nonperforming loans may suggest, for instance, poor underwriting practices or inadequate monitoring of changes in borrowers' financial conditions. The bank should determine the cause of the problem and institute appropriate corrective actions.

**Net Losses to Average Total Loans.** Loan losses after recoveries divided by average total loans. This ratio is another indicator of asset quality. An increasing ratio may indicate the allowance for loan and

lease losses (ALLL) is being depleted by increasing losses; thus, additional provisions to the ALLL may be necessary. Increasing losses also may reflect severe deterioration in the loan portfolio, management's inability to identify loan problems in their early stages, or management's inability to develop strong workout and collection programs for problem loans. The bank should determine the cause of the increased losses and take appropriate corrective actions.

#### BUSINESS PERFORMANCE: KEY AREAS TO MONITOR

Monitoring these financial ratios keeps the board aware of the bank's business performance. In addition, the board should keep the following indicators of a bank's business performance in mind when overseeing the bank:

##### ASSET QUALITY

Since a bank's condition can depend in large part on its ability to control credit risk, the board or its loan committee should monitor closely internal loan review findings to ensure that any weaknesses are addressed in a timely fashion before they become more serious, especially those identified in an external audit report or the OCC's Report of Examination. Issues that may raise concerns include a rapid increase in loan volume or the purchase of large numbers of participations from outside of the bank's normal trade area. If this occurs, the board should ascertain that credit quality does not suffer and that the bank's systems are adequate to monitor or service such loans. Also, if the board accepts higher risk as part of the bank's risk strategy, it should be certain that the bank is adequately compensated and is properly managing this risk.

##### LIQUIDITY AND INTEREST RATE RISK POSITIONS

The board must make certain that the bank's liquidity and interest rate risk positions are reasonable and do not compromise the bank's ability to maintain earnings and protect capital. While accepting some degree of interest rate risk and maturity mismatch is inherent to

the business of banking, the board and management must understand the risks the bank takes. Such risks must be commensurate with management's expertise and the bank's balance sheet flexibility, especially since rapidly changing market conditions can have a substantial impact on the bank's position.

The extent of the bank's dependence on volatile liabilities, the ratio of net loans and leases to assets, the level of mismatch between the bank's asset and liability cash flows, and the vulnerability of earnings and capital to movements in interest rates are useful indicators of risk positions. The board should be alert that certain strategies, such as funding long-term fixed rate assets with short-term liabilities, may enhance earnings in the short run but may threaten earnings and capital if market conditions change or if earnings do not materialize as expected.

#### NEW PRODUCTS AND SERVICES

The board should be certain that it fully understands the risks presented by any proposed new product or service. If, for example, the pricing will not support a reasonable return in comparison to the risks, the board should question whether the product or service is worth offering. Furthermore, this expansion should be consistent with the bank's strategic or business plan. The board should verify that management understands the risks of the new product or service and that adequate policies, procedures, and systems are in place to facilitate its introduction and ongoing risk management.

#### NONINTEREST EARNINGS

In many banks, a major component of noninterest earnings is income from fee-based products such as mutual funds, mortgage banking, and fiduciary services. These products can contribute substantially to the bank's income, but they also introduce new concerns and expose the bank to various risks, including transaction, compliance, strategic, and reputation risks. The bank must be equipped to service and stand behind its products, and to price them realistically and com-



petitively. To price these products successfully, the bank should perform an effective cost analysis before introducing the product and ensure that adequate management information systems are in place to support the offering. Management also must ensure that it has skilled personnel to administer and support these activities.

Noninterest earnings also may reflect the sales of assets or other non-recurring items. In these cases, the board should ask management to identify noninterest earnings that are inflated by unusual nonrecurring items. Directors should be concerned when nonrecurring transactions supplement earnings to maintain budgeted earnings levels unless they are incorporated into the budget.

#### OFF-BALANCE SHEET ITEMS

When evaluating the bank's capital position, the board should be aware of the nature and extent of all off-balance sheet items, especially items that may ultimately require funding. A loan commitment is an example of an off-balance sheet item that may require funding. When a bank is experiencing liquidity problems, borrowers typically draw down their commitments to be certain that the funding will be available. The board also should understand whether the bank uses off-balance sheet derivative contracts, such as swaps, futures, and options, to offset, alter, or manage existing or anticipated exposures or as an alternative investment product to generate earnings.

Management should provide regular reports to the board on all off-balance sheet activity. These reports should explain the types and amount of risk involved and indicate what internal controls, audit, and monitoring functions are in place to manage risks.

#### DIVIDENDS

The ability of a bank to pay dividends is an indication of its overall health and profitability. These dividends are a source of investment income to its shareholders. Banks must, however, strike a proper balance between income for shareholders and the retention of earnings

to maintain adequate capital levels. Moreover, federal law prohibits banks from paying dividends that would impair the bank's capital and a bank may need supervisory approval if it wishes to pay dividends in excess of certain amounts.

## SERVE COMMUNITY CREDIT NEEDS

Every national bank is required to fulfill its responsibilities under the Community Reinvestment Act (CRA). A board's plans and policies should address not only profits and safety and soundness, but should reflect efforts to help meet the legitimate credit needs of all communities the bank serves. Directors frequently represent a cross-section of these communities and thus are in an excellent position to assess community needs and to formulate appropriate, responsive policies.

A bank charter imposes significant responsibilities to serve the community. Under the CRA, bank regulators must review and consider public comments on a bank's record in meeting community credit needs before acting on applications for branches, mergers, and certain other structural changes. Moves toward interstate branching and other factors that may affect credit flows to and from local communities have heightened concerns about local community credit needs.

The board is responsible for ensuring that CRA efforts are an important element in a bank's overall plan and that they focus on performance rather than outreach, marketing, or other efforts. The board should encourage management to be innovative and committed to serving the needs of the community in which it operates. For many banks, active CRA efforts reflect good corporate citizenship as well as the development of profitable business. A good CRA performance rating can also facilitate a bank's expansion plans.

A board should evaluate whether any areas of its community have credit needs that have not been met and whether any changes to its current policies are appropriate. The board should consider whether otherwise sound policies and procedures could have the unintended effect of discouraging good quality business in older and low- or

moderate-income neighborhoods. For example, a policy that places a maximum age limit on structures held as collateral may result in blanket credit denials in the community's older neighborhoods. Such a policy could exclude responsible citizens attempting to rehabilitate housing from even being considered for credit.

The board should work with management to maintain a constructive dialogue with community members. Without good communication, the bank may find itself at odds with its community, even if it satisfies the objective goals of the CRA. Poor communication also may result in the filing of adverse comments to bank regulators. Often referred to as CRA protests, these adverse comments may cause costly delays for a bank seeking a regulatory decision on a corporate application.

# 3

## THE BOARD'S ROLE IN PLANNING AND POLICY

PLANNING  
POLICIES  
MAJOR POLICY AREAS

### PLANNING

Ongoing changes in the banking industry make it essential for each bank to have clear strategies and business plans. The board is responsible for establishing the bank's goals and for ensuring that the bank has the personnel as well as the financial, technological, and organizational capabilities to achieve those goals.

The planning process typically begins with the development of a long-term strategic plan. The plan usually contains a statement of the board's general philosophy and includes the board's vision of the bank's future. A long-term plan provides a framework for making business judgments and for considering proposals that deviate from the board's stated philosophy. The board should reassess the plan periodically to consider new opportunities or to respond to unanticipated external developments. Larger, more complex banks generally would have more detailed plans than smaller, less complex banks. A small bank operating in a stable environment may only need to define

the basic business of the bank and set goals. These plans do not need to be written, but they should be clearly communicated to affected personnel.

Short-term business plans translate long-term goals into specific, measurable targets. Management is often in the best position to formulate these plans. The board should approve these plans after concluding that they are realistic and compatible with the bank's tolerance for risk. The board will want to consider, for instance, whether the bank's capital and other resources are adequate to achieve the goals and whether management has realistically assessed staff expertise and systems adequacy.

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THE BOARD SHOULD REVIEW  
AND APPROVE ANY PROPOSED  
DEPARTURES FROM THE LONG-  
AND SHORT-TERM BUSINESS  
PLANS OF THE BANK BEFORE

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The board should review and approve any proposed departures from the long- and short-term business plans of the bank before they take place. For example, it should have a planning, review, and approval process for major new activities or products that bank

management proposes to undertake. Many new undertakings require substantial systems support, new expertise, substantial lead time, and significant financial investment. The board should ensure that bank management has identified potential risks and rewards and established adequate risk management systems to monitor, measure, and control risk and performance. Management or staff assessing the impact of these business plans on overall bank operations should address associated risks.

The planning process should include strategies to meet unanticipated operational contingencies to control strategic risk. Disruptions to operations can include loss of a physical plant or automated systems due to fire, flood, or another disaster. The contingency plan should forecast how departure from a business plan or a major operational loss could affect customer services or bank resources, including expert staff dedicated to the plans. Finally, operational contingency plans

should address insurance coverage and back-up procedures and facilities.

## POLICIES

Statutes, regulations, and some OCC issuances require written policies governing some activities. In other areas, the decision to put a policy in writing is up to the bank.

Regardless of whether it is written or not, all policies need to include clear standards of performance and should be clearly communicated through all levels of the bank to provide a single authoritative source that everyone can refer to and interpret consistently. Policies should be flexible enough to permit innovation and to respond to changing business conditions. Training programs can inform employees of policies and how they should be consistently applied.

Associated procedures detail how the policies will be implemented. They should include steps for obtaining appropriate approval for exceptions.

If policies and procedures are developed by bank management or some other party, the board's directors should assure themselves that they specifically address the bank's unique goals, systems, personnel, risk profile, and resources before giving their approval.

The board or its designated committee should review policies and oversee revisions as necessary to ensure that they remain consistent with the bank's goals. If the board and management receive many legitimate requests for exceptions, they may need to reconsider the policy. Finally, the board should ensure that bank policies and procedures are modified when necessary to respond to significant changes in the bank's resources, activities, or business conditions.

The bank's board and management should tailor policies and their implementing procedures to the types of risks that arise from the

activities the bank conducts, or plans to conduct. While all banks should have policies and procedures that address their significant activities and risks, the coverage and level of detail embodied in these statements will vary among institutions. The OCC generally would expect that a smaller, noncomplex bank whose management is heavily involved in day-to-day operations would have only basic policies addressing the significant areas of operations and setting forth a limited set of requirements and procedures. In a larger, more complex bank, where senior management must rely on a widely dispersed staff to implement strategies in an extended range of potentially complex businesses, the OCC generally would expect to see far more detailed policies and related procedures.

Policies and procedures should be in place before any new activity begins. Bank policies should require management to balance the risks and rewards of new products and services and the board should not act before it fully understands the risks and the potential profitability of a new activity. The board should specify appropriate tools to monitor the risks and should have a way to report risks to all responsible parties before the bank engages in a new activity.

Policies should be developed and approved in a manner the board deems most appropriate for the bank. Some examples of policy development follow:

- The full board develops broad guidelines and directions and delegates responsibility for developing more detailed operating procedures to board committees or management.
- The full board states general lending principles about the amount and type of commercial real estate loans, the loan committee designates who is authorized to make commercial real estate loans, and management drafts detailed operating procedures for commercial real estate lending activities.
- The full board delegates to management the development of the entire policy and procedures or relies on outside consultants or a correspondent bank.

## MAJOR POLICY AREAS

This section highlights the policy treatment of some important functional areas and identifies issues within these areas that may require special attention.

### LOAN PORTFOLIO MANAGEMENT

The board should oversee the management of the loan portfolio to control risks and maintain profitable lending operations. While lending traditionally has been at the core of a bank's activities, providing the greatest single source of earnings and accounting for the largest volume of assets, it also has posed the greatest single risk to the bank's safety and soundness. Whether due to lax credit standards, inadequate loan review practices, or weaknesses in the economy, loan portfolio problems have been a major cause of bank losses.

### LOAN POLICY

A bank's loan policy should address the composition of the loan portfolio as a whole and should have standards for individual credit decisions. Risk tolerances and limits should be specified. These elements of a sound loan policy set parameters for the loan portfolio, including:

- ❑ The portion of the bank's funding sources that may be used for lending.
- ❑ The types of loans to be made.
- ❑ The percentage of the overall loan portfolio that should constitute each type of loan.
- ❑ The geographic trade area in which loans will be made.



- ❑ Guidance on lending activities outside the defined trade area.
- ❑ Limits on purchased loans.
- ❑ Guidelines on insider loans. (These guidelines must be in writing, even if the remainder of the policy is not written.)
- ❑ Individual credit requirements.
- ❑ Loan underwriting criteria.
- ❑ Loan application requirements.
- ❑ Limits on concentrations of credit.
- ❑ Approval authority.
- ❑ Administrative practices.
- ❑ Compliance with lending-related laws and regulations such as the legal lending limit, insider lending regulations, the Community Reinvestment Act, and fair lending laws and regulations.

#### LOAN REVIEW PROGRAM

In addition to the general loan policy, the board should direct management to establish an internal loan review program that is independent of the loan portfolio function. This program, which is essential to managing credit risk, should monitor asset quality, adherence to established loan policy and credit standards, and compliance with laws and regulations.

The loan review function should report directly to the board or its audit committee. Individuals who perform the loan review should not review loans in which they have an interest or loans in which they participated in granting. Loan reviewers should have experience ana-

lyzing loans, identifying credit weaknesses, and assessing the degree of risk involved. In larger banks, the loan review function often is organized into a separate department. In smaller banks loan review can consist of loan officers reviewing one another's loans. Some loan review programs also use internal auditors, other compliance personnel, or outside consultants to assess whether the bank is complying with the board's lending policies and properly identifying problem loans.

The loan review program also monitors portfolio trends and conducts analyses of the potential risks in the portfolio. The program should quantify the repayment risk in the portfolio by estimating how much cash commercial borrowers could generate from operations or the value of collateral sources under current and adverse market conditions. Also, the bank should have a loan classification system that identifies the likelihood of repayment. Boards of directors may want to follow the loan classification system used by the OCC because the judgments the bank and the examiners reach should not be materially different if classification criteria are essentially the same.

The board and management can use the information drawn from loan portfolio reviews to assess whether the overall loan policy is effective and as an early warning system for identifying underlying problems. For example, improper documentation or continuing violations of lending limits might mean that loan officers need more training or that compliance efforts should be increased. Recurring credit quality problems can pinpoint weaknesses in the performance of individual loan officers or can warn of emerging problems in the local economy or industry sectors. Early warning will allow the bank time to take action before those problems have a major impact on the bank.

#### ALLOWANCE FOR LOAN AND LEASE LOSSES

The board must ensure that the bank has a program to establish and regularly review the adequacy of its allowance for loan and lease losses (ALLL). The board must know the bank's dollar exposure to

ensure that an adequate ALLL is maintained and that losses are promptly recorded on the bank's books. The ALLL should be maintained at a level adequate to absorb all estimable inherent losses in all loans, leases, and, to the extent that they are expected to be funded, any binding commitments to advance additional funds.

The board must require at least a quarterly assessment of the adequacy of the ALLL; if inadequate, the bank should make an additional provision to the ALLL. Since the ALLL provision affects the accuracy of the earnings statement, an understated ALLL expense will overstate the bank's earnings and can result in a violation of law. The board should verify with management that ALLL calculation records are maintained to support the basis for the analysis. The board should review periodically the ALLL methodology to determine that it estimates exposure properly—how actual losses compare to estimated losses—and the bank's auditors should review the data and calculations for accuracy.

Simple formulas based on a fixed percentage of the loan portfolio will not provide an adequate basis for accurately determining ALLL adequacy. Instead, management should use the information from the internal loan review to identify and record losses. Management should estimate unidentified and inherent losses based on economic conditions, portfolio growth, historical collection results on predictable credits (such as consumer installment and residential mortgage loans), exposure concentrations, and other factors that may affect the bank's ability to collect loans in the portfolio.

#### LENDING ACTIVITIES—AREAS OF CONCERN

When considering the bank's lending activities, the following practices or conditions should trigger additional board scrutiny:

Failure to have systems that properly monitor compliance with legal lending limits.

Violating lending limits can lead to excessive concentrations of risk, may present an opportunity for bank insiders or affiliates to abuse the bank's resources, and may result in financial liability for directors. As a result, the board must direct management to adopt a system to generate accurate and timely reports on the bank's legal lending limits. The reports should identify the limits applicable to all borrowers, including bank insiders and bank affiliates, and should reflect that loan limits were properly considered in loan decisions. Bank management should pay particular attention to circumstances in which loans should be aggregated or attributed to another. They also should be aware of the circumstances under which the board as a whole may be required by law to approve loans to insiders in advance. If a highly complex lending limit transaction is presented or the board or management is uncertain about whether a loan approval will exceed the bank's lending limit, it should consider obtaining guidance from counsel.

Relaxed standards or terms on loans to insiders and affiliates.

Several laws and regulations prohibit banks from providing preferential treatment to insiders and affiliates. Such treatment may subject the bank to unwarranted concentrations of risk or levels of credit risk. The bank also may face legal and financial liability as a result of these activities.

Failure to institute adequate loan administration systems.

A bank with an inadequate system to administer its loans can experience unnecessary losses. Management's ongoing assessment of risk in the loan portfolio may be compromised, for example, if current, detailed financial information on borrowers is not maintained. Failure to either perfect collateral positions or to carry out adequate follow-up and collection procedures also can trigger unwarranted risks and lead to otherwise avoidable losses. In addition, if management does not supervise loan performance adequately, it may be unable to evaluate the performance of individual loan officers who could be perpetuating portfolio weaknesses.

Over-reliance on collateral or character to support credit decisions.

A bank that unduly relies on factors other than cash flow or other repayment capacity to support credit decisions may increase its illiquid loans, its level of credit risk, and may expose the bank to loss. Loans not supported by adequate cash flow are often made for speculative purposes and pose greater risks than basic business and personal loans. The board should monitor carefully the bank's exposure to such loans and institute acceptable limits. Proper attention to repayment capacity is critical, even for lending products such as community development loans, unless the loans have government or other support, in which case flexible criteria may be appropriate.

Uncontrolled asset growth or increased market share.

One way for a bank to achieve rapid asset growth or increase its market share is to compromise its credit standards. The board should be alert to any activity that could indicate that loan officers are relaxing credit standards, because such practice may result in increases in illiquid assets and unwarranted losses to the bank.

The purchase of participations in out-of-area loans without independent review and evaluation.

Some banks purchase out-of-area participations in loans made by other institutions to increase loan volume or to diversify risk. To avoid undue losses, the bank or a party independent of the seller should review and evaluate the quality of such out-of-area participations before purchase.

Generating large volumes of loans for resale to others.

If a bank is planning to generate a large volume of loans to sell to others to increase income, the board should ensure that the bank's systems and controls are capable of handling the increase. Also, the board should verify that credit standards have not been lowered, because selling poor quality assets may cause the bank to lose access to the market. Purchasers could subject the bank to legal action or recourse for misrepresenting or improperly administering the loans.

## FUNDS MANAGEMENT POLICY

The asset/liability management policy provides the framework within which bank management carries out the board's objectives for the composition of on- and off-balance sheet positions. The policy parameters within which the board expects funds management activities to take place should be designed to control the actions of management and provide timely feedback to the board. Once the board has specified acceptable risk tolerances, management can begin to translate decisions into meaningful limits.

The policy should address the board's tolerances for interest rate and liquidity risks and should establish procedures for identifying, measuring, and controlling these risks. Risk tolerances should be based on a realistic assessment of the board's rate of return objectives. For example, a board that establishes extremely low tolerances for risk taking should recognize that this decision is likely to reduce the bank's ability to generate high returns. Such a strategy also can reduce return volatility, however, which may be of primary concern to the board.

When framing the bank's risk tolerances, directors should determine the maximum amount of bank earnings and capital they are willing to allow bank management to place at risk. For interest rate risk tolerances, the board should consider how movements in interest rates may adversely affect the bank's earnings and capital. The bank's projected earnings and capital often are used as a benchmark for evaluating this exposure. When determining liquidity risk tolerances, the board should consider how the bank's inability to meet its obligations when they come due may affect the bank's earnings, capital, and operations.

The asset/liability management policy should specify what products will be used to manage interest rate risk and liquidity positions. For liquidity, the policy might address what types of borrowings (such as federal funds, term federal funds, and term loans) are acceptable and

what counter parties are approved (for example, upstream bank federal funds). It should specify who can commit the bank to various transactions and when more senior levels of management or the board need to be notified. The board should approve the purchase of tools that can accurately and reliably measure exposures to interest rate risk and liquidity risk. Finally, the policy should include a liquidity contingency plan that specifies how the bank will handle a situation of unusual liquidity pressure.

#### FUNDS MANAGEMENT ACTIVITIES—AREAS OF CONCERN

When considering funds management activities, the following practices or conditions should trigger additional board scrutiny:

Excessive growth objectives.

A bank with excessive growth objectives may engage in activities that unduly increase its exposure to various risks. For example, staff may be inclined to purchase lower quality assets for the bank or set up an unprofitable pricing structure to increase business. Such unwise decisions could lead to significant funds management problems for the bank in its asset quality, earnings, or liquidity areas. Excessive growth also may lead to undue leverage and capital inadequate to support the bank's activities.

Heavy dependence on volatile liabilities.

Excessive holdings of volatile liabilities, such as large certificates of deposit, out-of-area funding sources, brokered deposits, and other interest-rate sensitive funding sources may pose a problem to a bank. Liquidity concerns triggered by the sudden withdrawal of such deposits can require the costly liquidation of assets. In addition, a bank typically must pay a higher interest rate to attract out-of-area funds, thereby lowering net interest margins on loans and investments made with those funds. Lower margins can create pressures on management to seek higher yielding, and potentially riskier, loans and investments to maintain earnings.

Exposure to a significant number of products with embedded options.

Holding significant amounts of assets, liabilities, or off-balance sheet products with embedded options can expose a bank to unwarranted interest rate and liquidity risks. Embedded options can be found in mortgage-backed securities, nonmaturity deposits, newer products such as structured notes, and even traditional retail bank products. The bank's risk measurement tools should be able to adequately capture this exposure to allow management to assess how these options may be exercised under various interest rate scenarios.

For example, embedded options incorporated into retail bank products can significantly alter the cash flow characteristics of the product under different interest rate scenarios. A residential mortgage with a penalty-free prepayment option, for example, gives the bank customer the right to exercise the option at any time, thereby creating uncertainty about the cash flow on the mortgage. Since customers generally exercise this option when they can refinance their mortgage at a lower rate, the bank is left to reinvest in lower yielding assets. Conversely, when market interest rates rise, fewer customers prepay their mortgages, leaving the bank with longer maturity assets and less cash to reinvest at the market rates.

Gaps between asset and liability maturities or between rate-sensitive assets and liabilities at various maturity time frames.

Excessive gaps resulting from differences in the repricing dates of assets and liabilities leave the bank vulnerable to impaired earnings and liquidity concerns if interest rates do not move according to projections. Management should monitor closely its use of volatile or short-term variable-rate funding sources to buy illiquid or long-term fixed-rate assets. The board should understand and agree with the interest-rate assumptions underlying management's gap planning.

Asset/liability expansion, both on—or off—balance sheet, without an accompanying increase in capital support.

A bank engaging in excessive leveraging activities may be violating capital requirements. Inadequate capital also may make the bank unable to fund or absorb potential exposures. The board should scrutinize the bank's capital position on an ongoing basis to avoid such



events.

Failure to diversify assets or funding sources.

Concentrations of assets or funding sources can expose a bank to risks including credit, interest rate, and reputation risks. Credit and interest rate exposures can occur in a bank that places undue reliance on particular companies or sectors of the economy because a downturn in the company or industry may result in losses. Similar risks exist for funding sources that depend on large depositors or depositors tied to certain economic sectors. The board should make sure the bank's policies and practices provide guidelines for diversifying assets and funding sources and for specifying how much reliance is to be placed on such sources. The board also should monitor periodically the bank's asset concentrations and dependence on large depositors.

Inadequate controls over securitized asset programs.

When a bank uses securitized assets to fund banking activities, it improves the marketability of its assets and enhances liquidity. To control risks associated with such programs, however, management should monitor how sales of its high-quality assets affect the strength of the remaining portfolio. Further, the bank should have risk management procedures adequate for its securitization activities. For example, management should consider limits on loan and investor concentrations when the bank retains some liability on the asset sold.

Lack of expertise or control over off-balance sheet derivative activities or other complex investment or risk management transactions.

The growth of various off-balance sheet derivative contracts such as swaps, futures, and options as well as structured note products provides banks with an increasing array of financial instruments that can be used to manage their risk exposures. Such products can be used to change the timing, direction, or level of a bank's risk. Some of these products may have complex cash flow and risk characteristics and may introduce additional leverage to the bank's risk profile. The board should be aware of the potential risks, and ensure that ade-

quate risk monitoring and control procedures are in place before the bank uses the products. The board and senior management also should understand the role such leverage transactions play within the overall business strategies of the bank.

## INVESTMENT POLICY

Investments traditionally have been a bank's second largest source of income. Investments should generate quality earnings, allow the bank to diversify its asset base, and provide liquidity.

While the board may seek advice from technically competent managers or external sources such as correspondent banks, brokerage houses, or consulting services, it may not delegate its responsibility for overseeing the investment portfolio. The investment policy should state that the bank must comply with legal restrictions on the types of securities it may hold. It also should specify the type and composition (including the maturity and repricing characteristics) of instruments the bank may have. Factors such as the bank's earnings, ability to accept risk, liquidity needs, pledging requirements, funding sources, and income objectives help define the board's policy objectives. The board should review the portfolio as necessary to confirm that the risk level remains acceptable and consistent with previously approved portfolio objectives. The review should include information on the current market value of the portfolio and consideration of whether the investment policy needs to be revised.

The board should direct management to establish systems to implement objectives and limits for each portfolio, taking into account applicable laws, regulations, and current accounting standards for each part of the portfolio. The bank's risk management systems should be able to evaluate how changes in market factors, such as interest rates, may affect the value of the bank's investment portfolios, especially securities with embedded options. They also should be capable of monitoring and controlling other risks associated with investment activities such as credit, liquidity, transaction, strategic, and reputation risks.

When considering investment portfolio activities, the following practices or conditions should trigger additional board scrutiny:

Failure to select securities dealers carefully.

Management should be aware of the credit standing, record, and reputation of securities dealers with whom the bank does business. The board should reaffirm a list of approved securities dealers annually to ensure that the bank does not deal with financially unstable, irresponsible, or dishonest securities dealers.

Efforts to obtain higher yields without regard for other portfolio objectives.

A bank should not extend the maturity of the investment portfolio to obtain higher yields without carefully considering liquidity and funding issues. Extending maturities without evaluating these issues increases liquidity and interest rate risks because unanticipated liquidity demands may lead to the sale of securities at depressed market prices. In addition, interest rate movements or changes in quality can cause the value of securities to decline.

The purchase of low-quality investments to obtain higher yields.

Low-quality investments are highly volatile because they can experience wide price fluctuations as interest rate or other investor expectations change. As a result, purchasing these investments increases credit risk. Lower quality investments also impair a bank's liquidity and reduce flexibility in managing the investment portfolio.

Failure to adequately diversify investments.

A bank that has concentrations of investments in the securities of individual obligors or groups of obligors with common economic ties could have an unsound investment portfolio strategy because price fluctuations, a deterioration of the quality of the securities, or loss of principal will have an increased impact on the bank's financial state-

ment.

Failure to consider pledging requirements in investment decisions.

To meet present and future funding needs, a bank must be able to pledge eligible securities to support deposits of public funds and to use as collateral. When developing portfolio and liquidity strategies, management must consider the eligibility of securities to meet the bank's pledging and repossession requirements.

Failure to institute adequate internal controls for investment and trading activities.

Some banks have experienced substantial losses because the internal controls on their investment and trading operations were inadequate to monitor and control risks. A bank with significant investment portfolio transactions or one engaging in trading activity should be certain that controls such as a segregation of duties are in place.

Failure to ensure the investment portfolio complies with current accounting standards.

Current accounting standards require a bank to divide its investment portfolio into three parts: held-to-maturity, available-for-sale, and trading. Securities in the held-to-maturity portfolio are those in which a bank has the intent and ability to hold until maturity; a bank may not use this portfolio to engage in trading or to conduct speculative securities transactions. The securities in the available-for-sale account are those that will be sold at a future date but will not be traded often enough to qualify for the trading account. The trading portfolio holds securities bought and held principally for selling in the near term; a bank must record and report trading transactions in this account.

## FIDUCIARY ACTIVITIES

Although traditional personal and employee benefit account administration remain primary fiduciary business lines for most banks, other banks have expanded their fiduciary activities to include such products and services as investment management accounts, advising

proprietary mutual funds, global custody, and securities lending. Many large banks have established a private banking department, offering a full array of investment management services, including fiduciary services, to high net worth individuals. As the fiduciary business continues to evolve, the wide variety of products and services, frequently offered in locations outside of the traditional trust department, presents a complex administrative challenge to bank boards.

Regardless of the scope of the fiduciary activities, however, the board is responsible for monitoring its administration. The board must protect the bank's fiduciary reputation, as well as the assets of the customer, by having effective policies and procedures, management information systems, and risk management practices. The board should confirm that individuals who administer fiduciary activities at the bank are knowledgeable, competent, and have high personal integrity. It also should ascertain that internal controls and compliance management systems are adequate to minimize compliance, transaction, reputation, and strategic risks associated with fiduciary activities.

#### FIDUCIARY ACTIVITIES: AREAS OF CONCERN

When considering fiduciary activities, the following practices or conditions should trigger additional board scrutiny:

The opening of new accounts not in compliance with account acceptance guidelines.

To protect the bank's reputation as a fiduciary, and thereby minimize reputation risk, the bank must know its customers. The board should establish, or delegate the establishment of, guidelines designed to make sure that only accounts that meet the board's selection standards are accepted. An account acceptance process helps prevent the opening of new accounts with unclear objectives, accounts that management is not qualified to administer, accounts that may lead to conflicts of interest, and accounts that may expose the bank to future

liabilities such as from environmental hazards. The guidelines also should specify how exceptions to policy are to be handled and that management should be able to support why an exception should be made.

The purchasing of securities not previously approved by the board or investment committee.

The board or investment committee normally establishes investment guidelines and approves investment lists to control the acceptable amount of risk. Any security purchase that falls outside of established guidelines should be carefully evaluated to determine its suitability for an account. Management should document its decision to purchase such an asset.

Higher than anticipated yields on investment portfolios, collective investment funds, or advised mutual funds.

Investment managers who are rewarded solely on the performance of the portfolios they manage may have an incentive to accept more risk in order to increase returns. Even if the securities purchased are authorized for the account or fund, the manager may be taking undue risks. For example, a pooled fund may allow investment in mortgage-backed securities. To increase yields, the manager may invest in higher risk mortgage-backed securities or have a concentration of those securities. The board should determine if the risk assumed to achieve higher than expected returns is acceptable.

The existence of accounts with unusually high cash balances or large or extended overdrafts.

A fiduciary is responsible for properly managing fiduciary assets. High cash balances in accounts may indicate that management is failing to meet its responsibility to make fiduciary assets productive. Similarly, large or extended overdrafts may indicate poor management of an account. These situations should be noted on an exception reporting system. The board should expect management to document its reasons for allowing high cash balances or overdrafts.

Failure to institute adequate internal controls for fiduciary activities.

Indications that internal controls are weak include references to numerous or repeat exceptions to policies and procedures in internal reports, internal or external audits, or in examination reports. To avoid this, the board should approve policies, which management should implement with procedures, establishing a strong internal control structure. The organizational structure of the department should provide for separation of duties. Reports noting exceptions to policies should be reviewed on a regular basis, with exceptions properly approved. Significant exceptions should require prior approval by the board or a designated committee.

Losses or settlements arising from actual or threatened litigation that are significant in either size or volume.

Losses or settlements may indicate that fiduciary assets are not being administered properly. The board should require management to explain thoroughly any significant losses or litigation, and make an effort to identify the cause of the problem. The board should then determine that the underlying reason for the problem has been corrected. Numerous or increased amounts of customer complaints also may indicate administrative weaknesses. To mitigate reputation and litigation risks, the bank should ensure that all customer complaints are investigated and addressed by management to ensure that customers are being properly served.

Any situations that give rise to a conflict of interest.

To protect the bank's reputation as a fiduciary, the board should direct management to implement policies and procedures to avoid conflicts of interest and even the appearance of conflicts. The board should have a review process that checks for compliance with applicable laws, regulations, policies, and procedures. Exceptions should be reported to the board, which should then instruct management to take appropriate corrective action.

## INSIDER ACTIVITIES

Public confidence in a bank's operation and condition is fundamental to its ability to attract and maintain deposits at a reasonable cost;

a bank must have a reputation for honesty and integrity. Insider abuse, often the result of a lack of clear written internal policies or a failure to enforce them, ranks high on the list of causes of bank failures. The importance of this issue to the very survival of a bank means that the board must assume a leadership role. The board must adopt and enforce strong written insider policies governing the relationship of the bank to insiders and their related interests. The board must adopt similar policies to cover bank officers and employees. Failure to control insider activities properly can subject the bank to reputation, strategic, credit, and liquidity risks. Among other things, the board's insider policies should address:

- ❑ Guidelines for insider lending and transactions with bank affiliates.
- ❑ The disclosure of actual and potential conflicts.
- ❑ Guidelines for handling confidential information.
- ❑ The need for dealings to be at arm's-length.
- ❑ Prohibitions against the use of insider information in securities transactions.
- ❑ Restrictions on the acceptance of gifts, bequests, or other items of value from customers or other persons having a business relationship with the bank.

The board must establish a method to administer and monitor compliance with the bank's insider policies. The board should ask management to develop training and awareness programs covering insider issues and should establish lines of communication outside of the normal chain of command. These communication channels, which are intended to increase the likelihood that insiders and employees will seek guidance, should provide advice and assistance to directors, officers, and employees as ethics questions arise. The board should monitor questions and responses periodically to ensure consistent



interpretations. Finally, the policies should provide clear guidance on what actions the bank will take in the event of noncompliance.

#### INSIDER ACTIVITIES—AREAS OF CONCERN

In addition to issues discussed elsewhere in this book, such as in the section entitled “Lending Activities—Areas of Concern,” the following practices or conditions should trigger additional board scrutiny:

Transactions resulting in a conflict of interest.

Bank insiders can and should bring legitimate and profitable business to the bank. Any transaction between a bank and an insider or his or her outside interest, however, should be made in a manner that avoids even the appearance of a conflict of interest with the personal or business interests of that insider. For example, an insider’s loans and deposits, and those to his or her interests, should be made on terms and at rates that are comparable with those offered other customers. Purchases or sales of assets or securities between a bank and its insiders should be made on an arm’s-length basis at fair market value. Insiders should disclose their interests and the board should ensure that procedures are in place to scrutinize closely insider transactions. Transactions between the bank and other persons or businesses an insider brings to the bank should be monitored. A bank insider should avoid accepting gifts or soliciting anything of value in connection with any transaction between the bank and its customers.

The payment of excessive compensation or unjustified fees.

Insiders who are not bank employees may be entitled to compensation for services they perform for the bank. Compensation can take the form of salaries, bonuses, fees, benefits, or other goods and services. Compensation that is either excessive or contributes to material financial loss to the bank, however, is an unsafe and unsound banking practice and is prohibited by regulatory safety and soundness standards.

Fees paid to insiders for specific services should be based on cost, cost

plus a reasonable profit, or current market value. The board should ensure that records are retained that demonstrate the fair value of the goods and services rendered, the benefit to the bank, and the appropriateness of the fees paid. The board should review these records as part of its ongoing supervision of the bank's affairs. If excessive compensation is discovered, the board is responsible for taking corrective action, including seeking restitution.

Failure to comply with laws and regulations.

Insider activities are governed by several laws and regulations. They include reporting requirements, limitations on the type and amount of certain insider transactions, approval requirements, and prohibitions on certain types or characteristics of insider transactions. A bank in noncompliance with these laws and regulations may face increased reputation risk and be subject to an administrative action or civil money penalties (CMPs). The board should ensure that bank insider policies and procedures incorporate legal requirements and that insiders receive training on these requirements. When complex situations arise, such as the applicability of the various combination and attribution insider lending limits rules, the insider should seek legal guidance.



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## THE DIRECTOR'S INDIVIDUAL RESPONSIBILITIES

BE DILIGENT  
BE LOYAL TO THE BANK'S INTERESTS

This chapter discusses in practical terms the director's individual responsibilities. It has common sense advice about how directors can meet these responsibilities when overseeing the bank's operations.

### BE DILIGENT

A director of a national bank has distinct individual duties, responsibilities, and potential liabilities. Directors must devote the time and attention necessary to do their jobs. They must be aware of the bank's condition and knowledgeable enough to contribute meaningfully to the board's work. Simply put, a director must diligently and actively perform his or her responsibilities. If not, under some circumstances, individual directors may be held personally liable for losses suffered by the bank or others. While not all-inclusive, the following five points discuss specific things a director can do to be diligent.

## ATTEND BOARD AND COMMITTEE MEETINGS

Directors who do not attend or participate in board and assigned committee meetings regularly are not fully meeting their responsibilities. Being present at those meetings is important to keeping informed about the bank's activities. The OCC considers this so fundamental that bank examiners may specifically criticize an individual director's unsatisfactory attendance. In addition, the securities laws may require certain banks to publicly disclose a director's poor attendance record. A director's absence from a board meeting, moreover, does not necessarily relieve that director from responsibility for what took place at the meeting. Any director who is unable to attend meetings regularly, because of ill health or for other reasons, should consider whether continuing membership on the board is in the bank's or the director's own best interests.

## REQUEST AND REVIEW MEETING MATERIALS

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DIRECTORS SHOULD DECIDE  
WHAT INFORMATION THEY  
NEED TO STAY INFORMED OF  
THE BANK'S CONDITION AND  
TO PARTICIPATE MEANINGFUL-

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Directors should decide what information they need to stay informed of the bank's condition and to participate meaningfully in board meetings. They are responsible for ensuring that the information selected for review permits the board to fulfill its

duties. For its part, management is responsible for providing adequate information to the directors.

Outside directors may benefit from reports specifically tailored to their needs. These directors lack day-to-day exposure to bank activities and should not be expected to monitor operations by receiving extensive, detailed reports on every issue or even the same abbreviated reports prepared for senior management. Instead, outside directors may find reports most useful when they present a current and concise picture of the bank and focus on the issues that demand the board's attention and action.

Directors should ensure that they receive meeting materials early enough before the meeting to allow them to review the information carefully. Each director should be familiar with the information provided and should review it carefully and follow up on any questions that the material may raise. A board functions at its best when informed directors interact and apply their individual expertise and varied backgrounds to the decisions facing them.

#### ASK QUESTIONS AND SEEK EXPLANATIONS OF PROBLEMS

Directors should have a complete and accurate understanding of the bank's condition. If particular matters are unclear, directors should ask management to provide more information. Directors must take the initiative to address potential problems they see. Exceptions from board policies, for instance, should generate directors' inquiries and requests for follow-up information to ensure that proper controls are in place.

Directors can and should feel free to communicate with other directors or management outside of the formal board meeting. Both directors and management can benefit from such informal contacts. A director who does not wish to interrupt or ask extensive questions during board meetings might, for instance, find it more convenient and productive to ask questions of management or other board members before or after board meetings. Directors also might find that sitting in on key management planning or review meetings helps them understand issues affecting the bank.

Whatever the method chosen, individual directors should not make decisions before their questions are satisfactorily answered. A director who cannot make an informed decision should ask the board to postpone the decision until adequate information is available or more time is provided for discussion. If this is a recurring problem, the board should review the format of board proceedings or management's responsiveness to inquiries from directors.

## UNDERSTAND AUDITS AND SUPERVISORY COMMUNICATIONS

Individual directors should review personally all reports and significant communications from the bank's auditors and regulators, and ensure they understand the important issues. Information from such third-party reviews of the bank's operations can help the director, and the entire board, assess the accuracy and validity of information from management. A director who wants help understanding the findings or recommendations of a report can contact the bank's audit committee, or the examiners, auditors, or outside consultants who prepared the report.

Regulatory and other third-party reports such as outside audit reports also provide notice to board members of problems in the bank. These reports may show that losses from uncorrected problem areas resulted from a board's failure to supervise the bank adequately. Because of the significance of these reports, and the fact that bank regulators may hold individual directors accountable, directors should understand the problems identified and ensure that management takes needed corrective actions within specified time frames.

## EXERCISE INDEPENDENT JUDGMENT

Directors should be objective and independent when overseeing the bank's affairs. Each director should examine and consider thoroughly management's recommendations. Examples of situations in which a director could feel uncomfortable exercising independent judgment include:

- ❑ Inside directors who may feel a need to support management actions to keep their jobs.
- ❑ Inside directors who may have a biased judgment because of their involvement in specific bank operations.
- ❑ Outside directors who may believe that they do not know enough

about banking to evaluate meaningfully management's recommendations.

- ❑ Outside directors invited by the CEO to join the board who may feel pressure to support management if they wish to remain directors.
- ❑ Both inside and outside directors who may feel compelled to vote with a controlling shareholder (who is also a director) to keep their positions.

Despite these fears, pressures, and concerns, individual directors must exercise independent judgment. Directors should ask management the questions and elicit the facts necessary to satisfy themselves that management's recommendations are feasible and in the bank's best interests.

Each director contributes an important perspective to the board. The exercise of objective judgment is critical to the board's effectiveness. If a director disagrees with a board action based on his or her own review of the matter, the director should state formally his or her view, explain the reasons for disagreement, and request that the position be recorded in the board of director's minutes. Thoughtful disagreement among directors is healthy and can suggest that the board is independent and not operating under undue influence by management or from an individual director. A director's recorded dissent in the board minutes also may protect that director from some potential liability resulting from that action.

## BE LOYAL TO THE BANK'S INTERESTS

Directors are responsible for dealing fairly with the bank in business transactions and for ensuring that their personal interests do not bias board decisions. While transactions between a bank and its directors may be important to the bank, directors must ensure that their own business and personal relationships with the bank, and the relationship of the bank with the other directors, are always at arm's length.



Also, directors must not improperly take business opportunities away from the bank. Although the law does not prohibit a bank director from doing business with the bank, directors must ensure that they do not abuse their position to benefit personally at the bank's expense. Directors must structure their business and personal dealings with the bank to comply with legal requirements and to avoid even the appearance of a conflict of interest. In addition, directors must take reasonable action to prevent other employees from abusing their position with the bank.

Insider activities can lead to reputation, liquidity, compliance, and credit risks. If a director does not follow insider laws and regulations carefully, the bank's reputation and that of its directors may be tarnished. If these problems become known to the public, the bank may experience liquidity problems and compliance risk may increase. A bank may be exposed to credit risk when insiders use their positions to obtain loans for which they might not otherwise qualify.

Directors must approve written insider policies for the bank that address codes of conduct, conflicts of interest, and other relevant issues. Insider policies, including codes of conduct, address the activities of directors, officers, and employees at all levels of the bank. An appropriate code of conduct can set a pattern for proper behavior by directors and all bank employees and help avoid future supervisory and legal problems. Board members and other insiders can conduct business with the bank according to an established routine that recognizes and observes all of the policies' requirements. Moreover, following these policies should make compliance with the legal restrictions on insider dealings easier.

After approving written insider policies for the bank as a whole, directors should have processes for handling insider transactions. For their part, individual directors can avoid illegal insider transactions in many ways, by:

- Following written insider policies including a reasonable, judicious bank policy on directors' salaries, fees, loans, and expenses.

- ❑ Consulting with bank or personal legal counsel before entering into or approving transactions involving the bank and a director or a company controlled by a director.
- ❑ Disclosing all real or potential conflicts to the entire board before a board decision is made. For example, a director should disclose any ownership interest in or other personal or business relationship to a borrowing entity before a loan is discussed or approved; in some instances, prior disclosure is required by law and regulation.
- ❑ Making sure that transactions between the bank and a director or company controlled by that director are documented fully. Documentation for such transactions might include:
  - Independent appraisals of property that the bank is considering buying, leasing, or selling from or to a director, or other documents establishing the competitiveness of the terms.
  - Information showing that a proposed loan to a director or his or her business interest is comparable with specific loans made by the bank to non-insiders.
  - Board minutes that reflect the nature of the board’s deliberations regarding a potential conflict of interest involving a director.
  - Board actions approving such transactions, as appropriate or required.
- ❑ Making sure that a director with a potential conflict of interest in any matter refrains from discussing, voting, or having any other involvement in the matter. Whether the matter requires board approval or not, the director should disclose all the facts relevant to the transaction and his or her potential conflict, and ensure that this action is documented, preferably in the board minutes. When directors engage directly in a transaction with the bank,

they are required to disclose all material information about the matter, even if the information is confidential.

- ❑ Observing the rule that the bank's interests must be paramount in any transaction involving a director or a company controlled by a director.

## DIRECTORS AND THE LAW

COMMON LAW LIABILITY  
STATUTORY AND REGULATORY LIABILITY  
INDEMNIFICATION AND INSURANCE

Earlier portions of this book provided practical guidance on the basic duties and responsibilities of a national bank's board of directors and its individual members. This chapter discusses how the law defines these responsibilities and the ways in which a director may be held personally accountable for wrongdoing. It includes synopses of key banking and other laws and regulations under which a director may face liability. The chapter concludes with a brief discussion of the law as it relates to indemnification and insurance agreements.

The law—through court decisions that are the basis of the common law and statutory and regulatory provisions—establishes standards for measuring a director's performance. An individual director who fails to meet these standards may be liable for losses or injury incurred by the bank or others, and may face administrative action. Although there may be some variation from state to state, both the common law and the statutes often address the same conduct.

The common law establishes broad standards about the level of dili-

gence a director must apply and the appropriate framework for a director's dealings with a bank. It holds a director accountable for loss or injury resulting from a failure to properly and adequately fulfill the duties of a director. Statutory and regulatory provisions reinforce these broad standards and address specific areas of conduct where directors may be held accountable and may face sanctions.

## COMMON LAW LIABILITY

The common law is that body of law made up of cases decided by the courts (as opposed to specific laws that are enacted by Congress or by a state legislature or regulations promulgated by an administrative agency). The common law establishes generally accepted legal principles and it imposes two basic duties on directors. One is the "duty of care." The other is the "duty of loyalty." These duties generally require that:

- ❑ A bank director must diligently and honestly administer the bank's affairs.
- ❑ A bank director must place the interests of the bank above his or her own interests.
- ❑ Any transactions between a director and the bank must be conducted on terms that are fair to the bank.
- ❑ A bank director may authorize bank management to take only those actions or perform only those activities that are legally permitted for the bank.

A national bank director—like the director of any other corporate entity—may be held personally liable in lawsuits for losses resulting from violation of the common law duties of a director. Parties such as the shareholders (either individually or on behalf of the bank), depositors, or creditors who allege injury by a director's failure to fulfill these duties may bring such suits.

## DUTY OF CARE

The common law holds an individual director to a specific standard of care which, in civil cases, is ordinarily established by state law. In actions brought against directors by the FDIC in its receivership capacity, however, the FDIC may rely on a federal statute that establishes gross negligence as the applicable standard if a state has adopted a less stringent standard for the director, such as “reckless disregard.” When a court examines whether a director has fulfilled the duty of care, the court will measure the director’s conduct against the applicable standard established by law. Courts often will consider any special factors that might affect how they will view a director’s conduct. For example, the court could expect different behavior from an “inside” director, such as the president of the bank who is familiar with day-to-day bank operations, than it would from an “outside” director, who may have less detailed knowledge of banking operations or issues.

The courts usually hold a director responsible for knowing what a reasonable and prudent director would have known, and the courts evaluate the director’s conduct based on that knowledge. A director who is unaware of a problem may still be liable if the ignorance resulted from inattention. If someone misled the director or provided incorrect information, however, these factors would weigh against liability, assuming the director had been diligent and had no reason to suspect a problem or to question the information. The courts presume that a reasonable and prudent director would investigate any indication of a problem.

The law does not expect a director to ensure or guarantee the bank’s profitability or to be able to control totally the actions of all the bank’s officers. Similarly, the law does not expect a director to be all-knowing about all business decisions regarding the bank. The law does expect, however, that under the duty of care, a director will carry out his or her responsibilities diligently. Satisfying this duty may protect a director from liability for losses resulting from an error in judgment. To be protected from liability, the director’s decision-making process

should have involved careful consideration of reasonably available and relevant facts and the information necessary to make a well-informed decision. The director also must honestly and reasonably have believed that the decision was in the bank's best interests.

When circumstances alert a director to an actual or potential problem, the "duty to investigate" requires that the director take steps to learn the facts and to resolve the situation. For instance, if a director learns about an examiner's or auditor's criticism, whether by informal communication or written report, the director is responsible for ensuring that the board and management review the matter and that any necessary corrective action is taken. Also, the recurrence of a situation that previously caused problems should alert the director to monitor the matter even more carefully, because the director will be considered to have been put on notice the first time the problem was discovered.

#### DUTY OF LOYALTY

The duty of loyalty generally prohibits a director from placing his or her personal or business interests, or those of others, above the bank's corporate interests. A director must be fair in all dealings with the bank, and personal interests must not affect his or her decisions as a director. A director must not take advantage of any corporate opportunities that the director learns about because of his or her position without first offering those opportunities to the bank. This is called the "usurpation of corporate opportunity" doctrine. Finally, the duty of loyalty requires that a director must neither disclose nor use for his or her personal benefit information about the bank or its customers acquired because of his or her position as a director. The following examples illustrate the concepts of "duty of loyalty," and "usurpation of corporate opportunity."

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**A group of directors offers to lease property or equipment to their bank.**  
To avoid breaching the duty of loyalty, the directors must advise the board of their specific interest in the matter and of any material information relevant to the transaction. The disinterested directors must then

decide independently that the transaction is fair to the bank because the terms are at least as favorable as those available from other persons or entities unaffiliated with the bank. To make this decision, disinterested directors may, for example, obtain independent appraisals and bids to be sure their deliberations are impartial and that they independently analyzed all relevant information.

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**A director discovers that property the bank has been considering** acquiring for a branch is for sale. The director wants to buy the property personally. A director may avoid liability under the usurpation of corporate opportunity doctrine if he or she allows the bank the first opportunity to purchase the property. If the bank decides against purchasing the property after disinterested directors have fairly and fully considered the facts, the interested director may pursue the matter or recommend it to others.

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The duty of loyalty does not mean that a director may not do business with the bank or may not participate in transactions in which the bank may have an interest. It does mean that a director must disclose fully to the board any personal interest that he or she has in matters affecting the bank and must also disclose all material, non-privileged information relevant to the matter. Independent and disinterested directors must decide that any transactions involving these interests are fair to the bank.

## STATUTORY AND REGULATORY LIABILITY

Although the common law legal duties of directors (duty of care and duty of loyalty) are independent requirements, various statutes and regulations incorporate these common law concepts. Unlike the broad standards found in the court decisions that comprise the common law, however, these statutes and regulations set out specific terms for the conduct and activities of directors and their banks.

Common law and statutory provisions, including federal banking statutes and state corporate and fiduciary statutes, often address the



same conduct. A party seeking redress against a director could therefore sue alleging a violation of either or both sources of law. For example, both the common law and statutory law prohibit directors from receiving preferential treatment, such as an interest rate on a loan that is lower than what is available to other borrowers in the same circumstances. The duty of loyalty under the common law prohibits this practice; a statutory prohibition on insider abuse also specifically prohibits this practice.

A director who violates any banking law or regulation, engages in an unsafe or unsound banking practice, or breaches a fiduciary duty (or permits another person to do so) may be held personally liable or subjected to monetary penalties or other sanctions. The director may be held responsible either alone or jointly with other board members or related interests of the director in lawsuits or in administrative actions.

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**Two directors are aware that an officer of the bank is authorizing** repeated overdrafts and loans that exceed the bank's legal lending limit. Although the officer's actions are illegal and subject the bank to substantial credit risk, the two directors take no steps to prevent the offending officer from continuing the practices and decide not to inform the board of the problem. The two directors' inaction enables the officer to continue these practices, which result in significant losses to the bank. The two directors' failure to take appropriate action to stop the practices and alert the rest of the board of the officer's conduct represents a disregard for the bank's safety and soundness and could subject them to a lawsuit or an administrative action. In addition, an administrative action may be brought against the officer who initially engaged in the improper conduct.

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## KEY BANKING LAW PROVISIONS

Directors are responsible for overseeing bank compliance with all applicable laws and regulations. These laws and regulations cover a

wide range of banking issues, such as general corporate structure and governance, bank assets, bank operating authorities, and consumer protection. Directors might find it helpful for in-house or outside counsel to review periodically the broad statutory and regulatory framework, brief the board on statutory or regulatory developments particularly relevant to their bank's activities, and advise the directors on specific compliance issues that may arise.

Listed below are some statutes and related regulations that merit special attention because they are often relevant to transactions engaged in by a bank. The descriptions of these statutes and regulations are not intended to be authoritative restatements of the law and regulations, particularly since statutory and regulatory changes may take place after this book is published. Directors and management are responsible for consulting the current version of the specific statutes and regulations implicated by a particular transaction or consulting legal counsel as appropriate.

The description covers the following issues:

- ❑ lending limits
- ❑ insider transactions
- ❑ transactions with affiliates
- ❑ safe and sound banking practices
- ❑ reporting requirements
- ❑ other laws and regulations.

#### LENDING LIMITS (12 USC 84, 12 CFR 32)

The law limits the total dollar amount a bank can lend to a single borrower (including any bank insider or employee). Congress imposed these limits to restrict the impact of a default by any individual bor-

rower on the overall safety and soundness of a bank. The limits are also intended to promote credit diversification among a broad range of borrowers.

A bank computes the dollar amount of the lending limit as a percentage of its capital and surplus. A bank must recalculate its lending limit quarterly when it files its call report, basing the new calculation on the amount of the bank's capital and surplus at the end of the previous quarter. In special circumstances, such as a merger or in the event of a major adverse change in a bank's financial condition, the OCC can send a written notice to a bank requiring it to calculate its limit more frequently. Also, a bank must recalculate immediately its lending limit any time its capital category changes under the OCC's prompt corrective action regulation.

In addition, the OCC's lending limit rules require that loans to separate but related borrowers be aggregated and attributed to one or more borrowers under specified circumstances, including when apparently separate borrowers in fact constitute a "common enterprise" or when one borrower receives a direct benefit as a result of a loan made to another borrower. Bank management must therefore review carefully all relevant facts and circumstances, including the purpose of the loan and the ultimate recipient of the proceeds, to determine whether combination or attribution is warranted.

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**A bank makes a loan to an officer of a corporate borrower. The corporate borrower has two earlier loans from the bank. The officer obtains the loan in his or her own name, disclosing that it is for the purpose of covering the corporation's overdraft, and deposits the loan proceeds directly into the corporate checking account with the bank. Although the bank makes the loan in the officer's name, the bank must attribute the loan to the corporate borrower and combine it with the corporation's other two loans since the lending limit law requires the bank to attribute a loan to an individual and combine it with loans to a corporation when proceeds of the individual's loans are used to benefit the corporation.**

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Before personally approving a loan, a director should always know, and should make sure that management knows, the applicable loan limit and the total debt to the bank attributable to the borrower. The assistance of legal counsel in analyzing complex lending limit questions can be helpful. A director should be certain that the bank has systems for monitoring the bank's current dollar loan limits and borrowers' loan balances so that a loan is not approved that exceeds the lending limits. Those systems should be adequate to alert management to loans made to separate but related borrowers that must be combined or attributed under the law. When bank officers or directors decide that loans to related borrowers need not be combined under the lending limit rules, they should document their decision and supporting rationale in the credit file.

INSIDER TRANSACTIONS  
(12 USC 375, 375 a, 375 b,  
1972 AND 12 CFR 31, 215)

Federal laws and regulations impose qualitative and quantitative limitations on a bank's ability to make loans to its "insiders" (directors, executive officers, and principal shareholders and their respective related interests (usually companies controlled by these insiders)). These laws and regulations are designed to prevent misuse of depositors' funds and to avoid potential conflicts of interest. Since the statutory and regulatory restrictions on insider transactions do not apply uniformly to all insiders, the board must become familiar with them and pay careful attention to whom a particular restriction applies. In addition, as with lending limits, certain loans to insiders require aggregation or attribution with loans to certain of their related interests.

Insider transaction laws impose dollar limits on a bank's ability to provide loans to individual insiders, just as they impose dollar limits on loans to borrowers unaffiliated with the bank. One of the key federal insider lending limit statutes expressly incorporates the dollar limits contained in 12 USC 84 (the national bank lending limit statute) and applies them to insiders. All of the exceptions to the

lending limits contained in 12 USC 84 and 12 CFR 32 (the OCC regulation that implements the lending limit statute) are also available to individual insiders.

Executive officers of the bank itself (but not of the bank's affiliates) are subject to some additional restrictions not applicable to other insiders. Broadly stated, these additional restrictions allow the bank to extend the following loans only if the executive officer has submitted a detailed, current financial statement; if the loans are reported to the board in a timely manner; and if the loans are not on preferential terms:

- ❑ A loan in any amount up to the bank's general lending limit for the purchase of a residence.
- ❑ A loan in any amount up to the bank's general lending limit for the education of the executive officer's children.
- ❑ A loan for any other purpose(s) up to the limit prescribed by regulation (currently \$100,000 for most banks).

When the aggregate amount of all loans outstanding to any individual insider reaches a certain limit, a majority of the disinterested members of the board must approve in advance any additional amount loaned to that insider. Federal law also imposes a separate limit on the dollar amount of loans that a bank can make to all of its insiders as a group. As is the case with loans to executive officers, some, but not all, of the exceptions contained in 12 USC 84 and 12 CFR 32 are available for the group lending limits.

Insider transaction laws also prohibit all insiders who transact business with their bank from receiving preferential treatment. Generally, the bank must conduct such transactions on terms comparable with those available to bank customers who are not insiders or employees of the bank. For example, a bank may not make a loan to a bank director at a lower interest rate or on other more favorable terms (such as waiving points on a mortgage loan) than loans provided to other

customers in similar circumstances. Other prohibitions on loans to insiders include:

- ❑ Making a loan to an insider without applying the bank's normal credit underwriting procedures.
- ❑ Making an insider loan when the loan carries a greater than normal risk of repayment.
- ❑ Failing to require the same type and amount of collateral that the bank requires of borrowers who are not insiders or bank employees.

The laws governing insider transactions also specifically prohibit banks from paying overdrafts on a director's or executive officer's account unless the overdraft is small (under \$1,000), short in duration (less than five days) and inadvertent, or payment has been preauthorized in writing according to regulatory requirements.

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**A \$5,000 check drawn on a director's account, which has a balance of only \$3,000, is presented for payment at the director's bank. The bank tries to reach the director to advise him of the problem and discovers that the director is out of the country for the next 10 days and is unavailable to cover the check. The director has not established an approved overdraft plan with the bank. As a result, the bank may not cover the check.**

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#### RESTRICTIONS ON PURCHASES OR SALES OF ASSETS AND SECURITIES

Other insider transaction limitations prohibit a bank from selling to or purchasing from its directors securities or other assets on preferential terms unless the transaction has received prior approval from a majority of the bank's disinterested directors. Before granting this approval, they must determine that such a transaction is consistent with safe and sound banking practices and with the directors' fiduciary duties.

TRANSACTIONS WITH AFFILIATES  
(12 USC 371c AND 371c-1)

Good business reasons may justify shifting resources among bank affiliates, including those within a holding company structure. Unfortunately, such transactions can sometimes strengthen an affiliate at the expense of its affiliate bank. Congress enacted statutory safeguards to prevent banks and their subsidiaries from being abused or disadvantaged by transactions with affiliated entities.

These statutory provisions limit specified transactions with affiliates to a percentage of the bank's capital and surplus. Transactions covered include loans to an affiliate; purchases of assets from or securities issued by an affiliate; the acceptance of an affiliate's securities as collateral for a loan to a third party; and the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate.

Additional nonquantitative restrictions apply as well. For example, loans to an affiliate must be properly secured according to a formula specified by statute. No bank may make a loan to an affiliate if that loan is secured by that or any other affiliate's securities. The law prohibits a national bank from purchasing from an affiliate low-quality assets, such as loans in a nonaccrual status, loans on which principal and interest are more than 30 days past due, loans classified or treated as "special mention" in the most recent report of examination or inspection, or loans whose terms have been renegotiated due to deteriorating financial condition.

To comply with these restrictions, directors should make sure that the bank independently evaluates the quality of an asset before it is purchased from an affiliate. They should question bank management as to whether assets purchased from affiliates meet statutory standards. They should be aware that all transactions with affiliates must be on an arm's-length basis; no preferential terms may be offered.

SAFE AND SOUND BANKING PRACTICES (12 CFR 30)

A director must oversee the bank's compliance with safe and sound

banking practices. A practice that is unsafe and unsound is any practice or conduct that is contrary to generally accepted standards for prudent bank operations and that, if continued, might result in abnormal risk of loss or damage to the bank.

Bank regulatory safety and soundness standards provide banks with broad guidance to follow when establishing their own standards. Twelve CFR 30 sets out guidance in the following general areas of bank operations:

- ❑ operational and managerial standards, including:
  - internal controls and information systems
  - internal audit systems
  - loan documentation
  - credit underwriting
  - interest rate exposure
  - asset growth
- ❑ asset quality and earnings standards
- ❑ compensation standards.

#### REPORTING REQUIREMENTS (12 USC 161)

The law requires banks to submit a Report of Condition and Income Statement (call report) on a quarterly basis. These call reports, which are public documents, along with other publicly available material about the bank, enable individuals engaged in or considering doing business with a bank to make informed decisions about the condition of that bank. In addition, the OCC may impose other reporting requirements on national banks to help it monitor the condition of banks.

The information a bank submits in a call report must be accurate. The report must be signed by a duly authorized officer of the bank and three directors must attest to its correctness. A bank that inac-



curately represents its true condition in its reports may be breaching its reporting responsibilities and be subject to penalties. Similar inaccurate disclosures in other bank documents also may violate the reporting and antifraud provisions of the federal securities laws.

## OTHER LAWS AND REGULATIONS

### SECURITIES LAWS (15 USC 77a,78a)

Directors who make material misrepresentations or omissions or act upon material nonpublic information or otherwise engage in fraudulent conduct in connection with the purchase or sale of securities may be liable for violations of the securities laws and therefore subject to penalties. Investors, the OCC, and the Securities and Exchange Commission (SEC) may bring an action against a director for fraudulent conduct under the antifraud provisions of the securities laws. A director may be liable for fraud in a securities transaction, depending on the nature of the director's involvement in, and knowledge of, the transaction. Directors who purchase or sell securities based on non-public confidential information to profit or avoid loss at the expense of other investors may be liable for insider trading under the antifraud provisions. Directors who engage in activity that violates state antifraud statutes governing intrastate sales of securities may be subject to liability under state law.

When a national bank issues securities, it is subject to regulations that are designed to protect the bank's capital and its investors. The OCC's regulations incorporate by reference certain SEC regulations and generally require the bank to prepare and file with the OCC an accurate and complete offering statement that gives public investors all the information they need to make an informed investment decision. The OCC may require a bank to correct or rescind an offering circular that does not disclose adequate and complete information. Directors responsible for material misrepresentations or omissions in an offering circular may be subject to liability under the antifraud provisions.

Any national bank with 500 or more shareholders at the end of its fiscal year and assets exceeding \$5 million must register its equity securities with the OCC. Banks that meet these requirements are often referred to as “registered” banks. Registered banks must comply with certain reporting and disclosure requirements under the federal securities laws. For example, directors are responsible for reporting changes in ownership of bank stock. A director may be liable in an action brought by the OCC, the SEC, or injured investors for a bank’s failure to comply with these requirements.

#### ANTITRUST LAWS (12 USC 1828(c), 15 USC 1, 2, 18)

Banks are subject to both generally applicable antitrust laws and antitrust laws that apply specifically to banks. Generally applicable antitrust laws prohibit banks from undertaking actions in restraint of trade, such as fixing interest rates or fees, allocating markets between competitors, or monopolizing a market.

Other antitrust laws and regulations apply specifically to banks, including those imposing restrictions on mergers and other types of business combinations. Antitrust regulations prohibit bank mergers that will substantially lessen competition. A merger that would be in restraint of trade also is prohibited, such as a merger whose sole purpose is to eliminate a competitor. Two other antitrust laws that specifically apply to banks cover management interlocks and anti-tying issues.

#### MANAGEMENT INTERLOCKS (12 USC 3201, 12 CFR 26)

Management interlocks laws and regulations generally prevent officials of one institution from being involved in the management of another institution in the same area or, in larger institutions, no matter where the institutions are located. Certain exceptions apply, however, such as in troubled institutions or institutions doing business outside of the United States.

## ANTITYING (12 USC 1972)

Broadly stated, banks are generally prohibited from extending credit, leasing or selling property, furnishing services, or varying prices if they impose a condition that the customer either (1) obtain another product or service from the bank or any of its affiliates or (2) not obtain an additional product or service from a competitor. For example, antitying provisions prohibit:

- ❑ The extension of credit or a reduction in the price of credit on the condition that a customer purchase “other real estate owned” from the bank.
- ❑ The sale of property to a customer on the condition or requirement that the customer obtain securities services from an affiliate.
- ❑ The extension of credit to a customer on the condition that the customer not obtain a loan from a competitor (unless the restriction ensures the soundness of the credit).
- ❑ The provision of a letter of credit to a customer on the condition that the customer lease space to the bank at a favorable rate.

Certain transactions are not subject to these antitying prohibitions. For example, a bank may rely on a “traditional bank products” exception to require a customer to obtain a loan, discount, deposit, or trust service in order to be eligible to obtain some other products offered by the bank. Likewise, a bank can vary charges on traditional bank products or brokerage services if the customer obtains a traditional bank product from an affiliate.

## CRIMINAL LAWS (18 USC 215, 656, 1001, 1005, 1344)

A national bank director may be criminally liable for his or her actions as a director. For example, directors may incur criminal liability if they:

- ❑ Falsify bank records.
- ❑ Misuse or misapply bank funds or assets.
- ❑ Request or accept fees or gifts to influence, or as a reward for, bank business.
- ❑ Make false statements generally.

In addition, criminal laws require national banks to report suspected criminal violations to the OCC and to federal law enforcement agencies. The OCC also refers suspected criminal activity in national banks to law enforcement officials. If a suspected criminal activity leads to a criminal conviction, a plea agreement, or a pre-trial diversion program (a program allowing first-time offenders to avoid formal prosecution by participating in community service projects), and the criminal offense involves dishonesty or breach of trust, the person may not serve as a director, officer, employee, or institution-affiliated party (IAP) of any FDIC-insured bank unless the FDIC provides specific consent. (In addition to directors, IAPs include bank officers, employees, controlling stockholders, and other individuals who participate in the affairs of the bank.)

## INDEMNIFICATION AND INSURANCE

A bank director may not be able to avoid being named as a defendant in lawsuits challenging the business decisions and activities of board members. A director can, however, obtain some protection against large financial losses through indemnification agreements and insurance. An indemnification agreement, which is included in the bank's bylaws if adopted, specifies that the bank will reimburse a director for expenses incurred in legal actions when the director was performing services for the bank. Such agreements should be consistent with safe and sound banking practices. The bank also may provide insurance protection for a director, generally in the form of director and officer liability insurance.

National banks are subject to regulations governing indemnification. For example, indemnification provisions that apply to administrative proceedings or civil actions initiated by a federal banking agency must be reasonable and consistent with the requirements of 12 USC 1828(k) and its implementing regulations. In addition, national banks may purchase insurance for expenses covered by indemnification provisions, but may not purchase insurance to pay civil money penalty (CMP) assessments imposed by a bank regulatory authority.

Indemnification provisions may reflect the state law in which the bank is located, the state law in which the bank's holding company is incorporated, the Model Business Corporation Act, or the Delaware General Corporation Law. Because indemnification statutes vary among states, bank directors should be familiar with the provisions applicable to them and aware of any limitations contained in these statutes or elsewhere.

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## ADMINISTRATIVE ACTIONS

POTENTIAL ACTIONS AGAINST NATIONAL BANKS  
POTENTIAL ACTIONS AGAINST INDIVIDUAL DIRECTORS

Previous chapters of this book described matters that a board of directors of any national bank should understand to help the bank operate soundly. This chapter deals with the types of remedies available to the OCC to address problems in a bank or with its directors. These remedies are designed primarily to help overcome deficiencies in a bank's operations.

Because the OCC and the bank's management and directors have a mutual interest in improving the condition of a bank in which problems have been identified, it is in both parties' best interests to take corrective action promptly. The OCC will decide on a case-by-case basis whether or not to bring an action against a bank or a director or other institution-affiliated party (IAP) and the nature and extent of the action taken. The OCC will always consider how best to correct violations and unsafe and unsound banking practices and to prevent future bank problems. Key factors in the OCC's decision-making process include:

- The seriousness of the problems or the violations of law.
- The board's history of cooperation with the OCC and the apparent ability and willingness of the board to take the appropriate corrective actions.

The examiner's exit meeting with bank management and the board may be the bank's first indication that the OCC has concerns about the bank and is considering an administrative action. Directors should always attend this meeting and should use this opportunity to seek advice about how to correct existing or potential problems.

The bank's directors also may request a meeting with other OCC personnel if the OCC has indicated that it is considering an administrative action. OCC personnel will discuss the reasons for the proposed action with them as well as the specifics of the proposed document.

A national bank can appeal any dispute concerning the examination findings to its OCC district administrator or deputy comptroller before the administrative process begins. If the bank foregoes this option, the period between the end of an examination and the time the findings are formalized in a report of examination provides a good opportunity for the bank to formulate and begin to carry out a reasonable plan to correct problems that examiners noted. The actions the board proposes to take to deal with these concerns should be documented in the board minutes. In addition, the OCC encourages, and under certain circumstances requires, banks to submit to it responses stating the bank's commitment to a corrective plan and specifying the terms of the plan. During this period, the bank is encouraged to keep in contact with its OCC supervisory office and to work with the OCC to respond promptly and positively to the agency's concerns.

Good faith discussions between the board and the OCC generally are successful in bringing about a speedy and mutually acceptable resolution of differences. These discussions should focus on devising a realistic and reasonable method to restore the bank to good condition. Failure to correct cited problems promptly and decisively can result in more severe OCC action.

## POTENTIAL ACTIONS AGAINST NATIONAL BANKS

The OCC may choose to take actions to correct specific problems identified at a bank. Actions typically specify what the bank needs to do to correct identified problems, such as improving lending practices, raising capital, instituting proper policies and procedures, or correcting specific violations of law. These actions may take the form of board resolutions, commitment letters, memoranda of understanding, formal agreements, cease and desist orders, capital directives, prompt corrective action directives, or safety and soundness directives. The OCC also may assess CMPs against a bank or, under certain extreme situations, place a bank into conservatorship or receivership.

The OCC will impose an administrative action on a bank after obtaining the consent of a majority of the bank's directors about the remedies to correct problems. If the OCC does not receive such consent, it may begin an administrative proceeding to impose one of the more formal actions. Whether the administrative action is entered into by consent or imposed through an administrative proceeding, all of the directors are ultimately responsible for the bank's compliance with the action. Administrative actions, with the exception of temporary cease and desist orders, remain in effect until the OCC determines that the bank's overall condition has improved significantly and the bank has achieved sustained compliance with the terms of the document. When this occurs, the OCC will terminate the administrative action.

### BOARD RESOLUTIONS

The OCC occasionally will ask a bank to pass a board resolution addressing certain problems or deficiencies in the bank. A board resolution, which is one of the least severe administrative tools available to the OCC, is used when more formal measures are deemed unnecessary.



## COMMITMENT LETTER

A commitment letter is also one of the least severe tools used by the OCC. It is, in effect, a document drafted by the OCC and signed by the bank's board of directors which enumerates the problems that require corrective action and lays out a plan and timetable to remedy the problems. A commitment letter may be used when the bank has been responsive to OCC concerns, does not have a history of serious problems, and the problems identified do not pose a serious threat to the bank's health.

## MEMORANDUM OF UNDERSTANDING

Like a commitment letter, a memorandum of understanding (MOU) is initiated by the OCC and is entered into between a bank's board of directors and the OCC. A MOU sets forth the bank's agreement to take certain actions within specified time periods to correct violations of law or unsafe or unsound banking practices. The OCC generally uses a MOU only when the problems do not pose a serious threat to the bank and when the agency expects that the bank will cooperate in correcting the problems so that legal enforcement will not be required to achieve compliance. The OCC views a MOU as slightly more formal than a commitment letter but, like a commitment letter, it is not administratively or judicially enforceable.

## FORMAL AGREEMENT

A formal agreement is similar in form to a MOU. Like a MOU and a commitment letter, it requires agreement between the OCC and the bank about the action necessary to correct the identified problems. It is proposed when the problems in the bank are not too severe and management is cooperative. A formal agreement differs from a MOU and a commitment letter, however, in that such an agreement is a formal, public document and the OCC may assess CMPs for any violation of that agreement. In addition, the OCC may order compliance with a formal agreement through a cease and desist order.

## CEASE AND DESIST ORDER

Through the use of a cease and desist order (C&D), the OCC may fashion appropriate remedies for violations of law or unsafe or unsound banking practices. The OCC may use a C&D to require banks to stop certain practices and to take affirmative action to correct conditions resulting from the violations or practices at issue. C&Ds are issued most often when the agency is not confident that bank management has the ability and willingness to take the necessary corrective action or when the problems are so severe that a lesser action cannot be justified.

When the OCC determines that a C&D is required, it will bring the problems to the directors' attention and will present them with an order specifying the corrective actions to be taken. Usually, the OCC will present the order at a board meeting. At that time, the OCC will ask for the board's consent to the order. Consent requires the signatures of the majority of the board. Once an order becomes effective, all directors are responsible for compliance with it. A C&D remains in effect until the OCC terminates it.

If consent to a C&D order is not obtained, the OCC may decide to serve a notice of charges setting forth the basis for the action. The bank must file an answer to the charges contained in the notice, after which the matter proceeds to a formal administrative hearing.

The Administrative Procedures Act specifies that an administrative hearing is to be held on the charges before an independent administrative law judge (ALJ). The hearing will be open to the public and the OCC will have the burden of proving the charges in the notice of charges by a preponderance of the evidence. After the hearing and the filing of briefs by counsel, the ALJ will file a recommended decision. The Comptroller will then review the entire case, with the assistance of agency counsel who have had no involvement with the administrative action, and will render a final agency decision. If the Comptroller's decision is adverse to the bank and results in the issuance of a C&D, the bank can appeal the case to a U.S. Court of Appeals.

If a bank fails to comply with a C&D, the OCC has the authority to impose CMPs against the bank. CMPs also may be directed against any individual officer, director, or IAP who, directly or indirectly, engaged in or participated in the violation. Alternatively, the OCC may take the matter to federal district court to seek a mandatory injunction requiring compliance with the C&D. If the injunction is not obeyed, contempt of court proceedings may be pursued.

#### TEMPORARY CEASE AND DESIST ORDER

The OCC may issue a temporary cease and desist order (temporary C&D) before a cease and desist proceeding is completed when the agency determines that such immediate action is necessary to protect the bank and when the alleged misconduct, or its continuation, would be likely to cause the bank to become insolvent, cause a significant dissipation of bank assets or earnings, weaken the condition of the bank, or prejudice the interests of the depositors. The OCC also may issue a temporary C&D if a bank's books and records are so incomplete or inaccurate that the agency cannot determine the financial condition of the bank or the details or purpose of any material transaction through the normal supervisory process. A temporary C&D may require the bank to cease and desist from the violation or practice and/or to take affirmative corrective action. A bank has 10 days within which to appeal a temporary C&D to a federal district court. A temporary C&D, however, is effective upon service and remains in effect until the administrative proceedings concerning the C&D are complete, unless it is set aside by court order or the OCC terminates the temporary C&D.

#### CAPITAL DIRECTIVE

Minimum capital requirements are established for all national banks by regulation. When appropriate, the OCC may establish higher capital requirements for a particular bank. Unless there are immediate time constraints, the OCC will give a bank notice and opportunity to comment on a proposal to increase the bank's minimum capital requirement.

If a bank fails to achieve or maintain its minimum capital requirements, the OCC may, among other choices, issue a capital directive against the bank. If the OCC decides to issue a capital directive, it will notify the bank and will solicit and carefully review the bank's views. If the OCC issues a capital directive, it will set forth in writing the reasons for issuing such an order. The capital directive becomes effective as soon as it is issued. The OCC may enforce a capital directive, or any plan the bank submits to comply with it, to the same extent as a C&D.

Once issued, a capital directive may require the bank to comply with any or all of the following:

- ❑ Achieve the minimum capital level applicable to it.
- ❑ Adhere to a preexisting plan to achieve the requisite capital level.
- ❑ Submit and adhere to a new capital plan.
- ❑ Take other actions, such as reducing assets or dividends, to restore the level of the bank's capital.

#### PROMPT CORRECTIVE ACTION DIRECTIVE

Legislation enacted in 1991 required the OCC and other banking agencies to establish five levels of capitalization for banks: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The legislation also authorizes, and sometimes requires, the OCC to impose restrictions on banks failing to maintain adequate capital by issuing a prompt corrective action (PCA) directive.

Unless there are immediate time constraints, the OCC will notify a bank in advance of its intention to impose discretionary PCA restrictions, and will give the bank an opportunity to submit views on the matter. If the OCC decides to issue a PCA directive, the directive will

be enforceable in district court, and noncompliance with a PCA directive can serve as a basis for an assessment of a CMP.

#### SAFETY AND SOUNDNESS DIRECTIVES

The OCC also has the authority to require compliance with safety and soundness standards established by 12 CFR 30. These safety and soundness guidelines cover internal controls, internal audits, loan documentation, credit underwriting, interest rate exposure, compensation, asset growth, asset quality, and earnings.

The OCC may require the bank to submit a compliance plan which specifies how the bank will correct the deficiency. If the bank fails to submit or implement such a plan, the OCC may issue an order or a safety and soundness directive requiring the bank to take certain steps to correct the deficiencies. These orders and directives can be enforced in district court and, alternatively, can serve as a basis for a CMP assessment.

#### CIVIL MONEY PENALTIES

Although the OCC has the authority to issue a CMP against a bank, it usually reserves this type of administrative action for individuals (except in a case of a bank filing a late, false, or misleading call report). The OCC can assess such a penalty in various amounts depending on whether the act or omission was inadvertent, knowing, or reckless. The OCC's decision on the amount of the penalty also will be based on the consequences of the act or omission.

#### CONSERVATORSHIP AND RECEIVERSHIP

In severe cases, the OCC has the authority to place a bank into conservatorship or receivership. In a conservatorship, a conservator selected by the OCC will manage the bank until it is determined what action should be taken. In a receivership, the bank will be closed immediately and handed over to the FDIC as receiver.

## SECURITIES EXCHANGE ACT ACTIONS

The OCC may pursue other actions against banks that conduct securities activities subject to the Securities Exchange Act of 1934. Such securities activities, including acting as a broker-dealer, a government securities broker-dealer, a municipal securities dealer, or a transfer agent, may be performed by a bank or its operating subsidiary. The OCC has authority under the Exchange Act to take action to redress violations of the federal securities laws by national banks and associated persons that it supervises. Depending on the severity of the violation, the OCC may censure a bank that has engaged in improper activities. The OCC also may deny or revoke a bank's registration for certain securities activities, thereby affecting the bank's ability to engage in such activities, or it may limit or suspend certain securities activities. The OCC may use these actions alone or in combination with other administrative remedies.

## POTENTIAL ACTIONS AGAINST INDIVIDUALS

The OCC has the authority to undertake certain administrative actions against individual bank directors or other IAPs. The agency may choose to take action if a director or other IAP:

- ❑ Violates any law, rule or regulation, or outstanding agency order or agreement or condition imposed in writing.
- ❑ Engages in an unsafe or unsound banking practice or breaches a fiduciary duty.

The actions available to the OCC include a formal agreement, a cease and desist order, a CMP, or a removal or prohibition action. These tools may require a director or other IAP to refrain from taking certain actions or they may require the director or other IAP to take certain affirmative actions (such as making restitution or correcting the problem).

## FORMAL AGREEMENT AND CEASE AND DESIST ORDER

Occasionally, the OCC may request a director or other IAP who has engaged in a violation or an unsafe or unsound banking practice to enter into a formal agreement or a C&D. The agreement or order might require the director or other IAP to take certain actions to correct the conditions that resulted from the violation or practice. It also might require the director or other IAP to reimburse the bank for losses resulting from the misconduct, and may even restrict the director's or other IAP's activity with regard to the conduct at issue.

If the director or other IAP declines to enter into the formal agreement or cease and desist order on a consensual basis and no settlement can be reached, the agency may issue a notice of charges against the individual. This notice seeks the formal issuance of a cease and desist order and must set forth the specific charges against the director or other IAP. In addition, it must be based on one or more of the following:

- ❑ A violation of law, rule, or regulation.
- ❑ A violation of a condition imposed in writing by the agency in connection with the granting of an application.
- ❑ A violation of a formal agreement previously entered into.
- ❑ An unsafe or unsound banking practice.

The individual must file an answer to the charges contained in the notice, after which the matter will proceed to a formal administrative hearing in the same fashion as described previously with regard to administrative actions against banks.

## REMOVAL AND SUSPENSION

The OCC may initiate action to remove a national bank director or

other IAP from banking in cases in which particularly serious misconduct has occurred. Removal actions must be based on the following statutory elements which address conduct, effect, and culpability:

- The individual must have engaged in or committed one or more of the following:
  - A violation of law, rule, or regulation.
  - A violation of a condition imposed in writing by the agency in connection with the granting of an application.
  - A violation of an outstanding formal agreement or cease and desist order.
  - An unsafe or unsound banking practice.
  - A breach of fiduciary duty.
- The conduct described above has resulted in either:
  - A loss or potential loss or other damage to the bank,
  - A financial gain or other benefit to the individual, or
  - Prejudice to the interests of the depositors.
- The conduct described above either:
  - Involved personal dishonesty, or
  - Demonstrated willful or continuing disregard for the safety and soundness of the bank.

The hearing process for a removal action is identical to the cease and desist hearing process, except that the ALJ's recommended decision is sent to the Federal Reserve Board for final agency decision. If adverse to the individual, the Federal Reserve Board's decision may be



appealed to a U.S. Court of Appeals.

Once in place, a removal order prohibits the individual from participating, in any manner, in the conduct of the bank's affairs, in voting for a bank director, or serving or acting as a director, officer, employee, or other IAP. The removal or prohibition order applies to all federally insured depository institutions (including banks, thrifts, holding companies, credit unions, and farm credit institutions) and to all federal bank regulatory agencies.

Exceptions to the restrictions of a removal order can be granted, but only if the removed individual receives the written consent of both the agency issuing the removal order and the agency supervising the financial institution with which the removed individual is seeking to become affiliated.

Once the removal action has been initiated, but before it is finalized, the OCC may issue a suspension order against the individual. This order temporarily removes the individual from the banking industry to the same extent as a final removal order. Such action is only taken, however, if the OCC determines that it is necessary to protect the national bank or its depositors. The suspended individual has the right to seek a stay of a suspension order from a federal district court within 10 days of the service of the suspension order. The suspension order is effective upon service by the OCC and remains in effect until the removal proceedings are completed, the OCC dismisses the charges, the agencies grant a written waiver, or the order is stayed by a court.

If a director or other IAP is indicted or charged with a felony involving dishonesty, breach of trust, or with a violation of the anti-money laundering statutes, the OCC also may suspend the individual after determining that the individual's continued service or affiliation with the bank may threaten the depositors' interests or may impair public confidence in the bank. The suspended individual may request an informal hearing before the agency to modify or terminate the suspension order. The suspension remains in effect until terminated by

the OCC or until the criminal charges are resolved.

If a director or other IAP is convicted of any offense involving dishonesty, breach of trust, or money laundering, the individual is removed automatically from the banking industry. Under certain circumstances, the individual may petition the FDIC for permission to reenter banking.

## CIVIL MONEY PENALTIES

The OCC also may assess CMPs of varying amounts against a director or other IAP for a violation of any law or regulation, temporary or permanent cease and desist order, condition imposed in writing, or written agreement. In certain instances, the OCC may assess CMPs for unsafe and unsound banking practices that are reckless and for breaches of fiduciary duty.

When determining whether to bring a CMP action and the amount of the assessment, the OCC will consider the following factors:

- ❑ The gravity of the violation.
- ❑ Any history of previous violations.
- ❑ Evidence of good faith.
- ❑ The individual's ability to pay.
- ❑ Other matters as justice may require.

The OCC's broad discretion to determine the amount of a CMP permits it to tailor the assessment to the facts of each case. For example, the OCC may assess an individual up to \$5,000 a day for violations of any law or regulation, temporary or permanent cease and desist order, condition imposed in writing, or written agreement. In extreme circumstances, the OCC may assess a CMP of up to \$25,000 a day for:

- ❑ Any of the violations described above.
- ❑ Any unsafe and unsound banking practice engaged in recklessly.
- ❑ Any breach of fiduciary duty.

The OCC also has the authority to assess very large CMPs on a daily basis. These assessments can take place when the individual knowingly engaged in any violation, practice, or breach and, as a result of that conduct, knowingly or recklessly caused a substantial loss to the bank or knowingly or recklessly received a substantial gain or other benefit.

When determining the amount of a CMP assessment, the OCC will take into account any mitigating factors, such as good faith, cooperation, or voluntary reimbursement for losses incurred by a bank. Conversely, the OCC may impose a more substantial penalty if an individual fails to cooperate with the OCC, fails to correct the violation, conceals the violation, or shows bad faith. Similarly, if the bank has suffered substantial loss or the insider has received personal gain from the violation, the OCC may be inclined to assess a higher penalty.

Before deciding whether to assess a CMP, the OCC will provide the individual an opportunity to submit information about the alleged violation as well as the specific factors the OCC should consider when reviewing the case. After thoroughly reviewing the response and analyzing the case, the individual will receive a “no action letter,” a “supervisory letter,” a “letter of reprimand,” or a “notice of assessment.” Supervisory letters and letters of reprimand state that no assessment will be imposed, but advise that a future violation may result in a CMP assessment by the OCC.

If a CMP is assessed, the individual may request a formal agency hearing. The hearing and appeal procedures to review CMPs are the same as those for cease and desist orders.

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