Guidelines for Financial Institution Directors

A financial institution's board of directors oversees the conduct of the institution's business. The board of directors should:

- select competent management;
- establish with management the institution's long and short term business objectives and adopt operating policies designed to achieve these objectives in a manner consistent with law and safe and sound practices;
- monitor operations to ensure they are controlled adequately and are in compliance with laws and policies;
- oversee the institution's business performance; and
- ensure the institution helps to meet its community's credit needs.

These responsibilities are governed by a complex framework of federal and state law and regulation. These guidelines do not modify the legal framework in any way and are not intended to cover every conceivable situation that may confront an insured institution. Rather, they are intended only to offer general assistance to directors in meeting their responsibilities. Underlying these guidelines is the assumption that directors are making an honest effort to comply with all applicable laws, regulations, and safe and sound practices.

In meeting the board's responsibilities, the board and its members should:

1. Maintain the independence of the board of directors. Effective corporate governance requires a high level of cooperation between an institution's board and its management. Nevertheless, a director's duty to oversee the conduct of the institution's business necessitates that each director exercise independent judgment in evaluating management's actions and competence. Critical evaluation of issues before the board is essential. Directors who routinely approve management decisions without exercising their own informed judgment are not serving their institutions, their stockholders, or their communities adequately.

2. Keep informed. Directors must keep themselves informed of the activities and condition of their institution and of the environment in which it operates. They should attend board and any assigned committee meetings regularly and should be careful to review closely all meeting materials, auditor's findings and recommendations, and supervisory communications. Directors also should stay abreast of general industry trends and any statutory and regulatory developments pertinent to their institution's operations. Directors should work with management to develop a

program to keep members informed. Periodic briefings by management, counsel, auditors or other consultants might be helpful and more formal director education seminars should be considered.

The pace of change in the nature of the business of financial institutions today makes it particularly important that directors commit adequate time in order to be informed participants in the affairs of their institution.

3. Act to ensure qualified management. The board of directors is responsible for ensuring that the day-to-day operations of their institution are in the hands of qualified management. If the board becomes dissatisfied with the performance of the chief executive officer or senior management, it should address the matter directly. If hiring a new chief executive officer is necessary, the board should act quickly to find a qualified replacement. Ability, integrity, and experience are the most important qualifications for a chief executive officer.

4. Supervise management adequately. Supervision is the broadest of the board's duties and the most difficult to describe, as its scope varies according to the facts and circumstances of each case. Consequently, the following suggestions should be viewed as general.

   a. Establish Policies. The board of directors should ensure that all significant activities are covered by written policies that are clearly communicated so that the policies can be readily understood by affected parties, including all employees. All policies should be monitored to ensure that they conform with changes in laws and regulations, economic conditions, and the institution's circumstances. Specific policies should cover at a minimum:

      - loans, including internal loan review procedures
      - investments
      - asset-liability/funds management
      - profit planning and budget
      - capital planning
      - internal controls
      - compliance activities
      - audit program
      - conflicts of interest
      - code of ethics

   These policies should be formulated to further the institution's business plan in a manner consistent with safe and sound practices. They should contain procedures, including a system of internal controls, designed to foster sound practices, to comply with relevant laws and regulations, and to protect the institution against external crimes and internal fraud and abuse.

b. Monitor implementation. The board's policies should establish mechanisms for providing the board the information needed to monitor the institution's operations. In most cases, these mechanisms will include management reports to the board. These reports should be carefully framed to present information in a form meaningful to the board. The appropriate level of detail and frequency of individual reports will vary with the circumstances of each institution. Reports generally will include information such as the following:

- the income and expenses of the institution
- capital outlays and adequacy
- loans and investments made
- past due and negotiated loans and investments
- problem loans, their present status and workout programs
- allowance for possible loan loss
- concentrations of credit
- losses and recoveries on sales, collection, or other dispositions of assets
- funding activities and the management of interest rate risk
- performance in all of the above areas compared to past performance as well as to peer groups' performance
- all insider transactions benefiting directly or indirectly controlling shareholders, directors, officers, employees, or their related interests
- activities undertaken to ensure compliance with applicable laws (including among others, lending limits, consumer requirements, and the Bank Secrecy Act) and any significant compliance problems
- any extraordinary development likely to impact the integrity, safety, or profitability of the institution

Reports should be provided far enough in advance of board meetings to allow for meaningful review. Management should be asked to respond to any questions raised by the reports.

Experience has shown that certain aspects of the lending function are responsible for a great number of the problems experienced by troubled institutions. The importance of policies and reports which reflect on loan documentation, performance, and review cannot be overstated.

c. Provide for independent reviews. The board also should establish a mechanism for independent third party review and testing of compliance with its policies and procedures and applicable laws and regulations, and of the accuracy of the information provided by management. This might be accomplished by an internal auditor reporting directly to the board, or by an examining committee of the board itself. In addition, a comprehensive annual audit by a CPA is desirable. It is highly recommended that such an audit include a review of asset quality. The board should review the auditors' findings with management and should monitor management's efforts to resolve any identified problems.

In order to discharge their general oversight responsibilities, the board or its audit committee should have direct responsibilities for hiring, firing, and evaluating the institution's auditors, and the board should have access to the institution's regular corporate counsel and the institution's staff as required. In some situations, outside directors may wish to consider employing their own outside counsel, accountants or other experts, at the institution's expense, to advise them on special problems arising in the exercise of their oversight function. Such situations might include the need to develop appropriate responses to identified problems in certain important areas of the institution's performance or operations.

d. <u>Heed supervisory reports</u>. Board members should personally review any reports of examination or other supervisory activity and any other correspondence from the institution's supervisors. Any findings and recommendations should be reviewed carefully, and progress in addressing identified problems should be tracked. Directors should discuss issues of concern with the examiners.

5. <u>Avoid all preferential transactions involving insiders or their related interests</u>. Financial transactions with insiders must be beyond reproach. They must be in full compliance with laws and regulations concerning such transactions, and be judged as objectively as transactions with unrelated customers. The basis for that judgment must be fully documented. Directors and officers who permit preferential treatment of insiders breach their responsibilities, expose themselves to serious civil and criminal liability, and may expose their institution to a greater than ordinary risk of loss.

Knowledgeable and effective directors are an integral part of a safe and sound banking system. These guidelines are intended to assist financial institution directors in understanding and fulfilling their duties.

A more detailed discussion of a director's role and responsibilities i available in the Office of the Comptroller of the Currency's new book, <u>The Director's Book - The Role of a National Bank Director</u>. It is available from the Communications Division, Office of the Comptroller of the Currency, Washington, D. C. 20219.