APPENDIX B

Pocket Guide for Directors

Guidelines for Financial Institution Directors

FDIC

Financial Institution Directors

Change in the financial marketplace has created a more competitive and challenging environment for all financial institutions. As a consequence of this change, the role of the financial institution board member has grown in importance and complexity.

This Pocket Guide has been developed by the Federal Deposit Insurance Corporation to provide directors of financial institutions with accessible and practical guidance in meeting their duties and responsibilities in a changing environment. These guidelines have been endorsed by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Home Loan Bank Board.

We hope this Pocket Guide will help to make the director's job one that can be approached with clarity, assurance and effectiveness. If you are helped in meeting these goals, then the larger goal of maintaining confidence in the safety and soundness of our financial system will also be achieved.

Sincerely,

L. Wm. Seidman

L. William Seidman
Chairman
Federal Deposit Insurance Corporation

C. C. Hope. Jr.

Robert L. Clarke   C. C. Hope. Jr.

FEDERAL DEPOSIT INSURANCE CORPORATION
Washington. D.C.
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General Guidelines

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

- select and retain competent management;
- establish, with management, the institution's long and short term business objectives, and adopt operating policies to achieve these objectives in a legal and sound manner;
- monitor operations to ensure they are controlled adequately and are in compliance with laws and policies;
- oversee the institution's business performance; and
- ensure that 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. The 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 deal fairly with their institutions and to comply with all applicable laws and regulations, and follow sound practices.

Maintain Independence

The first step both the board and individual directors should take is to establish and maintain the board's independence. 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.

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

Ensure Qualified Management

The board of directors is responsible for ensuring that day-to-day operations of the 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.

Supervise Management

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

Establish Policies. The board of directors should ensure that all significant activities are covered by clearly communicated written policies which can be readily understood by 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 laws and regulations, and to protect the institution against external crimes and internal fraud and abuse.

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 that benefit, *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 lending are responsible for a great number of the problems experienced by troubled institutions. The importance of policies and reports that reflect on loan documentation, performance, and review cannot be overstated.

Provide for independent reviews. The board also should establish a mechanism for independent third party review and testing of compliance with board policies and procedures, applicable laws and regulations, and accuracy of 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 its general oversight responsibilities, the board or its audit committee should have direct responsibility for hiring, firing, and evaluating the institution's auditors, and should have access to the institution's regular corporate counsel and staff as required. In some situations, outside directors may wish to consider employing independent 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 problems in important areas of the institution's performance or operations.

Heed supervisory reports. 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. Progress in addressing identified problems should be tracked. Directors should discuss issues of concern with the examiners.

Avoid Preferential Transactions

Avoid all preferential transactions involv ing insiders or their related interests. Finan cial transactions with insiders must be beyond reproach. They must be in full compliance with laws and regulations concerning such transactions, and be judged according to the same objective criteria used in transactions with ordinary customers. The basis for such decisions 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.

Copies of this publication, ***Pocket Guide for Directors*** *— Guidelines for Financial Institution Directors*, are available from the Office of Corporate Communications, Federal Deposit Insurance Corporation, 550 Seventeenth Street, NW, Washington, D.C. 20429, or through the Board of Governors of the Federal Reserve System, the Federal Home Loan Bank Board and the Office of the Comptroller of the Currency.

A more detailed discussion of a director's role and responsibilities is available in the Office of the Comptroller of the Currency's new book, ***The Director's Book*** *— The Role of a National Bank Director*, which is available from the Communications Division, Office of the Comptroller of the Currency, Washington, D.C. 20219.