Remarks by
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It is a great pleasure to be with you today at the Centennial Assembly for Bank Directors -- when anything lasts for 100 years, it must be good.

There is a widespread belief that Abraham Lincoln encapsulated his belief in democracy during his historic debates with Stephen A. Douglas with the words: "You can fool all the people some of the time and some of the people all the time, but you can not fool all the people all the time." This quotation endures, despite the fact that historians and other writers have found no evidence that Abraham Lincoln ever said the words.

It is an example of a myth -- a story people believe that has no basis in truth.

I am here today to talk about another myth -- one that is less positive -- a myth that could cause a great deal of harm to banks by discouraging capable and dedicated people from serving on a bank's board of directors. That myth is that federal regulators in general and the Federal Deposit Insurance Corporation in particular hold bank directors to standards that go well beyond those normally applicable to corporate directors.

The truth is that the general standards that we, and other bank regulators, expect bank directors to follow are substantially the same as the standards for directors of all companies. Today I will describe the standards for corporate directors and discuss how our standards are applications of those accepted standards. I will also sketch a brief history of our actions against bank directors when institutions fail and why those actions have made sense in light of accepted standards for the responsibilities of bank directors.

Our laws have long held that all corporate directors and officers have duties to the corporations they serve. These duties are generally known as the duty of care and the duty of loyalty. They embody the expectation that a director will pay attention to the operations of the organization and will put the organization's interests above his or her personal interests in doing the job.

The duty of care dates back at least to the early 1800s when the courts ruled that directors are required to use the same care and diligence that an ordinary person would exercise under similar circumstances. The U.S. Supreme Court applied virtually the same standard to bank directors more than a century ago when it ruled that the director

of a financial institution is expected to act as a reasonably prudent person would. The Supreme Court also stressed that bank directors, like their corporate counterparts, are not expected to guarantee the success of every business venture and bank directors are not liable for mere errors of judgment. No one expects bank directors to be liable when reasonable business decisions go wrong -- but all corporate directors are expected to take an active role in overseeing the management of the organization and to avoid self-interest and self-dealing in performing that function.

Historically, state common law defined the fundamental duties of corporate governance. It included the concept of "business judgment" -- a recognition that, while directors are required to oversee management, they must be entitled reasonably to rely on management, board committees, and the reports they generate in order to make decisions and authorize business risks without fear of personal liability.

In recent years, most state legislatures have enacted statutory standards of care applicable to corporations and, at least in a number of instances relating to bank failures, to insured financial institutions. Forty-four states in recent years have relaxed common law standards from "ordinary negligence" to gross negligence or, in some of the more extreme instances, to some form of recklessness or intentional behavior. Unfortunately, in the case of the extreme instances, states went too far beyond long accepted standards of conduct in their efforts to insulate directors from liability. In states that insulated directors from recklessness or intentional misconduct, it began to look as though directors could rarely be held accountable for any of their actions or inactions no matter how egregious.

Accordingly in 1989, at the height of the savings and loan crisis, Congress enacted a law to preserve lawsuits brought by the FDIC as receiver of failed financial institutions against directors and officers to the extent state law sought to insulate bank directors for conduct constituting gross negligence or worse. This federal attempt to modify by statute the liability of directors of failed banks left a lot of confusion and caused significant litigation over exactly what Congress intended.

The question was finally settled by the Supreme Court earlier this year. The Supreme Court decided that state law standards of conduct should continue to apply to all insured financial institutions regardless of charter but only so long as state law provides a minimum standard no worse than "gross negligence." Thus, if a state were to pass legislation insulating bank directors from all suits brought by the FDIC as receiver of a failed institution except for cases involving, for example, intentional misconduct, the FDIC as receiver would still be allowed to bring suits for gross negligence.

Coming full circle, gross negligence is precisely the standard the FDIC always applies in determining whether to sue outside directors for breaching their duty of care.

Let's look more closely at the duties of corporate directors in general and compare them to the expectations for bank directors.

A corporate director must be independent. A director should also be diligent, investing significant amounts of time and energy in monitoring management's conduct of the business and compliance with the corporation's operating and administrative procedures. Those are exactly the expectations that bank regulators have for bank directors. To meet those expectations, directors should regularly attend board meetings, obtain and read relevant materials, participate in discussions, ask questions, and require management to make timely and accurate reports to the board.

In meeting his or her duties, a corporate director is entitled to rely on reports, opinions, information, and statements of the corporation's officers, legal counsel, accountants, employees, and committees of the board, when under the circumstances it is reasonable to do so. Whether reliance is reasonable depends on the facts in a specific situation. Outside directors are not required to replicate the work of management, experts, or committees, but bank directors should question the source, timeliness, and accuracy of the information that management and others provide. In these ways, outside directors exercise oversight.

In the case of banks, a bank examination serves as an additional source of information on the accuracy of information provided by the institution's officers to the board. Let me be clear, however, that bank examinations are not audits, they are one way that we at the FDIC assess risks to the insurance funds and that all bank supervisors assess the safety and soundness of banks. They are not intended to replace audits. Directors have the responsibility to set up their own mechanisms to monitor compliance with policies and law. A bank examination does not take the place of a good system of internal controls. While no bank director wants to be in the position of having examiners point out that the bank's systems for reporting and internal controls have deficiencies, if such problems are revealed in an examination report, the director has the responsibility not to ignore them.

I was told by an examiner that the first thing he does when examining a problem institution is to ask the institution's officers for their copies of the last examination report. If the top has not been creased or folded, it is evidence that the officers did not take the time to find out what the examiners had to say the last time -- and it raises doubts about the seriousness of efforts to solve the problems.

Corporate directors have the responsibility for establishing policies for carrying out the major operations and functions of the business. In addition, directors have the responsibility to monitor compliance with those policies -- as well as compliance with laws and regulations -- and to take action to correct the deficiencies that are uncovered. In short, the duty of care requires members of the board to monitor the activities of management and not to act merely as a rubber stamp for management's actions.

I would stress that the FDIC does not require or expect that responses by directors to problems will invariably succeed in completely eliminating problems. We do, however, expect that directors will take reasonable steps to address material problems identified by management; examiners; and legal, accounting, and other advisors.

As I noted earlier, the duty of loyalty -- the second duty that applies to corporate directors, including bank directors -- simply means that a director must never put his own interests above those of the corporation, including any financial institution, he or she serves. The duty of loyalty requires that a director not use the position as director for personal benefit at the expense of the corporation. Our FDIC guidelines for bank directors clearly mirror this requirement. Under our guidelines, the duty of loyalty requires directors and officers to administer the affairs of the bank with candor, personal honesty, and integrity. Bank directors are prohibited from advancing their personal business interests, or those of others, at the expense of the bank.

Among businesses, banks are special because banks lend other people's money. The common law of corporations tells directors to question insider transactions closely so that positions of authority are not abused by officials of the corporation. In the case of banks, insider transactions are subject to regulatory limitations because insider abuse is frequently found when banks fail. We regulators expect a proper credit evaluation to be made each time an extension of credit is made, regardless of whether there are personal relationships between the credit applicant and bank officers or directors. We also expect the extension of credit to be made on an arms length basis -- that means on the same terms offered other customers of an institution.

If our expectations for bank directors are essentially the same as the long-standing expectations for corporate directors, how did the myth that we have significantly higher standards arise?

The answer lies in recent history. The FDIC's statutory responsibility to the insurance funds requires us to conduct an investigation of whether there are potential claims against the directors of every bank that has failed.

When the number of bank failures began to rise in the mid-1980s, the number of investigations necessarily began to rise also. These investigations, however, resulted in fewer lawsuits against directors than the myth suggests. All professional liability claims brought by the FDIC -- including claims against directors -- must meet a two-part test: One, is the case meritorious? And, two, is it likely to be cost effective? If a potential claim does not meet both parts of the test, a lawsuit is not initiated against a bank director, and settlements of potential claims are not sought. Since the mid-1980s, the FDIC has brought suit -- or settled claims without suit -- against directors and officers in only approximately 20 percent of more than 1,000 bank failures. Moreover, even when the FDIC brings suit, it is not always against all directors and officers of a failed institution. Each suit against each director must meet the two-part test.

The two-part test has served us very well. By focusing our resources on only the cases we believe are meritorious and likely to be cost-effective, the FDIC has avoided costly, full-scale litigation in numerous instances while successfully recovering substantial amounts for the insurance fund. We used the same two-part test in reviewing all of the claims we inherited from the RTC at its sunset on December 31, 1995. Fortunately, a

majority of the RTC claims we reviewed met the test. There were some cases, however, that simply were not cost-effective or displayed significant weaknesses on the merits. Where we found claims that lacked merit, the claims were withdrawn entirely by the FDIC. In one instance the FDIC refused to bring a case that had been authorized, but not filed, by the RTC, and decided to forego a $200,000 settlement offer that was on the table because the case lacked merit. All FDIC suits are reviewed on a semi-annual basis in order to ensure that the two-part test continues to be met.

The court decisions have generally found standards for bank directors applied by bank regulators, including the FDIC, to be appropriate. Let me give you two examples.

In a case from the late 1980s, a court found three outside directors of a thrift institution, who were members of an executive loan committee, liable for failing to oversee the management of the institution. In particular, the court faulted the directors for failing to correct the problems identified in a Cease and Desist Order issued by the Federal Home Loan Bank Board.

The directors had access to information on the problems in the savings and loan association from four sources: examination reports, the Cease and Desist Order, a court order enforcing the Cease and Desist Order, and the regulations that governed the institution. The court found the directors liable because the board had not followed up to ensure that the institution's problems were addressed after the board instructed management to comply with the cease and desist order.

In another example, the facts are that in 1981 the FDIC warned a bank that it must improve the quality of its loans and that the directors must "adequately monitor the lending function." The next year, the FDIC and the state banking department entered into a Memorandum of Understanding with the bank requiring a 50 percent reduction in substandard loans within 360 days. Despite these actions, the condition of the institution continued to deteriorate. In 1983, a second Memorandum of Understanding was entered into requiring a written loan policy and a reduction of substandard assets. The bank did not fulfill its agreement, its condition worsened, and the bank was declared insolvent in 1985. The FDIC suit against outside directors was based on bad loans put on the books after the regulators brought the bank's lending problems to the directors' attention. The court held bank directors liable for approving improvident loan transactions after repeated warnings from the bank regulator about the failure of the institution to monitor and correct deficiencies in the lending process.

These are just two of the many cases where the regulators, including the FDIC, have been upheld in court, but I think they show how reasonable our expectations are.

John F. Kennedy once said -- in a statement documented in his presidential papers -- that "the great enemy of truth is very often not the lie -- deliberate, contrived, and dishonest -- but the myth -- persistent, persuasive and unrealistic."

The myth is the great enemy of truth because it is accepted all too often without reflection. I came here today to challenge the mythology that the FDIC's expectations have been extraordinary and to confirm that our expectations for bank directors are essentially the same as those for a director on the board of any business corporation. I hope that I have reassured you -- and also reassured other people who may be considering service on a bank board.

The job that you do is critical. In thousands of communities across America, the bank links farmers and factories, local governments and merchants, consumers and builders to the global financial marketplace. In fulfilling your responsibilities as a bank director, you serve not only the bank, but your neighbors and your community as well. Indeed, when capable and dedicated people serve on a bank's board of directors, the bank benefits, its customers benefit, the community benefits, and the financial system benefits. We, and our fellow regulators, recognize the contribution that capable and dedicated bank directors make -- and we want to work with bank directors to achieve our common interest of assuring the safety and soundness of an insured bank. Our goal is to keep banks open and serving their communities safety and soundly. Bank failures benefit no one.

It is a challenging time for banks. Many of the old restraints and certainties are fading -- or are already gone. From the largest banks in the country to the smallest, new technology is transforming what the business of banking means. Given these and other considerable challenges, banks need the talents, expertise, and insight of capable, dedicated directors more than ever. There are responsibilities in serving on a bank's board of directors. There are also opportunities for real service. Never has there been more of an opportunity to shape a better future for banks and their customers.

Thank you.

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