Corporate Governance

San Francisco Bankers’ Forum August 21, 2014

Teleconference Objective

After participating on today's call you will:

- Become more familiar with the importance of maintaining a sound corporate governance framework
- Learn about the value of an active and independent board, strong management, and good training programs
- Takeaway the benefits of sound operational, strategic, and contingency plans, as well as satisfactory management information and Board reporting
- Learn the importance of effective vendor management, risk assessment, and audit programs
- Takeaway lessons learned from the recent crisis

Corporate Governance Defined

Corporate governance is how corporations are directed and controlled.

Importance of Corporate Governance

Two primary reasons that governance continues to be so important:

1. The multitude of stakeholders
2. The complexity of the financial industry

Importance of Corporate Governance (con't)

- Who are your "Stakeholders?"
- Due to complexities in the financial industry, corporate governance remains crucial

Where Does Corporate Governance Start?

- **The Board of Directors**
  - Establish and maintain the board's independence.
  - Effective cooperation between an institution's board and its management team.
  - 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 adequately serving their institutions, their stockholders, or their communities.

Board Structure

- Establish effective board committees
- Some committees are required by regulation/supervisory policy
- FDIC expectations for committees

Board Responsibilities

- Hold regular board and committee meetings
- Request and review meeting materials
- Ask questions/seek explanation of problems
- Review audits and supervisory communication
- Maintain well-documented minutes
- Avoid or manage dominant policymakers

Director Principles

- **DUTY of CARE: Maintain reasonable supervision of the activities and affairs of the institution.**
- **DUTY of LOYALTY: Ensure decisions are not governed by self-interest.**

Fair and Responsible Banking

- **Expands on concept of “fair lending” to:**
  - All products and services
  - Entire life-cycle of the product/service
  - Ensuring non-discriminatory practices, as well as those that are not considered to be unfair or deceptive

Director Principles

Management

Key Roles and Responsibilities

- Select, define duties, monitor, and evaluate
- Dismiss unqualified management
- Develop a plan for management succession
- Provide personnel administration and training

Strategic Planning

Effectively plan for and respond to risks arising from within, without, or via new/modified products and services

Ensure Appropriate People, Processes, and Systems

Mission Statement
Evaluate Internal Operations
Assess Present and Future Operations

Goals and Objectives
Resource Allocation

Implementation Plans on Identified Gaps
Establish Processes for Results analysis and revisions to plan

STRATEGIC PLANNING - Three Basic Steps:

1. Identify Goals

Are goals realistic?

2. Commit Resources

Are goals feasible?

3. Measure Performance

What defines success or failure?

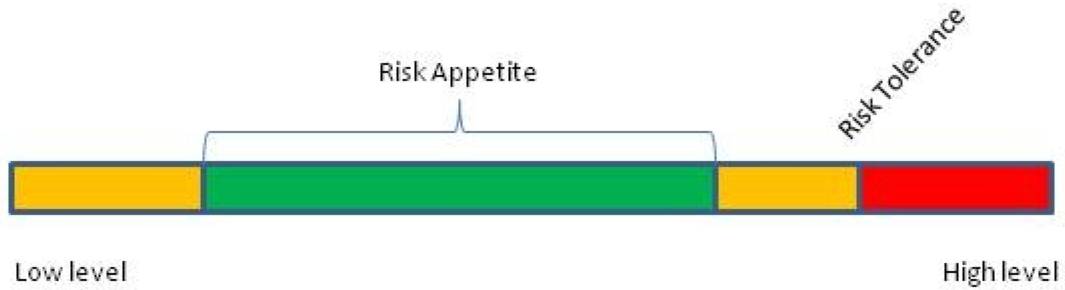
Fundamental Principle

It is the board's and management's responsibility to

identify, measure, monitor, and

control risk

Risk Tolerance



Directors need to collaboratively decide on the <u>amounts</u> and <u>types</u> of risk the organization is willing to accept in pursuit of its business objectives

Policies

- Involve periodic reviews
- Articulated to employees
- Approved before a new activity begins
- Flexible to permit innovation
- Responsive to changing business conditions
- Relevant to the bank
- Includes monitoring of adherence to policy

Monitoring

Board Oversight

- Create reliable financial statements/ reporting
- Establish, monitor, and test internal controls
- Satisfy regulatory and supervisory requirements

Monitoring

An internal control system should:

- Prevent or detect significant inaccurate, incomplete, or unauthorized transactions
- Identify deficiencies in safeguarding assets
- Detect unreliable financial reporting
- Identify deviations from laws, regulations, and bank policies

Audit

- **Board responsibilities for an effective Audit program**
  - Establish an Audit Committee
  - Ensure the appropriate development of risk assessments and audit plan
  - Establish and maintain appropriate audit program

Standards for Safety and Soundness

Standards for Safety and Soundness (Appendix A to Part 364)

- Internal Control and Information Systems
- Internal Audit System
- Loan Documentation and Credit Underwriting
- Interest Rate Exposure
- Asset Growth and Asset Quality
- Earnings
- Compensation, Fees, and Benefits

Vendor Management

The board has the ultimate responsibility for third-party, vendor activities, the same expectation as an activity handled directly by the bank.

- Effective third-party management programs incorporate:
  - Risk Assessment
  - Due Diligence (initial and ongoing)
  - Contract Structuring and Review
  - Oversight

Lessons Learned

- **Bank failures teach us something**
- **Material Loss Reviews provide insight into corporate governance weaknesses at failed institutions**
  - http://www.fdicoig.gov/mlr.shtml
  - "Comprehensive Study on the Impact of the Failure of Insured Depository Institutions" - January 2013

- **Material Loss Review Examples**
  - **Tennessee Commerce Bank**
    - TCB failed primarily because its Board and management did not effectively manage the risks associated with the bank's sustained high growth in C&I lending.
  - **First State Bank, Georgia**
    - FSB failed primarily because its Board and management did not effectively manage the risks associated with the bank's heavy concentrations in CRE and ADC loans.
  - **ShoreBank, Illinois**
    - ShoreBank failed due to insolvency brought on by the Board and management not implementing adequate risk management practices.

Lessons Learned

January 2013 FDIC OIG Evaluation Summary:

1. **Aggressive growth objectives;**
2. **Asset concentrations tied to commercial real estate (CRE) or construction, land, and land development (CLD) loans;**
3. **Inadequate <u>risk management capabilities and/or internal controls</u>.**

An October 2012 FDIC OIG Evaluation Summary:

- **A number of banks with construction lending concentrations were able to weather the crisis given a well-informed and active board, strong management, sound credit administration and underwriting practices, and adequate capital.**

Lessons Learned

Table 6: Most Common Contributing Causes of Material Loss Failures

	FDIC	OCC	FRB
High ADC or CRE Concentrations	95%	86%	100%
Rapid Asset Growth	69%	82%	82%
Relying on Volatile Funding Sources to Support Growth	55%	27%	14%
Inadequate Loan Underwriting	70%	50%	23%
Inadequate Credit Administration Practices	71%	55%	27%
Inadequate Credit Risk Management	76%	77%	73%

Source: OIG analysis of 131 MLR reports for 142 institutions that failed from January 2007 through September 2011.

Resources

- Statement Concerning the Responsibilities of Bank Directors and Officers
- Pocket Guide for Directors
- Standards for Safety and Soundness
- Directors’ Resource Center: Technical Assistance Video Program
- Interagency Policy Statement on the Internal Audit Function and its Outsourcing
- Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations

Next Bankers' Forum

- **Division of Depositor and Consumer Protection Bankers' Forum**
  - November 20, 2014: 1pm Pacific
  - Consumer Protection Hot Topics

Questions