

INTRODUCTION

The quality of management is probably the single most important element in the successful operation of a bank. For purposes of this section, management includes both the board of directors, which is elected by the shareholders, and executive officers, who are appointed to their positions by the board. In the complex, competitive, and rapidly changing environment of financial institutions, it is extremely important for all members of bank management to be aware of their responsibilities and to discharge those responsibilities in a manner which will ensure stability and soundness of the institution, so that it may continue to provide to the community the financial services for which it was created.

The extreme importance of a bank director's position is clearly emphasized by the fact that bank directors can, in certain instances, be held personally liable. Also, Congress has placed great emphasis on the role of bank management by passing legislation which allows regulatory authorities to utilize "cease and desist" actions against individuals (instead of solely against the institution) to assess civil money penalties (CMPs), and even remove an officer, director, or other person participating in the affairs of the bank when their gross negligence or disregard for safety and soundness considerations threatens the financial safety of the bank.

The board of directors is the source of all authority and responsibility. In the broadest sense, the board is responsible for formulation of sound policies and objectives of the bank, effective supervision of its affairs, and promotion of its welfare. On the other hand, the primary responsibility of executive management is implementation of the board's policies and objectives in the bank's day-to-day operations. While selection of competent executive management is critical to the successful operation of any bank, the continuing health, viability, and vigor of the bank are dependent upon an interested, informed and vigilant board of directors. Therefore, the main thrust of this section is devoted to the powers, responsibilities, and duties vested in bank directors.

MANAGEMENT/DIRECTORS**Selection and Qualifications of Directors**

Being selected to serve as a bank director is generally regarded as an honor, for it often denotes an individual's reputation as being successful in business or professional endeavors, public spirited, and entitled to public trust and confidence. It is this latter attribute and the public

accountability implicit therein that distinguishes the office of bank director from directorships in most other corporate enterprises. Bank directors are not only responsible to the stockholders who elected them, but must also be concerned with the safety of depositors' funds and the influence the bank exercises on the community it serves.

Various laws governing the election of board members emphasize the importance of a director's position. Statutory or regulatory qualifications usually include taking an oath of office, unencumbered ownership of a specific amount of the bank's capital stock, and residential and citizenship requirements. Other laws also pertain to the qualification and selection of directors. There are, for example, certain restrictions, prohibitions, and penalties relating to: interlocking directorates; purchases of assets from or sales of assets to directors; commissions and gifts for procuring loans; and criminal activities such as embezzlement, abstraction, willful misapplication, making false entries, and improper political contributions. These qualifications and restrictions have no counterpart in general corporate law and both illustrate and emphasize the quasi-public nature of banking, the unique role of the bank director, and the grave responsibilities of that office. The position of bank director is one, therefore, not to be offered or entered into lightly.

Aside from the legal qualifications, each director should bring to the position particular skills and experience which will contribute to the composite judgment of the group. Directors should have ideas of their own and the courage to express them, sufficient time available to fulfill their responsibilities, and be free of financial difficulties which might tend to embarrass the bank. The one fundamental and essential attribute, which all bank directors must possess without exception, is personal integrity. Its presence usually gives assurance of a well-intentioned, interested and responsible director capable of assuming the important fiduciary responsibilities of the office and representing fairly and equitably the diverse interests of stockholders, depositors and the general public. The Statement Concerning the Responsibilities of Bank Directors and Officers states that the duties of loyalty (to administer the affairs of the bank with candor, personal honesty and integrity) and care (to act as prudent and diligent business persons in conducting the affairs of the bank) are among the most important responsibilities of bank directors. Other desirable personal characteristics include: knowledge of the duties and responsibilities of the office; genuine interest in performing those duties and responsibilities to the best of their ability; capability to recognize and avoid potential conflicts of interest, or the appearance of same, which might impair their objectivity; sound business judgment and experience to facilitate understanding of banking and banking problems; familiarity with the community and trade area the bank

serves and general economic conditions; and an independence in their approach to problem solving and decision making.

Powers, Duties and Responsibilities of Directors

The powers, duties and responsibilities of the board of directors are usually set forth in the applicable banking statutes and the bank's charter and bylaws. Generally speaking, the powers and responsibilities of bank directors include but are not limited to those discussed below.

Regulating the Manner in Which All Business of the Bank is Conducted

Directors must provide a clear framework of objectives and policies within which executive officers operate and administer the bank's affairs. These objectives and policies should, at a minimum, cover investments, loans, asset/liability and funds management, profit planning and budgeting, capital planning, internal routine and controls, audit programs, conflicts of interest, code of ethics, and personnel. Specialty areas, such as the Bank Secrecy Act (BSA), Information Technology (IT), Trust Department activities, and consumer compliance should also be subject to similar appropriate oversight and internal guidelines. Objectives and policies in most instances should be written and reviewed periodically to determine that they remain applicable. Examiners may encounter situations (often in smaller banks with control vested in one or a few individuals) where written policies have not been developed for these operational functions, and management is reluctant to do so on the grounds that such written guidelines are unnecessary. To a considerable degree, the necessity for written policies may be inferred from the results achieved by management. That is, if the examiner's assessment of the bank reflects that it is sound and healthy in virtually every important respect, it may be difficult to convince management of the need for formalized written policies. However, when deficiencies are noted in one or more aspects of a bank's operations, it is nearly always the case that absence of written and clearly defined objectives, goals, performance standards, and limits of authority is an important contributing factor. There are few better means of ensuring that directors are properly supervising the bank's affairs than by their direct participation in devising, enforcing, and modifying the institution's written guidelines on such matters as investments, loans, marketing, capital and profit planning. Moreover, it is recognized that the depth and detail of written policies may properly vary among banks, depending on the nature, scope and complexity of their operations. Therefore, it remains the FDIC's strongly held belief that all banks should have written policies which are

readily understood by all affected parties, kept up-to-date, and relevant to the institution's needs and circumstances. While it is acceptable for a bank to obtain written policies from an outside source, it is the responsibility of management to ensure that the policies are suited to their bank and that the policies accurately describe the bank's practices. The board of directors should give final approval of the substantial content of policies.

The policies and objectives of the directorate should include provisions for adherence to the Interagency Guidelines Establishing Standards for Safety and Soundness set forth in Part 364, Appendix A, of the FDIC Rules and Regulations. These standards set specific guidelines for the safe operation of banks in the following areas: internal controls and information systems; internal audit system; loan documentation; credit underwriting; interest rate exposure; asset growth; asset quality; earnings; and compensation, fees, and benefits. The specific provisions for each area are discussed in further detail within the appropriate sections of this DSC Risk Management Manual of Examination Policies (Manual). Conformance to these standards may help identify emerging problems and correct deficiencies before capital becomes impaired. The standards, which should be viewed as minimum requirements, establish the objectives of proper operations and management, but leave specific methods of achieving these objectives to each institution.

Examiners should review the bank's conformance to the safety and soundness standards at each examination. The nature, scope and risk of the institution's activities should be considered when evaluating the adequacy of controls in each of the respective areas. Material deficiencies should be documented in appropriate sections of the Report of Examination.

Corporate Planning

A vital part of the responsibilities of directors is to set the future direction of the bank. Planning, organizing, and controlling are three fundamental dimensions of management. Planning, however, had not been a priority concern for a large part of the banking industry. This may have been due in part to the fact that the industry has historically been highly regulated and somewhat insulated from competitive pressures and sudden change. Dramatic changes in the structure, volatility and technology associated with the financial services market altered this situation and led to an emphasis on deregulating financial institutions. Increased competition and innovation consequently produced an environment characterized by uncertainty.

Sound planning is indispensable in dealing with this uncertainty and rapid change. In order to be effective,

planning must be dynamic, carefully attended to, and well supported. Projections must be revised periodically as circumstances change and new strategies devised to meet stated objectives. An increasingly competitive marketplace suggests that an inadequate or ill-conceived planning process may be as much the cause of bank failure as poor loans.

The adequacy of a bank's planning process may be judged by considering questions such as:

- How formal is the bank's planning process?
- Who is involved? The board? Middle management?
- Is the plan based on realistic assumptions regarding the bank's present and future market area(s) and nontraditional competitive factors?
- Does the bank monitor actual performance against its plan?
- Does the bank consider alternative plans in response to changing conditions?

Although the focus must be on an evaluation of the process, the plan itself cannot be ignored if, in the examiner's judgment, the plan is predicated on assumptions which are inappropriate or unrealistic. This assessment must take into account the personnel and financial resources and operating circumstances and conditions unique to the bank being examined. It is emphasized that plotting the future direction of the institution is, properly, the responsibility of the board of directors and not examiners. However, when the goals and objectives chosen by directors are likely to result in significant financial harm to the bank, examiners must identify the deficiencies in the plan and attempt to effect necessary changes.

Absence of a satisfactory planning process or glaring weaknesses in the plan itself must be considered in the appraisal of bank management.

Appointing, Dismissing at Pleasure, and Defining the Duties of Officers

It is a primary duty of a board of directors to select and appoint executive officers who are qualified to administer the bank's affairs effectively and soundly. It is also the responsibility of the board to dispense with the services of officers who prove unable to meet reasonable standards of executive ability and efficiency.

Personnel Administration

Recruiting, training, and personnel activities are vital to the development and continuity of a quality staff. Some features of good personnel administration are a designated

organization structure, detailed position descriptions, carefully planned recruiting, appropriate training and developmental activities, a performance appraisal system, quality salary administration, and an effective communications network.

Honestly and Diligently Administering the Affairs of the Bank

The board of directors is charged with the responsibility of conducting the affairs of the bank. It is not expected to directly carry out details of the bank's business; these may be delegated to senior officers. But they may not be delegated and forgotten. The power to manage and administer carries with it the duty to supervise; therefore, directors must periodically examine the system of administration they have established to see that it functions properly. Should it become obsolete, it should be modernized, or should the bank's officers fail to function as intended, the cause(s) should be determined and corrections made.

Observance of Applicable Laws

It is important for directors to ensure that executive management is cognizant of applicable laws and regulations; develop a system to effect and monitor compliance, which will likely include provisions for training and retraining personnel in these matters; and, when violations do occur, make correction as quickly as possible. Board members cannot be expected to be personally knowledgeable of all laws and regulations, but they should make certain that compliance with all laws and regulations receives high priority and violations are not knowingly committed by themselves or anyone the bank employs.

Avoiding Self-Serving Practices

Although somewhat independent from the responsibility to provide effective direction and supervision, the need for directors to avoid self-serving practices and conflicts of interest is of no less importance. Bank directors must place performance of their duties above personal concerns. Wherever there is a personal interest of a director that is adverse to that of the bank, the situation clearly calls for the utmost fairness and good faith in guarding the interests of the bank. Accordingly, directors must never abuse their influence with bank management for personal advantage, nor wrongfully employ confidential information concerning the bank's clients. The same principles with respect to self-serving practices and conflicts of interest apply to the executive management of the bank.

Paying Such Dividends as May Properly Be Paid

The board of directors has the responsibility of maintaining an adequately capitalized bank, and once this responsibility has been satisfied, the payment of dividends can and should receive consideration. Dividends represent the distribution of bank earnings to owners. Establishing the medium, rate, and date of payment must be based on the directors' overall assessment of the bank's financial condition.

Appropriate Internal Control System and Adequate Auditing Program

A sound framework of internal controls and a reliable and objective audit function are essential tools for bank directors. The existence of such enable directors to remain well informed of the adequacy, effectiveness, and efficiency of accounting, operating, and administrative controls and provide an assessment of the quality of ongoing operations. Establishment and oversight of such controls is the responsibility of the board of directors. Refer to the Internal Routines and Controls section for a complete discussion of these vital areas.

Management Information System (MIS)

The critical need for and dependence on information involves a concern and responsibility for the integrity of not only the specific information furnished, but the system that supplies it as well. Advances in technology have helped banks improve both information availability and models for analysis and decision making. Regardless of the technology employed, management is responsible for developing and implementing an information system that facilitates managerial activities. Review of these reports should be undertaken during onsite examinations to ascertain the accuracy of the information being provided.

An effective MIS is comprised of information from a number of sources, and the information must serve a number of users, each having various needs. The MIS must selectively update information and coordinate it into meaningful and clear formats. One possible approach would be to combine information from the bank's accounting system with other internal sources, such as personnel records, and include information from external sources regarding economic conditions, characteristics of the marketplace and competition, technology, and legal regulatory requirements. Quality, quantity and timeliness are factors that determine the effectiveness of management information systems.

Supervision by Directors

Supervision by directors does not necessarily indicate a board should be performing management tasks, but rather ensuring that its policies are being implemented and adhered to and its objectives achieved. It is the failure to discharge these supervisory duties, which has led to bank failures and personal liability of directors for losses incurred.

Directors' supervisory responsibilities can best be discharged by establishing procedures calculated to bring to their attention relevant and accurate information about the bank in a consistent format and at regular intervals. From this critical point, the remainder of a director's job unfolds. Directors who keep abreast of basic facts and statistics such as resource growth, capital growth, loan-to-deposit ratios, deposit mix, liquidity position, general portfolio composition, loan limits, loan losses and recoveries, delinquencies, etc., have taken a first, indispensable step in discharging their responsibilities. It is essential, therefore, that directors insist on receiving pertinent information about the bank in concise, meaningful and written form, and it is one of executive management's most important responsibilities to make certain directors are kept fully informed on all important matters and that the record clearly reflects this.

Directors' meetings that are conducted in a businesslike and orderly manner are a significant aid to fulfillment of the board's supervisory responsibilities. This requires, among other things, regular attendance (whether by actual or audio, video or other remote access). Absence without just cause is, like ignorance, not a valid defense. Moreover, a director's attendance should be an informed and intelligent one, and the record should reflect this. If directors dissent from the majority, they should, for their own protection, insist upon their negative vote being recorded along with reasons for their action.

Careful and consistent preparation of an agenda for each board meeting not only assists in the conduct of such meetings, but also provides board members reasonable assurance that all important matters are brought to their attention. Agenda items will vary from bank to bank depending on asset size, type of business conducted, loan volume, trust activities and so forth. In general, the agenda should include reports on income and expense; new, overdue, renewed, insider, charged-off and recovered loans; investment activity; personnel; and individual committee actions.

To carry out its functions, the board of directors may appoint and authorize committees to perform specific tasks and supervise certain phases of operations. In most instances, the name of the committee, such as loan,

investment, examination, and, if applicable, trust, identifies its duties. Of course, utilization of the committee process does not relieve the board of its fundamental responsibilities for actions taken by those groups. Review of the minutes of these committees' meetings should be a standard part of the board meeting agenda.

Communication of facts to a board of directors is essential to sound and effective supervision. However, with the ever-broadening scope of modern banking and the increased complexity of banking operations, the ability of a board of directors to effectively supervise is becoming more difficult. Because of this, the use of outside personnel to provide management supervision is relatively common. While this does not release the board from its legal and implied responsibilities, it does provide an opportunity for management improvement through the use of these external sources. The bank holding company can play a very large role in the supervision of its individual banks. Bank holding companies which control a number of banks may be able to provide individual banks' boards with lending and investment counseling, audit and internal control programs or services, profit planning and forecasting, personnel efficiency reports, electronic data processing services, marketing strategy and asset appraisal reports. Banks that do not operate within a holding company organization are also able to obtain management assistance from various firms offering the above services. In the interest of quality supervision by a bank's board of directors, the use of outside advisors, while not releasing the board from its responsibilities, can be a valuable management tool.

Legal Liabilities of Directors

In general, directors and other corporate officers of a bank may be held personally liable for: a breach of trust; negligence which is the proximate cause of loss to the bank; ultra vires acts, or acts in excess of their powers; fraud; and misappropriation or conversion of the bank's assets. From the standpoint of imposing directors' liability where the facts evidence that fraud, misappropriation, conversion, breach of trust or commission of ultra vires acts is clearly shown, a relatively simple situation presents itself. Difficulties usually arise, however, in cases involving negligence (or breach of duty) which fall short of breach of trust or fraud.

Directors' liability for negligent acts is premised on common law for failure to exercise the degree of care prudent individuals would exercise under similar circumstances, and/or noncompliance with applicable statutory law, either or both of which cause loss or injury to the bank. Statutory liability is reasonably well defined and precise. Common law liability is somewhat imprecise since failure to exercise due care on the part of a director

depends on the facts and circumstances of the particular case.

A director's duty to exercise due care and diligence extends to the management, administration and supervision of the affairs of the bank and to the use and preservation of its assets. Perhaps the most common dereliction of duty by bank directors is the failure to maintain reasonable supervision over the activities and affairs of the bank, its officers and employees. The actions and inactions listed below have been found to constitute negligence on the part of directors.

- An attitude of general indifference to the affairs of the bank, such as failing to hold meetings as required by the bylaws, obtain a statement of the financial condition of the bank, or examine and audit the books and records of the bank to determine its condition.
- Failure to heed warnings of mismanagement or defalcations by officers and employees and take appropriate action.
- Failure to adopt practices and follow procedures generally expected of bank directors.
- Turning over virtually unsupervised control of the bank to officers and employees relying upon their supposed fidelity and skill.
- Failure to acquaint themselves with examination reports showing the financial condition of a company to which excessive loans had been made.
- Assenting to loans in excess of applicable statutory limitations.
- Permitting large overdrafts in violation of the bank's internal policies or permitting overdrafts to insiders in violation of law.
- Representing certain assets as good in a Report of Condition when such assets were called to the directors' attention as Loss by the primary regulator and directions were given for their immediate collection or removal from the bank.

In the final analysis, liability of bank directors for acts of negligence rests upon their betrayal of those who placed trust and confidence in them to perform the duties of their office honestly, diligently and carefully. While applicable principles involving directors' negligence (or breach of duty) are easy enough to state, their application to factual situations presents difficulties. In essence, the courts have judged the conduct of directors "not by the event, but by the circumstance under which they acted" (*Briggs v. Spaulding*, 141 U.S. 132, 155(1890), 35L. Ed. 662, 672). Courts also have generally followed what may be called the rule of reason in imposing liability on bank directors, "lest they should, by severity in their rulings, make directorships repulsive to the class of men whose services are most needed; or, by laxity in dealing with glaring

negligences, render worthless the supervision of director's over...banks and leave these institutions a prey to dishonest executive officers" (Robinson v. Hall, 63 Fed. 222, 225-226 (4th Cir. 1894)).

The following quotation represents a brief recapitulation of the law on the subject (Rankin v. Cooper, 149 Fed. 1010, 1013 (C.C.W.D. Ark. 1907) :

"(1) Directors are charged with the duty of reasonable supervision over the affairs of the bank. It is their duty to use ordinary diligence in ascertaining the condition of its business, and to exercise reasonable control and supervision over its affairs. (2) They are not insurers or guarantors of the fidelity and proper conduct of the executive officers of the bank, and they are not responsible for losses resulting from their wrongful acts or omissions, provided they have exercised ordinary care in the discharge of their own duties as directors. (3) Ordinary care in this matter as in other departments of the law, means that degree of care which ordinarily prudent and diligent men would exercise under similar circumstances. (4) The degree of care required further depends upon the subject to which it is to be applied and in each case must be determined in view of all circumstances. (5) If nothing has come to their knowledge to awaken suspicion that something is going wrong, ordinary attention to the affairs of the institution is sufficient. If, upon the other hand, directors know, or by the exercise of ordinary care should have known, any facts which would awaken suspicion and put a prudent man on his guard, then a degree of care commensurate with the evil to be avoided is required, and a want of that care makes them responsible. Directors cannot, in justice to those who deal with the bank, shut their eyes to what is going on around them. (6) Directors are not expected to watch the routine of every day's business, but they ought to have a general knowledge of the manner in which the bank's business is conducted, and upon what securities its larger lines of credit are given, and generally to know of and give direction to the important and general affairs of the bank. (7) It is incumbent upon bank directors in the exercise of ordinary prudence, and as a part of their duty of general supervision, to cause an examination of the condition and resource of the bank to be made with reasonable frequency."

FEDERAL BANKING LAWS AND REGULATIONS PRIMARILY PERTAINING TO BANK DIRECTORS

Section 18(k) of the Federal Deposit Insurance Act (FDI Act) - Authority to Regulate or Prohibit Certain Forms of Benefits to Institution Affiliated Parties

Part 359 of the FDIC Rules and Regulations - Golden Parachutes and Indemnification Payments

Part 359, pursuant to Section 18(k), permits the FDIC to prohibit or limit, by regulation or order, golden parachute payments or indemnification payments. Refer to "Other Issues" within this section for additional information.

Section 39(c) of the FDI Act - Compensation Standards

This statute requires the FDIC to prohibit excessive compensation to executive officers, employees, directors, and principal shareholders as an unsafe and unsound practice. The definition of excessive compensation, as well as the specific prohibition required by Section 39(c), is found in Section III of Appendix A to Part 364, Standards for Safety and Soundness. Refer to "Other Issues" within this section for further information.

Section 32 of the FDI Act - Agency Disapproval of Directors and Senior Executive Officers of Insured Depository Institutions or Depository Institution Holding Companies

A troubled insured depository institution or troubled depository institution holding company may not add any individual to the board of directors or employ any individual as a senior executive officer if the appropriate Federal banking agency issues a notice of disapproval of such addition or employment before the end of the 90-day period beginning on the date the agency receives the required notice.

Section 19 of the FDI Act - Penalty for Unauthorized Participation by Convicted Individual

Section 19 of the FDI Act prohibits, without the prior written consent of the FDIC, a person convicted of any criminal offenses involving dishonesty or breach of trust or money laundering, or who has entered into a pretrial diversion or similar program in connection with a prosecution for such offense, from becoming or continuing as an institution-affiliated party (IAP), owning or controlling, directly or indirectly, an insured institution, or otherwise participating, directly or indirectly, in the conduct of the affairs of an insured institution.

The intent of Section 19 is not punitive. Rather, the purpose is to provide the applicant an opportunity to demonstrate that a person is fit to participate in the conduct of the affairs of an institution without posing a risk to its safety and soundness or impairing public confidence in

that institution. The FDIC's policy is to approve applications in which this risk is absent. For additional guidance, refer to the FDIC Statement of Policy for Section 19 of the FDI Act.

Section 22(g) and 22(h) of the Federal Reserve Act - Loans to Executive Officers of Banks and Extensions of Credit to Executive Officers, Directors and Principal Shareholders of Member Banks

The Federal Reserve Board's Regulation O – Loans to Executive Officers, Directors and Principal Shareholders of Member Banks

Section 337.3 of the FDIC Rules and Regulations – Limits on Extensions of Credit to Executive Officers, Directors and Principal Shareholders of Insured Nonmember Banks

Sections 22(g) and 22(h) are incorporated into the FDI Act via Section 18(j)(2) and pertain to loans and extensions of credit by both member and nonmember banks to their executive officers, directors, principal shareholders and their related interests. Section 18(j)(2) does not apply to any foreign bank in the United States but does apply to the insured branch itself. It is a very important statute in the examination and supervisory process because it is aimed at prevention and detection of insider abuse, a common characteristic of failed or failing banks.

Part 215 of the Federal Reserve Board's Regulation O was issued pursuant to Sections 22(g) and 22(h) of the Federal Reserve Act. It requires that extensions of credit to executive officers, directors, principal shareholders or their related interests be made on substantially the same terms and follow credit underwriting procedures that are not less stringent than those prevailing at the time for comparable transactions with persons not covered by the regulation. Aggregate lending limits and prior approval requirements are also imposed by Regulation O. Moreover, payment of overdrafts of directors or executive officers is generally prohibited unless part of a written, preauthorized interest bearing, extension of credit plan or by transfer of funds from another account at the bank. The requirements, prohibitions and restrictions of Regulation O are important and examiners should be fully familiar with them. The complete text of the regulation is contained in the FDIC Rules and Regulations.

Section 337.3 of the FDIC Rules and Regulations makes Regulation O applicable to state nonmember banks and sets forth requirements for approval of extensions of credit to insiders. Specifically, prior approval of the bank's board of directors is necessary if an extension of credit or line of credit to any of the bank's executive officers, directors, principal shareholders, or to any related interest of any

such person, exceeds the amount specified in the regulation when aggregated with the amount of all other extensions of credit or lines of credit to that person. This approval must be granted by a majority of the bank's directors and the interested party(ies) must abstain from participating directly or indirectly in the voting.

Any nonmember insured bank which violates or any officer, director, employee, agent or other person participating in the conduct of the affairs of a nonmember insured bank who violates any provision of Section 22(g) or 22(h) of the Federal Reserve Act may be subject to a CMP. In determining the amount of the penalty, the FDIC takes into account the financial resources and good faith of the bank or person charged, gravity of the violation, history if any of previous violations, and such other matters as justice may require. Examiners are reminded violations of Regulation O must be evaluated in accordance with the 13 factors specified in the Interagency Policy Regarding the Assessment of Civil Money Penalties by the Federal Financial Institutions Regulatory Agencies.

Part 348 of the FDIC Rules and Regulations - Management Official Interlocks

This act is contained in 12 U.S.C. 1823(k) and its general purpose is to foster competition. It prohibits a management official of one depository institution or depository holding company from also serving in a similar function in another depository institution or depository holding company if the two organizations are not affiliated and are located in the same area or if the two organizations are not affiliated and are very large, as defined in the regulation.

A number of exceptions allowing interlocking relationships for certain organizations and their affiliates are detailed in Part 348 of the Rules and Regulations. Under Section 8(e) of the FDI Act, the FDIC may serve written notice of intention to remove a director or officer from office whenever, in its opinion, such director or officer of an insured bank has violated the Depository Institution Management Interlocks Act.

Section 7(j) of the FDI Act and the Change in Bank Control Act of 1978

Section 7(j) of the FDI Act prohibits any person, acting directly or indirectly or through or in concert with one or more other persons, from acquiring control of any insured depository institution through a purchase, assignment, transfer, pledge, or other disposition of voting stock of the insured bank unless the appropriate Federal banking agency has been given 60-days prior written notice of the proposed acquisition. An acquisition may be made prior to the expiration of the disapproval period if the agency

issues written notice of its intent not to disapprove the action. The term "insured depository institution" includes any bank holding company or any other company which has control of any insured bank. The term "control" is defined as the power, directly or indirectly, to direct the management or policies of an insured bank or to vote 25% or more of any class of voting securities of an insured bank. Willful violations of this statute are subject to civil money penalties of up to \$1 million per day. This statute gives the FDIC important supervisory powers to prevent or minimize the adverse consequences that almost invariably occur when incompetent or dishonest individuals obtain positions of authority and influence in banks.

Section 737 of the Gramm-Leach-Bliley Act – Bank Officers and Directors as Officers and Directors of Public Utilities

This section of the Gramm-Leach-Bliley Act amends the Federal Power Act to preclude persons from serving both as an officer or director of a public utility and a bank except in certain circumstances. Dual service is permissible when the individual does not participate in any deliberations involved in choosing a bank to underwrite or market the securities of the utility, when the bank is chosen by competitive procedures, or when the issuance of securities by the public utility have been approved by all appropriate regulatory agencies.

Section 8 of the FDI Act

Among other things, Section 8 of the FDI Act provides the Federal banking agencies with the authority to take action to remove from office or prohibit an IAP from any further participation in the conduct of the affairs of any depository institution. Specifically, Section 8(e) and Section 8(g) are utilized in such proceedings. Actions taken under this authority represent serious charges with significant potential consequences. Therefore, outstanding guidelines should be closely followed during the examination process. For additional guidance, refer to Section 8 of the FDI Act and the Formal Administrative Actions section of this Manual.

OTHER ISSUES

Indebtedness of Directors, Officers and Their Interests

The position of director or officer gives no license to special credit advantages or increased borrowing privileges. Loans to directors, officers and their interests must be made on substantially the same terms as those prevailing at the time for comparable transactions with

regular bank customers. Therefore, management loans should be evaluated on their own merits. Their business operations will, in many instances, necessitate bank loans, and these will ordinarily be among a bank's better assets. Since directors usually maintain a deposit relationship with their bank, this carries with it an obligation to meet their reasonable and prudent credit requirements.

On the other hand, there have been many instances where improper loans to officers, directors, and their interests resulted in serious losses. Unfortunately, when the soundness of a management loan becomes questionable, an embarrassing situation usually results. That is, management loans frequently may not be subject to the same frank discussion accorded other loans. Bank directors may assent to such loans, despite knowledge that they are unwarranted, rather than oppose a personal or business friend or associate. Moreover, directors who serve on the board in order to increase their opportunities for obtaining bank credit are reluctant to object to credit extensions to their colleagues. Problems that occur with management loans have received considerable legislative attention and laws have been passed to curb abuses associated with the position of director or officer (i.e. Regulation O). However, while steps have been taken to reduce the potential for problems in this area, a review of the board's policies and actual practices regarding insider loans remains an important part of the examination process.

Conflicts of Interest

Examiners should be especially alert to any insider involvement in real estate projects, loans or other business activities that pose or could pose a conflict of interest with their fiduciary duties of care and loyalty to the bank. On occasion, loans are advanced to business associates involved in apparently unrelated projects where an insider nevertheless benefited. The involvement of bank insiders in these projects is sometimes not apparent since ownership is held in the form of "business trusts" or other entities without disclosure of the identity or personal guarantees of the principals. In order to help uncover these types of situations, examiners should routinely inquire of senior management, through incorporation in the "first day" letter or request, whether any of the following situations exist:

- Loans or other transactions existing at the bank in which an officer, director or principal stockholder (or immediate family member of each) of the bank holds a beneficial interest.
- Loans or other transactions in which an officer, director or principal stockholder (or immediate family member of each) of another depository institution holds a beneficial interest.

- Loans or other transactions at any other depository institution in which a bank officer, director, or principal stockholder (or immediate family member of each) holds a beneficial interest, either direct or indirect.
- Loans or other transactions in which an officer, director or principal stockholder (or immediate family member of each) has no direct interest but which involve parties with whom an insider has other partnership or business associations.
- Loans extended personally by officers, directors or principal stockholders (or immediate family member of each) to parties who are also borrowers from the bank or loans extended personally by any borrowing customers to an officer, director or principal stockholder of the bank.

If any of this information is not readily available, management should be requested to survey their officers, directors and principal stockholders, as necessary, to obtain it.

Examiners are also reminded to inquire into bank policies and procedures designed to bring conflicts of interest to the attention of the board of directors when they are asked to approve loans or other transactions in which an officer, director or principal stockholder may be involved. Where such policies and procedures are lacking or insufficient to reveal insider involvement before action is taken by the board, the bank should be strongly encouraged to remedy the deficiency. The board should also be encouraged to act specifically on any loan or other transaction in which insiders or their associates may be involved, either directly or indirectly, or because of business associations outside the loan or transaction in question. Moreover, the results of board deliberations on any matter involving a potential conflict of interest should be noted clearly in the minutes.

Examiners are also reminded to carefully scrutinize any loan or other transaction in which an officer, director or principal stockholder is involved. Such loans or other transactions should be sound in every respect and be in full compliance with applicable laws and regulations and the bank's own policies. Any deficiencies in credit quality or other aspects of the transaction should receive critical comment not only from an asset quality perspective but from a management perspective as well. More specifically, if a director has a personal financial interest in a loan or other transaction subject to adverse classification, the board should be urged to require that director to strengthen the credit sufficiently to remove the adverse classification within a reasonable time frame or resign from the board. In the event a principal stockholder or an officer who is not a director is involved in an adversely classified loan or other transaction, the board should be urged to assume special oversight over the loan or activity,

either directly or through a committee of outside directors, with a view towards limiting any further exposure and moving aggressively to secure or collect any exposed balances as the circumstances may permit. There should be concern that these types of situations not only tend to compromise the credit standards of the lending institution and eventually may lead to losses, but that they can also lead to violations of civil and criminal laws.

Nonbanking Activities Conducted on Bank Premises

Many banks conduct nonbanking activities on bank premises by selling insurance (e.g. credit life, accident and health) in conjunction with loan transactions of the bank. When these nontraditional banking activities take the form of establishment of a new department or subsidiary of the bank, the benefit and profit is directly realized by the bank and its shareholders. However, when these activities are conducted on bank premises for the benefit of others, a bank may be deprived of corporate opportunity and profit. The FDIC has long taken the position that when nonbanking activities are conducted on bank premises either by bank personnel or others and when the benefit and profit do not flow directly to the bank, certain disclosures, approvals, and reimbursements must be made.

In all cases, the bank's directors and shareholders should be fully informed regarding the nonbanking activity conducted on bank premises. The operation should be approved by the bank's shareholders, and expenses incurred by the bank in connection with these operations formally approved by the board of directors annually. The bank should be adequately compensated for any expenses it incurs in furnishing personnel, equipment, space, etc. to this activity. It is recommended that bank management disclose completely to its bonding company any such nonbanking activity conducted on its premises. Management would also be well advised to obtain acknowledgement from the bonding company that such activities do not impair coverage under the fidelity bond. Finally, the conduct of nonbanking activity must be in conformance with applicable State statutes and regulations.

Situations where the bank is being deprived of corporate opportunity through the diversion of opportunity or profit, or inadequately compensated for the utilization of its resources should be discussed with bank management and commented upon in the Risk Management Assessment and the Examination Conclusions and Comments pages, if appropriate. Additionally, the absence of disclosure and approval to the bank's directors, shareholders, and bonding company should be discussed with management and covered in the aforementioned schedule(s). Finally, in those instances where the examiner believes, based on

known facts, that a violation of applicable statutes or regulations has occurred, or where there is no question that a criminal violation has been committed, the matter should be handled in accordance with guidelines prescribed in other sections of this Manual.

Directors of Banks with Dominant Management Officials

Examiners should carefully consider the risks associated with institutions controlled by an official that dominates virtually all decisions involving the bank's policies and operations. A dominant official or policymaker is defined as an individual, or group of persons with close business dealings or otherwise acting together, that exerts an influential level of control or policymaking authority. The definition applies regardless of whether the individual or individuals involved have an executive officer title or receive compensation from the bank. The term is commonly used to describe situations where the institution's principal officer or shareholder dominates virtually all phases of the bank's policies and operations.

Examiners should not automatically view the presence of a dominant official negatively or as a supervisory concern. For example, in a small bank with limited staff, a dominant official may emerge because no one else at the bank has the skills or experience to operate the bank. However, the presence of a dominant official coupled with other risk factors such as ineffective internal controls, inadequate board oversight, or high-risk business strategies irrespective of established board policies, are a supervisory concern.

Situations involving dominant officials often involve boards that simply put their trust in the dominant officer and do not provide adequate oversight or effective challenge to management. This lack of effective challenge by boards may arise for various reasons. In particular, when first elected some directors may have a limited understanding of banking operations or of their oversight responsibilities and therefore feel dependent on operating management with more banking experience. Also, directors nominated by dominant officials may believe they owe allegiance to those dominant officials.

Operational risks inherent in these situations include the circumventing of internal controls by a dominant official. For example, a dominant official may simultaneously fulfill roles with conflicting responsibilities, such as chief executive officer (CEO) and chief financial officer, or serving as CEO and simultaneously chairing the audit committee. Situations involving dominant officials often involve boards that simply put their trust in the dominant officer and do not provide adequate oversight or

effectively challenge management. This lack of effective challenge by boards may arise for various reasons.

Other risks inherent in these situations include dependence on a dominant, yet highly qualified official that is core to the operation of the institution. For example, the loss or incapacitation of the dominant official may deprive the bank of critical institutional knowledge and competent management. The loss of a dominant official may also result in short- or long-term business disruptions, productivity losses, or negatively affect profitability. Further, the process to replace a dominant official can be expensive and lengthy.

If examiners identify dominant officials at an institution, they should assess the official's level of influence. Such influence, along with other risk factors and risk management controls designed to mitigate these risks, should be considered during on-site examinations, off-site monitoring, and in the evaluation of management in connection with the regulatory and supervisory processes.

In addition to assessing internal controls the institution established to mitigate risks associated with dominant management officials, examiners should evaluate the effectiveness of compensating controls that protect the institution from the loss of the dominant official. Compensating controls include items such as key-person life insurance, business-continuity and succession planning, and cross-training programs.

When examiners encounter situations that involve dominant management officials, they should review the risk profile and control environment of the bank and assess whether:

- An appropriate segregation of duties and responsibilities is achieved or alternative actions are taken to mitigate the level of control exercised by the dominant individual;
- Director involvement in the oversight of policies and objectives of the bank is at an appropriate level;
- Board composition provides the bank with a range of knowledge and expertise, including, but not limited to, banking, accounting, and the major lending areas of the bank's target markets;
- There are a sufficient number of outside and independent directors;
- Committees of major risk areas exert a proper level of function, responsibility, and influence, and the value of the committees is exhibited in the decision-making process;
- A proper level of independence has been achieved for board committees of major risk areas, including, but not limited to, audit committees;

- An adequate audit committee has been established with only, or at least a majority of, outside directors;
- A need exists for the performance of annual financial audits by an independent certified public accounting firm if not already required under Part 363;
- A qualified, experienced, and independent internal auditor is in place;
- A proper segregation of the internal audit function is achieved from operational activities;
- An appropriate rationale is established regarding any changes to a bank's external auditors, including, but not limited to, a review of the audit committee minutes or a review of auditor notifications¹;
- An adequate written code of conduct, ethics, and conflict of interest policies have been established;
- A need exists for the bank's board to perform and report on an annual conflicts of interest and ethics review;
- A need exists for a bank to engage outside consultants to conduct an external loan review; and
- A proper segregation of the internal loan review process is established.

Report of Examination (ROE) Treatment

If a dominant official or policymaker is identified during an examination, examiners should describe related risks in the ROE. ROE comments should identify the dominant official and describe the official's influence and effect on the bank. Comments should also describe the level of board independence and oversight and the effectiveness of any mitigating controls. Supervisory recommendations relating to a dominant official, such as non-compatible duties or pursuit of high-risk business strategies, or concerns relating to ineffective board oversight or other mitigating controls should also be included in ROE comments.

Examiners should consider how identified weaknesses might affect the institution when assigning component and composite ratings. Concerns should not be disregarded when assigning ratings simply because the bank's current financial condition is satisfactory. Forward-looking supervisory practices require that examiners consider how current practices may affect the future condition of the bank. Additionally, the extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority must be

¹ If the bank recently changed external auditors, examiners should assess the board/audit committee's rationale and review committee minutes and "change-in-auditor" notifications for possible opinion shopping and any other safety and soundness issues.

considered when assigning the Management rating. And finally, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution.

When warranted, supervisory concerns should be addressed with informal or formal corrective programs. When concerns are particularly elevated or prior supervisory actions do not effect corrective actions, consideration should be given, after consultation with the regional office, to recommending changes to board composition or management to reduce a dominant official's impact on material decisions.

Advisory Directors

A naturally sensitive situation develops where the value of a director diminishes due to extensive outside commitments, illness, etc. Often such individuals do not wish to relinquish their position and the bank may be hesitant to request they do so. Some banks have met this situation by establishing a position of honorary director (or similar title) for persons who are no longer able to effectively fulfill the demanding duties of bank director. Generally, the honorary director attends board meetings as desired and offers advice on a limited participation basis, but has no formal voice or vote in proceedings, nor the responsibilities or liabilities of the office, except where there may be a continuing connection with a previous breach of duty as an official director.

Restrictions on Golden Parachute Payments and Indemnification Payments

Golden Parachute Payments

- The rule (Part 359) limits and/or prohibits, in certain circumstances, insured depository institutions, their subsidiaries, and their affiliated depository institution holding companies from agreeing to make or making golden parachute payments when the entity making the payment is "troubled," as defined in Section 303.101 of the FDIC Rules and Regulations.
- The rule does not restrict the payment of golden parachutes by healthy institutions, except that depository institution holding companies (including healthy ones) are prohibited from making golden parachute payments to IAPs of troubled subsidiary banks and savings associations.
- Several exceptions to the prohibition are included in the regulation; some are required by statute, others have been added by the FDIC. These exceptions are as follows:
 - Bona-fide deferred compensation plans.

- Nondiscriminatory severance payment plans (for personnel reductions in force).
- Qualified pension or retirement plans.
- Payments pursuant to employee welfare benefit plans.
- Payments made by reason of termination caused by death or disability.
- Payments required by State statute or foreign law.

The final three listed exceptions require the approval of both the appropriate Federal banking agency and the FDIC:

- A troubled institution hiring new management .
- Severance payment in the event of an unassisted change in control.
- Any others on a case-by-case basis with the regulators' approval.

Indemnification Payments

- With regard to indemnification payments, Part 359 limits the circumstances under which an insured depository institution, its subsidiary, or affiliated depository institution holding company may indemnify institution affiliated parties IAPs for expenses incurred in administrative or civil enforcement actions brought by bank regulators. The circumstances where indemnification may be permitted are as follows:
 1. The institution's board of directors determines in writing that these four criteria are satisfied:
 - The IAP acted in good faith and in a manner believed to be in the best interests of the institution.
 - The payment will not materially adversely affect the safety and soundness of the institution.
 - The payment is limited to expenses incurred in an administrative proceeding or civil action instituted by a Federal financial institution's regulator.
 - The IAP agrees to reimburse the institution if he/she is found to have violated a law, regulation, or other fiduciary duty.
 2. An insurance policy or fidelity bond may pay the cost of defending an administrative proceeding or civil action. It may not pay a penalty or judgement.

- Under no circumstances may an institution or an insurance policy of the institution indemnify an IAP for any judgment or civil money penalty imposed in an action where the IAP is assessed a civil money penalty, is removed from office or prohibited from participating in the affairs of the institution, or is required to cease and desist from or take any affirmative action pursuant to section 8(b) of the FDI Act. However, partial indemnification is allowed for charges that are found in the IAP's favor as explained below under "Issues."

Issues

Generally speaking, the essence of Part 359 lies in its definitions of terms such as: golden parachute payment, bona fide deferred compensation plan, and prohibited indemnification payment, as well as certain significant exceptions to the general prohibitions.

The following are additional discussions on several issues encompassed in the regulation.

- The rule does not apply to contracts and agreements entered into prior to the effective date of the rule (April 1, 1996). However, the FDIC put institutions and their IAPs on notice in the proposed rule (March 29, 1995) that the FDIC will look unfavorably upon any golden parachute agreement which was entered into after the proposal, but before the date of the final rule, that attempts to circumvent the regulation. Appropriate orders should be pursued in such cases.
- With regard to indemnification payments, the majority of administrative or civil enforcement cases end in a settlement and no indemnification payment will be permitted unless charges are dropped. The parties concerned will have to factor in this cost of no indemnification in their decisions to settle or not.

However, there are situations when an individual has been charged with several significant items of misconduct, etc., and then during the process a settlement is reached where only some of the infractions are admitted. The rule permits partial indemnification in those cases. There is a special case-by-case exception to allocate costs to the sets of charges with indemnification permitted for those that are dropped.

Partial indemnification is not permitted in cases where an IAP is removed from office and/or prohibited from participating in the affairs of the institution.

It is recognized that in many cases the appropriate amount of any partial indemnification will be difficult

to ascertain with certainty. Although no prior regulatory consent is required, obviously the regulators are part of the settlement process. The process provides the opportunity for the regulators to give “non-objections” at the time of settlement, prior to the indemnification being made. As part of the settlement process, the bank should be required to provide from the attorney a statement containing a description of specifically attributable expenses. Concern should focus on the reasonableness of the allocations.

- If a golden parachute is prohibited to an individual leaving the institution, it is prohibited forever, even if the institution returns to health (after the individual has left the institution). There are ample exceptions and procedures for an individual who is leaving a troubled institution to avoid the prohibition if that individual has not contributed significantly to the demise of the institution. If an individual does not qualify for one of these exceptions, that individual should not benefit due to the institution reversing its course and returning to health after that individual has left the institution.
- Troubled institutions cannot apply for an exception to offer “white knight” parachutes to their current officers to not leave the institution. Rather it is to entice new management to join the institution by compensating for the uncertainty of joining a troubled institution. It is considered illogical for the FDIC to provide an exception to permit a troubled institution to offer a buyout to current management to get them to stay. The regulation does not prohibit an institution from offering golden parachutes to their current officers. It only prohibits the payment of a golden parachute if the individual leaves while the institution is troubled. On the contrary, it is believed to be of greater incentive that the only way the current officers’ golden parachutes will be of value is if they stay and work to return the institution to health.
- Approval is required for a severance payment in the event of an unassisted change in control. A maximum payment of 12 months salary is permitted under this exception. Any requests for payments in excess of this amount (12 months salary) would have to be considered for approval under the general case-by-case exception.

This exception is provided in recognition of the need for current management to be motivated to seek out acquirers. This exception is believed appropriate for cases where the IAP may not clearly demonstrate that all the factors for the general exception are evident, yet an acquisition of the troubled institution has been

arranged and the acquirer is willing to make the otherwise prohibited golden parachute payment. On the other hand, if after consideration of the factors for the general case-by-case exception, the appropriate Federal banking agency and/or the FDIC determines it inappropriate to make the severance payment, an exception should not be approved.

Excessive Compensation

Section III of Part 364, Appendix A, prohibits the payment of excessive compensation, as well as compensation that could lead to material financial loss to an institution, as an unsafe and unsound practice. Furthermore, Section II of Part 364, Appendix A, urges institutions to maintain safeguards that prevent excessive compensation or compensation that could subject the institution to material financial loss. Excessive compensation is defined as when amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder. The following items should be considered when determining whether compensation is excessive:

- The combined value of all cash and noncash benefits provided to an individual;
- The compensation history of the individual and other individuals with comparable expertise;
- The financial condition of the institution;
- Compensation practices at comparable institutions, based on such factors as asset size, location, and the complexity of the loan portfolio or other assets;
- For post-employment benefits, the projected total cost and benefit to the institution;
- Any connection between the individual and any instance of fraud or insider abuse occurring at the institution; and
- Any other factors determined to be relevant.

The FDIC does not seek to dictate specific salary levels or ranges for directors, officers, or employees. In fact, Section 39 of the FDI Act prohibits establishing guidelines that set a specific level or range of compensation for bank insiders. The criteria listed above are designed to be qualitative rather than quantitative in order to grant an institution’s directors reasonable discretion when structuring a compensation program.

Examiners should review the information used by the board to establish the compensation structure of the institution. The information should adequately explain the rationale for the system in place and should enable the board to consider the above items that determine whether compensation is excessive.

Gaining Access to Bank Records and Employees

Section 10(b)(6) of the FDI Act provides authority for examiners to make a thorough examination of any insured depository institution and to complete a full and detailed report of the institution's condition. In most instances, the executive officers of insured depository institutions cooperate with the requests of examiners. However, there are rare occasions when executive officers are extremely uncooperative, or refuse to provide access to bank records and employees that are essential to the evaluation of the condition of the institution. In such cases, this pattern of behavior by executive officers may be indicative of serious problems in the bank, including fraud, mismanagement, or insolvency. The Regional Office should be consulted when executive officers restrict access to bank records or employees.

Bank Owned Life Insurance (BOLI)

A number of banks use BOLI as a means of protecting against the loss of key employees or hedging employee compensation and benefit plans. However, the purchase of life insurance is subject to supervisory considerations and life insurance holdings must be consistent with safe and sound banking practices. Bankers should complete a thorough analysis before purchasing BOLI. Associated risks, minimum standards for pre-purchase analysis and basic guidelines are detailed in the Other Assets and Liabilities section of this Manual.

EVALUATION OF MANAGEMENT

A bank's performance with respect to asset quality and diversification, capital adequacy, earnings performance and trends, liquidity and funds management, and sensitivity to fluctuations in market interest rates is, to a very significant extent, a result of decisions made by the bank's directors and officers. Consequently, findings and conclusions in regard to the other five elements of the CAMELS rating system are often major determinants of the management rating. More specific considerations are detailed in the Basic Examination Concepts and Guidelines section of this Manual. However, while a bank's overall present condition can be an indicator of management's past effectiveness, it should not be the sole factor relied upon in rating management. This is particularly true when there is new management or when the bank's condition has been significantly affected by external factors versus internal decisions.

When significant problems exist in a bank's overall condition, consideration must be given to management's degree of responsibility. However, appropriate recognition

should also be given to the extent to which weaknesses are caused by external problems (such as a severely depressed local economy). A distinction should be made between problems caused by bank management and those largely due to outside influences. Management of a bank whose problems are related to the economy would warrant a higher rating than management believed substantially responsible for a bank's problems, provided that prudent planning and policies are in place and management is pursuing realistic resolution of the problems. Management's ability becomes more critical in problem situations, and it is important to note management's policies and acts of omission or commission in addressing problems.

The extent to which mismanagement has contributed to areas of weakness is particularly relevant to the management evaluation. Similarly, positive economic conditions may serve to enhance a bank's condition despite weak or undocumented policies and practices. At a minimum, the assessment of management should include the following considerations:

- Whether or not insider abuse is in evidence;
- Existing management's past record of performance in guiding the bank;
- Whether loan losses and other weaknesses are recognized in a timely manner;
- Past compliance with supervisory agreements, commitments, orders, etc.; and
- Capability of management to develop and implement acceptable plans for problem resolution.

Assessment of new management, especially in a problem situation, is difficult. Performance by individuals at their former employment, if known to the examiner, may be helpful, but the examiner should assess each situation based on its particular circumstances. The management rating should generally be consistent with any recommended supervisory actions. A narrative statement supporting the management rating and reconciling any apparent discrepancies between the assigned rating and any recommended supervisory actions (or lack of recommended actions) should be included on the confidential pages of the examination report.

Examination procedures regarding the evaluation of management are included in the Examination Documentation Modules.

RATING THE MANAGEMENT FACTOR

Uniform Financial Institutions Rating System

The Federal Deposit Insurance Corporation and the other Federal Financial Institutions Examination Council (FFIEC) member agencies adopted a uniform interagency system for rating the condition and soundness of the nation's banks. The Uniform Financial Institutions Rating System involves an assessment of six critical aspects of a bank's condition and operations. Management and administration is one of those critical dimensions.

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved.

The capability and performance of management and the board of directors is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of oversight and support of all institution activities by the board of directors and management.
- The ability of the board of directors and management, in their respective roles, to plan for, and respond to,

- risks that may arise from changing business conditions or the initiation of new activities or products.
- The adequacies of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities.
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and risk profile.
- The adequacy of audits and internal controls to: promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies.
- Compliance with laws and regulations.
- Responsiveness to recommendations from auditors and supervisory authorities.
- Management depth and succession.
- The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority.
- Reasonableness of compensation policies and avoidance of self-dealing.
- Demonstrated willingness to serve the legitimate banking needs of the community.
- The overall performance and risk profile of the institution.

Ratings

A rating of 1 indicates strong performance by management and the board of directors and strong risk management practices relative to the institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately

identified, measured, monitored, or controlled.

A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.