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## INTRODUCTION

The quality of management and the manner in which directors and senior management govern a bank's affairs are critical factors in the successful operation of a bank. For purposes of this section, the term *bank* includes all FDIC-supervised institutions and the term *management* includes the board of directors, which is elected by the shareholders, and executive or senior 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 importance of a bank director's position is emphasized by the fact that bank directors can, in certain instances, be held personally liable for violations of standards of conduct governing a director's responsibility for the operation and management of the bank as enacted by the governing jurisdiction for example, gross negligence or disregard for safety and soundness considerations threatening the financial safety of a bank. Also, Congress has placed great emphasis on the role of bank management by passing legislation which allows regulatory authorities to utilize formal cease and desist actions against institution affiliated parties (IAPs) to assess civil money penalties (CMPs), and/or to remove an officer, director, or other IAP from office or to prohibit any further participation by such party, in any manner, in the conduct of the affairs of any insured depository institution.

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. 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.

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<sup>1</sup>See [Statement Concerning the Responsibilities of Bank Directors and Officers](#) (Dec. 3, 1992).

## ← MANAGEMENT/DIRECTORS

### Selection and Qualifications of Directors

Selection to serve as a bank director is an honor. It often means an individual is successful in business or professional endeavors, is public spirited, and is deserving of public trust and confidence. It is this last attribute and the implied public accountability that distinguishes the office of bank director from directorships in most other corporate enterprises. Bank directors are not only responsible to the shareholders who elected them, but must also be concerned with the safety of depositors' funds, consequences to the Deposit Insurance Fund, and the influence the bank exercises on the community it serves.

Laws governing the election of board members emphasizing the importance of a director's position vary by state. 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. There are federal laws pertaining to directors that have 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, and making false entries.

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.

The Statement Concerning the Responsibilities of Bank Directors and Officers<sup>1</sup> explains the key duties and character traits of a successful director. The essential attribute that allows a director to fulfill the duties of loyalty and care associated with the office is personal integrity. Personal integrity usually gives assurance that a director capable of assuming the important fiduciary responsibilities of the office will fairly and equitably represent the diverse interests of shareholders, depositors, and the general public. A prudent director will exhibit independent thoughts and have the courage to express them, sufficient time available

to fulfill their responsibilities, and be free of financial difficulties that could negatively reflect on the bank.

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
- 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.

### **Governing the Manner in Which All Business of the Bank is Conducted**

Directors are responsible for providing a clear framework of risk appetite, strategic focus, objectives and general policies within which executive officers operate and administer the bank's affairs. These objectives and policies at a minimum, include written guidelines for such matters as 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. Policies for specialty areas, such as the Bank Secrecy Act (BSA), Information Technology (IT), Trust Department activities, and consumer compliance will also facilitate appropriate oversight. Objectives and policies that are written and reviewed periodically to determine that they remain applicable also demonstrate effective director oversight. 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. 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 that 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 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.

### **Strategic Planning**

A vital part of the responsibilities of directors is to set the future direction of the bank. The board and senior management face challenges and opportunities daily related to evolving economic and market conditions, competition, and innovation; along with emerging or unforeseen risks, such as cyber threats or natural disasters. Sound strategic

planning is crucial to successful performance in the face of uncertainty and change. The strategic plan is a strategic vision of the board of directors on how the bank should operate. The planning time horizon will not be identical for every bank, but a three- to five-year planning horizon is generally satisfactory for most banks. To be effective, strategic planning decisions must be dynamic and updated as circumstances change.

The strategic planning process is unique to each bank, driven by its culture, mission, business model, risk appetite, resources available (including management talent), risk profile, size, geographic location, communities served, and other considerations. As a result, the formality of the strategic planning process will vary from bank to bank.

The most effective strategic planning process is one that is dynamic, carefully attended to, and well supported. Strategic plan projections are intended to be reviewed and 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.

Examiners should consider the following when assessing the adequacy of the strategic planning process:

- How formal is the bank's planning process compared to the bank's business model, risk profile, size and complexity?
- Were the right people involved? The board? Middle management?
- Is the plan based on realistic assumptions regarding the bank's present and future financial condition, market area(s), and competitive factors?
- Does the bank monitor actual performance against its plan?
- Does the bank consider alternative plans in response to changing conditions?

In addition to an evaluation of the process, examiners should evaluate the reasonableness of the plan's assumptions. This assessment should take into account the personnel resources, financial resources, operating circumstances, and conditions unique to the bank being examined, including examination findings that would impact the bank's financial condition and ability to meet plan projections. Planning 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 through supervisory recommendations.

Examiners should consider the adequacy of the planning process and the plan itself when assigning the Management rating.

## **Selecting and Retaining Competent Management**

It is a primary duty of a board of directors to select and appoint executive officers who have the skills, integrity, knowledge, and experience 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.

An effective pre-employment screening program to appropriately vet candidates will help to ensure that the senior management team possesses a high level of integrity. Section 19 of the FDI Act prohibits any person convicted of certain criminal offenses from participating in the affairs of a bank without the prior written consent of the FDIC. Additionally, Section 32 of the FDI Act requires banks that are not in compliance with minimum capital requirements or are otherwise in a troubled condition to seek the FDIC's approval before hiring or appointing directors or senior executive officers.

Regular evaluation of the management and staffing structure helps the board to ensure that necessary positions and reporting lines are established and appropriate for bank's size, activities, complexity, and risk profile. Having these systems in place ensures there is accountability for key decisions and strategies. If the board is dissatisfied with the performance of senior management, the board should act quickly to find a qualified replacement if hiring senior management is necessary.

## **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.

## **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 corrections as quickly as possible. Board members cannot be expected to be personally knowledgeable of all laws and regulations, but they should ensure 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. Refer to the Indebtedness of Directors, Officers and Their Interests and the Conflicts of Interest sections of this Chapter for additional discussion.

### **Paying Dividends**

The board of directors has the responsibility of maintaining an adequately capitalized bank, and once this responsibility has been satisfied, the payment of dividends may 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. Refer to Section 2.1- Capital for additional information on payment of dividends.

### **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 enables directors to remain well informed of the adequacy, effectiveness, and efficiency of accounting, operating, and administrative controls and provides an assessment of the quality of ongoing operations. Establishment and oversight of such controls are 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. Examiners should review reports generated by the MIS to assess the quality and 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 regulatory requirements. Quality, quantity, and timeliness are factors that determine the effectiveness of management information systems.

### **Supervision by Directors**

The board of directors is charged with conducting the affairs of the bank. However, this task may be delegated to senior officers, provided there is proper oversight. 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 that has led to the decline and failure of banks 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 and taking appropriate action in response to the information received. 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 in person or by remote access). Regular attendance at board and committee meetings demonstrate a director's commitment to stay informed about the bank's risks, business and operational performance, and competitive position in the marketplace. Generally, minutes of the board and committee meetings record the attendance of each director, other attendees, and directors' votes or abstentions. Prudent directors that dissent from the majority, will, 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, an appropriate agenda include reports on income and expenses; 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, audit, 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 is usually 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 practice does not release the board from its 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 that 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; gross negligence and recklessness 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 because 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), 35 L.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 directors over...banks, and leave these institutions a prey to dishonest executive officers." (*Robinson v. Hall*, 63 F. 222, 225-226 (4th Cir. 1894)).

The following quotation represents a brief recapitulation of the law on the subject (*Rankin v. Cooper*, 149 F. 1010, 1013 (C.C.E.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 of the circumstances. (5) If nothing has come to the 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 resources 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**

An insured depository institution or depository institution holding company must notify the appropriate Federal banking agency of the proposed addition of any individual to the board of directors or the employment of any individual as a senior executive officer of such institution or holding company at least 30 days (or such other period, as determined by the appropriate Federal banking agency), which period may be extended an additional 60 days for FDIC-supervised institutions, before such addition or employment becomes effective, if (i) the insured depository institution or depository institution holding company is not in compliance with the minimum capital requirements applicable to such institution or is otherwise in a troubled condition; or the agency determines, in connection with the review by the agency of the plan required under Section 38 or otherwise, that such prior notice is appropriate. *See also*, 12 CFR Part 303, Subpart F.

### **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 information, refer to Subpart L of Part 303 of the FDIC Rules and Regulations.

### **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 made applicable to nonmember insured banks via Section 18(j)(2) of the FDI Act 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. In addition, Section 11(b) of the Home Owners’ Loan Act makes Sections 22(g) and 22 (h) applicable to every savings association in the same manner and to the same extent as if the savings association were a member bank

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 generally makes Regulation O applicable to FDIC-supervised institutions 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 part(y)(ies) must abstain from participating directly or indirectly in the voting.

Any FDIC-supervised institution that violates—or any officer, director, employee, agent or other person participating in the conduct of the affairs of a FDIC-supervised institution—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**

The Depository Institution Management Interlocks Act (DIMIA) is codified at 12 U.S.C. 3201 *et seq.* and its general purpose is to foster competition. The DIMIA 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 FDIC Rules and Regulations. In addition, Section 303.249 of the FDIC Rules and Regulations provides a procedure to seek the approval of the FDIC to establish a management interlock. 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 management interlock regulation.

### **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 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 ordinarily will 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 (e.g., Sections 22(g) and (h) of the Federal Reserve Act). 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 a director's 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 benefits. The involvement of bank insiders in these projects is sometimes not apparent because 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 and of reasonably recent compilation, 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, examiners should strongly encourage the board 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, examiners should determine whether the results of board deliberations on any matter involving a potential conflict of interest are 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. These types of situations not only tend to compromise the credit standards of the lending institution and increase the risk of eventual 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, it is important for the bank's directors and shareholders to be fully informed regarding the nonbanking activity conducted on bank premises. The operation is typically 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. A well run bank ensures that it is 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. For additional discussion, refer to the Interagency Statement on Retail Sales of Nondeposit Investment Products.<sup>2</sup>

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 material or substantial evidence 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 has material influence over virtually all decisions involving the bank's policies and operations. A dominant official can be an individual, family, shareholder, or group of persons with close business dealings or otherwise acting together regardless of whether the individual or any other members of the family or group have an executive officer title or receive compensation from the institution.

The definition of dominant official, as provided in this section, is not intended to capture individuals who merely occupy multiple positions, particularly in small institutions, if they do not also exert material influence over virtually all decisions involving the bank's policies and operations. Nevertheless, in such situations additional transaction testing to confirm the adequacy of segregation of duties and internal controls may be necessary.

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. The presence of a dominant official does however present two potential challenges for boards of directors: incapacitation or loss of the dominant official and difficulties in resolving mismanagement, should it occur.

Incapacitation or loss of the dominant official may deprive the bank of competent management presenting key person risk. Key person risk results when an institution is dependent upon a single, yet highly qualified official that is core to the operation of the institution. For example, the loss or incapacitation of the key person may deprive the

<sup>2</sup> See [Interagency Statement on Retail Sales of Nondeposit Investment Products](#) (Feb. 15, 1994) and [Joint](#)

[Interpretations of The Interagency Statement on Retail Sales of Nondeposit Investment Products](#) (Sep, 12, 1995).

bank of critical institutional knowledge and competent management. The loss of a key person may also result in short- or long-term business disruptions, productivity losses, or negatively affect profitability. Further, the process to replace a key person can be expensive and lengthy. In these cases, examiners should evaluate the effectiveness of compensating controls that protect the institution from the loss of the key person. Compensating controls include items such as key person life insurance, careful business-continuity and succession planning, and cross-training programs.

Problem situations resulting from mismanagement by a dominant official are more difficult to solve through normal supervisory efforts, therefore, it is extremely important that examiners assess the bank's control environment and, when applicable, recommend necessary changes to the control structure. 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 and require enhanced supervision. Red flags associated with institutions operated by a dominant official are discussed in Section 9.1- Bank Fraud and Insider Abuse of this Manual.

Situations involving dominant officials may involve boards that simply put their trust in the dominant officer without providing 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. In some cases, the dominant official may control the flow of information to the board of directors and could limit the board's knowledge of daily management activities, thereby contributing to the lack of adequate oversight or effective challenge to bank management by the board.

Conversely, the dominant official could be an officer or non-officer board chair and/or principal shareholder who dominates the bank's affairs through the threat of dismissal of non-compliant officers and/or control of the board of directors.

Operational risks inherent when a dominant official is present may include the circumvention of internal controls by the dominant official. For example, a dominant official that simultaneously fulfills roles with conflicting responsibilities, such as chief executive officer (CEO) and chief financial officer, or serving as CEO and chair of the audit committee. In another situation, sound risk

management practices may be ignored, such as when a dominant CEO does not involve the board with strategic decisions and policy matters in a timely manner.

If examiners identify dominant officials at an institution, they should assess the official's level of influence. Does the official direct the affairs of the institution without challenge from the board of directors? Is the official an officer or non-officer board chair/principal shareholder who dominates the board and management? Does the official determine the policies and/or the strategic direction of the bank? Does the official control the flow of information to the board of directors? These are examples of material 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 these situations, examiners 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, if not already required by Section 363.5 of the FDIC's Rules and Regulations;
- 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 notifications;<sup>3</sup>

- 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 is identified during an examination, examiners should describe related risks in the ROE. ROE comments should identify the dominant official, describe the official's material influence and effect on the bank, describe the level of board independence and oversight, and describe the effectiveness of any mitigating controls. If no concerns are identified, the comments should be included in the Confidential-Supervisory Section. If concerns attributed to a dominant official are identified, supervisory recommendations should be scheduled on the Examination Conclusions and Comments or Risk Management Assessment pages, as appropriate, according to ROE instructions. Concerns attributed to a dominant official, including non-compatible duties, pursuit of high-risk business strategies, ineffective board oversight, or lack of other adequate mitigating controls should be raised on the Matters Requiring Board Attention (MRBA) report page. Supervisory recommendations, including those raised on the MRBA page, should specify clear corrective actions that mitigate risk. Additionally, when a dominant official is identified, the Dominant Officer/Policy maker line item of the Summary Analysis of the Examination Report (SAER) should be answered "Yes."

Examiners should consider how identified dominant official related weaknesses might affect the institution when assigning component and composite ratings. Concerns or deficiencies should not be excluded from the ROE or disregarded when assigning ratings simply because the bank's current financial condition is satisfactory or does not reflect deterioration. 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 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.

Enhanced supervision to address supervisory concerns related to dominant management or ownership include recommending director education to assist board members in performing their fiduciary responsibilities and engaging outside directors during the examination and other supervisory processes. Directors' fiduciary duties, include changing management composition, or seeking change in board composition, if a dominant official's influence hinders a director's oversight, independence, or influence.

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 timely 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. Enforcement action provisions should be tailored to, and specifically address, the risks identified by specifying what actions the institution should take to mitigate the risk. For instance, a provision requiring the board to obtain a management study should also require the study to provide recommendations for specific actions that the institution should take to implement appropriate controls to mitigate the risk associated with the dominant official. Case managers should also record and retain information regarding the basis for key supervisory decisions and actions in a memo to the file, including instances where supervisory actions are considered or recommended but not ultimately taken.

Application review and processing should include an assessment of whether a dominant influence is present, mitigating factors are adequate, and related prior supervisory actions have been effective. If mitigating factors are not adequate or related supervisory actions did not have the intended effect, case managers should reflect that in the Summary of Investigation and consider whether changes to the application or appropriate conditions should be sought prior to approving an application.

### Advisory Directors

Some banks establish a position of honorary director (or similar title) for various reasons for persons who do not want to relinquish their position but are no longer able to effectively fulfill the demanding duties of director, such as due to illness. Generally, the honorary director attends board meetings as desired and offers advice on a limited

notifications for possible opinion shopping and any other safety and soundness issues.

<sup>3</sup> If the bank recently changed external auditors, examiners should assess the board and audit committee's rationale and review committee minutes and "change-in-auditor"

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

- Part 359<sup>4</sup> of the FDIC Rules and Regulations 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; and
  - 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; and
- 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 its affiliated depository institution holding company may indemnify 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; and
    - 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 restitution and the reasonable 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.

<sup>4</sup> Part 359 implements Section 18(k) of the FDI Act, 12 U.S.C. 1828(k).

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

- 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 by reasonable payment of legal or professional expenses in those cases if there has been a formal and final adjudication or finding in connection with a settlement that the IAP has not violated banking laws or regulations or engaged in unsafe or unsound banking practices or breaches of fiduciary duty. There is a special case-by-case exception to allocate costs to the sets of charges with indemnification permitted for those that are dropped.

Regardless of findings or adjudication conclusions, 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, the regulators, obviously, 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 or expert seeking fees 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 such provisions are intended 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 non-permissible 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 12 months’ salary would have to be considered for approval under the general case-by-case exception.

The change-in-control 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 requires them 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. Examiners are to assess whether bankers 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.



## MODEL RISK MANAGEMENT

Some banks routinely use models for a broad range of activities, including underwriting credits; valuing exposures, instruments, and positions; measuring risk; managing and safeguarding client assets; determining capital and reserve adequacy; and many others. The use of models can improve business decisions, but can also introduce risk, such as potential adverse consequences (including financial loss) of decisions based on models that are incorrect or misused. To ensure safe and sound operations, it is important that, like any other risk, a bank's board and management identify, measure, monitor, and control model risk.

The Supervisory Guidance on Model Risk Management (MRM Guidance) describes the key aspects of effective model risk management. While this manual section provides an overview of model risk management principles, examiners should refer to the MRM Guidance for a more thorough discussion of model risk management.

Appendix A to Part 364 has long-established standards for safety and soundness for banks in the areas of internal controls and information systems; internal audit systems; loan documentation; credit underwriting; interest rate exposure; asset quality; earnings; and compensation, fees, and benefits. To the extent that models are used in these major operating areas of the bank, whether the model was developed and operated internally or through a third party, examiners are to assess model risk management practices for consistency with safety and soundness standards.

## Overview

The term *model* refers to a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates. A model also includes quantitative approaches whose inputs are partially or wholly qualitative or based on expert judgement, provided that the output is quantitative in nature.

It is important for model risk management practices to be commensurate with the bank's risk exposures, as well as the complexity and extent of its model use.



An effective model risk management framework includes:

- Disciplined and knowledgeable model development processes that are well documented and conceptually sound, with controls to ensure proper implementation and processes to ensure correct and appropriate use;
- Effective validation processes; and
- Strong governance, policies, and controls.

Tools used for simple mathematical calculations are generally not considered models, but should nonetheless be subject to a reasonable control process.

### Model Development, Implementation, and Use

Disciplined and knowledgeable development and implementation processes that are consistent with the model's intended use and with bank policy are critical to appropriately managing model risk. There are many important aspects to model development and implementation, including:

- A clear statement of purpose to ensure development is aligned with intended use;
- Design, theory, and logic that are well documented and supported;
- Rigorous assessment and documentation of data quality and relevance;
- Documented testing during model development to determine whether the model is performing as intended; and
- Controls and testing for model implementation and systems integration.

Model use provides additional opportunity to test whether a model is functioning effectively and to assess its performance over time as conditions and model applications change. Also, an understanding of model uncertainty and inaccuracy and a demonstration that the bank is accounting for them appropriately are important outcomes of effective model development, implementation, and use.

### Model Validation

Model validation is the set of processes and activities intended to verify that models are performing as expected, in line with their design objectives and business uses. Effective validation helps ensure that models are sound. It also identifies potential limitations and assumptions, and assesses their possible impact. Independence, competence, knowledge, skills, expertise, incentives, influence, and authorities of staff conducting validation are important elements of model validation.

Key elements of comprehensive validation include: evaluation of conceptual soundness, ongoing monitoring, and outcomes analysis.

- Evaluation of conceptual soundness includes assessing the quality of the model design and construction, a review of documentation supporting the methods used and variables selected for the model, sensitivity analysis (where appropriate), and evaluating qualitative information and judgment.
- Ongoing monitoring includes designing a program of ongoing testing and evaluation of model performance to confirm that the model is appropriately implemented and is being used and is performing as intended, which may include process verification and benchmarking.
- Outcomes analysis, including backtesting, includes a comparison of model outputs to corresponding actual outcomes, with the precise nature of comparisons depending on the objectives of a model.

### Governance, Policies, and Controls

Developing and maintaining strong governance, policies, and controls over the model risk management framework is fundamentally important to its effectiveness. Even if model development, implementation, use, and validation are satisfactory, a weak governance function will reduce the effectiveness of overall model risk management. A strong governance framework provides explicit support and structure to risk management functions through policies defining relevant risk management activities, procedures that implement those policies, allocation of resources, and mechanisms for evaluating whether policies and procedures are being carried out as specified. Notably, the extent and sophistication of a bank's governance function is expected to align with the extent and sophistication of model usage.

### Examination Review

Examination planning contact with bank management, as well as interim contacts, provides examination staff with opportunities to discuss the extent of model use and determine whether there are any material changes since the prior examination. If management indicates new model use or material changes since the prior examination, examiners should consider asking some additional questions to assist in exam scoping and to appropriately tailor the request list. For example, ask management:

- Where model risk management is addressed in policies and whether there are any procedures, standards or monitoring practices the bank may have that address model risk management practices.
- Whether the bank maintains a model inventory. While banks are not required to maintain a model inventory, identifying models used across the bank can be an important practice to assist in model risk management. For banks with minimal model use, model risk, and model complexity, the inventory may

be an informal list. To the extent a bank maintains an inventory, it will be useful in the exam planning process in developing the scope of the model risk review.

- Whether the bank has model documentation or validation reports for models used.
- Whether model risk management is covered in the audit scope.
- Whether the bank maintains any exception or findings tracking reports.

Based on discussion with management, examiners should consider including relevant documents in the request list. Based on management discussions and the response to the request list, examiners should determine whether a review of the model risk management framework or review of specific models is necessary or warranted. Examiners should tailor the examination review scope based on the bank's risk exposure, activities, complexity and extent of model use. The review should focus on assessing the adequacy of the model risk management framework. To the extent models are used for key operating areas, examiners should consider reviewing the model documentation and validation. This review process can provide examiners with insight not only into the model and its quality but also the adequacy of risk management practices. If examiners determine the risk posed by the bank's model use is not at a level to necessitate a model sample review, examiners should consider reviewing internal risk management standards imbedded in operating policies and discussing vendor model due diligence processes with bank management. Such information can provide examiners with meaningful insight into whether model risk is managed appropriately.

#### *References:*

- Appendix A to Part 364 of FDIC Rules and Regulations
- Supervisory Guidance on Model Risk Management (FIL 22-2017)



## 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 or could be 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 financial institutions. The Uniform Financial Institutions Rating System involves an assessment of six critical aspects of an institution'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, strategic, compliance, legal, liquidity, and other risks.<sup>5</sup> 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 planning;
- 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; and
- 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.

<sup>5</sup> This sentence was shortened from the similar sentence in the Uniform Financial Institution Rating System.

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.