MANAGEMENT

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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MANAGEMENT/DIRECTORS

Selection and Qualifications of Directors

Selection to serve as a bank director is an honor. It often means an individual has a reputation as being 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[1] 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

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

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.

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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