



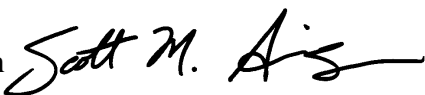
Office of Thrift Supervision

Department of the Treasury *Managing Director, Examinations, Supervision, and Consumer Protection*

1700 G Street, N.W., Washington, DC 20552 • (202) 906-7984

October 13, 2006

MEMORANDUM FOR: Chief Executive Officers

FROM: Scott M. Albinson 

SUBJECT: Updated Director's Responsibility Guide and Guide to Management Reports

The Office of Thrift Supervision (OTS) is issuing updated versions of the Directors' Responsibility Guide and the Directors' Guide to Management Reports to highlight our supervisory expectation for a strong, consistent approach towards sound corporate governance practices, as well as the importance of strong, independent boards of directors.

The updated Director's Guide adds a new section on statutory and regulatory responsibility and clarifies the issue of blurred lines of responsibility between the board and management. We have also added a chart on the applicability of selected Sarbanes-Oxley requirements. The streamlined, restructured Guide to Management Reports consolidates some existing reports and adds additional red flags to monitor internal controls and financial performance. Electronic versions of both guides are available on our website at www.ots.treas.gov/issuances.

For further information contact Josephine Battle, Program Analyst, Operation Risk at (202) 906-6870.

Attachments

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Office of Thrift Supervision
Department of the Treasury



**Directors’
Responsibilities**

Guide

September 2006

Directors' Responsibilities Guide

Introduction

As the financial services industry continues to evolve, the role of directors remains critical. The corporate scandals of 2002, the Sarbanes -Oxley Act, as well as the NYSE and NASDAQ rules and regulations, have raised the public's awareness of corporate governance. While financial headlines may change, the Office of Thrift Supervision's (OTS's) principles of corporate governance remain consistent. OTS has long endorsed the need for sound governance practices as well as the importance of strong, independent boards of directors.

Scope

This guide is an overview of your core responsibilities as a fiduciary with the public trust of federally insured deposits, not a complete set of guidelines for savings association directors. A complex framework of federal and state laws and regulations governs you in your role as a director. This guide does not modify the legal framework in any way, nor does it cover every conceivable situation that you may confront. Rather, it offers general guidance for you to meet your responsibilities in a changing business environment.

You face special challenges because insured banks and savings associations differ from other corporations. Federal deposit insurance subjects a depository institution to special scrutiny and control because of the nature of the business risks involved and the importance of a safe and sound banking system to the nation's economy.

Requirements

Directors do not require extensive training, but they should receive some form of orientation and continuing education to assure they achieve and maintain a necessary level of expertise. The board may seek appropriate advice from independent consultants or outside counsel at the expense of the association, if necessary to direct the association appropriately.

Other Guidance

To help you make informed decisions, OTS has additional guidance available for directors:

- *Directors' Guide to Management Reports.* This guide discusses accurate and timely information you need about your association's performance and its compliance with regulatory requirements.
- *Examination Handbook Section 310, Oversight by the Board of Directors.* This handbook section outlines your responsibilities as a director.

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We also list some helpful resources at the end of this guide as well as a chart to clarify the applicability of selected Sarbanes-Oxley Act requirements. We encourage you to contact OTS regional office staff if you have questions concerning your duties or responsibilities.

Responsibilities

The directors and management have separate roles. Board members should avoid crossing the line into management activities and vice versa.

The savings association board of directors is ultimately responsible for overseeing the affairs of the association. Specifically, the board has the following responsibilities:

- Establish the association's overall objectives and strategy.
- Select and retain competent management.
- Monitor and assess operations.
- Conduct affairs ethically and avoid the appearance of conflicts of interest.

- Ensure that the association is meeting the needs of its community.

Management, in turn, has the following responsibilities:

- Run day-to-day operations.
- Implement board policies.
- Report on performance.
- Recommend improvements when possible.

Management knowledge and skills are among the association's most valuable assets. However, the board must not follow management's recommendations unless it thoroughly discusses, independently evaluates, and fully understands significant issues and events.

In order to stay well informed you should:

- Prepare in advance and attend all board meetings.
- Be proactive and independent.
- Require a complete and consistent board information package in advance of meetings.

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- Require complete and accurate minutes of all board meetings.
- Be aware of news about the association, the financial services industry, and the general business climate of the association's communities.
- Review and heed regulatory examination reports and all supervisory correspondence.
- Discuss key issues with senior management both in and out of board meetings.
- Review and respond to reports from internal and external auditors and board committees.

Generally information flows to the board from a wealth of sources, but formal sources include:

- Management reports.
- Internal audit reports.
- External audit reports.
- Examination reports.

These reports should provide you with valuable information. You should watch for con-

cerns, weaknesses, negative trends or other developments noted in these reports and ensure they are corrected as necessary. Additionally you should watch for significant inconsistencies among these sources and obtain a satisfactory explanation for any major discrepancies.

Establish the Association's Objectives and Strategies

Business objectives are the overall priorities of the association. The association must have written objectives that are realistic. Timeframes must be clear. Every association's business plan should include clear objectives and measurable implementing strategies.

You must identify and understand the risks presented by the association's objectives and strategies. OTS recognizes that associations must assume certain risks to be profitable. The Board should carefully assess risks and calculate the impact of those risks prior to engaging in any material activity. The association must establish an adequate system for identifying and managing risks to ensure they are appropriate for the expertise, skills, and abilities of management, as well as the size and

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complexity of operations. The board and management must work together to ensure that they adequately identify, measure, monitor, and control risks. Some risks of particular importance to savings associations are interest-rate risk, credit risk, concentration risk, technology risk, liquidity risk, and reputation risk.

The board must oversee and approve policies and procedures — guiding principles and broad courses of action — that will help the association attain its objectives. Specific operating policies are necessary to govern key business activities. At a minimum your association's policies should address:

- Lending.
- Investments.
- Capital planning.
- Internal controls.
- Valuation allowances.
- Asset quality and credit risk management.
- Asset/liability and interest-rate risk management.
- Off-balance-sheet activities.

- Human resources and benefits.
- Business planning and budgeting.
- Internal and external audit programs.
- A code of ethics to reduce conflicts of interest.
- Compliance with safety and soundness, consumer protection, and other public policy, statutes and regulations (including the Community Reinvestment Act).
- Business continuity and contingency planning, including employee safety and security.
- Information and physical security.
- The privacy and accuracy of customers' personal information.

The board should review the policies and procedures at least once a year to consider appropriate changes.

Select and Retain Competent Management

The most important factor in the success of an association is the quality of its management. The board must select and retain man-

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agement who will follow the board-approved strategies and objectives of the association.

It is rare that the cause of a serious problem or the failure of a savings association is other than mismanagement. Most association failures are the result of inattentive, inadequate, or dishonest managers. You must stay keenly aware of management's activities. Your early detection of managerial problems can mean the difference between success and failure of the association.

Meeting periodically, the board makes major decisions about the association's business goals, policies, and procedures. Management, in turn, translates the board decisions into day-to-day business activities. You and your fellow directors can fulfill your responsibilities only with the help of a skilled and trustworthy management team.

Monitor and Assess Operations

Once objectives, strategies, policies, and procedures are in place, the board should establish an ongoing review of the association's performance. This review should include management reports to the board.

Periodically, management and the board should carefully review the makeup of the board management reports to ensure that the information is concise, complete, timely, useful, and transparent.

Transparency relies on the accessibility of comprehensible, rational, relevant, and reliable information about publicly traded firms such as:

- periodic performance
- financial position
- investment opportunities
- governance
- value
- risk

Corporate transparency is desirable because it enhances the quality of information provided in financial statements, audit opinions, credit ratings, and analyst reports.

In today's environment a lack of transparency can impose unexpected, significant, and costly exposure to unwanted and unnecessary risks. All directors should strive for providing high-

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er quality information to depositors, borrowers, investors, and other stakeholders so that they are able to make better decisions.

Directors should be comfortable with the accuracy and integrity of distributed information so that the public can assess and make informed decisions.

Reports should present relevant information. Too much detail, too little detail, or irrelevant information can hide potential risks that are visible in concise, thorough summaries. Consistency in reporting improves the effectiveness of a report as an oversight tool. Management can use frequent changes to mask serious problems. You should review reports in advance of board meetings to allow for a meaningful discussion. You should compare current operating results against:

- Business objectives.
- Established performance targets.
- Previous period results.
- Recognized standards.
- Peer group and industry performance.

- Results of periodic reports by independent auditors and regulators.

You must read and understand management reports, ask questions to further your understanding, and in some cases obtain third party validation that the reports are prepared under acceptable policies and procedures.

Internal reports will generally include the following information:

- Budget projections and comparisons.
- Income and expenses.
- Capital outlays and adequacy.
- Loans and investments.
- Past due and renegotiated loans and investments.
- Problem loans, their present status, and workout programs.
- Allowance for probable and estimable loan losses.
- Concentrations of credit.
- Losses and recoveries on disposition of assets.

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- Funding activities and the management of interest rate risk.
- Performance in all of the above areas compared to past performance as well as to peer group performance.
- All insider transactions that benefit, directly or indirectly, controlling shareholders, directors, officers, other employees, or their related interests.
- List of actions taken to ensure compliance with applicable laws.
- Any extraordinary development likely to affect the integrity, safety, or profitability of the savings association.

The board must ensure that the association maintains an effective system of internal controls. The board should monitor compliance through several means, including the following:

- Board committees.
- Internal audit reports.
- Management reports.
- Independent audit reports.
- Management letters from the auditor.

- Regulatory reports and correspondence.

Conduct Your Affairs Ethically and Avoid the Appearance of Conflicts of Interest

Everything you do must comply with applicable laws. You have fiduciary duties of care, loyalty, and candor to your association. If you are a dual director, serving as a director for both the holding company and the association, there may be times when the interest of the holding company and the association conflict. Your duty to the association is paramount to your duty to the holding company or other affiliate because of the public trust vested in you as a savings association director. You must take whatever steps are necessary to ensure that the association maintains a corporate existence that is separate from its holding company, affiliates, and subsidiaries.

You should also avoid conflicts of interest or even an appearance of conflict, especially where a management interlock exists. (12 CFR Part 563f) You must think independently and act in the best interests of the association at all times.

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The association should not engage in preferential transactions with insiders. This includes transactions with directors, executive officers, principal shareholders, and related interests. Transactions with insiders must be beyond reproach. They must be in full compliance with applicable laws, and you must document the basis for such decisions to avoid personal civil and criminal liability.

When acting in an official capacity, your personal financial or business interests and those of your family and associates must be subordinate to the best interests of the association. When deciding such matters, you should never advance your own interest or those of your family or associates at the expense of the association. If an issue comes before the board that poses a potential conflict, you should:

- Disclose to your fellow directors all material information relevant to the board's decision.
- Refrain from participating in any board discussion of the issue.
- Abstain from voting on the issue.

Association counsel owes a duty of loyalty to the association, not to the directors, management, or owners. The association should obtain separate counsel to negotiate employment agreements and director benefits. In addition, you should not use the association's legal counsel for personal business. You should retain your own counsel for personal purposes.

Ensure that the Association is Meeting the Needs of its Community

Under the Community Reinvestment Act, you are responsible for ensuring that your association meets the credit needs of the communities where it operates, including low- and moderate-income areas and borrowers. In doing so, you will be supporting the community that supports the association. Adherence to fair lending laws is a major factor in your Community Reinvestment Act evaluation. An association that engages in illegal discrimination cannot effectively serve the community. You must ensure that appropriate fair lending policies, procedures, and controls are in place at your association.

Committees

You may find it useful to establish committees of the board with special expertise to understand and interpret specialized areas. You may delegate assignments, but you **must never delegate your responsibilities as a director.**

Each committee should establish in writing the committee's functions, responsibilities, and membership qualifications. Depending on its function a committee may include a mixture of inside directors, outside directors, and management. Committee members should have appropriate expertise and independence based on the objective of the committee. Committees should report regularly to the full board. The proceedings of each meeting of the committee must be documented.

Some common committees are the Executive, Strategic Planning, Loan, Audit, Examination, Nominating, Corporate Governance, Investment, Asset/Liability, Interest Rate Risk, Information Technology, Compensation and Personnel, Compliance, and Community

Reinvestment Act (CRA) and Fair Lending committees. The board may also establish ad hoc committees to deal with particularly significant current issues. We describe the four most important and common committees below:

The executive committee generally acts with authorization in the board's absence between board meetings, with actions subject to board ratification or prior blanket approval. The executive committee can perform reviews of information and operations that are more detailed and coordinate the work of the other committees.

The strategic planning committee considers the environment in which the association operates, including the law, the economy, and competition. It decides how best to address these external factors by carefully selecting and achieving long-range goals. The committee recommends a plan to the board with benchmarks for measuring progress.

The loan committee approves loans, reviews lending policies, and monitors management compliance with these policies. The loan com-

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mittee reviews the adequacy of the allowances for loan and lease losses.

The audit committee monitors management and staff compliance with board policies, laws, and regulations. The audit committee supervises the internal and external audit functions. An audit committee should include members with savings association or related financial experience. Members must be independent of management and free from any relationship that would interfere with the exercise of independent judgment. Members must also be independent of operating personnel who audit procedures, systems, or records. An association with significant transactions with affiliates needs to ensure that its audit committee membership also is independent from its affiliates.

Statutory and Regulatory Liability

Directors are responsible for ensuring that the association complies with all applicable laws. A director who violates any banking law or regulation, engages in an unsafe or unsound banking practice, breaches a fiduciary duty, or knowingly allows another to do so, may be held personally liable or subjected to monetary penalties or other sanctions.

Listed below are some key statutes and related regulations that establish specific terms for the conduct and activities of directors and their association. The following chart is not intended to be all inclusive, nor is it intended to be an authoritative restatement of the law and regulations, particularly since statutory and regulatory changes might take place after publication of this guide.

Directors and management are responsible for consulting the current version of the specific statute or regulation ■

APPENDIX I

Statute/Regulation Policy

Authority

Report of Condition

12 USC § 1817(a)(3)
TFR Instructions

Director's Responsibility (DR) — *Two or more members of the board must attest to the report.*

Interbank Liabilities

12 CFR § 206.3

DR — *Directors must review and approve the association's interbank liability policies and procedures.*

Payment Systems Risk

12 CFR § 210.25

DR — *Directors must control the risks of participation in the systems by establishing caps and reviewing policy compliance.*

Annual Independent Audits and Reporting Requirements

12 CFR Part 363

DR — *If the association has total assets of \$500 million or more, the board must establish an independent audit committee.*

Real Estate Lending Standards

12 CFR § 560.101

DR — *Directors must, at least annually, review and approve lending policies for extensions of credit secured by real estate. Such lending policies should reflect risk levels that are acceptable to the board and provide clear and measurable underwriting standards.*

Statute/Regulation Policy

Authority

Classification of Assets

12 CFR § 560.160

***DR** — Directors should ensure that management evaluates and classifies the association’s assets on a regular basis in a manner consistent with or reconcilable to OTS’s asset classification system.*

Board of Directors - General Requirements

12 CFR § 563.33(a)

***DR** — Directors must ensure that the composition of the board is within the guidelines of § 563.33(a).*

Executive Compensation and Employment Contract Oversight

12 CFR § 563.39

***DR** — The board must annually review and approve all employment contracts and compensation arrangements for senior officials and directors.*

Financial Derivatives

12 CFR § 563.172

***DR** — The board is responsible for effective oversight of financial derivative activities and must establish written policies and procedures governing such activities.*

BSA Compliance

12 CFR § 563.177(b)

***DR** — The board of directors must approve the BSA compliance program that establishes and maintains procedures reasonably designed to assure and monitor compliance with BSA requirements.*

APPENDIX I

Statute/Regulation Policy

Authority

Interest Rate Risk Management Procedures

12 CFR § 563.176

DR — *The board of directors must review the association's interest rate risk exposure and devise and adopt policies for the management of interest rate risk. The board must review the results of operations at least quarterly and make appropriate adjustments as necessary.*

Bond Coverage for Directors, Officers, Employees, and Agents

12 CFR § 563.190

DR — *The board must formally approve and annually review and assess the association's standard and supplemental bond coverage.*

Conflicts of Interest

12 CFR § 563.200

DR — *The board must review each director's business and personal interests to ensure that the director does not advance his or her interests, or those of others with whom he or she has a personal or business relationship, at the expense of the association.*

Appraisal Policies and Practices of Savings Associations and Subordinate Organizations

12 CFR § 564.8,
TB 55a 11/1/94

DR — *Directors should develop, implement, and maintain appraisal policies to ensure that appraisals reflect professional competence and reliable market value of the collateral.*

Statute/Regulation Policy	Authority
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Written Security Program	12 CFR Part 568
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DR — *The board must ensure that the association has a written security program for the main and branch offices. The board must designate a security officer to report at least annually on the implementation, administration, and effectiveness of the security program.*

Safety and Soundness Standards	12 CFR Part 570, Appendix A
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DR — *Directors and senior management must ensure that the association has a system of internal controls that operate effectively as well as an internal audit function that is appropriate to its size, nature, and scope of activities.*

Standards for Safeguarding Customer Information	12 CFR Part 570, Appendix B
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DR — *The board must approve the association’s written information security program and oversee the program’s development, implementation, and maintenance.*

Supervisory Policy Statement on Investment Securities and End-User Derivatives Activity	Interagency Policy Statement
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DR — *Directors must approve major policies for conducting investment activities including the establishment of risk limits.*

APPENDIX I

Statute/Regulation Policy

Authority

Networking Arrangements

Examination Handbook
Section 710, 1/1/04;
CEO Memo Number
178, 7/11/03

DR — *If the association permits the sale of nondeposit investment products on its premises, the board must ensure that customers receive disclosures about the nature and risk associated with such products. The board must also adopt and periodically update a written statement that addresses the risks associated with the association's sales program.*

Internal Audit Function and its
Outsourcing

TB 81
3/17/03

DR — *The board and senior management are responsible for having an effective system of internal control and an effective internal audit function in place at their institution.*

Third Party Arrangements

TB 82a
9/01/04

DR — *Directors and management must effectively manage risks that arise from all types of third party arrangements.*

Statute/Regulation Policy

Authority

Allowance for Loan and Lease Losses Methodologies and Documentation

CEO Memo
Number 142, 7/17/01

***DR** — The board is responsible for ensuring that controls are in place to determine the appropriate level of ALLL.*

Compliance Management Program - SMAART

Self Assessment Guide
12/29/02

***DR** — The board must adopt and maintain a comprehensive compliance management program predicated on systems, real-time monitoring, periodic self-assessment, organizational accountability, responsiveness to needed improvements, and effective training (OTS's SMAART Compliance Program Components).*

Business Continuity Planning

CEO Memo
Number 176, 6/10/03

***DR** — Directors and senior management must establish policies and procedures to ensure that comprehensive corporate business resumption, contingency planning, and testing takes place.*

APPENDIX II

APPLICABILITY OF SELECTED SARBANES-OXLEY

Note: Institutions that meet more than one audit category should default to the first listed category (highest category in the hierarchy established in this chart). For example, a public company that is also subject to FDICIA would be required to comply with all titles in Sarbanes-Oxley and default to the public company category.

Institution's Audit Category	Title II - Auditor Independence¹
Public companies ²	<u>Required</u> ¹
FDICIA required audits ³	Institutions are required to comply with Sections 201, 202, 203, and 206. Section 204 does not apply under the existing audit standards, but the FDIC may amend Part 363 to encompass standards that mirror Section 204. ^{4, 5}

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ACT REQUIREMENTS TO FINANCIAL INSTITUTIONS

Title III - Corporate Responsibility	Title IV - Enhanced Financial Disclosure ¹
<p style="text-align: center;"><u>Required</u>¹</p>	<p style="text-align: center;"><u>Required</u>¹</p> <p>Section 404 has been finalized. The banking agencies worked with the SEC to establish an option for institutions to prepare one report to meet both Section 404 and FDICIA requirements. Institutions may choose to prepare separate reports for the FDIC and SEC.</p>
<p>Institutions are not required to comply with Section 301; however, they must have an audit committee that is independent of management. Institutions are not required to comply with Section 302. Institutions are not required to comply with Section 303 but it is an unsafe and unsound practice to exercise improper influence on the conduct of an audit.⁵</p> <p>Spread →</p>	<p>Institutions are not required to comply with Sections 401, 402, 404, and 406. However, the FDIC may amend Part 363 to require compliance with those sections.</p> <p>Institutions are not required to comply with 407; however, institutions with more than \$3 billion in assets are required to have at least one member of the audit committee with banking or related financial management expertise. The audit committee must have access to its own outside counsel.⁵</p>

APPENDIX II

APPLICABILITY OF SELECTED SARBANES-OXLEY — *continued*

Institution's Audit Category	Title II - Auditor Independence¹
OTS required audits ⁶	Independent public accountants are required to meet the independence requirements and interpretations of the SEC and its staff. ⁶
All other audits ⁸ - supervised by OTS, FRB, or OCC.	An institution may be required by another law or regulation, an order, or another supervisory action to have its financial statements audited by an independent public accountant. If warranted for safety and soundness reasons, the institution's primary federal regulator may require that the institution and its independent public accountant comply with the auditor independence requirements of Section 201. ⁴

ACT REQUIREMENTS TO FINANCIAL INSTITUTIONS

<p>Title III - Corporate Responsibility</p>	<p>Title IV - Enhanced Financial Disclosure¹</p>
<p>Institutions are encouraged to periodically review their policies and procedures relating to corporate governance and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the institution's size, operations, and resources.⁷</p>	<p>Institutions are encouraged to periodically review their policies and procedures relating to corporate governance and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the institution's size, operations, and resources.⁷</p>
<p>Compliance may be required. If not required, institutions are encouraged to periodically review their policies and procedures relating to corporate governance and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the institution's size, operations, and resources.⁷</p>	<p>Institutions are encouraged to periodically review their policies and procedures relating to corporate governance and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the institution's size, operations, and resources.⁷</p>

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APPENDIX II

APPLICABILITY OF SELECTED SARBANES-OXLEY

— *continued*

Institution's Audit Category	Title II - Auditor Independence ¹
All other audits ⁸ - supervised by FDIC.	Compliance not required. However, institutions are encouraged to follow the internal audit outsourcing prohibition in Section 201, audit partner rotation and "time out" periods similar to Section 203, institute auditor reporting practices similar to Section 204, and to comply with the conflicts of interest requirements in Section 206 given the institution's size, complexity, and risk profile. ⁵

Footnotes

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- ¹ Highlights of Selected Sarbanes-Oxley Act Requirements (Appendix A).
- ² Public companies: Banks, savings associations, and holding companies that have a class of securities registered with either the SEC or the federal banking agencies (including OTS) under Section 12 of the Securities and Exchange Act of 1934 or are required to file reports with the SEC under Section 15(d) of that Act (commonly referred to as "public companies"), and are required to have an external audit.
- ³ FDICIA required audits: Banks and savings associations with assets of \$500 million or more that are subject to the FDIC's external audit and reporting requirements under 12 CFR Part 363.
- ⁴ Interagency Policy Statement on the Internal Audit Function and Its Outsourcing (March 17, 2003).
- ⁵ FDIC Financial Institution Letter (FIL) - 17 - 2003, Corporate Governance, Audits and Reporting Requirements (March 5, 2003).
- ⁶ OTS required audits: Savings associations and savings association holding companies required by OTS to have an audit pursuant to 12

ACT REQUIREMENTS TO FINANCIAL INSTITUTIONS

Title III - Corporate Responsibility	Title IV - Enhanced Financial Disclosure ¹
<p>Compliance not required. However, institutions are encouraged to establish an audit committee consisting entirely of outside directors, similar to Section 301, asked to consider implementing Section 302, and strongly encouraged to comply with Section 303 (improper influence over external auditing work).⁵</p>	<p>Institutions are encouraged to implement to the extent feasible given the institution's size, complexity, and risk profile. Institutions are encouraged to implement Sections 401, 404, and 406, and continue to comply with Section 402 (Regulation O).⁵</p>

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CFR 562. Includes audits of:

- ◆ Savings associations with composite CAMELS rating of 3, 4, or 5;
- ◆ Savings association holding companies that control a savings association subsidiary(ies) with aggregate consolidated assets of \$500 million or more;
- ◆ De novo savings associations; and
- ◆ Other audits deemed necessary for safety and soundness reasons.

⁷ Joint Interagency (OTS, FRB, OCC) Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations, OTS CEO Letter No. 174 (May 5, 2003).

⁸ All other audits include: Banks, savings associations, and holding companies that are (1) required to have an audit by another law or regulation, an order, or another supervisory action, warranted for safety and soundness reasons; and (2) not required to have an external audit, but do so.

Comments

Section 102 of *Sarbanes-Oxley Act (Appendix A)* requires that “registered” accountants perform audits of public companies. This requirement does not apply to non-public companies. Auditors of non-public institutions must follow the AICPA independence standards identified in the Code of Professional Conduct.

Section 906 of *Sarbanes-Oxley Act (Appendix A)* requires a signed certification by senior corporate officers that the financial statements and the disclosures fairly present in all material respects the operations and financial condition of the issuer. This is an amendment to federal criminal law. The Section 906 certification is required for public companies in addition to the Section 302 certification.

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Office of Thrift Supervision
Department of the Treasury



Directors' Guide to

**Management
Reports**

September 2006

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Directors' Guide to Management Reports

Introduction

The increasing complexity of the financial services industry underscores the need for savings association directors, like you, to take an active role in monitoring, evaluating, and overseeing the business risks of your savings association. To make informed decisions, you must receive accurate and timely information about your savings association's performance and its compliance with applicable law.

This publication outlines the information needs of savings association directors. Our intent is to stimulate an informed discussion and give you a benchmark to compare the content and quality of your board report package. **This guide is not a list of requirements for board reports.**

You are always welcome to contact Office of Thrift Supervision (OTS) regional office staff to arrange for individual or group meetings concerning your duties or responsibilities as a savings association director. These meetings will provide you and your fellow directors the opportunity to pose any questions you may have.

Section 310 of the OTS Examination Handbook, "Oversight by the Board of Directors," outlines your responsibilities. The *OTS Directors' Responsibilities Guide* provides an overview of core responsibilities for savings association directors. To fulfill these responsibilities, you must obtain monthly, quarterly, and annual reports. You should receive and review these reports before regular meetings.

Periodically, management and the board should carefully review the content of the board report package to ensure that the information is concise and complete. Reports should present only relevant information without unnecessary detail.

Although reports evolve and improve over time, report formats should remain comparable from period to period. Consistency improves the effectiveness of a report as an oversight tool. Frequent changes can mask serious problems.

We do not recommend all reports described in this publication for all savings associations. Instead, this is a compilation of reports you may want to consider for your use. Furthermore, the reports described here are not all-encompassing. There are other types of reports that may be useful. For instance, reports on business plans and performance, trust activities, and sales of uninsured products may be useful for some savings associations. Each savings association has its own objectives and goals. Reports should identify problems and provide strategies to resolve them. Reports should also highlight progress toward goals. We remind you that, in some cases, a regulation may require you to obtain information in a periodic report from management.

This guide discusses possible reports for your consideration in the following general categories:

- Financial Reports
- Asset Quality Reports
- Asset/Liability Management Reports
- Internal Audit and Management Review Reports
- External Reports
- Other Reports

The Financial Reports consist of basic accounting reports for any savings association. The Asset Quality Reports focus on credit risk. Asset/Liability Management Reports address interest rate risk and liquidity. The Internal Audit and Management Review Reports provide unbiased information from internal sources. The External Reports provide another independent source of information about the savings association's performance. The last section describes miscellaneous reports of importance to the board.

Each report profile includes a description of the report content, examples of related warning signs or red flags, a brief rationale for the report, and references for additional information. The warning signs or red flags listed for each report are not all-inclusive. You should watch for emerging risks and be alert to changing circumstances that you need to address. Examples of emerging risks include changes in law and regulations, competition, the economy, and technical innovations and complex accounting practices. Also, some report descriptions refer to items over "\$X" amount. Each board should establish its threshold limits for these items to avoid excessively detailed reporting.

You may find it difficult to deal with the increasing volume and complexity of information presented to the board. You may require the special expertise of committees to understand and interpret specialized data. The Table of Suggested Reports that follows this section lists some areas where committees may be advantageous.

For additional guidance, please see the OTS Directors' Responsibilities Guide.

Table of Suggested Reports

Suggested Minimum Frequency	Financial Reports	Possible Committee Report
Q	Key Financial Ratios	
M	Comparative Balance Sheet and Off-Balance-Sheet Items	
M	Comparative Income and Expense Statement	
Q	Capital Adequacy	
Asset Quality Reports		
Q	Asset Classifications and Criticism	Yes
Q	Allowance for Loan and Lease Losses (ALLL)	Yes
Q	Real Estate Owned (REO) and Other Repossessed Assets	Yes
M	Delinquent Loans and Leases	Yes
*	Modified and Restructured Loans	Yes
Q	Concentrations of Credit	Yes
M	New Loan Summary	
M	Status of Major Loans and Investments	
Q	Subordinate Organization Financial Reports	Yes
Asset/Liability Management Reports		
M	Investment Securities Portfolio Analysis	Yes
Q	Exposure to Changes in Interest Rates	Yes
M	Summary of Hedging Activities	Yes
M	Asset Securitization	Yes
M	Mortgage Banking	Yes
M	Statement of Cash Flow and Liquidity Risk	Yes
Q	Savings and Core Deposit Analysis	Yes
Internal Audit and Management Review Reports		
Q	Internal Audit Reports	Yes
Q	Internal Loan Review	
A	Regulatory Requirements	
Q	Regulatory Requirements — Information Technology	Yes
External Reports		
Q	External Audit Reports, Management Letters, and Communications With External Auditors	Yes

M - Monthly

Q - Quarterly

A - Annually

* - As needed

Table of Suggested Reports

		Other Reports	
Suggested Minimum Frequency			Possible Committee Report
*		Transactions with Affiliates	
*		Transactions with Insiders	
A		Ethics Policy	
M		Product Pricing	Yes
*		Nontraditional Assets and Commitments and New Business Activities	
A		Security Reports and Insurance	Yes

M - Monthly

Q - Quarterly

SA - Semiannually

A - Annually

***** - As needed

Financial Reports

KEY FINANCIAL RATIOS

Report Description

The report should include key financial ratios that quantify each examination element: Capital Adequacy, Asset Quality, Earnings, Liquidity, and Sensitivity to Market Risk. The ratios should cover the most recent quarter, previous quarter, and prior-year quarter. (See the end of this section for a suggested report format.)

The report should also include budget reports comparing actual performance for the current period, quarter, and year-to-date with projections. You should review the savings association's Uniform Thrift Performance Report (UTPR) for significant variations (favorable and unfavorable) between the savings association and its peer group. You should obtain explanations of significant variations from projections and from peer and industry standards.

Warning signs or red flags

- Unfavorable trends in the savings association's financial performance (for example, deteriorating earnings, shrinking capital, declining asset quality, or increasing interest rate risk).
- Unfavorable or unexplained variances from the savings association's peer group, regulatory requirements, or industry standards.
- Unexpected favorable and/or unfavorable trends during the fourth quarter.
- Forecasting and exactly meeting earnings per share and/or net income.

Rationale

Your goal is to maintain a well-capitalized, profitable savings association that meets the needs of its community and shareholders or members. This requires sufficient core income; prudent control of credit risk, liquidity risk, and interest rate risk; and compliance with safety and soundness standards.

The report helps you to assess the financial performance of the savings association and identify potential problems.

A comparison of actual performance with projected results, as well as a periodic analysis of peer group data, helps you put the savings association's performance in perspective. You should obtain divisional performance reports if your savings association has independent profit centers. Management should explain any significant departures from the savings association's budget or strategic plan, as well as major differences with peer group norms, industry standards, or projections.

References

OTS Examination Handbook, Sections: 120 (Capital Adequacy); 410 (Financial Records and Reports); 430 (Operations Analysis); and 510 (Funds Management)

Key Financial Ratios Report
(Suggested Format)

(1) (2) (3) (4) (5) (6)

Major Balance Sheet Items

Total Assets

Cash, Deposits, and Investment Securities / Total Assets

Mortgage Backed Securities / Total Assets

Mortgage Loans / Total Assets

Nonmortgage Loans / Total Assets

Deposits and Escrows / Total Assets

Total Borrowings / Total Assets

Equity Capital / Total Assets

Derivatives / Capital

Off Balance Sheet / Assets

Net Commitments / Assets

LIP & Lines of Credit / Assets

Regulatory Capital Ratios: *

Tier 1 (Core) Capital / Adjusted Total Assets

Total Risk Based Capital / Risk Weighted Assets

Dividends / Net Income

Asset Quality (net of specific valuation allowances)

30-89 Day Delinquents / Total Loans

90+ Day Delinquents / Total Loans

Total Net Charge Offs / Total Loans

Nonaccrual and 90+ Day Delinquents / Total Assets

Assets / Total Assets

Troubled Debt Restructured / Total Assets

Real Estate Owned / Total Assets

Nonperforming Assets / (Core Capital + ALLL)

Assets / (Core Capital + ALLL)

Assets / Nonperforming Assets

ALLL / Loans and Leases

Nonperforming Loans / ALLL

(1) Current Quarter; (2) Previous Quarter; (3) Percent Change; (4) Same Quarter, Prior Year; (5) Budget; (6) Peer Group Annual (peer group data to the extent available). The report may also show variances in these figures, expressed as dollars and percentages.

* From the Thrift Financial Report Schedule CCR

Key Financial Ratios Report

(Suggested Format)

(1) (2) (3) (4) (5) (6)

Other Ratios

Employees / \$10 Million Assets
Asset Growth / Assets
Deposit Growth / Assets

Earnings (Annualized)

Spread:

Interest-Earning Asset Yield
Cost of Funds
Interest Income / Average Assets
Interest Expense / Average Assets
Net Interest Income / Average Assets
Noninterest Income / Average Assets
Noninterest Expense / Average Assets
Provision for Losses / Average Assets
Income Taxes / Average Assets
Extraordinary Items & Accounting Changes / Average Assets
Net Income / Average Assets (ROAA)
Net Income / Average Equity Capital (ROE)
Interest Earning Assets / Total Assets
Interest Earning Assets / Interest Bearing Liabilities

Interest Rate Risk

Base-case Net Portfolio Value (NPV)
Pre-Shock NPV Ratio (NPV as % of Present Value of Assets)
Post-Shock NPV Ratio (Exposure Measure)
Change in NPV Ratio (Sensitivity)
Change in NPV as % of Present Value of Assets

(1) Current Quarter; (2) Previous Quarter; (3) Percent Change; (4) Same Quarter, Prior Year; (5) Budget; (6) Peer Group Annual (peer group data to the extent available). The report may also show variances in these figures, expressed as dollars and percentages.

COMPARATIVE BALANCE SHEET AND OFF-BALANCE-SHEET ITEMS

Report Description

- Asset, liability, capital accounts, and material off-balance-sheet items for the most recent month (or quarter), compared to the prior month (or quarter), prior year, and budget, with columns showing variances (expressed as dollars and percentages).
- Include an analysis of the consolidated financial statements if there are significant subsidiaries.

The report should classify material off-balance-sheet items (such as recourse obligations and direct credit substitutes) by type, include notional and present values, and include descriptive footnotes. At least quarterly, the report should compare actual results to budget projections and explain significant differences.

Warning signs or red flags

- Significant variances from prior periods or the budget.
- Rapidly growing or shrinking balances.
- New activity in new subsidiaries and/or significant changes in business lines or activities.

Rationale

Comparative monthly balance sheets are essential to evaluate the savings association's current financial condition and developing trends. You should monitor the savings association's progress in meeting its budget and address any adverse trends. Management should explain any significant variances from the savings association's budget or strategic plan.

Rapid increases or decreases in account balances may indicate that the savings association is deviating from previous business practices. You should question the underlying reasons for the deviation and assess whether to adjust the savings association's budget to accommodate the changes. You should also determine whether any growth in assets is prudent; considering the source, volatility, and use of funds that support such growth, and any resulting increase in credit risk or interest rate risk, and the effect of the risk on the savings association's capital.

Off-balance-sheet items such as commitments, loans sold with recourse, letters of credit, and financial derivatives can affect the savings association, and you must consider them in your oversight.

References

OTS Examination Handbook, Sections: 410 (Financial Records and Reports); 430 (Operations Analysis); and 510 (Funds Management).

COMPARATIVE INCOME AND EXPENSE STATEMENT

Report Description

The report should contain significant categories of income and expense for the most recent month (or quarter) and fiscal year-to-date, compared with the prior month (or quarter) and prior fiscal year-to-date.

The report should compare actual results to the budget and explain significant variances. Periodically, the report should assess the profitability of departments or lines of business as well as individual products. The nature of this analysis depends on the sophistication of the savings association's cost allocation system and the complexity of its lines of business and products.

Warning signs or red flags

- Significant favorable or unfavorable variances from prior periods or the budget.
- Material amounts classified in financial statements as "Other."
- Rapidly increasing or declining earnings.
- Excessive reliance on non-operating or non-recurring income to overcome poor operating results.
- Significant amounts of income attributable to accounting conventions that are subject to interpretation and driven by assumptions and projections.

Rationale

You should ensure that earnings are sufficient to maintain adequate capital and reserves consistent with the savings association's size, growth rate, and the nature and scope of its operations. Comparative monthly income statements will help you to judge a savings association's performance and measure the financial results of existing budgets, policies, and procedures. You should explore the underlying reasons for favorable and unfavorable earnings trends and consider whether to continue in the same direction or make changes.

You should consider the risk-return equation when evaluating earnings: savings associations with little credit risk or interest rate risk can expect lower, although stable, earnings. On the other hand, excessive interest rate risk or credit risk may indicate that management is taking unacceptable risks to boost the current net interest spread at the expense of future earnings. This will result in earnings fluctuations. You should also be sensitive to business decisions driven by accounting conventions that inflate current earnings at the expense of long-term profitability (for example, the sale of assets for a quick profit, or aggressive valuation of loan-servicing rights). Strong cost accounting systems provide measured performance of units, departments, lines of business, and products as they affect the bottom line, allowing you to ensure that each unit or product is performing adequately and efficiently.

References

OTS Examination Handbook, Sections: 410 (Financial Records and Reports); 430 (Operations Analysis); and 510 (Funds Management).

CAPITAL ADEQUACY

Report Description

A capital adequacy report is an analysis of the savings association's performance in meeting regulatory capital requirements and the savings association's own internally determined capital requirements.

In the case of a capital deficiency, the report should explain the causes and describe a corrective plan. It should analyze future capital adequacy, including estimated ratios based on a budget that projects general operating results and balance sheet categories for at least three years.

Warning signs or red flags

- A declining capital position, approaching the savings association's minimum regulatory capital requirements.
- Management's failure to meet internal capital levels targeted by the approved business plan.
- Capital growth rate is significantly different from peer ratios.
- Dividend payout ratio is significantly higher than peer ratios or has increased significantly from historical levels.
- Significant growth in off-balance-sheet activities.
- Excessive reliance on "double leverage" where a savings and loan holding company issues debt and downstreams the proceeds to the savings association as capital.

Rationale

Capital is a widely accepted indicator of a savings association's financial health. Failure to meet regulatory capital requirements may result in regulatory restrictions, penalties, and corrective actions. Undercapitalized savings associations must submit a capital restoration plan to regulators.

Directors should always consider a savings association's capital position in light of other factors that significantly affect capital adequacy, such as credit quality, asset risk profile, interest rate risk, growth, and earnings.

In the case where a savings and loan holding company controls a savings association, you should examine capital levels and the ability to service debt on a consolidated basis.

References

OTS Examination Handbook, Sections: 110 (Capital Stock and Ownership); 120 (Capital Adequacy); and 261 (Adequacy of Valuation Allowances).

Asset Quality Reports

ASSET CLASSIFICATIONS AND CRITICISM

Report Description

- A comparative summary of criticized assets, valuation allowances, and delinquency rates for comparable dates.
- A summary of all watch list assets and assets currently designated as Special Mention or internally classified as Substandard, Doubtful, and Loss, categorized by asset type (such as 1- 4 family mortgage loans, consumer loans).
- The amount of the Allowance for Loan and Lease Losses (ALLL) allocated to the various classified assets groups.
- A separate itemized list of Special Mention and Substandard assets over \$X amount, and a list of Doubtful and Loss assets over \$X amount (generally a lower amount than for Special Mention or Substandard assets).
- A list of loans not meeting underwriting standards (for example, low documentation loans) with reasoning to support the loans.

Each list should include the asset's cost basis and any charge-offs, the carrying value of the asset, any valuation allowance established against the asset, and the fair market value or other applicable measure of the value of the collateral. The report should also note whether the asset was first classified internally, by regulators, or by independent auditors. The savings association's internal asset review system should generate the report with complete independence from the lending function to ensure objectivity.

Warning signs or red flags

- Large increases in classified asset amounts.
- Significant differences between classifications established by management and those established by regulators or independent auditors.
- Transfers of investments from held to maturity to available for sale or trading accounts.

- Newly classified delinquent or foreclosed loans (ideally, classification should precede collection problems).
- Not classifying modified or restructured loans to struggling borrowers that continue to present more than normal risk of loss.
- Significant increases or decreases in classified assets without corresponding increases or decreases in the ALLL.
- Growth in the ALLL that is significantly greater or less than the percentage growth in total loans over a given period.
- Loan officer compensation tied solely to growth or volume targets (that is, without credit quality attributes).
- Insufficient controls or due diligence when purchasing loans.
- Excessive reliance on third-party loan brokers or service providers.
- Borrowers on the overdraft report.

Rationale

Asset classification and criticism are essential tools for evaluating asset quality, the adequacy of the ALLL, and loan portfolio risk. OTS regulations require every savings association to classify its assets on a regular basis using an internal asset review system and to establish appropriate valuation allowances.

The volume and severity of classifications serve as a barometer for assessing the financial condition of an association and reflect the savings association's ability to formulate and implement sound lending policies and procedures. You should review this information to evaluate material asset concentrations, establish reserves sufficient to absorb estimated losses, resolve problem assets, and assess overall asset quality.

Measures of delinquencies and repossessed assets usually do not reflect modified or restructured loans. Modifying or restructuring non-performing loans can disguise their problem status. Disguising problem loans as a "refinancing" makes the savings association appear stronger. However, it actually increases the risk of loss. Lending additional funds to a struggling borrower may compound the problem. However, there are legitimate reasons for working with troubled borrowers. You should determine whether loan modifications benefit the savings association or merely postpone the inevitability of more significant action (such as foreclosure), and thus increase the amount or risk of loss.

References

OTS Examination Handbook, Sections: 260 (Classification of Assets) and 261 (Adequacy of Valuation Allowances).

ALLOWANCE FOR LOAN AND LEASE LOSSES (ALLL)

Report Description

Support for the savings association's ALLL and other general valuation allowances, including both quantitative and qualitative information.

Savings associations with diverse portfolios should provide a separate ALLL analysis for each loan type. Classification and delinquency trends are usually material factors in the calculation of the ALLL and should be part of the analysis. The report should also provide information on losses and loss provisions recognized during the quarter and a comparison of performance with policy goals.

Warning signs or red flags

- Ratios that indicate decreased coverage of probable losses.
- A trend of increasing losses.
- Adverse changes in national and local economic and business conditions and forecasts.
- Growth in the ALLL that is significantly greater or less than the percentage growth in total loans over a given period.

Rationale

Generally accepted accounting practices (GAAP) require that you establish loan loss allowances at the time you deem a loss to be probable and estimable. Managing the ALLL is an integral part of your savings association's credit risk management process. Your savings association should maintain prudent, conservative, but not excessive, loan loss allowances. To determine the right amount of ALLL, you should consider your savings association's historical loss experience. You should also consider your savings association's portfolio composition, level of classified assets, its underwriting standards, adequacy of collateral, environmental conditions, and current economic trends. The ALLL is increased through an expense provision for loan losses. An inadequate provision for loss will overstate current operating results and will require increased provisions in subsequent accounting periods, which may significantly depress future earnings. You may not want to wait until the loss is certain. For some portfolios, this may require provisions coincident with originations. Failure to recognize and account for probable and estimable losses may delay prompt actions needed to reduce lending risks for the savings association.

Reference

OTS Examination Handbook, Section: 261 (Adequacy of Valuation Allowances).

REAL ESTATE OWNED (REO) AND OTHER REPOSSESSED ASSETS

Report Description

A summary of real estate owned and acquired in lieu of payment of debt by the borrower (REO), as well as any other repossessed assets. List all REO over \$X amount with the following information:

- Date acquired.
- Borrower's name.
- Name and location of the property.
- Carrying amount.
- Fair value (including date and method of determination).
- Internal classification (if any).
- Income or loss generated by the property (for the period and cumulative).
- A comparison of property disposal efforts with management's marketing or disposal plan.
- Source of the loan, last classification of the loan.
- Disposition of assets, gain or loss.

Warning signs or red flags

- A rapidly increasing level of REO.
- A disproportionate amount of REO from one source (loan officer, branch, broker).
- REO resulting from a loan that was not classified.
- REO that is not classified.
- REO not adjusted to the lower of fair market value less cost to sale or the recorded investment in the loan, as of the acquisition date.
- Long holding periods for REO.
- REO sold at a price significantly below its carrying value.

Rationale

REO usually results from defaults on loans. Rapid increases in REO and repossessed assets are a warning sign that economic conditions are deteriorating or that loan underwriting or administration standards are deficient or not being followed. You must review the salability of properties held for an excessive time period. Properties held for more than five years may affect the

savings association's regulatory capital requirements. A long holding period generally indicates that a property is not worth its stated value or is not marketed effectively. REO sold for a price significantly below its carrying amount may suggest a faulty appraisal or a poorly managed sale. Regulators are likely to question the valuations of REO for savings associations with a history of significant losses on the sale of REO.

Reference

OTS Examination Handbook, Section: 251 (Real Estate Owned and Repossessed Assets).

DELINQUENT LOANS AND LEASES

Report Description

- Summary of all loans and leases past due 30 to 59 days, 60 to 89 days, and 90 days or more.
- Summary of nonaccrual loans, categorized by loan type (for example, one- to four-family permanent loans, construction loans).
- List all delinquent loans and leases over \$X amount or more than 120 days past due with the following information:
 - ◆ Identification number.
 - ◆ Name of borrower or lessee.
 - ◆ Amount of loan or lease.
 - ◆ Classification status.
 - ◆ Months delinquent.
 - ◆ Market value of collateral (if any) and date of determination.
 - ◆ Date of most recent contact with borrower or lessee and outcome.
 - ◆ Status of foreclosure efforts (for secured loans only).
 - ◆ Management's estimate of collectability.
 - ◆ Collection dates.
- Summary of all loans and leases over 30 days past due that were originated within the past year.
- Periodic summary of all loans with due dates extended.
- Periodic summary of all loans modified or restructured more than once.

Warning signs or red flags

- Increasing levels of delinquency, especially longer-term delinquencies of 60 days or more.
- Seriously delinquent loans and leases that have not been classified.
- Unexplained or excessive extensions of due dates or maturity.
- Unrealistic assessments of collectability by management.
- Delinquent loans and leases originated within the past year.
- Modifying, extending, re-aging, or restructuring a loan, or advancing funds to pay interest, merely to avoid reporting a delinquency, without strengthening the savings association's position.
- Lending additional funds to delinquent or struggling borrowers or their affiliates without acquiring additional safeguards.

Rationale

Accurate delinquency data enables the board to monitor asset quality, the adequacy of the ALLL, and lending standards. An increasing level of delinquencies, as well as failure to collect delinquent amounts, may be a warning sign that economic conditions are deteriorating or that loan and lease underwriting or administration standards are either deficient or not followed.

References

OTS Examination Handbook, Sections: 219 (Leasing Activities); and 240 (Troubled Debt Restructurings); and 260 (Classification of Assets).

CONCENTRATIONS OF CREDIT

Report Description

A list showing concentrations of credit to a single borrower, industry, geographic region, loan type, or collateral type, including significant unsold speculative construction inventory.

Warning signs or red flags:

- Increasing exposure to one borrower.
- High or increasing exposure to high-risk obligors.
- Violation of regulatory restrictions on loans-to-one-borrower.

- Increasing concentration of loans:
 - ◆ To one industry (for example, energy-related loans).
 - ◆ In one geographic region (for example, a factory town).
 - ◆ Of one risky loan type (for example, land loans, subprime loans, nontraditional mortgages with negative amortization features, or high loan-to-value loans).
 - ◆ For one collateral type (particularly single-purpose or special-use properties).

Rationale

Diversification of payment sources reduces credit risk. You should be alert to any threat to the savings association's profitability or capital adequacy arising from the financial problems experienced by a single borrower, industry, or geographic region. You should relate concentrations to both assets and to capital to recognize how they may effect earnings and solvency if they deteriorate. OTS regulations at 12 CFR 560.93 specifically limit loans to one borrower.

Reference

OTS Examination Handbook, Sections: 201 (Overview — Lending Operations and Portfolio Risk Management); 560 (Deposits and Borrowed Funds).

NEW LOAN SUMMARY

Report Description

- A summary of new loans generated and loans purchased in the most recent period. The report should be broken down by loan type, number of loans, and total dollar volume, and provide comparisons to budget targets.
- A chart of new loan volume for loan types that represent higher-than-average risk, such as high loan-to-value, subprime, nontraditional mortgages with negative amortization features, construction, and commercial real estate loans.

The board should review all new loans over \$X amount individually. The report should summarize these loans for overall concentration and past performance. Data should provide a comparison with prior periods. In addition, the report should also provide a section that separately summarizes loans generated under special programs and lending policy exceptions.

Warning signs or red flags

- Rapid entry into new types of lending without adequate planning.
- Long-term loans that increase the savings association's interest rate risk.

- Loans with a high credit-risk weighting (see the Nontraditional Assets and Commitments section).
- New loans that vary significantly from the savings association's business plan.

Rationale

The number and volume of new, good quality loans are measures of the savings association's performance. Loan volume will generally ebb and flow with economic conditions; however, there are other reasons for fluctuating loan volume. You should understand the causes of lending fluctuations and shifts in the portfolio.

References

OTS Examination Handbook, Sections: 201 (Overview — Lending Operations and Portfolio Risk Management); 212 (One- to Four-Family Residential Lending.)

STATUS OF MAJOR LOANS AND INVESTMENTS

Report Description

A summary of current performance status and financial data. Also, include a narrative description of progress to date on all major loans, subordinate organizations, equity investments, and new business lines or services, with related management plans.

Warning signs or red flags

- Deviations from prior projections.
- Lack of progress in major developments.
- Requests for additional financing.
- Absence of a firm schedule for completion of the project.

Rationale

Whenever the savings association commits significant resources to a loan, subordinate organization, equity investment, or new line of business, the board should require ongoing status reports. You should review these reports to evaluate financial performance and guard against loss, waste, and fraud.

Certain loans and investments pose greater risk simply due to their large size, while others (for

example, the development of raw land) carry more risk due to the nature of the activities involved. All major loans and investments require thorough planning, knowledgeable management, strong internal controls, prior approval, and close monitoring by the board.

References

OTS Examination Handbook, Sections: 214 (Other Commercial Lending); 540 (Investment Securities); 230 (Equity Investments); and 730 (Subordinate Organizations).

SUBORDINATE ORGANIZATION FINANCIAL REPORTS

Report Description

- The report should provide the balance sheet, income statement, and statement of cash flows for each subordinate organization that significantly affects, or has the potential to significantly affect, the parent savings association's operations.
- The report should include a description of all major transactions between the savings association and its subordinate organizations, their effect on the savings association, and an assessment of their compliance with applicable laws and regulations.
- The report should describe all new activities (such as the sale of nondeposit investment products) that the savings association plans to engage in through a subordinate. (Note: OTS requires an advance notice process for new activities.)

Warning signs or red flags

- Financial weaknesses in subordinate organizations (for example, operating losses, declining capital, asset quality problems, or difficulty in meeting obligations).
- Unexplained liquidity demands by subordinate organizations.
- Intercompany transactions that are not conducted at arm's length.
- Delinquent financial reporting from equity investments and subordinate organizations.
- Lack of separate corporate identity and existence for subordinate organizations.

Rationale

Subordinate organizations can significantly affect the operations and overall condition of a savings association. There are two primary types of savings association subordinate organizations: service corporations and operating subsidiaries. Each type of organization is subject to different regulatory standards. Operating subsidiaries can only engage in activities that are permissible for

the savings association. Operating subsidiaries may establish lower-tier entities. There are no limits on the amount a savings association may invest in an operating subsidiary; however, the savings association must maintain over 50 percent ownership of voting shares and effective operating control.

Service corporations may engage in certain additional activities that are not permissible for the parent savings association. A savings association's investment in service corporations cannot exceed a total of 3 percent of assets, of which any amount over 2 percent must be community development related. Service corporations may invest in lower-tier entities that are not generally subject to the geographic and ownership restrictions imposed on the parent.

The board should closely scrutinize subordinate organizations to prevent any negative financial effect on the parent and guard against potential fraud and abuse. You should be especially watchful to ensure that subordinate organizations maintain their separate corporate identities. If they do not, a court may determine that the parent has "pierced the corporate veil," and render the parent liable for the actions of the subordinate organization.

You should also note that subordinate organizations can be subject to fair lending and other consumer-compliance laws and regulations. Therefore, you should periodically review the subordinate organization's performance in this area, especially when a subordinate organization's activities would otherwise be part of the parent savings association's ordinary operations.

Reference

OTS Examination Handbook, Section: 730 (Subordinate Organizations).

Asset/Liability Management Reports

INVESTMENT SECURITIES PORTFOLIO ANALYSIS

Report Description

- An analysis of the savings association's securities transactions and holdings by accounting classification [Held-To-Maturity (HTM), Available For Sale (AFS), and Trading] for each type of investment (for example, Treasuries, U.S. agencies, municipals, mortgage derivatives, corporates), for the two most recent TFR reporting periods.
- A maturity distribution of securities held.
- Agency rating by security and changes in the rating.
- Exposure to individual counterparties.
- Call date information on all callable securities.

The report should show:

- Carrying amount.
- Market value.
- Physical location.
- Portfolio activity during the most recent reporting period (including gains or losses on sales), yield to maturity.
- Rating provided by two of the four recognized rating agencies. (Management should obtain market values from a third party, other than the seller of the investment.)
- Compliance with board-approved limits on investments.
- Margin accounts with the collateral securing the accounts.
- Due-diligence review of new or proposed dealers and a review of any payment and delivery issues.

The report should describe and assess the risks of derivative securities (for example, collateralized mortgage obligations) and structured notes. The report should also explain the purpose of the instrument considering the savings association's overall investment or hedging strategy.

The report should include an internal auditor attestation to its accuracy.

If the savings association has a trading account, a separate report should describe the activity in that account.

Warning signs or red flags

- A substantial decline in the market value of an investment especially for periods in excess of 12 months.
- A downgrade of an investment by a credit rating service.
- Frequent purchases and sales of securities.
- Purchasing securities with no readily available market values.
- Purchases of high-risk investments:
 - ◆ Investments with high credit risk.
 - ◆ Longer-term investments.
 - ◆ Complex products that require sophisticated management (such as structured notes and mortgage derivative securities).
 - ◆ Thinly traded securities.
- Concentration of investments or trading with one seller.
- Deviations from the authorized investment policy, such as purchase of securities in excess of concentration limits or investment purchases from securities dealers not approved by the Board.
- Transactions with disreputable or unknown dealers.
- Failure to review payment/delivery contracts.
- Widening spread due to thinning liquidity or credit risk tightening.
- Frequent revision of policy limits without adequate rationale.
- Securities purchased without prepurchase risk analysis.
- Absence of management's estimation of portfolio valuation sensitivities.
- Purchase of securities with yields well above market levels (possible yield chasing).
- Purchasing a relatively large amount of securities in a short time period.
- Frequent use of lending authority to acquire securities.

- Sale of securities previously designated as HTM, or transfer of securities from HTM to AFS.
- The classification of securities with high value sensitivity as HTM.
- Large volumes of non-rated, below investment-grade (lower than BBB or Baa), or out-of-area bonds (may indicate a credit quality problem).
- Exclusive reliance on rating agencies' ratings for non-government securities.
- Investment yields that are well above or below the market or peer group average.
- Significant changes in the type, quality, or maturity distribution of the portfolio.
- Significant deterioration in the market value of investments.
- Absence of credit risk assessment for safekeeping agent.

Rationale

The investment portfolio may contain high levels of counterparty credit risk and interest rate risk. The board should review and discuss any decision to substantially increase these risks and identify potential negative consequences or losses and their context within the portfolio.

Complex securities (which require special expertise to evaluate) and thinly traded securities (which may be difficult to value and liquidate) pose other risks. OTS Thrift Bulletin 13a *Management of Interest Rate Risk, Investment Securities, and Derivatives Activities* provides guidelines for analyzing investments. Additionally, there are risks associated with safekeeping or delivery of an investment. The integrity of dealers and the safety and soundness of transactions are key issues.

References

OTS Examination Handbook, Sections: 540 (Investment Securities); 230 (Equity Investments); 510 (Funds Management); and 660 (Derivative Instruments and Hedging).

EXPOSURE TO CHANGES IN INTEREST RATES

Report Description

A comparison of the savings association's estimated Net Portfolio Value (NPV) ratios with the limits established by the board of directors for hypothetical interest rate shocks of plus and minus 100, 200, and 300 basis points. Interest rate risk (IRR) reports should be consistent with those prescribed by the board as described in *Risk Measurement, Monitoring, and Control Functions* in Appendix B, part C of OTS Thrift Bulletin 13a *Management of Interest Rate Risk, Investment Securities, and Derivatives Activities*.

The report should provide an evaluation of the savings association's standing relative to the industry, based on its Post-Shock NPV Ratio and Sensitivity Measure. For those savings associations with internal models, it should also outline the major differences between the results of the OTS NPV Model and the savings association's own interest rate risk model. The report should discuss management's strategy for maintaining the savings association's interest rate exposure within the board's limits. The board should list approved derivative instruments (such as swaps, futures, options, or forward commitments) that management can use to limit the savings association's interest rate risk.

Warning signs or red flags

- The estimated decline in the savings association's NPV in response to hypothetical changes in interest rates exceeds the IRR limits established by the board of directors.
- Management recommends frequent IRR limit changes.
- The savings association ranks among the riskier segments of the industry based on its Post-Shock NPV Ratio and Sensitivity Measure.
- Significant variance between OTS reports and management reports.
- An adverse examination Sensitivity rating.
- Significant changes in net interest income.
- High or increasing volume of liabilities with embedded options, such as puttable or convertible funding products or structured CDs.
- Lack of an independent review or audit of the interest rate risk management process.
- Unauthorized or frequent exceptions to the interest rate risk policy.
- The inability of management to provide reports that identify and quantify the major sources of the association's interest rate risk in a timely manner and describe assumptions used to determine interest rate risk.

Rationale

The objective of IRR management is to maintain an association's earnings and net worth within self-imposed parameters over a range of possible interest rate environments. You must be aware of the potential effect of changes in interest rates on the savings association's NPV ratios and ensure that the savings association operates in compliance with the board's established limits. Comparing the savings association to the industry IRR measures distributed quarterly by OTS will provide you with a useful perspective on the savings association's level of risk. Board members should review Thrift Bulletin 13a and familiarize themselves with the various measures of IRR produced by OTS.

The measurement of IRR involves the use of assumptions (such as assumed prepayment rates, future interest-rate movements, and changes in the shape of the yield curve). The choice of those assumptions may have a major effect on the results of the measurement. In your discussions with management, you should identify management's critical assumptions used in measuring the savings association's IRR and ensure that these assumptions are reasonable.

Reference

OTS Examination Handbook, Section: 650 (Interest-Rate-Risk Management).

SUMMARY OF HEDGING ACTIVITY

Report Description

A summary of the savings association's actions to hedge risk through the use of financial derivatives (such as futures, options, forward commitments, swaps, or mortgage derivatives).

The Board package should summarize the performance of the hedges and include the following reports:

- A report showing the current market value and purpose of all derivatives held in portfolio.
- A report showing the current market value changes of all derivatives held in portfolio.
- A listing of the realized or unrealized gains or losses on all derivatives bought or sold during the period.
- A report summarizing the effectiveness of all current hedge accounting relationships and of any hedge accounting relationships terminated during the period.
- Reports detailing management's compliance with various board limits on derivatives and hedging (such as, counterparties, notional values.)
- Minutes of recent meetings of the Asset/Liability Management Committee.
- Valuation of derivatives that do not qualify for FAS 133 and hedge accounting treatment.

Warning signs or red flags

- Deviation from the savings association's hedging policies and procedures.
- Management's use of technical jargon — rather than clear, simple facts — in response to your questions about hedging activities.

- Participation in transactions without appropriate knowledge of derivatives or experience in the market.
- Reliance on the understanding and advice of only one employee to conduct hedging operations.
- Acceptance of hedging recommendations from third parties with little internal analysis or exploration of alternatives.
- Substantial exposure to a counterparty whose ongoing ability to meet its obligations is uncertain.
- Large losses (or gains) on hedging instruments without offsetting gains (or losses) in the items being hedged.
- Micro (asset- or liability-specific) hedges that increase overall enterprise exposure to changes in interest rates.
- Failure to identify the net portfolio (macro) risk rather than only the specific (micro) risk of hedging specific items.
- Disposing of instruments without disposing of the assets or liabilities they are meant to hedge without adequate explanation of the effect of the transaction on the portfolio.
- Excessive transaction costs in relation to the benefits derived from a hedge.
- Many transactions with little change in the net position.
- Market values provided by counterparties with a conflict of interest rather than independent sources.
- Rapid growth in the notional amount of derivative contracts.
- A large ratio of derivative notional amounts to total assets.
- Written options on derivatives, such as interest rate caps or floors.
- Concentration of credit risks (total credit exposure) with a derivatives counterparty.
- Use of complex or illiquid derivative contracts.
- Derivatives embedded in cash market securities.
- “Off market” derivative contracts, for instance, a loan to or from a counterparty).
- Large net payments or receipts of cash.
- Unilateral collateral posting (collateral arrangements should be bilateral).
- Use of only one firm for all, or nearly all, derivative transactions.
- Activity in new derivative products without subjecting the product to a new product review.
- Insufficient understanding of accounting rules for derivatives (FAS 133).
- Insufficient understanding of rules for derivative transactions with affiliates (12 CFR 223).
- Absence of legally enforceable netting agreements.

Rationale

Hedging is a very complex activity with significant financial risks. Hedging is properly done only when it reduces risk. Management should monitor — and the board should oversee — hedging activities to ensure that employees and agents do not engage in unauthorized transactions.

Given the highly technical nature of hedging, savings associations often turn to the advice of consultants and brokers. The interests of these parties may not always coincide with the interests of the savings association. To prevent abuse, management and the board should always reserve final decision-making authority over hedging transactions and exercise a healthy skepticism of all trades recommended by third parties or counterparties.

Complicated technical responses to the board's questions may indicate a lack of knowledge or an abuse of investment authority. Management's failure to identify the portfolio risk being hedged suggests that it is speculating rather than hedging. Excessive transaction volume with little benefit or change in the net position may indicate account churning or other abuses.

The accounting standards for hedging activities are complex and evolving. You should seek an explanation from management for the accounting treatment used for each significant hedging activity. A micro-hedging analysis that matches gains and losses on hedging instruments with gains and losses on the hedged items should complement, rather than distract from, the intended macro (whole enterprise) approach to hedging.

You should also ensure that management effectively controls any hedging operations. A lapse of control may be indicated when micro hedges are not terminated simultaneously with the underlying assets or liabilities. Also, profits or losses arising from the disposal of hedging instruments without offsetting gains or losses in the accounts being hedged may indicate that the hedges did not perform as planned.

Reference

OTS Examination Handbook, Section: 660 (Derivative Instruments and Hedging Program).

ASSET SECURITIZATION

Report Description

Management information systems reports that monitor the securitization pool performance on an aggregate and individual transaction level. Although the association may have sold the ownership rights in the controlling assets, the association's exposure continues as an underwriter or

servicer. To control the effect of deterioration in pools originated or serviced by the association, management should have a systematic monitoring process to track pool quality and performance throughout the life of the transactions. Management should regularly report to the board on the extent and significance of any risks.

Savings associations most often securitize transactions such as credit cards, auto receivables, residential first mortgages, and home equity loans. These reports should show:

- The gross and net portfolio yield.
- Delinquencies.
- The charge-off rate.
- The base rate (investor coupon plus servicing fees).
- Monthly excess spread.
- The rolling three-month average excess spread.
- The monthly payment rate.
- Number and status of extended, deferred, modified, or re-written accounts.
- Servicing advances.
- Principal prepayment speeds.
- Outstanding principal compared with original security size.
- Residuals.
- Policy exceptions.
- Covenant compliance.
- Exposure limits by type of transaction and aggregate transactions outstanding.

Warning signs or red flags

- High level of residual assets relative to capital.
- Over-reliance on securitization as a funding source.
- Credit line increases to borrowers without appropriate credit analysis.
- Increase in policy exceptions, scorecard overrides, or multiple re-aging of delinquent accounts.
- Significant growth or pressure for growth.
- Shift in pricing and credit enhancement levels required by the market.

- Asset-backed securitization activities not fully integrated with critical savings association planning processes.
- Adverse performance trends.
- Transactions with affiliates that are not at arm's length terms.
- Purchasing large amounts of non-government backed securitizations, significant in relation to total assets.

Rationale

The primary risks associated with securitization activities are related to strategic planning, credit, earnings, capital management, liquidity, credit quality of the remaining on-book portfolio after securitization, servicing, compliance, market, reputation and fiduciary/trustee exposures. Invariably, the selling savings association will retain some of the risks of securitization. Securitization transactions often receive substantial attention early in their lives, but the level of scrutiny often declines over time. Many of the problems that associations experience occur in the later stages of the transactions. Therefore, savings associations must carefully supervise and monitor such transactions for the entire duration of its involvement. Effective securitization risk management requires the association to do the following:

- Understand and control the amount of risks involved in the entire transaction.
- Identify the risks transferred from one party to another, and the risks retained.

References

OTS Examination Handbook, Section: 221 (Asset-Backed Securitization).

MORTGAGE BANKING

Report Description

Detailed information on the mortgages in the pipeline and warehouse, as well as associated hedge positions. Examples include the warehouse aging report and the report on assets priced at the lower of cost or market (LOCOM). The reports should project how those positions are likely to change in the short term (because of fallout, changes in interest rates, or other reasons).

If there is a substantial volume of mortgages intended for sale in the production process relative to capital, the savings association should conduct a stress test estimating the effect of extreme (200 basis points or more) interest rate movements on the pipeline and warehouse. The

stress test should adjust for actual hedged positions. Compare the resulting estimates to any maximum limits established by the board.

Management should provide you with current annual financial statements demonstrating the financial viability of counterparties to transactions.

Warning signs or red flags

- Volatility in earnings attributable to secondary marketing sales.
- Dramatic increases in the volume of pair-off fees beyond projected limits.
- Pipeline and warehouse exposure exceeding any board-established limits.
- Volume-based compensation arrangements with inadequate safeguards.
- Minimal management oversight of mortgage banking functions.
- An accumulation of unsaleable loans.
- High or increasing delinquencies or foreclosure rates on serviced loans.
- High or increasing level of policy exceptions.
- Unauthorized exceptions to policy guidelines.
- High level of mortgage servicing assets relative to capital.
- Unsupported prepayment speeds, discount rates, and other assumptions in MSA valuation models.
- Rapid increases in mortgage loan production volume relative to the association's capital or asset size without corresponding increases in staff or systems.
- High or increasing level of third-party originated mortgage loans without proper controls.
- Inadequate audit coverage of mortgage banking activities.
- Absence of meaningful risk limits.

Rationale

A savings association with active secondary marketing operations must be able to explicitly identify the level of risk exposure inherent in its pipeline and warehouse. This includes the ability to develop reasonable estimates for identifying expected pipeline fallout rates. Additionally, the savings association must have the management expertise to design and maintain an appropriate secondary marketing hedge program. All of these items should be explicitly addressed in a written, board-approved, secondary marketing policy. The board is responsible for monitoring adherence to this policy on a regular basis.

Reference

OTS Examination Handbook, Section: 571 (Mortgage Banking).

STATEMENT OF CASH FLOW AND LIQUIDITY RISK

Report Description

- A summary of the sources and uses of cash for the most recent quarter and prior quarter, along with forecasts of planned cash flows for each of the next two quarters.
- The weighted average maturity of investments held for liquidity purposes reported with current market rates of return for short-term investments.

Warning signs or red flags

- Liquidity risk that exceeds risk limits established by the board.
- Failure to diversify funding sources.
- Increased reliance on volatile funding sources (such as wholesale deposits) or nontraditional funding sources (such as asset sales) to meet funding obligations.
- Inadequate funding sources for anticipated use of loan commitments and lines of credit.
- Rapid asset growth funded by rate and/or credit sensitive funding, such as borrowed funds or brokered deposits.
- Increased concentration of cash and cash equivalents in a single savings association.
- A significant variation in cash flows from period to period.
- Change in significant funding sources.
- Significant unexplained changes in the weighted average maturity of the liquidity portfolio.
- Investments in unfamiliar, nontraditional, or thinly traded assets. Increased funding costs because of customer or counterparty concerns about increasing risk.
- Eliminated or decreased credit line availability from lenders, including correspondent associations.
- Mismatched funding- (funding long-term assets with short-term liabilities) or funding sources containing embedded options.
- Frequent exceptions to the association's liquidity risk policy.
- Absence of an effective contingency funding plan that is current and commensurate with the complexity of the association's funding activities.
- Improper identification of cash flows from operations, financing, and investment activities.

Rationale

Adequate liquidity ensures a savings association's ability to meet its obligations. A review of a savings association's past and projected cash flow will identify costly sources and improper uses of funds, thereby highlighting potential funding problems. Liquidity problems generally become apparent when the savings association begins relying more heavily on wholesale deposits and other short-term borrowings to meet its cash needs.

Reference

OTS Examination Handbook, Section: 530 (Cash Flow and Liquidity Management).

SAVINGS AND CORE DEPOSIT ANALYSIS

Report Description

A chart of savings deposits by type as of the most recent quarter, prior quarter, and prior year. (Deposits can be further broken down by region and branch office.)

The report should include:

- Average balances for each type of deposit.
- List of rates paid by the savings association and its competitors.
- List of large cash transactions.

Warning signs or red flags

- Shift from retail (core) deposits to wholesale deposits (such as brokered deposits).
- Shifts in balances among types of accounts.
- Shift from longer-term to shorter-term deposits.
- Large deposit inflows or outflows.
- Significant changes in transaction volume, average balances, or average maturity.
- Significant concentration in any account type, customer, or maturity.

Rationale

Deposits are the primary source of funds for most savings associations. Core deposits are a savings association's most stable source of funds and, for many savings associations, constitute the

largest component of its franchise value. Deterioration of a savings association's deposits can be an early warning sign of future funding or earnings problems. It could indicate that the savings association is providing inferior service to its depositors or improperly pricing its deposit products.

Management and the board should analyze the causes of significant changes in deposits and take appropriate corrective action when necessary. The board should also determine whether the level of brokered deposits is appropriate given regulatory constraints. You may include deposit analysis in your CRA strategy and delineation of your community.

Reference

OTS Examination Handbook, Section: 560 (Deposits/Borrowed Funds).

Internal Audit and Management Review Reports

INTERNAL AUDIT REPORTS

Report Description

Periodic reports from the internal auditor indicating the:

- Extent of the savings association's compliance with, and the effectiveness of, its policies and procedures.
- Reliability of the information produced by the savings association, including reports to OTS, SEC, the board, and critical management reports.
- Savings association's compliance with, and the adequacy of, its internal controls.
- Extent to which the savings association's assets are protected against loss.
- Recommended corrective actions and improvements in operations.
- Progress made in completing the internal audit schedule.

Warning signs or red flags

- Negative findings, particularly those that persist over time.
- Findings substantially different from those of external auditors or examiners.
- Management's failure to correct cited deficiencies.

- Delays in completing audits.
- Continual revision of the internal audit plan.
- Reporting relationships that compromise the independence of auditors.
- Unexplained or unexpected changes in external auditor or significant changes in the audit program.
- A reduction of, or increased turnover in, internal audit staff.
- A significant decrease or increase in the audit budget.
- Internal or external auditors relying heavily on the other's conclusions.
- Employees in key or influential positions who were not on vacation or otherwise absent for two consecutive weeks during the year.
- The inability of management to provide timely and accurate financial, operational, and regulatory reports.
- Unrecognized differences between trial balances, subsidiary ledgers, and the general ledger.

Rationale

Outside directors have a limited amount of time to devote to oversight of the savings association, and it is essential that they receive unbiased information about the savings association's performance. On the other hand, it is unrealistic to expect management to be unbiased in reporting its deficiencies. Internal audit reports provide the board with impartial information about the savings association's operations. To ensure impartiality, the internal auditor should report directly to the board or a board committee (such as the audit committee) that sets audit staff compensation. Also, management should be present, only at the request of the board or committee, when the internal auditor presents findings.

A small savings association that may not be able to afford a separate internal audit function should provide for internal audits by other means, such as:

- Hiring an independent auditor.
- Establishing a dual compliance officer/ internal auditor function.
- Periodically requiring certain departments to review the work of other departments.
- Performing directors' audits of critical areas.

FDIC requires all insured depository institutions with assets of \$1 billion or more to engage an independent audit. (12 CFR 363.3) OTS requires savings associations with a CAMELS rating of 3, 4, or 5 to engage an external audit, regardless of size. (12 CFR 562.4(b)(i)) In addition, if a savings association is publicly traded, regardless of size, it is subject to the auditor independence and certain other internal control report requirements of the Sarbanes-Oxley Act.

An internal audit function is especially important for eligible savings associations that have chosen to omit an annual external audit. A savings association's internal audit function should be appropriate to the size of the savings association and the nature, scope, and risk of its operations.

Reference

OTS Examination Handbook, Section: 355 (Internal Audit)

FDIC Regulations Part 363. Additional audit related publications are listed at the end of this guide.

INTERNAL LOAN REVIEW

Report Description

- An independent report, generated either internally or externally, showing the extent of management's adherence to board-approved lending policies, underwriting standards, and loan-servicing procedures.
- An independent report on asset criticisms.

The report should be based on a review of samples of the entire loan portfolio, not just new or large loans. To ensure objectivity, an individual or group that is completely independent of the lending function should prepare the report. The report should also assess the accuracy and controls over loan servicing, particularly rate and payment adjustments, and escrow accounts.

Warning signs or red flags

- Significant deviations from lending policies or underwriting standards established by the board.
- Significant discrepancies between reports produced by the internal loan review function and regulators or auditors.
- Loan purchases that do not conform to the savings association's underwriting standards.
- A significant number or ongoing pattern of loan servicing errors.

Rationale

An independent loan review function serves as an early warning system for poor loan administration and problem loans. This vital function assesses the adequacy of and adherence to internal loan policies and procedures and loan documentation requirements. It identifies potential problem loans, and provides management and directors with an objective assessment of the

overall quality of the loan portfolio. The review function should also encompass loan servicing. Servicing errors may expose the savings association to significant financial liability for restitution and penalties.

References

OTS Examination Handbook, Section: 200 (Asset Quality).

REGULATORY REQUIREMENTS

Report Description

A periodic review of, and follow-up on, board-approved policies and procedures designed to promote the safe and sound operation of the association and ensure compliance with all regulatory requirements.

You may assign these reviews to the internal audit function, a compliance officer, or another designated person — as long as the board reviews and approves the results at least annually.

General warning signs or red flags

- Absence of written policies.
- Policies or procedures that are not followed.
- Lack of comprehensive periodic reports to the board.
- Ineffective or poorly designed policies and procedures.
- Lack of procedures to ensure staff training and compliance.
- The compliance officer reporting to someone other than the board or a committee of the board.
- Inadequate review of any function by internal audit.
- Lack of due diligence when the association purchases compliance third-party vendor services and products.
- Lack of regular attendance at board meetings.
- Domination of the board by one director or officer.
- Management incompetence.
- Losses arising from poor underwriting or ineffective management of interest rate risk.

- Entry into new lending or investment areas without formal policies.
- Transactions with officers or directors that violate established ethics policies or regulatory guidelines.
- Regulatory deficiencies cited in examination reports, especially repeat violations or comments.
- A large volume or an emerging pattern of consumer complaints against the savings association.

CRA and Fair Lending warning signs or red flags

- An existing or proposed lending policy that includes, directly or indirectly, reference to any prohibition (race, color, national origin, religion, sex, age, marital status, familial status, handicap, receipt of public assistance, or the exercise of a right under the Consumer Credit Protection Act).
- An existing or proposed lending policy whose standards for underwriting, pricing, or setting terms and conditions are vague or unduly subjective, or which allow substantial loan officer discretion.
- Any statements by officers, employees, or agents, indicating a personal prejudice; a stereotype on a prohibited basis; or an aversion to doing business in minority areas.
- Significant turnover, including the compliance officer, or a reduction in the staff responsible for ensuring compliance with laws or specific consumer products.
- Staff who are unaware of, or inexperienced in, compliance issues and requirements.
- Community protests or legal challenges.
- Substantial errors in CRA and HMDA data and requests for data resubmission.
- Lawsuits or investigations by government agencies.
- Compliance-related deficiencies cited in examination reports, regulatory correspondence, or enforcement actions.
- Inadequate review of the compliance function by internal audit.
- Lack of evidence that compliance was adequately considered when new products and delivery systems were developed and introduced, or when new marketing materials were designed.
- Consumer complaints alleging discrimination in specific transactions.
- Low levels of minority applicants even though minorities represent a significant part of the service area.
- Use of credit scoring models that are not validated.
- Substantial disparities in the numbers of loans originated within groups of contiguous low- or moderate-income geographies.

- Reports that show lending performance, particularly when viewed against primary competitors, is significantly below the performance of other lenders in the association's assessment area.
- Reports that show that the association has few or no qualified investments in its assessment area, even though investment opportunities exist.
- Customer complaints about the level of services and products offered in some parts of the association's trade area compared with those offered in other areas served by the association.

BSA warning signs or red flags

- Lack of independent audit to test for BSA/AML compliance.
- No individual who is responsible for coordinating and monitoring compliance with BSA/AML/OFAC.
- No written BSA compliance program.
- No written policies and procedures on customer identification.
- Association personnel are not trained regularly on the BSA/AML/OFAC.
- A number of identified high-risk customers or products.
- Frequent international wire transfers.

Rationale

Every insured savings association must operate in a safe and sound manner and comply with applicable laws and regulations. To fulfill these requirements, the board must adopt policies and procedures in all significant areas of the association's operations. The board should review policies and procedures at least once a year to consider what changes are appropriate.

References

OTS Examination Handbook, Section: 310 (Oversight by the Board of Directors).

Safety and Soundness Guidelines and Compliance Procedures

Appendix A, Interagency Guidelines Establishing Safety and Soundness Standards

Appendix B, Interagency Guidelines Establishing Information Security Standards (12 CFR Part 570).

Federal Financial Institutions Examination Council (FFIEC) — Bank Secrecy Act/Anti-Money Laundering Examination Manual.

INFORMATION TECHNOLOGY

Report Description

- A periodic report, at least annually, from management that describes the overall status of an institution's written information security program and compliance with the Interagency Guidelines Establishing Information Security Standards (Security Guidelines).
- Annual review and approval of the institution's Business Continuity Plan, including testing results.
- Annual review and follow-up on other significant, board-approved policies and procedures for information security and information technology, for example, vendor management and audit.

As provided in the Security Guidelines, the board can assign any of these reviews to an appropriate committee of the board.

Warning signs or red flags

- Policies and procedures are not followed.
- Policies and procedures are poorly designed or proving ineffective.
- Lack of board policies, procedures, and controls to identify, manage, and mitigate information technology risks within the association's environment.
- Lack of a comprehensive, association-wide business continuity plan that clearly defines how the association can maintain, resume, and recover its operations after disruptions.
- Lack of an oversight program to manage the association's technology outsourcing relationships.
- Software procurement and installation activities do not conform to sound principles found in project management and systems development methodologies.
- Contracts for acquired computing resources are not in the best interests of the savings association.
- Management lacks knowledge concerning the development, operation, and control of information technology.

Rationale

Accurate and timely information is essential to financial institution operations and up-to-date systems are required for delivery of competitive products and services. Savings associations use complex information systems and telecommunications to process and protect their corporate and customer data. The board's adoption and annual review by the board of information security and information technology policies and procedures are integral to developing and maintaining a strong and secure information technology environment.

References

OTS Examination Handbook, Section: 341 (Technology Risk Controls).

Interagency Guidelines Establishing Standards for Information Security, 12 CFR, Part 570 Appendix B (Security Guidelines)

- Supplement A, Interagency Guidance for Response Programs for Unauthorized Access to Customer Information and Customer Notice (Incident Response Guidance)

Bank Protection Act, 12 CFR Part 568.5

Federal Financial Institutions Examination Council (FFIEC) — Information Technology Examination Handbook.

External Reports

EXTERNAL AUDIT REPORTS, MANAGEMENT LETTERS, AND COMMUNICATIONS WITH EXTERNAL AUDITORS

Report Description

- Independent annual audit report and accompanying management letter.
- Minutes of the Audit Committee's meeting with the external auditors.

Warning signs or red flags

- A qualified, adverse, or omitted opinion.
- Auditor liability limitation clauses in engagement letters.
- Internal control deficiencies, particularly deficiencies not identified by the internal audit and those that are recurring.
- Significant unexplained or unsupported changes in audit expenses.
- Significant disagreements between management and auditors.
- Late annual audit reports (more than 90 days after fiscal year-end) or late quarterly reports (more than 45 days after quarter-end).
- Unexplained or unexpected changes in the external auditor or significant changes to the scope of the audit.
- Internal or external auditors relying heavily on the other's conclusions and assumptions.
- An external auditor or audit firm that has a financial interest in the association, loan from the association, or other conflict of interest.
- An external auditor or audit firm that performs both financial statement audit services and other non-audit services, including outsourced internal audit services, for the association.
- An external audit lead partner who has performed external audit services for the association for more than five consecutive years.

- Significant numbers of audit adjustments.
- Unusual relationships between auditors and staff that may impair or give the appearance of impairing independence.
- Significant comments from regulators in response to public filings and the association's response to those comments.
- Absence of an adequate number of meetings with the external auditor.

Rationale

The financial community relies on audit reports to gauge the financial condition of the savings association. Audit reports may identify unknown losses and deficiencies in internal controls and records. While all savings associations are encouraged to obtain an independent audit, savings associations with a CAMELS rating of 3, 4, or 5, and those with \$1 billion or more in assets, are required by FDIC regulation to have an independent audit.

An independent audit provides an objective look at the performance of the savings association. You should pay close attention to factors that could impede audit independence or access to information. The auditors should be experienced in auditing savings association operations.

Reference

OTS Examination Handbook, Section: 350 (Independent Audit).

Other Reports

TRANSACTIONS WITH AFFILIATES

Report Description

A summary of all transactions (such as loans, the purchase or sale of assets, or service contracts) between the savings association (or its subsidiaries) and its affiliates, or an unrelated third party if an affiliate derives a benefit. The report should identify:

- The terms of the transaction, including evidence that the transaction is on market terms.
- Whether the board was fully informed of the transaction and approved it (if necessary) after a full discussion with any interested party abstaining.
- Whether the savings association complied with all applicable laws and regulations governing the transaction, including making any required reports or providing prior written notification to OTS.

Warning signs or red flags

- Transactions with affiliates that are not conducted at arm's length.
- Conflicts of interest and lack of separate corporate identity.
- A difference between the form and substance of a transaction.
- Lack of disclosure to or (when required) approval by the board of directors.
- Regulatory violations.
- Significant activities that may or may not require consolidation or deconsolidation.

Rationale

OTS Regulation 12 CFR 563.41 incorporates by reference the Federal Reserve Board's Regulation W (12 CFR Part 223) that contains detailed guidelines and restrictions related to a savings association's transactions with affiliates. Section 563.41 also contains additional prohibitions. Section 563.41 lists the various recordkeeping and reporting requirements that apply to affiliate transactions. A review of such records and reports, regardless of whether the regulations specifically require board review or action, reveals whether the savings association has achieved regulatory compliance. It also identifies concerns that management should address. These records and reports include information on each transaction involving an affiliate (or an unrelated third party when an affiliate derives a benefit), including the:

- Identity of the affiliate.
- Type and amount of transactions.
- Collateral involved.
- Information that documents compliance with regulatory requirements.

Undue pressure on an association to engage in transactions with an affiliate, or failure to maintain separate corporate identity, may subject the savings association to significant risk. This risk may include liability for the affiliate's obligations.

References

OTS Examination Handbook, Section: 380 (Transactions With Affiliates and Insiders).

TRANSACTIONS WITH INSIDERS

Report Description

- The identity of all insiders of the savings association or its affiliates, executive officers or principal shareholders, including their related interests.
- All extensions of credit by the savings association or its subsidiaries to the savings association's own or its affiliate's insiders, including the amount and terms of each extension of credit. (For purposes of this section extensions of credit to a third party are generally considered to be extensions of credit to an insider where proceeds are transferred to or used for the tangible economic benefit of an insider.)
- The identity of any executive officer of the savings association who becomes indebted to any other bank or savings association in an amount that exceeds the lending limits.

- All extensions of credit to the savings association's executive officers and principal shareholders by correspondent banks.
- All transactions occurring between the savings association and its insiders, including any transfers of property or provisions of services.
- Each report should indicate:
 - ◆ Whether the insider obtained terms more favorable than those available to the general public or pursuant to a widely available employee benefit plan, or involve more than the normal risk of repayment or present other unfavorable features.
 - ◆ Whether the transaction creates an actual or apparent conflict of interest.
 - ◆ Whether the board was fully informed of the transaction and approved it (if necessary) after a full discussion with the interested party providing full disclosure of his or her interest, refraining from participation in the board's discussion, and abstaining from voting on the transaction.
 - ◆ Whether the savings association complied with all applicable laws and regulations governing the transaction, including any individual and aggregate dollar limitations and making any required reports.

Warning signs or red flags

- Extensions of credit to insiders that are not conducted at arm's length or include more than the normal risk of repayment or present other unfavorable features.
- Conflicts of interest.
- Lack of disclosure to or (when required) approval by the board of directors.
- Regulatory violations.
- Any insider benefiting, directly or indirectly, from a transaction (such as, loans, sales of real or personal property, or services) with a third party that deals with the savings association.

Rationale

OTS Regulation 563.43 incorporates by reference the Federal Reserve Board's Regulation O (12 CFR Part 215), which contains detailed guidelines and restrictions, related to a savings association's extensions of credit to its own or an affiliate's insiders. Section 215.2 contains the definitions of important terms such as "affiliate," "director," "executive officer," "insider," "principal shareholder," and "related interest."

Regulation O sets the various recordkeeping and reporting requirements for extensions of credit involving insiders. A review of such records and reports, regardless of whether the regulations specifically require such action, should reveal whether the association achieved regulatory compliance.

Abuse by insiders undermines their ability to lead the savings association effectively. Eventually, abuse leads to an erosion of public confidence in the savings association.

References

OTS Examination Handbook, Sections: 310 (Oversight by the Board of Directors); 360 (Fraud/Insider Abuse); 380 (Transactions with Affiliates and Insiders); and 730 (Subordinate Organizations).

ETHICS POLICY

Report Description

- Data showing compliance or noncompliance with the savings association's code of ethics.

Warning signs or red flags

- Absence of written policies.
- Noncompliance with the association's ethics policy.
- Lack of disclosure to, or (when required) approval by, the board of directors.
- Apparent or actual conflicts of interest.
- Political contributions or loans with special rates and terms.

Rationale

OTS encourages every savings association to adopt a code of ethics. Generally, a code of ethics should address these points:

- Conflicts of interest.
- Confidentiality of savings association information.
- Standards for reporting personal transactions that may affect savings association performance.
- Guidelines on outside activities.
- Protection of savings association property.
- Compliance with laws and regulations.
- Procedures for ensuring compliance with the code.

Directors and management should not:

- Use their position to profit personally, directly or indirectly, at the expense of the association.
- Solicit or accept preferential treatment from the association or its affiliates.
- Engage in any transaction that would give the appearance of a conflict of interest, preferential treatment, or usurpation of corporate opportunity.
- Use their positions to solicit preferential treatment for an affiliate or related interest.

The Federal Election Commission's rules and regulations prohibit savings associations from making political contributions or paying political expenditures under specific circumstances. A savings association may make a loan to a political candidate or committee only if the loan is granted at the savings association's usual and customary rates, terms, and conditions.

The Foreign Corrupt Practices Act includes requirements for books, records, and internal accounting controls, as well as prohibitions on payments to foreign officials and political parties.

References

OTS Examination Handbook, Sections: 360 (Fraud/Insider Abuse) and 310 (Oversight by the Board of Directors).

PRODUCT PRICING

Report Description

Information on the pricing and fee structure of all major products (such as mortgage loans and deposit accounts) offered by the savings association. This includes rates and yields offered by the savings association compared to rates and yields offered by a sample of key competitors.

Warning signs or red flags

- Rates or terms on deposits that differ substantially from those offered by competitors or exceed the cost of other sources of funds with the same maturity.
- Rates or terms on loans that do not adequately compensate the savings association for the amount of actual risk involved (including credit risk, liquidity risk, interest rate risk).
- Rates or terms on new asset and liability products with similar maturities that do not result in a profitable spread.
- Failure to factor in all costs (for example, operating expenses) associated with a product.

Rationale

Reasonable, supportable product pricing is essential for profitability. Competitive pressures can lead to unsound pricing decisions. Directors should know and understand the savings association's product pricing relative to market rates and the competition's prices. Above- or below-market rates can affect loan volume, interest rate risk, liquidity, earnings, and retention of core deposits. Insupportable rate structures can expose the savings association to government review, private legal action, or both.

References

OTS Examination Handbook, Sections: 510 (Funds Management) and 560 (Deposits and Borrowed Funds).

NONTRADITIONAL ASSETS AND COMMITMENTS AND NEW BUSINESS ACTIVITIES

Report Description

A summary of the savings association's proposed new major activities and lines of business.

A chart showing the total of all assets with higher-than-average risks. These include high loan-to-value loans, subprime mortgages, commercial loans, as well as commitments to purchase such assets. The report should show such assets for the following time frames: as of the most recent month-end (compared to the budget), the prior month, and prior year. The report should also have a separate column showing the percent change from the previous month and year.

Follow-up reports should be presented on activities commenced recently (a comparison of actual results to prior projections and the budget).

Warning signs or red flags

- A rapid increase in the association's exposure to nontraditional assets, particularly if the association has not planned such growth.
- Unanticipated or unexplained changes in business strategies.
- Substantial changes or growth in account types, account balances, or products or services offered.
- Entry into a new activity or business venture without proper:
 - ◆ Management.

- ◆ Policies and procedures.
 - ◆ Training.
 - ◆ Internal controls.
 - ◆ Independent reviews.
 - ◆ Supporting capital.
 - ◆ Information systems support.
 - ◆ Integration into management accounting.
 - ◆ Regulatory approval if applicable.
- A new activity or business venture deviating from the budget.
 - Lack of progress in major developments.
 - Requests for additional financing.
 - Absence of a firm schedule for completion.
 - Fiduciary assets or relationships that the association lacks expertise to manage (for example mineral interests or farm/ranch properties).
 - Sale, loan, or transfer of fiduciary account assets to the association or association insiders.

Rationale

Rapid growth in nontraditional assets of higher-than-normal risk is not necessarily unsafe and unsound. Rather, new activities and products are unsafe and unsound when they are not thoroughly planned and lack the necessary controls. All major loans and investments require thorough planning, knowledgeable management, strong internal controls, prior approval, and close monitoring by the board.

Entry into new business activities such as sales of noninsured products or electronic banking without adequate planning, controls, resources, and oversight can be a major cause of losses. Whenever the association commits significant resources to a loan, subordinate organization, equity investment, or new line of business, the board should require ongoing status reports. You should review these reports to evaluate financial performance and determine whether the activity may be prohibited by law, entail excessive risk, or involve conflicts of interest. Certain loans and investments pose greater risk simply due to their large size, while others (for example, the development of raw land) carry more risk due to the nature of the activities involved.

Savings associations should also have a good cost accounting system to assess performance of a new activity or line of business.

Reference

OTS Examination Handbook, Sections: 201 (Asset Quality); 330 (Management Assessment); 760 (Permissible Activities).

SECURITY REPORTS AND INSURANCE

Report Description

- Annual report from the board-approved security officer regarding the effectiveness of the savings association's security program, as required by the Bank Protection Act.
- Regular reports regarding crimes and losses, such as from robberies, burglaries, and embezzlements, including Suspicious Activity Reports filed by the savings association.
- Information on the insurance policies obtained by the savings association, including rates, coverages, and deductible amounts.

The report should include information on all major insurance policies, including property and casualty coverage, fidelity blanket bonds, and directors' and officers' errors and omissions insurance.

Warning signs or red flags

- Increasing or repeated instances of robberies, burglaries, or embezzlements.
- Staff or management awareness of, or collusion in, possible criminal activity.
- An increasing number of claims or recurring claims.
- Cancellation of insurance by the savings association or the insurer.
- A significant increase in rates or decrease in coverage by the insurer.
- A significant increase in deductibles.
- A significant increase in exclusions from coverage.
- Significant claims against the savings association that are not covered by insurance.
- Failure to report claims on a timely basis.

Rationale

Crimes against an association can cause significant financial loss, expose employees and customers to harm, and result in liability exposure and additional expense. While it may be impossible to eliminate criminal activity completely, an association can take steps to reduce losses and limit the possibility of recurrence. Increasing or repeated instances of criminal activity may indicate that the savings association has failed to implement adequate safeguards.

Adequate insurance coverage is a critical component of any well-run business. At least annually, the board should review the savings association's major insurance policies to ensure that they provide adequate coverage at a reasonable price.

Reference

OTS Examination Handbook, Sections: 405 (Bank Protection Act); 720 (Insurance).

ADDITIONAL REFERENCE PUBLICATIONS

We encourage you to routinely access the OTS web site at <http://www.ots.treas.gov>, or contact your OTS regional office for more information and background materials. The following is a list of available references that contain information of general interest to directors:

AICPA Audit & Accounting Guide, Depository and Lending Institutions, American Institute of Certified Public Accountants, 2004. Phone: (212) 596-6200, Internet: <http://www.aicpa.org>.

Audit Committee Guide, Arthur H. Bill, Bowne & Co. Inc., Second Edition, Phone: (202) 229-7337 FAX: (202) 229-3421, Internet: <http://www.bowne.com>

The Audit Committee Handbook, America's Community Bankers, 4th Edition. Phone: (202) 857-3100 Fax: (202) 659-1134, Internet: <http://www.acbankers.org>.

The Board Member's Manual, 11th Edition, America's Community Bankers, 2001. Phone: (202) 857-3100 Fax: (202) 659-1134, Internet: <http://www.acbankers.org>.

Community Bank Director, (video tape series), ICBA Education Department. Phone: (800) 422-7285, Internet: <http://www.icba.org>

Corporate Director's Guidebook, 4th Edition, American Bar Association. Phone: (312) 988-5000, Internet: <http://www.abanet.org>

Directors' Responsibilities Guide, Office of Thrift Supervision, U.S. Department of the Treasury, 2005. Internet: <http://www.ots.treas.gov>.

The Director's Book, Office of the Comptroller of the Currency, U.S. Department of the Treasury, 1997. Phone: (202) 874-4700, Internet: <http://www.occ.treas.gov>.

Directors & Trustees Digest, (monthly), America's Community Bankers. Phone: (202) 857-3100 Fax: (202) 659-1134, Internet: <http://www.acbankers.org>.

Directors' Guide to Management Reports

Executive Compensation Review For Banks and Thrifts, (annual), SNL Securities. Phone: (434) 977-5877, FAX: (424)984-8020, Internet: <http://www.snl.com>.

The Guidebook to Effective Board Committees, America's Community Bankers, Phone (202) 857-3100, Internet: <http://www.acbankers.org>.

Guidelines for Legal Advice to Financial Institution Directors, FIL-15-98 Federal Deposit Insurance Corporation, 1998. Phone (877) 275-3342, Internet: <http://www.fdic.gov>.

Information Technology Examination Handbook, Federal Financial Institutions Examination Council. Phone: (202) 872-7500, Internet: <http://www.ffiec.gov>.

Pocket Guide for Directors, Federal Deposit Insurance Corporation. Phone (877) 275-3342, Internet: <http://www.fdic.gov>

Regulatory Bulletins (Series), Office of Thrift Supervision, U.S. Department of the Treasury, 1996. Internet: <http://www.ots.treas.gov>.

Regulatory Handbooks, (Examination Handbook, Thrift Activities, Compliance Activities, Holding Companies, Trust Activities) Office of Thrift Supervision, U.S. Department of the Treasury. Internet: <http://www.ots.treas.gov>.

Responsibilities and Liabilities of Bank and Bank Holding Company Directors, Barnett, Robert E.: Commerce Clearing House, 1991. Phone: (312) 583-8500, Internet: <http://www.cch.com>.

New FDIC Guidelines Issued to Clarify the Responsibilities of Bank Directors and Officers, FIL-87-92 Federal Deposit Insurance Corporation, 1992. Phone (800) 276-6003, Internet: <http://www.fdic.gov>.

Thrift Bulletins (Series), Office of Thrift Supervision, U.S. Department of the Treasury, 1996. Internet: <http://www.ots.treas.gov>.

