Oversight by the Board of Directors

The board of directors oversees management activities and is ultimately responsible for the affairs of a savings association. Laws and regulations governing board activities require directors to exercise care and loyalty toward the savings association and not to advance their own personal or business interests at the expense of the savings association.

RESPONSIBILITIES OF THE BOARD OF DIRECTORS

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As the financial services industry continues to evolve, the duties of directors are becoming more complex and demanding. In addition, the corporate scandals of 2002 and the Sarbanes-Oxley Act have raised public awareness in the area of corporate governance. Today's board of directors must take an active role in shaping and controlling a savings association's business operations and risks. The following are some basic responsibilities the board has in actively overseeing the association's affairs:

- Establish business goals, standards, policies and procedures, and operating strategies and understand the risks involved in following certain strategies.
- Approve standards for ensuring that the savings association's transactions with affiliates are sound, and are considered solely from the association's interests.
- Establish a compliance program emphasizing the importance of regulatory compliance as an inherent part of business operations ensuring compliance with external standards, such as laws and regulations, and the association's own policies and procedures.
- Hire and retain executive officers with the skills, integrity, knowledge, and experience appropriate for the nature and scope of their responsibilities and periodically evaluate management's performance.
- Establish and maintain appropriate committees that have written charters delineating the committee's functions, responsibilities, and membership qualifications.
- Ensure that the association maintains a corporate existence that is separate from its affiliates, subsidiaries, holding company, and sister banks.

- Ensure that the association serves the credit needs of its community or communities and meets responsibilities under the Community Reinvestment Act (CRA).

- Review operating results, compliance performance and performance of new and existing activities.

In fulfilling these responsibilities, the board of directors should observe the following standards:

- Operate independently from management.

- Stay well informed and be attentive to risk.

- Attend board meetings regularly.

- Conduct business affairs ethically; avoid conflicts of interest and self-serving practices.

OTS federal charters for mutual and stock associations authorize the number of directors to be not fewer than five nor more than 15, except when the Director of OTS approves a lesser or greater number. A quorum for board meetings is the majority number of directors that an association's bylaws prescribe, even if the association has not yet elected the prescribed number.

For a list of board of directors' statutory and regulatory responsibilities, see the References at the end of this Handbook Section and the Questionnaire.

Analyzing Board Performance

Evaluating the effectiveness of a board of directors is an important examination function. The results often provide a useful indicator of an association's future condition and help OTS design a regulatory profile. In carrying out the evaluation, you should perform the following steps:

Evaluating the effectiveness of a board of directors is an important examination function.

- Tailor the scope of the examination to the risk profile of the association. A comprehensive assessment of each director and officer usually is not necessary.

- Concentrate on issues rather than on personalities. Analyzing the board's performance is a sensitive process that requires focusing on problem solving, not fault finding.

- Determine the level of director awareness and accountability. Board members should know and fulfill their responsibilities.

To evaluate board effectiveness you must review board minutes and other documents, interview management, and check on the board's response to supervisory directives. In rare instances, you may need to expand the scope of the examination and interview individual directors. You should only need to do this if the information is unavailable from other sources. Meetings with the entire board provide an additional means of evaluating a board's effectiveness. See Examination Handbook Section 070.

Directors generally welcome regulatory review and specific recommendations for improvements. In unusual cases, however, directors may be uncooperative or attempt to hide instances of incompetence, lack of care, or even fraud or criminal malfeasance. Possible causes for the condition of a troubled association include any of the following reasons:

- Self-dealings or other conflicts of interest.
- Unsafe and unsound practices.
- Management incompetence.
- Lack of director participation.
- Domination of the board by one director or officer.
- Disregard for the regulatory process.
- Lack of independence.

The board is ultimately responsible for prevention or correction of these problems. If the board is unable or unwilling to correct serious problems, you must act immediately to protect the association and ensure its safety and soundness. For more information in this regard, refer to Examination Handbook Section 370, Enforcement Actions.

Board Minutes

The primary sources of information you need to evaluate a board of directors and its actions are the minutes of its regular and committee meetings. You should review these minutes to determine the status of the following areas:

- **Adequacy of management's reports to the Board** – Management reports submitted to the board should be thorough and accurate and cover all aspects of the association's operations. Management should provide such reports to the directors before regular board or committee meetings to allow adequate time for review before the meetings.
  - — Reports should document any significant changes to capital, financial performance results, compliance performance, and major business activities, including information technology risks.
  - — Reports for technology risks should address information security, technology audit work, business continuity planning, and vendor oversight activities. Additionally, the minutes

should document that the board received a status report on and approved the association's compliance with the Interagency Guidelines Establishing Standards for Safeguarding Customer Information, which implement Section 501(b) of the Gramm-Leach-Bliley Act of 1999.

- **Oversight of management** – Minutes should reflect the board's discussion and approval of any major strategic or operating decisions and the adoption of major operating policies and procedures. Management should obtain board approval before implementing new policies or engaging in new activities.

- **Attendance and participation** – The minutes should evidence "regular" attendance by board members. Attendance at 75 percent of all regularly scheduled board meetings is the benchmark for "regular" attendance. Minutes should also identify board members who ask questions or make motions, indicating that they are active in the meetings. Another indicator of active involvement is participation on committees.

- **Performance evaluations** – Minutes should reflect the board's election of officers, its review of management performance, and its deliberations regarding salaries and compensation for officers and fees for attorneys, appraisers, directors and others.

- **Compliance with board directives** – Savings associations should have internal systems to monitor operations and ensure that management's actions are appropriate and conform to board-approved policies and directives.

Board minutes should be a complete and accurate representation of meeting discussions, including dissenting opinions or votes. Minutes should indicate that the directors studied pertinent documentation and based their decisions upon such documentation. Each director should have the opportunity to review and, if appropriate, modify the minutes before the board ratifies them. However, board minutes should never be altered to distort facts.

Reports to the Board

A board's excessive reliance on benchmark financial statistics rather than on comprehensive financial analysis suggests that the directors may not be overseeing the association's affairs appropriately. Undue reliance on only a few indicators may result in erroneous evaluations of the association's condition. Therefore, you should determine that the reports to the directors include information that is complete, supported, understandable, and accurate.

The quality of report information that management provides to board and committee members is critical in a board's decision-making process. Not only must directors carefully review information that management provides, they must also ensure themselves that the information is complete and contains all pertinent data required to oversee the association.

The quality of report information that management provides to board and committee members is critical in a board's decision-making process.

Each regular board meeting should include a review of financial reports. Directors should not accept questionable report figures at face value, but should question the information and verify it when necessary. The association should promptly follow federal or state examination report recommendations. The audit committee composed solely of outside directors, if necessary, should provide for annual audits by an independent accounting firm, and should ensure the establishment of and adherence to a system of internal controls.

Audit Committee

The board should appoint an audit committee composed of directors who are independent of management and free from any relationship that would interfere with the exercise of independent judgment as a committee member. Members should also be independent of operating personnel who audit procedures, systems, or records. Operating personnel may, however, attend meetings to provide necessary information.

The major responsibilities of the audit committee include:

- Handling relations with the independent auditor (such as to select the auditor and to discuss the scope and results of the audit).
- Improving internal auditing functions and controls.
- Establishing policies and procedures that ensure full and accurate disclosure of the association's financial condition.
- Monitoring management and staff compliance with board policies, laws, and regulations.
- Measuring the effectiveness of the association's compliance management program.

All insured institutions with total assets of $500 million or more must have an independent audit yearly. If any savings association is a subsidiary of a holding company, it can satisfy this requirement by an independent audit of the holding company. See Examination Handbook Section 350, Independent Audit. 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 Sarbanes-Oxley. See attached Appendix A, Applicability of Selected Sarbanes-Oxley Act Requirements to Financial Institutions. Ideally, independent auditors provide an objective look at the performance of the association. You should carefully review independent audits for the following red flags:

- A qualified or adverse opinion.
- Significant adjustments to net income or capital.
- Internal control deficiencies, especially if recurring or not reported by the internal audit.

- Significant variances in time spent by auditors on the premises or in the audit expense incurred by the institution.
- Significant disagreements between management and the independent auditors.
- Significant variances from findings in the reports of examination.
- Failure of management to submit a plan for the correction of deficiencies.
- Late audit reports (more than 90 days from fiscal year-end).

Compliance Officer and Audit

A compliance officer who has direct access to the board and all areas of operations plays a key role in the internal audit function. It is the responsibility of this officer to monitor the association's business transactions to ensure compliance with regulatory provisions and safety and soundness standards.

The compliance officer, the audit committee, or the outside auditor, should annually prepare a compliance audit report. An audit of this nature will give the association an opportunity to resolve any internal problems that might otherwise be the subject of an adverse examination report.

Qualified Management

A board's most important responsibility is to select a capable managing officer (or chief executive officer) for the association. The board is also responsible for appointing or approving other senior management. Although economic conditions are a major influence on a savings association's well being, capable management and personnel are the dominant factors that contribute to an association's success.

Directors should give the chief executive the latitude he or she needs to run day-to-day operations; therefore, the board must be certain that the person is competent and trustworthy. As a further control, the board should define a managing officer's duties and responsibilities in writing and establish an adequate management succession plan. (See Examination Handbook Section 330, Management Assessment.) The board should also establish reasonable compensation packages, including appropriate incentives, for executive officers. In addition, the directorate is responsible for evaluating the performance of top management.

Board Oversight of Management

The board of directors must ensure that a savings association's management has procedures in place to implement board-adopted policies. The board should ensure that management performs the following functions:

- Hires and retains employees and agents with the skills, integrity, knowledge, and experience appropriate to the nature and scope of their responsibilities. Proactively engages and supervises vendors.

- Provides ongoing comprehensive training programs, including the association's information security program.

- Follows the board's direction and provides periodic reports to the board concerning policy compliance, such as interest rate risk exposure reports, earnings and capital projections and analysis, and information security.

- Develops, implements, and monitors 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).

- Maintains an awareness of regulatory issues and developments.

- Reviews the board's policies periodically and suggests changes when appropriate.

- Develops, tests, and implements a comprehensive, association-wide business continuity plan that reflects the technology environment.

- Implements and manages operations to achieve the board's financial objectives and establishes operational policies for financial functions.

- Supervises investment portfolio management activities. Invests excess liquid funds in securities that complement the association's overall risk/return profile.

- Maintains an awareness of the economic and interest-rate environment, particularly local economic conditions, prepayment trends, volatility, and related regulatory developments.

- Reviews asset quality, including trends in delinquencies, nonaccrual loans, real estate owned, and charge-offs and recoveries. Also reviews the adequacy of reserves and quantifies the effect of nonperforming assets on the risk/return profile.

- Develops, reviews, and monitors capital plans, business plans, information technology plans, and strategic plans. Integrates this role with the budgeting function. Also generates variance and rate and volume analysis reports.

- Provides adequate support, planning, and oversight when the association enters nontraditional banking activities, new business lines, or acquires and implements significant new technology. Considers these activities, which may be organizationally distinct from the association's operations, in connection with the association's overall risk/return profile. Sets specific standards concerning risks and assumptions.

- Manages capital market activities, including capital raising, debt issuance, dividend policies, and merger and acquisition analysis. Considers these activities with the management of the association's overall risk/return profile.

- Ensures that product development activity and pricing comport with the association's overall risk/return objectives. Compares the savings association's product pricing to a sample of key competitors.

Use of Consultants

Savings associations sometimes hire third parties, such as consulting firms, investment bankers, lawyers, accountants, or other professionals, to provide services not usually required in the normal course of business. Consultants normally provide such services before and during proposed mergers, systems conversions, implementation of new technology, capital raising efforts, major asset sales, boards of director's internal investigations, and defenses against regulatory determinations. The board of directors must justify and approve contracts that the association enters into with third parties. Using a third party to perform services does not diminish the board's responsibility to ensure that services are provided in a safe and sound manner, and in compliance with applicable laws and regulations. Generally, the risk management policies that apply to a savings association conducting an activity directly, also apply to third parties conducting activities on the association's behalf. See TB 82a, Third Party Arrangements.

The board of directors should remind management to take care in contracting with outside parties that propose to provide business plans or financial models at no direct cost to the association. Such vendors usually expect the association to transact business with them on an exclusive basis, and management may feel an obligation to do so. These vendors will have exclusive access to detailed information about the association that could lead to proposals or transactions that are not in the association's best interest.

The board should ensure that management does not rely on outside consultants to excess, or use overly simplistic assumptions.

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Policies and Procedures

The board establishes policies as guidelines for an association's activities. Procedures represent the methodology for implementing an activity. Operating policies and procedures are necessary to establish management's strategy to communicate the association's goals and to provide a basis for gauging performance.

The directors must provide a clear framework so that the managing officer can operate and administer the association's affairs. These areas include the business strategy as set forth in the business plan, investment and loan policies, capital planning, funds management, risk management, including technology risks and controls, information security policies and procedures, and compliance policies and procedures. The Handbook covers these areas in other sections. The board of directors must approve all major policies.

Board policies and procedures should meet the following parameters:

- Establish and provide guidance and direction for an association's operations.
- Exist for all major phases of the association's operations.
- Be tailored to the association's operations and risk profile.
- Provide guidance and promote controlled and efficient operating practices.

Management's implementation of board policies and procedures and the association's adherence to operating standards indicate the effectiveness of the board. Positive indications of successful implementation of policies and procedures include:

- Current policies and procedures.
- Established systems to support stated objectives.
- Required evaluations and benchmarks for measuring and monitoring performance.

Business Plan

Directors are responsible for establishing a business plan that documents major financial policies, including funds management, lending, investments, dividends, growth, and interest rate risk management. For more information on the latter, refer to the Interest Rate Risk Management Handbook Section and Thrift Bulletin 13a. While management may develop such policies at the direction of the board, the directors must thoroughly review and give final approval to each contemplated policy. Directors must also approve the association's budget and ensure that it is realistic, allows for secure transactions, and reflects adequate capital.

Ideally, the board should have access to information on economic issues because the performance of the economy affects the savings association's performance. Early recognition of changes in the economy provides notice of new opportunities or potential deterioration of asset quality.

Setting Financial Goals: The Risk vs. Return Tradeoff

Savings associations generally express overall financial return objectives in terms of net earnings maximization or net equity value maximization. These financial goals are subject to internal and external risk factors. The greater the risk embedded in individual assets, portfolios, or the overall institution, the greater the variability of returns over time.

The board of directors and management must realize that the savings association can generate higher returns (earnings or equity value) only if the association takes on greater risk; this is the risk/return tradeoff. The choice between these two alternatives relates to the management of all the association's financial functions.

To manage risk effectively, a savings association must have an informed board of directors that is capable of guiding the association's risk strategy. It is important for the board to develop a rational decision-making process for determining a savings association's optimal risk/return profile. An analysis of the effect of numerous risk/return tradeoffs is crucial to successful financial management. See Examination Handbook Section 510.

Types and Sources of Risk Exposure

There are several significant types and sources of risk exposure applicable to savings associations. For each type and source, the board of directors must provide direction to management as to the extent of risk the association may undertake.

Credit Risk – The risk that the borrower or issuer will not repay principal or interest on loans or investments. This area of risk includes counterparty credit risk, which is the risk that the counterparties will not honor their commitments for items such as over-the-counter option transactions or derivative instruments.

Interest Rate Risk – The vulnerability of an association's financial condition to movements in interest rates. Interest rate risk arises from four sources: repricing (mismatched) risk, yield curve risk, basis risk, and options risk. Repricing risk, the primary source of interest rate risk, comes from timing differences in the maturity and repricing of assets, liabilities, and off-balance sheet positions. Yield curve risk arises when unexpected shifts of the yield curve affect a savings association's income or economic value. Basis risk arises from the imperfect correlation in the adjustment of the rates earned and paid on different financial instruments with otherwise similar pricing characteristics. Options risk arises from options, embedded in many financial instruments, that provide the holder with the right, but not the obligation, to buy, sell, or in some manner alter the cash flows of the instrument. See Thrift Bulletin 13a for a more detailed discussion of interest rate risk. TB 13a requires the board of directors to establish and maintain an association's interest rate limits.

Liquidity Risk – The risk that funds may not be available to meet cash outflows when they arise. Liquidity risk occurs when an association is unable to liquidate assets or obtain adequate funding to continue operating. This situation may occur if the association cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions.

Compliance Risk – The risk to earnings, capital and market viability as well as on investor, customer, and regulatory relationships arising from violations of or noncompliance with laws, rules, regulations, industry practices, internal policies and procedures, ethical standards, or customer service goals. It exposes an association to fines, civil money penalties, litigation costs, diminished reputation, reduced franchise value, and reduced business opportunities.

Other Risks – Includes operational risk, legal risk, reputation risk, fraud and insider abuse risk, and disasters or catastrophe risks.

Documentation

An integral part of a savings association's books and records includes documentation of all business transactions. The records should reflect regulatory compliance and adherence to safe and sound procedures. The directors should have full access to such records and use them in approving loans and other investment transactions.

To facilitate examinations each savings association, affiliate, and subordinate organization should establish and maintain accounting and other records that provide an accurate and complete record of all business it transacts. Associations, affiliates, and subordinate organizations must also ensure that the documents, files, and other material or property comprising the records shall always be available for examinations. For supervisory purposes, associations should retain these original business transaction records until the savings association has two regular examinations and the association and OTS resolve any supervisory matters raised in the examinations. Savings associations must also comply with the records retention requirements of safety and soundness, enforcement, compliance, nondiscrimination and consumer affairs laws and regulations.

Due to differing local customs and state laws, associations should obtain recordkeeping (including microfilming, microfiche, and digital imaging) guidance and advice from local sources, such as attorneys, independent auditors, and income tax consultants. OTS encourages associations to develop and follow a formal written recordkeeping policy and records retention schedule.

Employment Contracts and Executive Compensation

This section provides guidance for review of compensation provisions and clarifies OTS policy on unsafe and unsound practices relating to executive compensation and employment contracts.

Definitions

Compensation includes any payment of money or other items of value in consideration of employment. Compensation includes the following items:

- Base salary
- Commissions
- Bonuses

- Pension and profit sharing plans
- Severance payments
- Retirement
- Director or committee fees
- Fringe benefits
- Payment of expense items for a nonbusiness purpose, or that do not meet the IRS requirements for deductibility by the association.

OTS does not ordinarily consider the grant or exercise of stock options as compensation unless they are sufficiently material in amount or conditioned upon factors that result in incentives that cause supervisory concerns.

A senior executive officer includes any individual who holds the title or performs the function of one or more of the following positions (without regard to title, salary, or compensation):

- President
- Chief executive officer
- Chief operating officer
- Chief financial officer
- Chief lending officer
- Chief investment officer
- Chief compliance officer

Senior executive officer also includes any other person identified by OTS in writing as an individual who exercises significant influence over, or participates in, major policymaking decisions, whether or not hired as an employee.

An employment contract is any agreement, intended to be legally enforceable, that materially affects the terms and conditions of a person's employment.

A savings association is in troubled condition if it meets any of the conditions below:

- OTS notifies the association in writing that OTS has assigned the association a composite numerical rating of 4 or 5 under the Uniform Financial Institutions Rating System or an equivalent rating under a comparable OTS rating system.

- The association is subject to a capital directive, a cease and desist order, a consent order, a formal written agreement, or a prompt corrective action directive relating to the safety and soundness or financial viability of the association.

- OTS informs the institution, in writing, of its troubled condition based on information available to OTS. Such information might include current financial statements, reports of examination, or limited scope review of the institution.

General Policy

OTS regulation 12 CFR § 563.39, Employment Contracts, allows a savings association to enter into employment contracts with its officers and other employees with the specific approval of the board of directors. Savings associations may not enter into contracts that constitute an unsafe or unsound practice. The regulation defines as unsafe or unsound any practice that could lead to a material financial loss or damage. OTS regulation 12 CFR § 563.161 provides that compensation to officers, directors, and employees must be reasonable and commensurate with their duties and responsibilities.

Savings associations may not enter into contracts that constitute an unsafe or unsound practice.

Determining Compensation and Directors' Fees

OTS considers all six CAMELS components rated under the Uniform Financial Institutions Rating System in its review of employment contracts and other compensation arrangements.

OTS generally defers to the savings association's board of directors concerning executive compensation arrangements, provided that the following conditions exist:

- The institution is not in troubled condition.

- The compensation arrangements do not present significant safety or soundness concerns that could lead to material financial loss or damage to the association.

- Members of the board complied with their fiduciary duties in approving the compensation arrangement.

OTS requires the board of directors of each savings association to annually review all employment contracts and compensation arrangements for senior executive officers and directors. The board must also document its justification and approval in board minutes. Directors who have a personal interest in the compensation arrangements should not participate in the deliberations or vote on the arrangements. Renewal or extension of employment contracts requires approval by the board of directors.

In determining the compensation of principal officers, the board of directors should consider at least the following factors:

- The qualifications and experience of the officer.
- The compensation paid to other persons that the association or service corporation employs.
- The compensation paid to persons having similar duties and responsibilities in other insured associations or service corporation affiliates.
- The size of the association or service corporation, and the complexity of its operations.
- The financial condition, especially capital position and income level, of the association or service corporation and the individual's contributions to the association or service corporation.
- Any other amounts the officer receives, either directly or indirectly, for other services performed for the association or service corporation such as fees for serving as appraiser, attorney, escrow agent, insurance agent.
- The value of personnel fringe benefits provided to the employee, and perquisites such as an automobile, club membership, and expense account.

Directors should be keenly aware of their fiduciary responsibilities when they establish fees and benefits for themselves. Each director should keep in mind that a primary responsibility is to establish policies that protect the assets of the association. Thus, in setting its own fees, directors should use factors similar to those used in setting officers' compensation.

The board of directors must also determine and document whether the fees of outside appraisers and attorneys are reasonable and commensurate with the services performed. This is particularly important if the outside appraiser or attorney is an affiliated person. The board should determine whether the fees are comparable to those that other appraisers or attorneys performing similar services charge. The board should also consider the comparative advantages of employing a staff appraiser or attorney to perform appraisal or legal services for the association or service corporation.

Unsafe or Unsound Compensation Practices

OTS generally does not require changes to preexisting contracts in healthy associations. Contract provisions, however, that raise significant safety and soundness concerns will be subject to examination comment or formal enforcement action until the association terminates or modifies the contract. OTS may, on safety and soundness grounds, insist that the board replace unacceptable managers and use its best efforts to renegotiate employment contracts that are excessively burdensome on the association.

OTS reviews compensation provisions in savings associations in troubled condition under the following circumstances:

- During examinations.
- In conjunction with applications that contain compensation arrangements.
- When the association submits employment contracts and compensation payments for review.

You should review, comment, or take other appropriate action to correct unsafe or unsound employment contracts.

OTS considers the guidelines below illustrative examples of unsafe or unsound compensation provisions. Other compensation provisions may also be objectionable depending on individual circumstances. OTS bases these guidelines on safety and soundness concerns that are especially important for savings associations in troubled condition. You must use judgment in the application of the guidelines, taking into account the condition of the association, the reason for the provision, and the materiality of the provision.

The illustrative examples of unsafe or unsound compensation provisions include the following:

- Compensation arrangements that provide incentives contrary to the safe and sound operation of the association. For example, compensation based primarily on short-term operating results may encourage unreasonable risk-taking to achieve short-term profits. The board of directors should closely monitor compensation tied to current operating results.
- Compensation arrangements that significantly exceed compensation paid to persons with similar responsibilities and duties in other insured associations of similar size, in similar locations, and under similar circumstances, including financial health and profitability.
- Contracts that contain automatic renewals or extensions without providing for the board of directors explicit review and approval.
- Contracts that provide for an excessive term. Generally, a term exceeding three years is objectionable.
- Total compensation paid out upon the departure of an employee, regardless of the reason, that exceeds three times the employee's average annual compensation. (The association should not make any payment when termination is for cause.) Total compensation must include payments for the remaining contract term, if applicable, as well as any severance payments. Associations should base average annual compensation on the five most recent taxable years.
- Contracts that do not adequately reflect or define the duties and responsibilities of the employee.
- Compensation programs (including deferred compensation, retirement, and insurance) for independent directors that are not commensurate with their duties, or that jeopardize their

independence. For example, vesting requirements that require an independent director to forfeit previously accrued amounts if they do not serve for a minimum number of years.

- Contracts that the savings association collateralizes or otherwise guarantees, unless one of the following conditions are present:
  - — The terms provide that the contract is unenforceable if the association becomes an association in a troubled condition.
  - — The regional director approves the contract.

Note: Contracts that the holding company guarantees are permissible.

- Contracts that provide for employer reimbursement of costs that employees incurred seeking to enforce employment contract terms in the absence of legal judgment or settlement.
- Change in control provisions that provide for immediate vesting, particularly for savings associations in a troubled condition.
- Contracts that require payment upon the voluntary resignation of the employee.

The foregoing does not apply to employment contracts or other compensation arrangements between a holding company and a holding company executive. OTS does not comment on employment contracts between a holding company and a savings association executive unless such contract or arrangement is likely to adversely affect the financial or managerial condition of the association. If applicable, OTS requires separate employment contracts between a savings association executive and the association, and the savings association executive and the holding company.

Savings associations should include the following golden parachute provision in new and renewed employment contracts. "Any payments made to the employee pursuant to this agreement, or otherwise, are subject to and conditioned upon their compliance with 12 USC § 1828(k) and FDIC regulation 12 CFR Part 359, Golden Parachute and Indemnification Payments."

Operating Results

The board of directors is responsible for maintaining an adequate level of capital for the association. See Examination Handbook Section 120, Capital Adequacy. You should be alert to salary increases and dividend payouts in an association experiencing unstable or declining levels of capital or earnings. If an association fails to meet any capital standard, you should question the board of directors and management of the association. They should justify any increases in compensation for principal officers and directors or dividend payouts.

> The board of directors is responsible for maintaining an adequate level of capital for the association.

OTS bases its regulatory and supervisory scheme on performance-based standards that tie directly to capital compliance. Well-capitalized, well-managed institutions that do not pose significant supervisory concerns receive significantly less intrusive oversight, including a longer examination cycle.

Presented below are some of the more common restrictions placed on undercapitalized associations or those institutions in troubled condition.

Capital Plan

OTS requires a capital restoration plan when an association falls below its adequately capitalized level. The association must adhere to an OTS approved capital restoration plan and comply with all prompt corrective action restrictions.

Capital Distribution Restrictions

OTS regulation 12 CFR § 563.134, Capital Distributions, establishes limits on capital distributions.

Prior Approval of Officers and Directors

Section 563.560 requires savings associations in troubled condition to provide 30 days prior notice to OTS if the association wishes to add a director or employ a senior executive officer. OTS has the authority to disapprove the addition or employment of the individual within a 30-day period. OTS may extend the 30-day period for an additional period not to exceed 60 days and must notify the individual in writing of the extension.

Prior Approval of Employment Contracts

A savings association in troubled condition must submit all senior executive officer and director employment contracts to the regional director for prior review. The regional director may extend this requirement to other employees of the association as well. Compensation at associations in troubled condition requires regulatory scrutiny on a case-by-case basis. OTS must balance the association's need to lower operating expenses against the need to provide a higher than normal level of compensation to attract and retain qualified management.

Golden Parachute Provisions

FDIC regulation 12 CFR Part 359, Golden Parachute and Indemnification Payments, implements 12 USC § 1821(k). Part 359 prohibits, with certain exceptions, troubled insured institutions from making golden parachute payments.

The FDIC's Part 359 defines a golden parachute payment generally as any payment that meets the following criteria:

- The institution makes the payment to an institution-affiliated party.

- The payment is contingent on this person's resignation.
- The institution makes the payment while it is in troubled condition.

An institution-affiliated party includes any director, officer, employee, or controlling stockholder (other than a depository institution holding company) of, or agent for, an insured depository institution or depository institution holding company. The rule excepts legitimate business expenses such as the following from the golden parachute payment prohibition:

- Qualified retirement plans.
- Nonqualified "bona fide" deferred compensation plans.
- Nondiscriminatory severance pay plans.
- Other types of common benefit plans.
- Certain payments required by state law.
- Death benefits.

The regulation provides for other limited exceptions in cases involving the hiring of a new manager to improve the institution's condition or when the owners sell a troubled institution without FDIC assistance.

Regulatory Review of Third-Party Contracts

A savings association with a composite CAMELS rating of 4 or 5 must first notify and receive Regional Director approval before it enters into third-party contracts for services outside the normal course of business. OTS has particular concerns regarding third-party contracts at troubled associations because they frequently waste scarce resources. The regional director may establish a de minimis threshold amount to apply on a case-by-case basis. The requirement for regional director preapproval does not apply to contracts in the normal course of business, such as annual audits, debt collection, or routine legal services.

A savings association with a composite CAMELS rating of 4 or 5 must first notify and receive Regional Director approval before it enters into third-party contracts for services outside the normal course of business.

Third-party contracts must not contain provisions that are detrimental to the savings association or contrary to public interest. You should scrutinize them closely since the costs may ultimately increase the cost of an association's failure to the deposit insurance fund. You should use the following guidelines when reviewing such contracts for associations with a composite CAMELS rating of 4 or 5:

- Associations must clearly identify the services the consultant will provide and discuss how they relate to the association's approved business or capital plan.

- The association must provide evidence that fees to be paid and terms of payment are within prevailing market norms and are consistent with the interests of the insurance fund.

- Reimbursable expenses, if provided, should include only necessary costs directly related to the service provided. (OTS does not consider costs such as entertainment and unnecessary travel as reasonable.)

- Each contract must contain a provision stating that the association may cancel for unsatisfactory or nonperformance.

- In most circumstances, associations should enter into only one contract for each service a consultant will perform. OTS generally considers multiple contracts to different providers for the same service to be a dissipation of assets.

- The association must receive written approval from the regional director to enter into a proposed third-party contract.

Other Requirements

Directors should be ever-mindful of the savings association's obligation to serve the community. Directors represent the association and their behavior can enhance or detract from the association's image and ultimately its fiscal well-being. A director's business and personal affiliations should be compatible with those of the association.

You should be alert to self-serving practices that include:

- Gratuities to directors to obtain their approval of financing arrangements.

- The use of particular services.

- The use of association funds by insiders to obtain loans or transact other business.

- Transactions involving a conflict of interest.

Composition of the Board of Directors

The composition of the board must meet the following requirements of 12 CFR § 563.33:

- A majority of the directors must not be salaried officers or employees of the savings association or any subsidiary or (except in the case of a savings association having 80% or more of any class of voting shares owned by a holding company) any holding company affiliate thereof.

- Not more than two of the directors may be members of the same immediate family.

- Not more than one director may be an attorney with a particular law firm.

Accordingly, boards should be made up of both inside and outside directors, each providing a distinct role:

- *Inside directors* are responsible for approving high-level budgets prepared by upper management, implementing and monitoring business strategy, and core corporate initiatives and projects. Inside directors are either shareholders or high-level management from within the company. Inside directors help provide internal perspectives for other board members.

- *Outside directors* have the same responsibilities as the inside directors in determining strategic direction and corporate policy; however, outside directors are different in that they are not directly part of the management team. The purpose of having outside directors is to provide unbiased and impartial perspectives on issues brought to the board.

Conflicts of Interest

Directors must particularly avoid conflicts of interest of any sort, or even the appearance of a conflict of interest. Also, because a director's personal characteristics may reflect on the association's trustworthiness, a director should be a responsible and trusted member of a community. OTS's regulation on conflicts of interest, 12 CFR § 563.200, prohibits persons who owe a fiduciary duty to a savings association from advancing their own personal or business interests at the expense of the association. This regulation also prohibits persons who owe a fiduciary duty to the savings association from advancing the personal or business interests of others with whom they have a personal or business relationship at the expense of the association.

The following examples are types of transactions that the rule prohibits:

- A person who owes a fiduciary duty to an institution receives money or other benefits (such as a loan, forgiveness of debt, goods or services) from a third party. In return, the third party receives a benefit from the association (such as granting a loan to or buying property from the third party).

- A third party makes payments to a spouse, child, parent, sibling, or business partner of a person identified in the rule. Those payments generally provide a benefit to the person identified in the rule because of the personal or business relationship.

- A person who owes a fiduciary duty to an institution facilitates a transaction between the savings association and companies in which that person owns shares, is on the board of directors, or is an officer, at the expense of the institution.

Generally, OTS will not deem a person to be advancing his, her, or its interests at the expense of the institution if the transaction complies with sections 23A and 23B of the Federal Reserve Act and

Federal Reserve Board Regulation O. In addition, the regulation provides that if persons who owe a fiduciary duty to a savings association have an interest in a matter or transaction before the board they must take the following steps:

- Make full disclosure to the board.
- Refrain from participating in the board's discussion of the matter.
- Recuse themselves from voting on the matter if they are board members.

TWA's Sister Bank Exemption

One exemption to 23A, the Sister Bank Exemption, exists for transactions between a bank or thrift and another bank or thrift if a company controls 80 percent or more of the voting securities of both banks or thrifts or if one bank controls 80 percent or more of the voting securities of the other. According to the Federal Reserve, such exemptions reflect the fact that, under the cross-guarantee provisions of the Federal Deposit Insurance Act, an insured depository institution is generally liable for any loss incurred by the FDIC in connection with the default of a commonly controlled depository institution. Notwithstanding the cross-guarantee provisions, the board must ensure that all transactions between the thrift and its affiliates are safe and sound, and in the thrift's best interest.

Corporate Opportunity

OTS's corporate opportunity regulation prohibits directors, officers, and persons that have the power to direct the management or policies of a savings association, or otherwise owe a fiduciary duty to an association, from taking advantage of corporate opportunities that belong to the association. OTS follows common law standards governing usurpation of corporate opportunity. The following are examples of issues the board should consider under this standard:

- The institution's financial condition and management resources.
- The level of risk presented by the business.
- Potential profit from the business weighed against any profits that might arise from transfer of the business.

The rule does not apply when an institution receives fair market value consideration for the transfer of a line of business. In addition, the rule does not generally apply if a disinterested and independent majority of the savings association's directorate, after receiving a full and fair presentation of the matter, rejects the opportunity as a matter of sound business judgment. A disinterested director has no interest in the matter or transaction before the board of directors. An independent director must not be a salaried officer or employee of the savings association, any subsidiary or holding company affiliate. In addition, an independent director must not be dominated or controlled by an interested officer or director.

Political Contributions and Loans to Political Candidates and Committees

The board of directors is responsible for authorizing any political activity by a savings association and must ensure that borrowers properly report political loans.

The Federal Election Commission (FEC) administers, interprets, and enforces the Federal Election Campaign Act of 1971 (the Act) as amended (2 USC § 431). The FEC's implementing regulations that govern political contributions and bank and savings association loans are at 11 CFR Part 100.

The Act and the FEC's regulations apply to the political activities of the following entities:

- Federally chartered corporations in connection with any election, whether federal, state, or local.
- Nonfederally chartered corporations in connection with a federal election.

Thus, a state-chartered subsidiary of a federal savings association is usually not subject to the prohibitions governing its federally chartered parent, absent any circumvention of the Act or implementing regulations.

The FEC's rules and regulations prohibit savings associations from making political contributions and paying political expenditures. For federal associations these prohibitions apply to any election, but for state associations the prohibitions apply to federal elections. Directors should consult legal counsel regarding any questionable activities related to political contributions and loans or payment of expenditures to any political candidates or committees.

Besides the Act's requirements and FEC regulations, savings associations may also be subject to state and local political activity laws.

You should report apparent violations and, when appropriate, forward them to your supervisor. OTS may forward the referral to the FEC for enforcement action. You should consider filing a Suspicious Activity Report when a violation is of a serious, knowing, and willful nature.

Associations may direct their requests for FEC advisory opinions to the following address:

> Federal Election Commission
> Office of the General Counsel
> 999 E Street, N.W.
> Washington, D.C. 20463

Foreign Corrupt Practices Act of 1977

Congress designed the Foreign Corrupt Practices Act (FCPA) (15 USC § 78dd – 1&2) to prevent the use of corporate assets for corrupt purposes. The FCPA makes it a crime for a U.S. company (or individuals acting on behalf of a company) to bribe foreign officials or foreign political candidates or parties to acquire or retain business. There is an exception for generally accepted "grease" payments to facilitate processing. The FCPA applies to issuers of registered securities and domestic concerns, their officers, directors, agents, and stockholders. Under the FCPA, the company may be criminally liable if it indirectly engages in prohibited acts through any other person or entity, including a foreign subsidiary.

The FCPA also requires the establishment of internal controls to ensure that organizations execute transactions according to management's authorization and properly record the transactions so as not to disguise corrupt payments. Anyone acting on behalf of a savings association, in any transaction with a foreign official, should have benefit of legal counsel to ensure compliance with the far-reaching provisions of the FCPA.

Regulation O

Savings association directors bear a major responsibility in dealing with loans to members of the directorate and other insiders. They must make decisions that preclude the possibility of partiality or favored treatment. Losses that develop from unwarranted loans to an association's insiders or to their related interests weaken the association's general credit standards. See Examination Handbook Section 380, Transactions with Affiliates and Insiders.

Reporting of Loans from Correspondent Banks

Under 12 CFR Part 215 Subpart B requirements, executive officers and principal shareholders and their related interests must submit an annual report to their board of directors regarding their indebtedness to correspondent banks. OTS incorporates this provision in 12 CFR § 563.43.

Securities Laws

Directors of stock associations must take care not to violate federal securities laws in their own securities trading activity. These laws prohibit anyone, insider or not, from purchasing or selling securities with the use of material corporate information that is not available to the general public. Examples of such material inside information include:

- Significant corporate actions.
- Reduced or increased earnings.
- Changes in loan loss reserves.
- Mergers, acquisitions, or proposed tender offers.
- Actual or potential enforcement or supervisory actions.
- A change in supervisory status (such as a prompt corrective action category or a CAMELS rating).

Federal securities laws also prohibit insiders from passing inside information to other persons, even if the insider does not actually trade securities based on such information.

Related to insider trading prohibitions are short swing profit recovery provisions of § 16 of the Securities Exchange Act of 1934 (15 USC § 78c). A "short swing" transaction generally includes purchases and sales, or sales and purchases, of equity securities within a period of six months. Section 16(b) provides that an issuer, or shareholder acting on behalf of an issuer, may recover from an insider any profits realized on certain short swing transactions.

Corporate insiders have a fiduciary responsibility of trust and confidence to refrain from trading based on material nonpublic information concerning their corporation. The misuse of material nonpublic corporate information is a fundamental breach of fiduciary duty and an unsafe and unsound practice.

Other Areas of Review

Management Official Interlocks

OTS regulations also address management official interlocks and depository interlocks. See OTS regulation 12 CFR Part 563f. A management official of a depository institution or depository holding company may not generally serve as a management official of another depository institution or depository holding company if the two organizations are not affiliated and are very large or located in the same local area.

Indemnification Payments

A federal savings association may indemnify its directors, officers, and employees according to OTS regulation 12 CFR § 545.121. Such indemnification however, is subject to and qualified by 12 USC § 1821(k). This regulation limits the ability of insured institutions to pay the liabilities or legal expenses of a director or employee who is subject to an enforcement proceeding.

Part 359 in the Code of Federal Regulations limits indemnification payments. The rule generally prohibits indemnification payments made to or for an institution-affiliated party in connection with a civil money penalty or judgment resulting from a federal administrative or civil enforcement action instituted by any federal banking agency. The rule also prohibits payment of liability or legal expenses with regard to administrative proceedings or civil actions instituted by any federal banking agency that results in a final order or settlement pursuant to which an institution-affiliated party is:

- Assessed a civil money penalty.
- Removed from office.
- Prohibited from service.
- Subject to various other penalties.

The rule permits institutions to buy commercial insurance to cover expenses other than judgments and penalties. The rule also permits the institution to pay up front for an employee's legal or other professional expenses if the institution's board makes certain findings, and the employee agrees to reimburse the institution if the alleged violation is upheld.

Insurance

Fidelity Bond Coverage

Savings associations must maintain adequate fidelity bond and directors' and officers' insurance coverage. Directors should periodically review the adequacy of this coverage and carefully review the riders thereto that might impair its utility. The terms of these policies are negotiable. See Section 330, Management Assessment.

> Savings associations must maintain adequate fidelity bond and directors' and officers' insurance coverage.

Life Insurance

It is common practice for savings associations to buy life insurance policies for the benefit of employees. Institutions may also obtain key-person protection for the association. If the beneficiary of the policy is the savings association, refer to Examination Handbook Section 250, Other Assets/Liabilities, for applicable policy and review procedures. If the beneficiary of the policy is the employee, OTS considers the cost of the coverage to be compensation. The board should annually review and approve the policy for reasonableness.

REFERENCES

United States Code (2 USC)

The Federal Election Campaign Act of 1971

United States Code (12 USC)

§ 375b	Extensions of Credit to Executive Officers, Directors, and Principal Shareholders of Member Banks (22(h))
§ 1817(a)(3)	Reports of Condition

United States Code (15 USC)

§ 78m	Periodical and Other Reports
§ 78dd-1&2	Prohibited Foreign Trade Practices/Foreign Corrupt Practices Act of 1977

§ 1828(k)	Authority to Regulate or Prohibit Certain Forms or Benefit to Institution-Affiliate

Code of Federal Regulations (12 CFR)

Chapter II: Federal Reserve Board Rules and Regulations

Part 215	Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks (Regulation O)

Chapter III: Federal Deposit Insurance Corporation Rules and Regulations

Part 359	Golden Parachute and Indemnification Payments

Chapter V: Office of Thrift Supervision Rules and Regulations

§ 544.5	Federal Mutual Savings Association Bylaws
§ 545.121	Indemnification of Directors, Officers and Employees
§ 552.6-1	Board of Directors
§ 560.130	Prohibition on Loan Procurement Fees
§ 561.18	Director
§ 563.33	Directors, Officers and Employees
§ 563.39	Employment Contracts
§ 563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§ 563.42	Additional Standards Applicable to Transactions with Affiliates and Subsidiaries
§ 563.43	Loans by Savings Associations to their Executive Officers, Directors and Principal Shareholders
§ 563.161	Management and Financial Policies
§ 563.200	Conflicts of Interest
§ 563.201	Corporate Opportunity in Savings Associations
§ 563.555	Notice of Change in Control of Director or Senior Executive Officer
Part 563f	Management Official Interlocks

Part 570	Safety and Soundness Guidelines And Compliance Procedures Appendix A, Interagency Guidelines Establishing Standards for Safety and Soundness Appendix B, Interagency Guidelines Establishing Standards for Safeguarding Customer Information

Office of Thrift Supervision Guidance

Regulatory and Thrift Bulletins

RB 3b	Policy Statement on Growth for Savings Associations
TB 13a	Management of Interest Rate Risk, Investment Securities, and Derivatives Activities
TB 23a	Sales of Securities
TB 82a	Third Party Arrangements

CEO Memos

CEO No. 133	Risk Management of Technology Outsourcing
CEO No. 171	OTS' Revised Compliance Self-Assessment Guide (SMAART Compliance Management Strategy)
CEO No. 174	Joint Interagency Statement On Application of Recent Corporate Governance Initiative to Non-Public Banking Organizations
CEO No. 176	Business Continuity Planning Booklet
CEO No. 180	SEC's Final Rule Discussing Reports on Internal Control That May Satisfy Both SEC Requirements and FDIC Part 363 Requirements

Other References

Office of Thrift Supervision, *Directors' Responsibilities Guide* (October 1999)

Office of Thrift Supervision, *Director's Guide to Management Reports* (October 1999)