

## **Introduction – Management**

The purpose of this tutorial is to help directors better understand their roles and responsibilities in overseeing the institution's affairs. In general, directors are responsible for formulating sound policies, setting strategic direction, and effectively supervising its management team; whereas the management team is responsible for implementing those policies in managing day-to-day operations. As you proceed with the First State Bank exercise, keep in mind that the bank's deficiencies and the management rating are a direct result of insufficient board oversight. We will begin with the Instructional Content component of the management module.

## Instructional Content - Management

### The Role of a Bank Director

Being selected as a bank director is an honor reflecting your reputation for success in business, your community involvement, and your high integrity. The board is a critical factor in the success of an institution and a significant factor in assigning the management component rating. Bank directors are not only responsible to the stockholders who elected them, they must also be concerned with the safety of depositors' funds and the pervasive influence the bank exercises on the community it serves. While selection of a competent executive management team is critical to the successful operation of any bank, the continuing health and success of the bank are dependent upon an interested, informed and vigilant board of directors. The one fundamental and essential attribute that all bank directors must possess, without exception, is personal integrity. Other desirable personal characteristics include:

- A genuine interest in performing your duties and responsibilities to the best of your ability
- An ability to recognize and avoid potential conflicts of interest
- The capacity for sound business judgment
- A familiarity with the bank's trade area and economic conditions
- Independence

This module will discuss the key responsibilities of directors, explain how management is evaluated and rated during an examination, and help you to develop ideas on how to enhance your performance as a director. The numerous deficiencies noted in the examination exercise will reinforce these concepts.

### Key Responsibilities of Directors

It is important to differentiate between the board's and the management team's responsibilities. As board members, your primary responsibilities are to:

- **Establish clear direction, policies, and risk limitations for the bank** - Directors should not be involved in the day-to-day operations of the bank, but need to establish policies that give clear guidance with regard to acceptable activities, procedures, and risk limitations.
- **Hire qualified senior officers** - Senior officers should have a proven ability to operate departments or institutions of similar complexity and share the same attributes as directors (personal integrity, knowledge of trade area, capacity for sound business judgment, etc.).

- **Ensure that management operates the bank within your established policies and risk limitations:** Since directors are not typically involved in day-to-day activities, this is accomplished by:
  - Implementing an effective internal audit and review program
  - Establishing an effective management reporting system (board packages, committee minutes, UBPR analysis, etc.)
  - Reviewing regulatory examination reports
  - Staying involved by visiting the bank, attending meetings (especially with regulators and auditors), and by **asking questions**

### **How do Examiners Evaluate and Rate Management?**

Examiners evaluate and rate management on a variety of factors and criteria, many of which are listed below. We will consider how well the board and senior management:

- **Plan for and oversee operations** – This includes funding strategies, portfolio management, compliance, information technology, new business activities, etc. The best managed banks have an active and fully informed board that is encouraged to ask questions during board meetings and requires management to fully assess operations when doing their strategic planning. Also, make sure the board packages provide you with enough information for you to make independent and objective decisions.
- **Identify, measure, monitor, and control risks** - Examiners will consider management practices when rating all of the CAMELS components; however, the management component rating encompasses our assessment of risk management practices throughout all operational areas.
- **Establish and implement adequate policies, procedures, and controls** - Policies can be effective tools for the board, senior officers, and employees, but only if they truly reflect the needs of your bank. These policies communicate your risk tolerances to management and set the operational tone for your bank. The board is ultimately responsible for the institution, so make sure that you are sharing your perspective with the staff through well-written policies, procedures and controls.
- **Provide for an effective audit program** - An effective audit program is one that is comprehensive, independent, objective, and overseen by an audit committee comprised of outside directors. These audits are your opportunity to validate management's procedures and to ensure that the information that management provides you is accurate. Make sure that the audit committee is the primary contact with auditors and that management does not have an overwhelming influence on those auditors.

- **Avoid dominant influence or concentration of authority** - Allowing an officer or director to have a dominant influence can overwhelm even the best control systems. This is a leading cause of poor performance and one that has contributed to several bank failures. This issue is a critical component to the examination exercise in this program.
- **Provide for management depth and succession** – The loss of key officers will disrupt any bank’s operations, so prepare for this loss by identifying and grooming key individuals.
- **Avoid self-dealing** - All of the regulatory agencies have regulations that govern transactions between financial institutions and their insiders and affiliates. The Federal Reserve Board’s Regulation O and Parts 23A and 23B establish limitations and reporting requirements for insider and affiliate transactions. Essentially, these laws require that you put the interests of the bank first, that you fully disclose all of your interests in any transaction with the bank, and that you make sure that all transactions are comparable to third-party terms.

Again, directors should not be performing day-to-day management tasks. Their work should be in setting strategic direction and ensuring that policy defined objectives are met. Directors who keep abreast of basic facts and statistics such as asset growth, capital growth, loan-to-deposit ratios, deposit mix, liquidity, portfolio composition, loan losses, delinquencies, etc., have taken a critical step in performing their responsibilities. Directors need to ensure that board meetings are conducted in a businesslike manner and effective directors will plan for regular attendance. A director's attendance should be an informed, intelligent, and diligent one, and the board minutes should show involvement. The example noted in First State Bank is clearly an extreme example, albeit one that most experienced examiners have come across many times. Note how many of these basic principals are not being adhered to as you read the management comment in the Report of Examination.

## **Examination Conclusions and Comments**

### **MANAGEMENT SUPERVISION**

The institution's risk profile has risen to a level of concern due to ineffective board supervision. Policies are not being enforced by the board or followed by management, and the Loan Policy is not adequate for the bank's needs. Additionally, this examination cites several apparent violations of laws and regulations.

#### **Board Oversight**

The board of directors has not demonstrated active participation in the oversight of the institution. Board and committee meeting minutes reflect minimal discussion and show that two directors have had unsatisfactory attendance (less than 70% of meetings attended). Furthermore, board packages do not contain sufficient information to allow directors to make independent decisions and assessments. President Apple appears to be exerting a dominant influence over board members as he chairs every committee and prepares all of the information for the meetings. Information that he provides to the board does not reflect the numerous policy exceptions noted during this examination.

#### **Internal Audit**

The bank's internal audit program is inadequate. The internal audit schedule has not been completed in over two years, and the Audit Committee meets infrequently. Additionally, the internal audit function is not independent. Audit reports, when produced, are presented to President Apple rather than directly to the Audit Committee, and President Apple chairs the committee. Furthermore, there are no formal procedures in place for responding to audit criticisms/recommendations, and there is no documentation of corrective actions taken by management.

#### **Policies and Procedures**

Although the bank's policies are generally adequate, they are not being enforced by the board. Management is operating outside of policy guidelines and board awareness and approval of policy exceptions is not evident. Furthermore, the board does not review and approve bank policies annually, bringing into question the board's knowledge of these policies. Additionally, the Loan Policy is not adequate and should be revised to strengthen loan underwriting guidelines, establish prudent limits for loan concentrations, and develop an effective methodology for monitoring concentrations.

#### **Strategic Plan**

The board has not established a realistic strategic plan. The current strategic plan is general in nature and has not been updated for nearly three years. Led by President Apple, the bank's actual growth has far outpaced the strategic plan's growth targets. He has also changed the bank's strategic focus to that of a real estate lender. This was done

without board approval and without consideration to the lending expertise required to properly underwrite and administer such loans.

### **Apparent Violations**

Several apparent violations of law were noted during the examination and are summarized below:

- Part 323 of the FDIC Rules and Regulations - missing or inadequate appraisals and appraisal reviews
- The Federal Reserve Board's Regulation O - exceeding limits on loans to executive officers
- The Bank Secrecy Act - inadequate written compliance program, and
- Part 365 of the FDIC Rules and Regulations - inadequate real estate lending guidelines and monitoring procedures

Details are provided in the Violations of Laws and Regulations pages of this report.

## Discussion Points - Management

The major concerns noted in the management comment include the following:

- Inadequate board oversight
- President Apple exerts a dominant influence over board members
- The internal audit program is inadequate
- The internal audit program lacks independence with audit reports going to President Apple rather than the board
- The bank is outside of policy guidelines with no plans for correction
- The board is not being made aware of policy exceptions
- The loan policy is inadequate
- The board has not established a realistic strategic plan - the existing plan is general and has not been updated in three years
- President Apple changed strategic focus without board approval and without considering what lending expertise would be required to underwrite and administer these new loans
- Several apparent violations of law were noted

### **What are some recommendations you would make to the directors of First State Bank?**

[Click here for answer #1 \(Become more active as directors\)](#)

[Click here for answer #2 \(Address the dominance of President Apple and replace him as chairman of the committees\)](#)

[Click here for answer #3 \(Require more informative board reports\)](#)

[Click here for answer #4 \(Review and amend policies, and require exceptions to be reported to the board\)](#)

[Click here for answer #5 \(Establish a special committee to address the examination concerns\)](#)

[Click here for answer #6 \(Develop an audit correction tracking system and/or committee\)](#)

[Click here for answer #7 \(Strengthen the audit program - examination findings should have already been identified by internal or external audit\)](#)

[Click here for answer #8 \(Reconsider the bank's growth strategy\)](#)

[Click here for answer #9 \(Improve the lending function and evaluate the quality/ability of the lending staff\)](#)

[Click here for answer #10 \(Adopt a more thorough loan review program to identify policy exceptions and deteriorating loans\)](#)

[Click here for answer #11 \(Consider hiring additional staff to address the loan problems\)](#)

Now that you know what the problems are, we're ready to rate management. Continue on to the management component rating definition from the Uniform Financial Institution Rating System.

## **Rating Management**

The following is an excerpt from the Uniform Financial Institutions Ratings System. Take a couple minutes to read the ratings guide and rate the management component for First State Bank.

### **Uniform Financial Institution Ratings System**

This rating reflects the board's and management's ability to identify, measure, monitor, and control the risks associated with an institution's activities and to ensure safe, sound, and efficient operations in compliance with applicable laws and regulations. While directors may not need to be actively involved in day-to-day operations, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards. This rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved. The capability and performance of management and the board of directors is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of oversight of all institution activities by the board of directors and management
- The ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products
- The adequacy of, and conformance with, appropriate internal policies and controls
- The accuracy, timeliness, and effectiveness of management information systems
- The adequacy of audits and internal controls
- Compliance with laws and regulations
- Responsiveness to recommendations from auditors and supervisory authorities
- Management depth and succession
- The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority
- Reasonableness of compensation policies and avoidance of self-dealing
- Demonstrated willingness to serve the legitimate banking needs of the community
- The overall performance of the institution and its risk profile

#### Ratings

- 1 A rating of "1" indicates strong performance by management and the board of directors and strong risk management practices relative to the institution's size,



complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

- 2 A rating of “2” indicates satisfactory management and board performance and risk management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.
- 3 A rating of “3” indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.
- 4 A rating of “4” indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.
- 5 A rating of “5” indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

### **What is the most appropriate rating for management?**

Consider the ratings definitions above and compare them to the circumstances described in the Report of Examination for First State Bank. What do you think management should be rated?

1. Strong (link to management answer)
2. Satisfactory (link to management answer)
3. Less than satisfactory (link to management answer)
4. Unsatisfactory (link to management answer)
5. Critically deficient (link to management answer)

[Answer] Examiners rated management a “3”. The capabilities of the board and senior management may be insufficient for the activities of the bank, particularly within the lending function. The board has not provided effective oversight and the president is exerting a dominant influence, which has elevated the bank’s risk profile. Risk identification and management practices are less than satisfactory, policies and procedures are inadequate, and deteriorating conditions are not adequately identified or reported to the board. If you rated the management team a “4”, we certainly understand your perspective given the board’s dramatic failure to oversee the institution and management’s lack of prudence. However, the “3” rating is likely based on expectations that the board and management can and will address the identified problems. Keep in mind that the rating for management is based on their performance in every major operational area of the bank. This would include findings associated with the specialty examinations - Information Technology, Compliance, and Trust.

Now let’s move on to the composite rating module.