Comptroller of the Currency
Administrator of National Banks

Executive Summary

Web and Telephone Seminar
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Corporate Governance and the Community Bank: A Regulatory Perspective

Speakers:

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Karen Kwilosz
Kirk Spurgin
Maryann Kennedy

Following is an executive summary of this OCC Web/Telephone seminar covering:

- The basics of effective corporate governance.
- How strong governance starts with the culture and "tone at the top."
- The delineation of roles and responsibilities between directors and management.
- The importance of an effective and updated risk management program.

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Corporate Governance and the Community Bank: A Regulatory Perspective

Speakers: **Julie L. Williams,** Acting Comptroller of the Currency, Office of the Comptroller of the Currency
Karen Kwilosz, Director, Operational Risk Policy, Chief National Bank Examiner's Office
Kirk Spurgin, National Bank Examiner and Operational Risk Policy Analyst, Chief National Bank Examiner's Office
Maryann Kennedy, Assistant Deputy Comptroller, Northeastern District

Overview

The corporate scandals of recent years and the subsequent legislation have brought new scrutiny to corporate governance and have raised the bar for all corporate boards. While Sarbanes-Oxley does not apply to most community banks, and while most are already practicing many components of effective governance, there are actions that community bank boards can take to strengthen their governance. These suggested actions are: 1) Assessing the "tone at the top" and fostering a culture of personal integrity, accountability, and open communication; 2) Forming an effective relationship between the board and management, where roles and responsibilities are clearly delineated; and 3) Continuously evaluating and improving the bank's risk management and audit programs through steps such as re-evaluation of the bank's strategic objectives and risk tolerances.

Context

Following an introduction by the Acting Comptroller, this panel of experts discussed the key components of strong governance for community banks, shared best practices, and responded to questions from participants.

Key Learnings

- **Effective corporate governance for community banks requires that boards employ a "back to basics" approach.**

  The recent governance scandals have increased the attention on corporate governance and have resulted in new regulations, most notably Sarbanes-Oxley (SOX). Some of the scandals were simply a result of fraud, but others resulted from lapses in oversight and failures in governance. While SOX, which applies only to public companies, does not apply to most community banks, a result of this new regulation has been to raise the bar for all boards.

  The term "corporate governance" may be relatively new to most community banks, but the concepts and components of good governance are not new at all. The OCC has always looked at and emphasized basics such as oversight, policies, processes, and strong internal controls when examining community banks.

  It is important to recognize that the focus of good governance is not compliance through a "one-size-fits-all" or a "check the boxes" approach, but through a principle-based approach which emphasizes culture and values. Board directors at each community bank are encouraged to determine which governance approach makes sense at their bank based on their size, profile, complexity, market, and resources. This will vary for each bank.

- **Strengthening corporate governance starts with assessing the culture and the "tone at the top."**

  Effective governance is ultimately about people, values, and culture. Healthy cultures are those where an ethical environment exists based on the combination of policy and behavior.

  > *"Processes and policies are important [to achieve good governance], but the right culture is crucial."*
  > - Kirk Spurgin

  Among the elements of a strong culture and an effective tone at the top are: a strictly enforced code of ethics that applies to everyone; open and candid communications throughout the organization; clear lines of authority and responsibility; transparency; and strong internal controls. Specific actions boards can take to improve the tone at the top include:

  – *Evaluate the board's qualifications, skills, and competencies:* This involves looking at individual board members and at the board as a whole to assure that directors bring skills and competencies that contribute to the board's composite judgment. Paramount is that each board member has personal integrity demonstrated by strength of character and objectivity of judgment. In addition, board members must be willing to devote significant time to the bank's affairs, must have a basic understanding of the bank's business and of the financial services industry, and should possess knowledge of the community. Diverse business backgrounds can be beneficial to the composition of a community bank's board.

  – *Examine the board's relationship with management*: The board and directors must have adequate independence from management, with no significant relationships that could affect a director's judgment. Directors must be objective in representing the interests of all stakeholders—creditors, depositors, minority shareholders, and even the Bank Insurance Fund.

  > *"There are no specific requirements for the independence of directors of community banks, but you want arm's length oversight."*
  > - Kirk Spurgin

  - *Assess how the board conducts its business*: Boards should take a fresh look at their operations and processes. This includes how the agenda is set (with the input of directors and not just by management), how meetings are run, how far in advance materials are distributed, and how performance of both the board and management is evaluated. To set the right tone around effective governance, boards are encouraged to consider developing guidelines in such areas as director qualifications, director responsibilities and compensation, director continuing education, and management succession.

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The tone at the top is illustrated by four types of boards:

1. *Negative impact*: This type of board is comprised of risk-averse directors who are unprepared for meetings, micromanage, are adversarial, have poor decision processes, and panic in crisis situations. This board can have a harmful effect.
2. *Neutral/no impact*: This board, which is quite common, avoids conflict, rubber stamps management recommendations, and fails to hold management accountable. This board has abdicated responsibility and robbed itself of decision powers.
3. *Basic monitor/checklist*: This type of board is trying to do the right thing, but is driven by process and compliance, and not by principles. This board has a "check the box" mentality; they are good at reviewing and approving decisions, but do not engage in rigorous decision making. This board needs to take a step back and focus on the bank's overall strategic direction and on the board's priorities and decision- making processes.
4. *Performance enhancer*: This board knows and understands the bank's business, and they focus on strategic issues, rigorous analysis, and risk management. They support governance best practices, they select outstanding management, and they hold management accountable. Through the focus and actions of this board, the performance of the bank is enhanced.

- **Boards can strengthen governance by clearly defining and delineating the roles of the board and management.**

Effective governance is based on a partnership, with clearly defined roles, between the board and management. The board's role is to direct and lead, while management's job is to manage. These roles are separated by a line in the sand which can shift based on the circumstances. Frequent, open, and honest communication helps the partnership work.

The board has three key roles—strategy, people, and oversight:

1. *Define the strategic direction*: This entails developing and approving the bank's strategic plan, which involves an assessment of strengths, weaknesses, opportunities, and threats, an articulation of the bank's vision, and decisions about products, services, geography, etc. Providing clear direction also entails establishing specific and measurable performance goals, setting specific risk tolerances (such as acceptable concentrations by product or geography), and clearly communicating the board's expectations.
2. *Select good management*: The board's role is to select the right people to manage the business, to establish performance standards and compensation practices, and to hold management accountable. The board must also terminate people who are unable to meet its expectations.

   Regarding executive compensation, while this has not been a problem for community banks, the most important principles are: a) Pay should be linked to performance and based on the creation of long-term shareholder value; and b) Incentive plans that focus on short-term financial performance, and have the potential for manipulation, should be avoided. Also, terms relating to change of control, such as "golden parachutes," should be closely scrutinized.
3. *Provide active oversight*: This role involves monitoring the bank's progress in executing upon its established strategy. Providing proper oversight requires that board members regularly receive appropriate and meaningful information such as the bank's financial results, key operating metrics, and audit results. This requires a process to clearly define the exact information required to perform the oversight function. The information provided to the board should be summary in nature, combining key pieces of data, trends, and analysis from management.

> *"The board can't provide oversight for what is not monitored and reported."*
> - Maryann Kennedy

In contrast, management's primary role is to implement the board's strategies, risk tolerances, and policies by managing the bank's day-to-day operations. This involves establishing management information systems and policies for areas such as exception tracking. An example of how these roles work: When a bank examiner identifies a matter requiring attention (MRE), it is management's responsibility to provide corrective action, and is the board's responsibility to oversee this corrective action to make sure it takes place on the timing required. (The board's role is explained by NIFO, standing for "Nose In, Fingers Out.")

- **Boards can also improve governance through active oversight of the risk management and audit functions.**

Regular assessments and evaluations are the key to an effective risk management program. This is best done before problems emerge. Steps that boards can take to gauge the effectiveness of their risk management programs include:

1. *Self-education* about the industry, competition, and the bank's exposure and risk areas, and an analysis of the bank's control systems to see if proper controls are in place for each risk area.
2. *Re-evaluation of the bank's strategic objectives and risk tolerances*. The strategy and risk tolerances may change over time as circumstances change. The board must ask if the strategy is still appropriate and if the risk limits are right.
3. *Ask candid questions of management,* such as reasons for policy exceptions.
4. *Clean up board reports*. Assess the information provided to the board to assure it is meaningful in assessing risk.
5. *Use board committees for key risk areas*. For major areas of risk, chartering a board committee is appropriate. Serving on these committees takes additional time and requires knowledge of the specific subject area.

Also critical is oversight of the internal controls and the audit program. Evaluation of the audit function can be performed by a self-assessment of the audit committee, by being educated to understand the information shared by the auditor, by evaluating the internal control program—which is the backbone of audit, and by speaking directly with the auditors and the internal audit staff. Direct contact is important as the board, not management, is charged with hiring and overseeing the auditor. A suggestion is for boards to engage in an audit continuing education program to stay knowledgeable about relevant audit issues.

> *"Audit is the cornerstone of the risk management program."*
> - Karen Kwilosz

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Speaker Biographies

Julie L. Williams
Acting Comptroller of the Currency, Office of the Comptroller of the Currency

Julie L. Williams became Acting Comptroller on October 14, 2004, succeeding John D. Hawke, Jr. at the end of his term of office. Ms. Williams was initially appointed Chief Counsel of the Office of the Comptroller of the Currency in June 1994, with responsibility for all of the agency's legal activities, including legal advisory services to banks and examiners, enforcement and compliance activities, litigation, legislative initiatives, and regulation of securities and corporate practices of national banks. As the agency's statutory "First Deputy," she previously served as Acting Comptroller from April 6, 1998 through December 8, 1998, before Mr. Hawke was sworn in as the 28th Comptroller of the Currency. As Chief Counsel, Ms. Williams also supervised the Licensing Department and the Community Affairs Department, and served as a member of the OCC's Executive Committee. In her current position, Ms. Williams leads the Executive Committee in providing policy and strategic direction to the agency.

Ms. Williams joined the OCC in May 1993 as Deputy Chief Counsel with responsibility for special legislative and regulatory projects. Before joining the OCC, Ms. Williams served in a variety of positions at the Office of Thrift Supervision and its predecessor agency, the Federal Home Loan Bank Board, culminating in a position as Senior Deputy Chief Counsel at the OTS from 1991 to 1993. Ms. Williams joined the Bank Board in 1983, after working as an attorney with the law firm of Fried, Frank, Harris, Shriver & Kampelman in Washington, D.C. from 1975 to 1983.

Ms. Williams is the author of *National Banks and the Dual Banking System* (Comptroller of the Currency, 2003) and *Savings Institutions: Mergers, Acquisitions and Conversions* (Law Journal Seminars-Press, 1988), and has published numerous articles on the regulation of depository institutions, financial services, securities and corporate law matters.

She was awarded a B.A. in 1971 from Goddard College, Plainfield, Vermont, and a J.D. in 1975 from Antioch School of Law, Washington, D.C., where she was first in her class.

Karen Kwilosz
Director, Operational Risk Policy, Chief National Bank Examiner's Office

Karen Kwilosz was named in 2002 as director for Operational Risk Policy in the Chief National Bank Examiner's Office. Karen oversees the development of regulatory policy for national banks in the areas of corporate governance, audit and controls, payments systems, and supervision by risk. Karen spent the first half of her OCC career examining banks in the Denver, Colorado area. She transferred to OCC's Washington, D.C. Headquarters office in 1995 and spent seven years managing the training operations division. Karen is a native of Chicago, Illinois and was graduated from Millikin University in 1982.

Kirk Spurgin
National Bank Examiner and Operational Risk Policy Analyst, Chief National Bank Examiner's Office

Kirk is an operational risk policy analyst in the Chief National Bank Examiner's office. The Operational Risk Policy division is responsible for developing regulatory policy for national banks in areas such as corporate governance, audit and controls, and supervision by risk. Kirk's primary responsibilities pertain to policy development in the arena of board and management supervision. Kirk is currently working on a new *Comptroller's Handbook* booklet on that topic. A native of Texas, Kirk spent approximately 10 years as a community bank examiner in various locations in Texas in the 1980s and early 1990s. He then transferred to San Francisco, where he managed the problem bank and examination support divisions. Kirk spent two years in the large banks program in San Francisco before relocating to Washington, D.C., and joining the Operational Risk Policy division in 2001.

Maryann Kennedy
Assistant Deputy Comptroller, Wilkes-Barre Field Office, Maryland National Capital Area, Satellite

Maryann Kennedy became in May 2000 the assistant deputy comptroller for the Wilkes-Barre field office of the Office of the Comptroller of the Currency (OCC) and in April 2005 assumed responsibility for the Maryland National Capital Area as a satellite office. Prior to joining the OCC, Maryann worked for eight years in the banking industry in positions within loan review, commercial lending, and consumer lending. Before moving to Wilkes-Barre, she worked for the OCC in both community bank and large bank supervision in the Philadelphia area. Maryann also has experience in the OCC's "midsize" banks as well as the monoline credit card companies. In this capacity she served for five years on the OCC's Northeastern District Credit Committee. She was graduated from Ohio State University.

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