

THE DIRECTOR'S PRIMER

**A GUIDE TO MANAGEMENT OVERSIGHT
AND BANK REGULATION**

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**THE FEDERAL RESERVE BANK OF ATLANTA
DEPARTMENT OF SUPERVISION
AND REGULATION**

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PREFACE

Being a bank director can be a very rewarding experience. However, directors have a tremendous responsibility to shareholders and for ensuring that their banks are operated in a safe and sound manner. This booklet has been written to acquaint you with some key aspects of your responsibilities about the proper oversight of a bank. This booklet is not intended to be an all encompassing textbook or final authority on how to oversee a bank's affairs. Rather, we hope that it will prove helpful to new and veteran directors alike who might be looking for a quick reference on director responsibilities and pertinent laws and regulations.

Banking has become increasingly complex. Competitive forces both inside and outside of the industry place tremendous pressure on bank management. The major problems in the thrift and banking industries in the late 1980s and early 1990s are evidence of these pressures. Despite these factors, banks can be operated in a successful and profitable manner if a sound strategic plan is followed and sound risk management practices are in place.

Broken down into its simplest equation, **MANAGEMENT = SUCCESS**. Banks succeed or fail because of management, and directors are the first line of management. As a director, you are responsible not only for assembling and maintaining a competent senior management team but also for establishing the risk appetite of the organization and for ensuring that proper safeguards are in place and are being followed. You are assumed to possess an above average business acumen, be highly regarded in your community, and understand your responsibilities as a director. You have more than just a financial investment riding on your bank's performance. Your reputation is on the line, and you can be held financially responsible by the regulatory authorities for the

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activities and overall condition of your bank. Therefore, it is important for you to be armed with as much knowledge as possible. Ignorance may not be a criminal act, but the regulators tend not to view it as a suitable reason for poor bank performance either.

One final note before you begin your reading. This booklet was written by Federal Reserve Bank of Atlanta personnel and is primarily intended for use by directors and management of state chartered banks that are members of the Federal Reserve System. The citations reference mainly Federal Reserve regulations. The underlying principles, however, generally apply to all banks. If the Federal Reserve is not your bank's primary federal regulator, you should consult with your regulator about interpretation of parallel laws and regulations.

Finally, many other publications or information sources such as Federal Reserve SR letters are available that explain more about director responsibility and liability, and about the regulatory process. Additionally, training courses geared specifically to directors are offered by various banking organizations. You are encouraged to use these sources. You can also learn more about the Federal Reserve's supervisory process by reading items such as the Bank Holding Company Supervision Manual, the Commercial Bank Examination Manual, and the Bank Secrecy Act Examination Manual through the Federal Reserve's web site at www.federalreserve.gov. Your institution may also want to consider purchasing the Federal Reserve Regulatory Service (FRRS), which includes convenient references to the statutes administered by the Board of Governors of the Federal Reserve System as well as the regulations, interpretations, rulings, and opinions issued by the Board of Governors and its staff.

CHAPTER I BANKS COMPARED TO OTHER CORPORATIONS

BANKS AS CORPORATIONS

Banks are corporations. They have shareholders, pay dividends, and are overseen by a board of directors. However, the single greatest factor differentiating banks from their corporate brethren is *deposit insurance*. Both banks and corporations get their initial capital from their shareholders, but a bank's main source of funding (cash) is the deposits gathered from the public, and these deposits carry the full protection of the Federal Deposit Insurance Corporation (FDIC) up to prescribed limits.

Although most of the last decade of the 20th century proved to be a period of relative stability and prosperity for the banking industry, the industry has at times been beset by economic hardships, insider abuse, and poor credit judgement. In the late 1980s and early 1990s, these problems contributed to the insolvency of many banks, which resulted in their closure by regulatory authorities.

Despite increased and intense competition from nonbank companies, banks remain the primary safekeepers of cash funds for individuals, corporations, and governments. Many depositors view banks as safe havens for the money that they cannot afford to lose and as a place where they can realize a reasonable return. Conversely, investors in stocks and bonds have returns that are not fixed, and investors can see their initial investment quickly erode during adverse market conditions.

Positive public perception of the banking system is extremely important to the viability of the system. Real or perceived deterioration in a bank's financial condition can create so-called depositor runs where

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depositors rush to withdraw their funds to avoid the possibility of personal losses. The public has entrusted its assets to banks. Bank directors and officers must be mindful that most of the money loaned to customers belongs not to the bank's owners, but to others, most notably the depositors. As a consequence, although deposit insurance is in place, depositors assume the role of bank creditors and can become linked with the fortunes of their bank. Therefore, bank directors and operating management must act responsibly to maintain public trust, which ultimately protects the bank insurance fund and the taxpayer.

The key to understanding how banks operate is knowing that banking is a high leverage, low margin, high volume business. Because loans are a bank's principal assets and deposits are the primary liabilities, banks can be exposed to a high degree of credit risk and can be highly vulnerable to interest rate fluctuations.

One of the primary responsibilities of a bank director is to ensure that the bank maintains adequate capital to protect against losses. Capital, consisting mainly of stockholders' equity plus the allowance for loan and lease losses, is one of the best indicators of a bank's financial strength. Generally, banks with high ratios of capital to assets are better prepared to withstand financial setbacks and comfortably support asset growth. However, as shown in the following example, which compares a typical bank to another company such as a manufacturing concern, capital of a bank is relatively small compared to total assets.

December 31, 200x		
	Bank	Mfg. Company
Total Assets	\$100,000,000	\$100,000,000
Total Capital	8,000,000	30,000,000
Capital/Assets	8.00%	30.00%

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A bank's highly leveraged condition brings significant risks, but also significant opportunities. Several large loan losses or several imprudent business decisions can quickly erode a bank's capital base and the investor's return and investment. On the positive side, what may seem on the surface to be a seemingly small return on the bank's assets may be a very favorable return or profit for the shareholder. Continuing with the example, if only 8 cents of each dollar of assets belong to the bank's investors, the investors' return is 12.5 percent if the bank earns a 1 percent return on that dollar of assets. Stated another way, the shareholders get to use assets funded to a large degree by insured deposits to generate good returns and good shareholder value.

December 31, 200x	
	Bank
Total Assets	\$100,000,000
Total Capital	8,000,000
Net Income	1,000,000
Return on Assets	1.00%
Return on Equity	12.50%

One might ask why a bank's return on assets is not typically equal to that of other corporations. As noted, banking is a high-leverage and therefore low-margin business, which means that costs or expenses greatly offset the yields or income received on loans, securities, and other "earning" assets. To better understand this, it is necessary to analyze the composition and nature of a bank's income and expenses.

Loans generally represent a bank's principal earning assets, and they usually generate the largest share of income. The question then becomes why banks cannot invest all available funds in loans. There

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are two key reasons: liquidity and overall risk. To meet routine or unanticipated cash needs (i.e., liquidity needs) such as large or sudden deposit withdrawals, banks must maintain a reasonable level of assets that can be easily converted to cash. Loans typically provide higher yields than securities because loans carry more overall risk than securities. Also, loans are usually less liquid than securities, which have broader markets in which to sell. A tremendous challenge faced by bank management is striking the appropriate balance between maximizing the bank's earnings and maintaining adequate liquidity and a reasonable risk profile.

The following example helps illustrate a typical bank's earnings performance. If a bank were able to yield (earn) an average of 10 percent on its assets and paid an average of 6 percent for its deposits and other funding sources, its net interest income (i.e., difference between interest income and interest expense) would be 4 percent, or 4 cents on each dollar of assets. For our example let's assume that banks average 1 cent in

December 31, 200x	
	Bank
Total Assets	\$100,000,000
Interest Income (10%)	10,000,000
Interest Expense (6%)	6,000,000
<i>Net Interest Income (4%)</i>	4,000,000
Noninterest Income (1%)	1,000,000
Overhead Expenses (3%)	3,000,000
<i>Net Income Before ALLL Provisions and Taxes</i>	2,000,000
ALLL Provisions	500,000
Taxes	500,000
NET INCOME	\$1,000,000

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noninterest income generated from fees. Adding this to the 4 cents in net interest income brings the bank's income before overhead expenses to roughly 5 cents on each dollar of assets. Out of this 5 cents, the bank pays about 3 cents in overhead expenses. This leaves 2 cents on each dollar of assets to cover income tax expense, provision expense (to maintain an adequate allowance for loan and lease losses), and dividends to shareholders.

On the liability side of the balance sheet are the bank's sources of funds, primarily deposits. Because of competitive pressures in the market place and the many investment alternatives now available to potential depositors, a bank's percentage of low-cost demand deposit and passbook savings accounts has decreased significantly in recent years while higher-cost deposits, particularly certificates of deposit and money market deposit accounts, and other borrowings such as Federal Home Loan Bank advances have risen and now represent a major portion of many banks' funding mix. The interest expense associated with the deposits and other funding sources remains the single largest expense for most banks.

To retain deposits, banks are often forced to outbid other bank and nonbank competitors, placing increased pressure on earnings. When banks have to increase the rates paid for deposits, management often must try to increase the rates charged on loans, or the bank's net interest income suffers. Although this strategy would appear to be the simple solution for maintaining a favorable profit margin, raising rates on loans, especially for the strongest customers, is often difficult given the intense competition in the banking industry.

Overhead is also a significant expense for every bank and if not well managed, can impede a bank's ability to earn a profit (see "Efficiency Ratio" in the Glossary). Overhead expenses include such items as salaries and benefits of employees, rent on the bank building, furniture and equipment costs, data processing expense, legal

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and consulting fees, and FDIC assessments for deposit insurance. Overhead also includes the costs of performing the so-called "back office" functions like proof and transit, wire transfer, marketing, auditing, and bookkeeping.

Because loans involve varied degrees of risk and some loan losses are inevitable over time, banks routinely expense amounts (i.e., provision expense) to build an "allowance" for loan losses. This allowance is usually called the allowance for loan and lease losses (ALLL) and is often expressed as a percentage of the bank's total loans. The ratio of ALLL to total loans is typically 1 percent or higher. An ALLL of 1 percent of total loans might be adequate for well managed banks with little perceived asset quality problems. Banks with asset quality problems, riskier loans, or a concentration of loans to a particular industry would likely need to maintain a higher ALLL.

Maintaining an adequate ALLL is one of the most important ongoing responsibilities of the board.

Provision expense for the ALLL can be a substantial expense for the bank, especially if the bank begins having asset quality problems. When management is under pressure to enhance profits, the loan loss provision expense can be an easy target for cuts. Such action would be inappropriate. In accordance with regulatory guidance, the board must review the adequacy of the ALLL at least quarterly. An adequate

ALLL depends on a number of factors including the bank's historical record of losses, the existing quality of the loan portfolio, the inherent risk in the loans being made by the bank, the health of the local and national economy, the expertise and credit skills of the lenders, and the health of an industry in which the bank may have a concentration of loans. Despite the analysis that is involved, the decision the board must make in arriving at an appropriate ALLL inevitably involves a certain level of subjectivity. The analysis and justification of the ALLL

balance should be clearly documented by the board.

Because provision expense is one of the larger expenses typically incurred each month by a "de novo" or new bank, management at these banks is sometimes reluctant to make adequate provisions in the bank's early stages, thus placing the bank in a catch-up position regarding its ALLL later on. As a director, you should make sure that an adequate ALLL is maintained from day one, thereby ensuring that the bank's Call Report, which is a financial report filed with the regulatory authorities depicting the bank's overall condition, is accurate.

BANKING RISKS

Banks are exposed to a wide array of risks: credit, market, operational, liquidity, reputational, and legal risks. It is the directors' responsibility to ensure that these risks, which are briefly discussed below, are managed on an integrated, bank-wide basis and properly controlled.

~ Credit Risk ~

Credit risk is often the greatest risk faced by the bank, and banks often have inherently moderate to high levels of credit risk. Credit risk relates mainly to the quality and composition of the loan portfolio and the likelihood that the borrowers will be able to repay their loans according to the agreed-upon terms. Banks must carefully screen loan applicants to determine their creditworthiness. Inadequate analysis of a borrower's repayment ability often leads to poor loan quality, substantial loan losses, and the erosion of the bank's earnings and capital. Remember, loans are generally funded with money owned by the depositors, not the investors. Therefore, directors must ensure that strong loan underwriting and loan administration policies and

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procedures are in place and being followed to minimize credit risk and potential loan losses.

Many manuals and articles have been written about sound loan underwriting and administration practices. You are strongly encouraged to read some of these publications. Please ask, and we will provide you with a copy of detailed guides: "Components of a Sound Credit Risk Management Program" and "A Guidebook for Managing and Evaluating Specialized Credit Activities in Community Banking Organizations" published by the Federal Reserve Bank of Atlanta to help your bank improve its credit risk management practices. The components addressed in these guides that should be implemented by your bank are briefly mentioned below. The list is not all-inclusive, and the practices can be modified depending on the complexity of your bank's lending activities. Furthermore, these practices will not prevent the bank from having loan losses. Making loans involves an element of risk and as a result, some loans will go bad. However, employing the practices below should help substantially reduce the bank's risk of making poor quality loans and incurring losses.

Components of a Sound Credit Risk Management Program



Loan Policy. The bank needs to have a comprehensive and tailored loan policy to guide all aspects of the bank's lending activities. The loan policy is the foundation for maintaining sound asset quality because it describes the bank's risk tolerance for loans and provides the parameters for managing those risks. The policy should address such items as the types of loans the bank will and will not make, the lending territory, the overall mix or diversification of loans within the portfolio (to prevent having "all eggs in one basket"), loan underwriting standards as discussed below, the bank's process for approving loans of different sizes and complexity, loan file and loan documentation requirements, and the requirements that must be met for the bank to make loans that are outside of the loan policy parameters. Generally, the loan policy should be reviewed and revised by the board of directors at least annually and clearly communicated to all appropriate personnel. Deviations from the loan policy should not be common or excessive and should be clearly reported to the board of directors.

Credit Underwriting Practices. The bank also needs to employ sound credit underwriting practices. Regulatory experience has shown that many banks base credit decisions on management's previous experience with borrowers and on collateral values rather than on a thorough analysis of information in financial statements. Although experience with the borrower and collateral protection are very important considerations, credit decisions including loan pricing decisions (i.e., the rates charged on loans) should be based on a proper analysis validating a borrower's cash flow position and ability to repay the loan. Furthermore, as a bank grows, it becomes increasingly difficult for the bank's management team and lending staff to thoroughly know all borrowers, further supporting the point that a proper financial analysis needs to be performed.

For commercial and commercial real estate loans above a pre-determined size, a credit memorandum should be prepared

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addressing, at a minimum, the following:

- ⇒ Purpose of the loan, thereby helping to ensure that the loan is structured properly in terms of amortization schedule, pricing, etc.
- ⇒ Primary and secondary sources of repayment
- ⇒ Complete description and valuation (including valuation source and date) of collateral
- ⇒ Analysis of the borrower's current financial information and repayment ability including the borrower's ability to repay the proposed loan and all other existing loans
- ⇒ Analysis of the guarantor's financial condition
- ⇒ Risk rating for the loan
- ⇒ Rationale for deviating from loan policy guidelines if applicable.

For consumer loans, underwriting guidelines should require at least the following:

- ⇒ Complete and signed loan application that, in part, references the purpose of the loan
- ⇒ Debt-to-income calculation on the borrower, demonstrating the borrower's ability to repay the proposed loan and all existing loans
- ⇒ Current credit bureau report on the borrower
- ⇒ Income and employment verifications on all new borrowers
- ⇒ Tax returns for self-employed borrowers
- ⇒ Written explanations for extending credit to borrowers with debt-to-income ratios outside of policy guidance, less than ideal credit scores, or poor payment performance with the bank.

Loan Review Function. Another component of a sound credit risk management program is an effective loan review function. A bank is

expected to have an effective loan review function whether the function is performed internally by bank staff or externally by consultants. An effective loan review program is an excellent tool that the board can use to routinely and proactively gauge the overall quality of the loan portfolio and whether the lending staff is complying with all of the policies and procedures laid out by the board to protect credit quality. To conserve costs, many banks hire consultants to perform loan review. Regardless of whether the function is in-house or external, the board needs to ensure that the individuals performing the function are qualified and that their findings are reported to the board. The best loan review functions are fully independent of the lending staff.

Credit Grading System. A bank is also expected to have a formal, credit-grading system that assigns accurate risk grades or ratings to the loans in the bank's loan portfolio. These risk grades, or ratings, are expected to ultimately translate into the pass, special mention, substandard, doubtful, and loss categories used by the regulatory authorities.

The loan review function and the credit-grading system play a critical role in alerting the board quickly to emerging problems or trends in the loan portfolio. Furthermore, these processes play a critical role in the bank's requirement to maintain an accurate internal problem loan list, which is a necessary tool for tracking and resolving existing or potential loan problems and for maintaining an adequate allowance for loan and lease losses.

Common Lending Mistakes. The following common lending mistakes are seen by regulators:

- ◆ Absent or inadequate cash flow analyses validating a borrower's ability to repay debt
- ◆ Speculative real estate loans that are extended to borrowers without adequate cash flow and liquidity analyses validating the borrower's ability to carry inventory for an extended time

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- ◆ Consumer loans that are made based on collateral values rather than on debt service capacity
- ◆ Inaccurate risk ratings assigned to loans, resulting in an inaccurate problem loan list and an underfunded ALLL
- ◆ Loan pricing that is not commensurate with the risk of the loans.

~ Operational Risk ~

Operational risk may be the second greatest risk if not at times the greatest risk affecting banks, and it basically is the risk that the bank will suffer unexpected financial loss or harm because of inadequate information systems, weaknesses or breaches (including fraud) in its operational or internal control processes, and unforeseen catastrophes. Banks can quickly suffer devastating financial losses, even to the point where the bank's continued viability is threatened, because of internal control weaknesses. Operational risk exists in basically every area in the bank. Specifically, this risk is present in the bank's processes for booking and funding loans, posting items in the accounting system, sending funds electronically (wire transfers), ensuring that the bank is complying with laws such as the Bank Secrecy Act, and ensuring that information technology is operating properly.

The board of directors is responsible for putting in place an internal control structure or a system of "checks and balances" that limits the bank's exposure to operational risk. Elements of an effective control structure include competent staff, proper segregation and possible rotation of duties, routine reconcilements of asset and liability accounts, proper control over access to vital systems and records, and a comprehensive internal and external auditing process to monitor staff's compliance with the policies, procedures, and other controls established by the board of directors. Internal controls and the audit function are discussed in greater detail in Chapter II, "The Role of the Director."

~ Market Risk ~

Sensitivity to market risk, often referred to as interest rate risk, is basically the degree to which changes in market rates or prices such as interest rates, foreign exchange rates, or equity prices, can adversely affect the bank's earnings and the market value of its assets and liabilities.

A bank that is "asset sensitive" has more assets than liabilities that reprice (i.e., change interest rates) during a particular period. For an asset-sensitive bank, rising interest rates would benefit the bank's earnings because a larger volume of assets compared to liabilities would reprice at a higher rate. However, an asset-sensitive bank's earnings would be hurt if rates fell. If the bank were liability sensitive, earnings would be favorably affected by falling interest rates because a larger volume of liabilities compared to assets would reprice at a lower rate. Liability-sensitive banks would be hurt if rates rose. Furthermore, just as the market value of a treasury security or corporate bond changes with interest rate fluctuations, so does the market value of a bank's assets and liabilities. Because equity is the difference between the value of assets and liabilities, changes in the market value of a bank's assets and liabilities affect what is known as the bank's "economic value of equity" or "EVE."

A director should be concerned if the bank's earnings or economic value of equity are overly vulnerable to changes in interest rates. Various tools are available to measure the bank's exposure to interest rate changes including GAP, income simulation, and EVE models. GAP analyses, if performed properly, can be a useful tool. However, income simulation and EVE models can provide more precise measurements, and banks are strongly encouraged to use these models in addition to any GAP analysis, especially as banks grow in size and complexity. It is important that directors understand the nature of interest rate risk and take adequate steps to ensure that rate movements do

not expose their banks to unacceptable levels of risk. Clear policy guidelines/parameters and the necessary interest rate risk measurement tools need to be implemented to control the risk. Typically, the measurement tools will measure at least the projected changes in a bank's net interest income caused by interest rate changes of +/- 100 basis points and +/- 200 basis points for certain periods (e.g., 3 months, 6 months, 1 year, etc.). Also, the directors should regularly review the bank's compliance with the policy guidelines, typically no less than quarterly.

~ Liquidity Risk ~

Liquidity risk is basically the potential that a bank will be unable to meet its funding obligations as they come due because of its inability to liquidate assets or obtain adequate funding elsewhere, or because it cannot easily unwind or offset specific exposures without significantly lowering earnings because of inadequate market depth or market disruptions. Simply stated, banks need to maintain the flexibility - or liquidity - necessary to honor all of their obligations such as expected or unexpected requests by depositors for cash withdrawals without adversely affecting their financial condition.

Banks maintain this flexibility in part by attracting and retaining stable deposits such as core deposits. Banks also maintain this flexibility by maintaining a sufficient level of securities and other assets that routinely are or can be easily converted with little or no penalty to cash, and by maintaining back-up cash sources such as lines of credit with other commercial banks, the Federal Home Loan Bank, and the Federal Reserve. Loans typically are better earners than more liquid assets like investment securities, but banks need to be careful not to sacrifice a sound liquidity position for the sake of attempting to maximize earnings. The board needs to establish clear policy guidelines including liquidity targets to ensure that liquidity risk remains manageable, and the board should regularly review compliance with these policy guidelines.

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Discount Window. As mentioned previously, a bank is able to borrow from the Federal Reserve's Discount Window. The main purpose of the Discount Window is to provide the bank with funds when its ordinary sources of liquidity are not reasonably available. Primary Credit is available for very short terms as a backup source of liquidity for banks that are in generally sound financial condition as determined by the Reserve Bank. Primary Credit is priced at a margin above the Federal Open Market Committee's target federal funds rate. For those banks unable to qualify for Primary Credit, Secondary Credit may be available under appropriate circumstances as determined by the Reserve Bank. Secondary Credit is priced above Primary Credit.

The Discount Window is available to depository institutions that hold liabilities subject to reserve requirements. Collateral must be pledged on any borrowings through the Discount Window, and it is prudent to pledge collateral in advance so as to be ready for any unforeseen need. A vast array of assets may be pledged as collateral.

*Additional information on how
to establish access to the Discount Window is available
on the Federal Reserve Bank's web site at www.frbatlanta.org
or by calling the Federal Reserve Bank.*

~ Legal and Reputational Risks ~

Legal risk is the possibility that unenforceable contracts, lawsuits, or adverse judgements can disrupt or otherwise negatively affect the bank's operations or condition, and reputational risk is the possibility that negative publicity about a bank's business practices or financial condition will cause a decline in the customer base or result in costly litigation or income reductions. These risks are typically controlled by continually operating the bank in a safe and sound manner as described in this Director's Primer.

~ Information Technology Risk ~

The rapid growth of information technologies has presented new opportunities for banks, but along with this growth has come increased risks that must be properly controlled. Risks related to weaknesses or breakdowns in a bank's information technology function can be substantial and can encompass or spill over into all of the risk areas noted above. For example, problems in the information technology function could result in work stoppages, the loss of data, or the reporting of inaccurate data, thereby impairing management's ability to monitor and control credit, liquidity and market risks among others. Problems could also allow for unlawful intrusion into the bank's systems, allowing for the release of private customer information, which could subject the bank to legal and reputational risks. Other problems in the wire transfer area, for example, could permit fraud and lead to financial loss by the bank.

The board needs to ensure that a program is in place that identifies, measures, and controls the risks associated with the technology services being used or provided by the bank. Many banks choose to go through or contract with third parties to provide services to or on behalf of the bank. Although this "outsourcing" arrangement can improve banking services, help control costs, and provide the technical assistance needed to maintain and expand product offerings, it also introduces additional risks that need to be controlled. Regulatory guidance addresses elements for controlling these risks. In part, the bank needs to perform a risk assessment, carefully select and monitor the condition of the service providers, and carefully evaluate the contracts with the providers.

It is important to mention that among many other things, the risk management program needs to ensure that customer information is being properly protected. The Gramm-Leach-Bliley Act has placed additional emphasis on customer security. The responsibility for the

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security or privacy of customer information rests with the board of directors, regardless of whether an outsourcing arrangement is in place.

Finally, the board of directors is required by the Federal Financial Institutions Examination Council (FFIEC) policy statement SP-5 dated July 1989 to review and approve the bank's enterprise-wide disaster recovery or business resumption contingency plans, which include the information technology function and business lines. The tragic events of September 11, 2001, and more specifically the destruction of the World Trade Center towers, highlight the need for good disaster recovery planning.

CHAPTER II THE ROLE OF THE DIRECTOR

As a director, you have a legal and fiduciary duty to properly represent the shareholders who elected you, and to promote the owners' interest in the long-term success of the bank. Additionally, on a wider scale, you have a duty to help preserve the public's confidence in the banking system. You carry out these responsibilities by taking on an active oversight role in the affairs of your bank and by ensuring that your bank is being operated in a safe and sound manner. These responsibilities are discharged, in part, by establishing an effective risk management program. Specifically, the board, which should be comprised substantially of outside, independent directors, is responsible for establishing a competent and capable senior management team; developing the bank's long-range objectives and goals with input from the senior management team; setting the bank's risk appetite; establishing comprehensive policies, procedures, internal controls and information systems to protect the bank; and seeing that management is adhering to the policies, procedures and goals laid out by the board. The board of directors should be guided by a formal mission statement or charter that clearly defines these responsibilities and provides a clear distinction between the roles of the board and management. These responsibilities are discussed in greater detail below.

A director's firm commitment to the bank is crucial. Numerous meetings will be required to establish and maintain adequate policies and strategic objectives, to supervise loan and investment decisions, to develop plans for new business, to track the bank's performance, and to monitor senior management. Considerable work outside of regular meetings may also be necessary. If for any reason the bank's condition deteriorates to less than satisfactory in the regulator's view, additional time and work will likely be required. A director should also be prepared to resign if these duties cannot be fulfilled.

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The role of a director entails a high degree of trust. A director receives and has access to large amounts of confidential information on businesses and individuals. Additionally, some information on the bank itself is confidential and may be accessible only to regulators, other directors, and senior management. The director should be careful to refrain from using or giving out confidential information and thus breaching the trust required of a director.

Without active and knowledgeable participation, a director is doing a disservice to the bank. A director is presumed to bring a business, market, or industry acumen to the board and bank, and this knowledge or expertise needs to be shared.

ACTIVE BOARD OVERSIGHT

Regular attendance and active participation at meetings are critical to a director's role. Generally, less than 75 percent attendance at board meetings renders a director ineffective because of the time required to understand and stay fully abreast of the affairs of the bank. Common reasons for poor attendance have been job conflicts, illness, and residing a long distance from the bank. Regardless of the reason, the result can be ineffectiveness as a director. A director's responsibility and liability do not end because of absence from meetings. Some banks have attempted to circumvent attendance requirements with telephone conference calling and detailed transcriptions of board minutes. These methods have serious pitfalls and should be avoided.

Attending committee meetings is as important as attending the full board meetings. Directors contribute to the operation of the bank through committees. Credit (loan), asset and liability management, audit, and compensation committees are some of the more common risk committees. Committee members need to possess the independence,

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technical skills, and competencies necessary to evaluate the activities and related risks under their purview, and these committee members should pursue ongoing training that is relevant to their committee responsibilities. Failure to attend committee meetings and failure to possess or maintain necessary skills could mean that senior management is not supervised properly. For example, poor loans could be approved by the bank's loan committee, and illiquid investments could be approved by the bank's investment committee with little or no input from outside directors. The board of directors can delegate authority to committees, but the full board must monitor the committees because the board is ultimately responsible for each committee's actions.

The board needs to receive routine reports from management detailing the bank's condition and activities. These reports and other information on bank matters are crucial for a director's knowledge and input. Each director should formulate and voice an opinion on bank matters. A director will not always agree with senior management or a majority of the board on all issues. This is expected. The board minutes should be appropriately detailed reflecting all discussion, both for and against a measure, and all votes should be registered. Approval of issues need not be unanimous. On the flip side, regular disruptive participation at board meetings is discouraged. Each director must evaluate whether his/her actions are for the good of the bank. Participation must be tempered with knowledge, judgement, and an overall willingness to learn and be objective. Balanced input from all directors will best serve the bank.

The outside directors are encouraged to hold an executive session at least annually without officer-directors or other members of management present, where the directors can talk frankly about sensitive issues such as CEO performance, management succession, and management & director

interaction. The board is also encouraged to consider undertaking periodic self assessments of its performance to identify any improvement opportunities.

MANAGEMENT

The board is responsible for hiring and maintaining a senior management team that is fully capable of managing the activities and related risks of the bank in conformance with the policies and controls prescribed by the board. With guidance and oversight by the board, senior management needs to be capable of identifying, measuring, monitoring, and controlling the risks of the bank. Senior management must be capable of executing strategies in a manner that is safe and sound and complies with laws and regulations. Management should possess sufficient knowledge of and expertise in all business lines including the policies, procedures, and internal controls needed to limit the related risks. Accountability and lines of authority need to be clearly delineated.

The board needs to have confidence in its senior management team. However, the board should never assume or blindly trust that senior management is "minding the shop" perfectly or is not capable of committing any wrongdoing, and, therefore, does not need active oversight by the board. Numerous examples exist when lax board oversight allowed senior management's activities to go unchecked, leading to substantial losses or even failure of the bank. A few of these examples are mentioned at the end of this section.

Management depth and succession are important to the success of a bank. No matter how small the bank, the board needs to ensure that qualified and capable people are in a position to temporarily or permanently assume the duties of key personnel such as the president, senior lending officer, and controller if these persons become

incapacitated or leave the bank for any reason. Development and maintenance of a formal management succession plan is a critical responsibility of the board of directors.

ADEQUATE POLICIES, PROCEDURES, AND LIMITS

Because boards of directors have ultimate responsibility for the financial condition of and the level of risk taken by their banks, the boards are responsible for establishing policies and procedures to control the risks. Written policies should be in place for all of the bank's major areas or functions. The policies and the related detailed procedures should be tailored to meet the individual bank's needs and complexity, and they should provide detailed guidance to staff and include limits to shield the organization from excessive and imprudent risks.

The bank's policies and procedures should provide for adequate identification, measurement, monitoring and control of the risks posed by lending, investing, trading, and fiduciary activities, information technology, and other significant activities. The policies should clearly delineate accountability and lines of authority. Although policies are generally drafted by senior management, directors should have significant input and the final say-so in the formulation process. A policy should not be just a copy of another bank's policy or be in place only to appease the regulators. Rather, a policy should be useful. Policies should be developed in writing, reviewed for adequacy by the board at least annually, and properly communicated to all personnel. All policies are important, and three critical policies are mentioned below.

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Each bank needs a sound *loan policy* because credit risk is so significant. Full details about all lending areas should be provided in the loan policy. As discussed previously in the Banking Risks section of this booklet, the bank's lending territory, desired loans, underwriting standards, collateral standards, loan approval process, and size and mix of the loan portfolio are only a few of the important areas that should be addressed. Failure to delineate and follow prudent underwriting standards is the chief cause of credit problems.

The *investment policy* should provide the bank with a means for making prudent investment decisions that are consistent with the bank's earnings and liquidity goals. For example, long-term investments that offer high yields at the present may cause problems if interest rates rise and liquidity is needed in the future. The quality of the investment portfolio is equally important in protecting the bank against losses. Quality, size, mix, maturities, and approval of investments need to be outlined in the bank's investment policy.

The *asset/liability management policy* is critical to the bank in part because understanding how the yields, costs, or values of assets and liabilities can change is a key to the earnings success and possibly the capital adequacy of the bank. The costs to unwind mismatched assets and liabilities can be substantial, and months or perhaps years may be lost before a bank can correct poorly priced assets or liabilities. For example, de novo banks have occasionally aggressively used short-term deposits to fund long-term, fixed-rate mortgage loans. Although these loans may be of good quality, they offer a thin profit margin, are slow to reprice, and can turn into illiquid assets in times of rising rates. As discussed in greater detail in the Banking Risks section of this booklet, asset/liability management must be evaluated and fully understood by both senior management and the board of directors.

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*Policies that
are not followed are
useless.*

The board of directors is ultimately responsible for ensuring that senior management, employees, and the board itself are adhering to policies. Directors must be familiar with policies and receive and evaluate routine reports and other information to ensure that compliance with all policies is being maintained. Independent internal audit and loan review functions can help the board do this. A director should never be afraid to question practices of senior management and to review for policy compliance. Generally, most policy exceptions should require the approval of the board of directors. Strong policy administration and monitoring are as important to the success of a bank as the policy itself.

ADEQUATE RISK MONITORING AND MANAGEMENT INFORMATION SYSTEMS

Effective risk monitoring requires banks to identify and measure all material risk exposures. Consequently, risk monitoring activities must be supported by information systems that provide senior management and the directors with timely reports on the financial condition, operating performance, risk exposure, and other significant activities of the bank. The sophistication of the information systems and the reports needs to be consistent with the size and complexity of the individual bank. Reports supplied to the directors must provide accurate and timely information. Directors should provide input as to the nature and format of information provided to them. More than one bank has failed largely because senior management did not provide the directors with accurate or meaningful information. Although it can be difficult to prevent or detect the intentional misrepresentation of facts, there are many red flags which should alert a director that something might be "amiss."

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There is a core set of information that should be reviewed at each board meeting. Omission of or a sudden change in the form of this information should be thoroughly explained by management. Omissions or a lack of candor by senior management in answering board questions should simply not be accepted. Management would rarely intentionally mislead a board, but it has happened. Few directors spend much time in their banks actually observing operations, so the board package is often a director's most direct line to what is happening in the bank. Preferably, each director should receive the board package at least 5 days before the board meeting to allow for detailed review prior to discussion. A good board package typically would include the following reports or items:

Statement of the Bank's Condition. This should detail the assets and liabilities of the bank as of the most recent month end of business. "Other" assets and other liabilities should be detailed, not lumped together, as should any other unusual category on the financial statement. Comparison to any budget projections should also be provided with any major variances discussed.

Income and Expense Statement. This should detail at least income and expenses for the most recent month end and year to date. It is important to know what sources the bank depends on for income and exactly what expenses are being incurred. It is also important that performance in relation to monthly and annual budget projections is noted and any major variances discussed.

Watch List and Past Due/Nonaccrual Loan List. This should detail the bank's problem and potential problem loans. Watch list loans are not always past due. If

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only past due loans are listed on the watch list, senior management may be slow to either recognize problem loans or admit that the loans are a problem. The board of directors should consider having an independent party review loans to help the board and senior management recognize problem loans.

Although examiners focus on a bank's loan portfolio, management and the directors should not depend on examiners to identify problem loans. Timing is critical in resolving problem or potential problem loans. The earlier a problem or potential problem loan can be identified, the better the chances are for the bank to minimize losses on the loan. The past due loan report reviewed by the directors should include all past due and nonaccrual loans, not just those loans past due over 30 days. Progress on sales of other real estate and repossessions should also be noted and discussed.

Loans for Approval. This should detail the loans that need director approval or ratification. Loans brought before the directors should carry the endorsement of senior management. This endorsement is critical because senior management will be working daily with the borrowers and monitoring the credit. Directors may not agree with senior management on each loan. Directors should review each loan on its own merits. The credit, collateral, character, and capacity of each borrower must be evaluated. Any time a director has a possible conflict of interest relating to a loan, financial or otherwise, the director should abstain from voting on the loan.

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Investments. This should detail the bank's securities bought and sold during the period and whether the securities comply with policy. The quality and maturity of the portfolio also should be monitored because the investment portfolio is a primary source of liquidity.

Asset/Liability Management. This should detail the bank's sensitivity to changes in interest rates and whether the sensitivity position is within policy guidelines.

Liquidity. This should detail the bank's liquidity position and whether key ratios are in compliance with policy guidelines.

Capital. This should detail the bank's capital position including the calculation of key capital ratios. Adequate capital should be maintained in relation to regulatory guidelines and in relation to the bank's condition and risk profile. If asset quality or other significant problems exist, capital should be maintained at a higher level until the problems subside.

Policy Exceptions. This should detail all substantive policy exceptions that need to come before the board for approval or ratification. The board must be aware of exceptions to determine whether policies are being followed and are adequate and current. Policy exceptions should be held to a minimum.

Uniform Bank Performance Report (UBPR). The UBPR has balance sheet and income information for the bank and ranks the bank among other banks in its peer group. An essential management tool, the UBPR is mailed

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quarterly to every bank. Management should routinely assess the bank's performance with the directors using the UBPR. A related report, the Bank Holding Company Performance Report (BHCPR), details data similar to the UBPR for holding companies with consolidated assets over \$150 million. The BHCPR is also an essential management tool and should be a normal part of the review of the holding company.

Other Reports. Other reports a board may routinely receive include internal audit reports or summaries, loan review reports, and reports detailing real estate loans in excess of supervisory loan-to-value limits as defined in Regulation H (this report is required quarterly if such loans exist). *Again, the board should feel free to request any information or other report that it feels it needs to properly oversee the bank's and senior management's activities.*

ADEQUATE INTERNAL CONTROLS/AUDIT FUNCTION

An adequate internal control structure is paramount to the safe and sound operation of the bank. Aspects of an effective internal control structure include the enforcement of official lines of authority, the appropriate segregation of duties, and an independent audit function. When properly structured, a system of internal controls helps to safeguard assets, promote reliable financial and regulatory reporting, and ensure compliance with relevant laws, regulations, and bank policies and procedures.

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A necessary component of a good internal control structure is an effective audit function, encompassing both internal and external audits.

The minimum audit requirements usually are defined in state law. The strongest internal control environments include a truly independent internal audit function that reports directly to a board-designated audit committee, consisting solely of outside directors. Because of the costs and training requirements associated with having an internal audit

function housed in the bank, many banks, especially smaller banks, outsource some or many internal auditing tasks to accounting firms. Furthermore, some smaller banks choose in lieu of a formal internal audit function, to rely on regular reviews of essential internal controls by bank personnel who are independent of the area being reviewed. All banks are strongly encouraged to implement a formal internal audit program.

Regardless of the arrangement, the board needs to ensure that the person or firm performing the audits or reviews is competent to do so. Even with an outsourcing arrangement, the bank, and more specifically, the board of directors retains full responsibility for the oversight and effectiveness of the audit program. Given the importance of appropriate internal controls to banking organizations of all sizes and risk profiles, the internal audit results or reviews should be documented in writing as should management's responses to them. Communication channels should exist that allow negative or sensitive findings to be reported to the outside directors. Significant weaknesses revealed by the audits or reviews need to be corrected by management in a timely manner. The corrective action needs to be tracked carefully. A policy governing the bank's internal audit or review activities and a plan detailing the audits or reviews that will be conducted during the coming year should be approved or ratified annually by the board. Banks are also strongly encouraged to contract for an annual external audit of the bank, whereby an accounting firm expresses an opinion on the bank's financial statements taken as a whole.

BUDGET AND STRATEGIC PLANNING PROCESS

Generally, the budget is originated by senior management with major input from department heads. A draft budget is prepared by senior management and submitted to the board of directors for review, revision, and approval. The budget should be prepared in detail annually and should serve as one of the benchmarks by which the board evaluates the bank's and senior management's performance. The bank's performance in comparison to the budget should be tracked carefully throughout the year.

The annual budget should be supported by a formal strategic plan that serves as a guide for the bank's activities and risk appetite. Both management and the board must fully understand the plan and the desired results, and this plan should detail the bank's short- and long-range goals. Many strategic plans cover a three-year time period, but the plan should be reevaluated by the board annually. The plan should be detailed and realistic, and progress under the plan should be tracked carefully and reported to the board routinely. The rationale for the assumptions in the plan and the budget needs to be explained.

Each director brings his or her past experiences into the process of formulating budgets and strategic plans. The input of every director in budgeting and planning is important to make the process work and serve the best interest of the bank.

COMPLIANCE WITH LAWS AND REGULATIONS

Compliance with laws and regulations is mandatory. Directors should be familiar with the statutes and regulations that affect them personally as well as the bank directly. Banks and their directors and senior management teams can face stiff sanctions or penalties, including monetary penalties and removal, for noncompliance with laws and regulations. Regulation O and Section 23A of the Federal Reserve Act have a very broad reach and are summarized in the Laws and Regulations

chapter in this booklet. However, familiarity alone does not ensure compliance. Comprehensive policies and procedures and good internal controls such as an effective audit function are key elements in ensuring compliance with banking statutes and regulations. Management and directors alike are encouraged to seek legal counsel or contact the bank's primary federal or state regulator if there is any question about the requirements of a law or regulation.

INSIDER TRANSACTIONS AND CONFLICTS OF INTEREST

Insider transactions require considerable disclosure and prudence in handling. Loans to directors, executive officers, and their related interests are permitted, but certain procedures and limitations must be followed. Regulation O defines these procedures and limitations. Depending on ownership percentages, a director's related interests could be viewed as affiliates of the bank. Section 23A of the Federal Reserve Act places conditions and limitations on transactions with affiliates. Overall, directors need to know how these requirements apply to themselves and their related interests.

Conflicts of interest can be financial or personal, direct or indirect. If a director is an attorney, appraiser, or real estate agent and would receive a fee for services rendered on a recommended loan, he or she should abstain from voting on the loan. Loans for relatives or business partners of directors would also require a director to abstain from voting. Ideally, the director will physically leave the room when voting occurs on these loans.

Conflicts of interest may not be limited to loans. If a director is a general building contractor bidding on providing improvements to the main or branch office of a bank, the director should abstain from voting on the matter. Each director must disclose any interest he or she may have before the matter is voted on, and then he or she must abstain from the vote in order to avoid a conflict of interest.

~ Examples of Weak Board Oversight or Controls ~

The following are only three of the many examples when weak oversight or internal controls led to substantial financial loss by a bank. Although not all of the examples involve fraud, remember that individuals who are willing to commit fraudulent acts will know how to find and exploit control weaknesses. Furthermore, many fraudulent acts are committed by long-term and "trusted" employees of a bank, stressing how important it is for the board not to blindly trust or believe that a particular employee is incapable of committing such acts, from senior management on down.

Example ~ Fraudulent Activity

The president of a small bank became involved in a fraudulent scheme in which he granted several loans to one borrower and his related interests without the knowledge and approval of the bank's board or its loan committee. The president also approved large overdrafts on the accounts of the borrower's related interests. When the borrower could no longer cover the overdraft, the president began to manipulate accounts to conceal the overdraft from the board of directors. Because proper accounting controls were not in place and the directors reviewed only month-end overdraft reports at their board meetings, the president needed to manipulate accounts for only one day each month to temporarily remove the accounts from the overdraft list.

The president was able to successfully conceal the overdraft for three months until the bank's chairman paid a visit to the bank. The chairman visited the bank frequently; however, this time he took the unusual step of reviewing several reports including the loan delinquency report and an overdraft list. This list was not

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as of month end, so it showed the large overdraft the president had approved. When the chairman questioned the president about the overdraft, the president described the entire scheme and the transactions he had used to conceal the overdraft from the board.

The Outcome ~ The loss to the bank as a result of the uncollectible overdraft and related loans totaled over \$500,000. Although this example may not sound like a success story, the chairman's interest and involvement resulted in the discovery of a situation that could have rapidly deteriorated and could have eventually resulted in a much larger loss to the bank.

Example ~ Growth without Adequate Controls

A de novo bank grew very rapidly under the leadership of its president. The president and the directors shared an overwhelming desire for profits because they were all significant shareholders of the bank, and they pushed hard to cut costs. As a result of management's desire to limit costs, the bank did not have any internal audit function. There were weak controls over the lending area, and loans could be disbursed at any of the bank's three branches. The originating officer could authorize the disbursement, and there was no documentation review before loan proceeds were disbursed. The president reviewed loan files at random after proceeds had been disbursed. Overall, the president relied primarily on his employees, many of whom he had employed at another bank that he had successfully operated for several years.

The bank's inadequate controls were criticized by examiners and to some extent by the bank's external auditors. The

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directors did not ensure that management corrected the deficiencies, and the bank continued to grow. Eventually, a number of loans granted by one of the branch loan officers began to show up on the delinquency reports. When the president reviewed the files for these loans, he discovered that the officer had granted a number of loans that exceeded his lending authority. Also, the officer had made loans without important documentation, and he had granted a number of loans to people with poor credit histories. Many loans were unsecured, and the officer had even released collateral in some cases.

The Outcome ~ The officer was fired, but the bank eventually had to charge off over \$400,000 in loans that had been made by the officer. This situation occurred because the directors and management did not implement adequate lending controls and oversight, did not provide a sufficient audit program for the bank, and overemphasized profits - at least in some employees' minds. The bank likely lost more money than the implementation of these programs would have cost.

Example ~ Collusion

One final example involves a long-time and well-regarded (in the community) president of a small bank who had substantial control over the bank's operations, with minimal oversight by the board of directors. This president colluded with another bank employee to make several fictitious loans over a period of time, the proceeds from which the president used to make speculative investments in the stock market based on the apparent belief that rapid appreciation in the investments would allow the president to repay the loans in a short period of time (thereby avoiding detection) and retain sizeable profits. However, after the

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investments were made, the stock market and the specific investments declined in value, preventing the repayment of the loans and leading to their ultimate detection.

The Outcome ~ The president was fired, but not before the bank incurred well over \$1 million in loan losses, substantial legal expenses, and damage to its reputation because of the fraud. Arguably, detecting fraud when collusion is involved can be difficult, but this example again illustrates the need for strong board oversight and a strong internal control structure.

CHAPTER III THE ROLE OF THE REGULATOR

The regulatory community that oversees or regulates commercial banks in the United States includes three federal agencies as well as representatives of the various state governments. The following commentary briefly outlines the roles and responsibilities of these related supervisory organizations and the regulatory process.

REGULATORY AGENCIES/AUTHORITY

To operate, a bank needs to be granted either a state or federal charter. State charters are granted by the individual states, and each state in turn has a department of banking that supervises or regulates the institutions that it charters. The Federal Reserve System (FRS), and more specifically the respective Federal Reserve Bank, also supervises the state-chartered banks that elect to join the FRS. The FRS also supervises the country's numerous bank holding companies that own commercial banks. The Federal Deposit Insurance Corporation (FDIC) is responsible along with the state banking authorities for examining state-chartered banks that are not members of the FRS. Federal - or national - charters are issued by the Treasury Department's Office of the Comptroller of the Currency (OCC), and the OCC has primary supervisory responsibility for national banks.

THE EXAMINER'S ROLE

Who are the regulators? To most bankers, regulators are the people commonly referred to as the "examiners." Although they may have similar training, examiners are not charged with the same

responsibilities or functions as accountants or auditors.

The role of the regulatory authorities, and more specifically the examiners, is to ensure that banks and bank holding companies are being operated in a safe and sound manner. This regulatory oversight protects the bank insurance fund and helps to maintain the public's confidence in the nation's banking system. Examiners are responsible for judging the quality of a bank's assets and capital base and the effectiveness of its management and risk management practices, including internal controls and audit procedures. Examiners also review a bank's compliance with laws and regulations. The regulators desire to have a good working relationship with the directorate and senior management of the banks, and their examination findings and related recommendations are intended to benefit the bank.

External auditors, on the other hand, conduct an independent examination (audit) of the accounting data of the organization to obtain reasonable assurance that the financial statements are free of material misstatements. With these audits, auditors express an opinion on whether the organization's financial statements present fairly the financial position of the organization in conformity with generally accepted accounting principles.

Examiners serve as one of the early defenses for the bank's depositors and the bank insurance fund, but they cannot and should not be expected by the board to uncover fraudulent or dishonest acts. A bank's own strong internal controls, operating procedures, and audit programs should be its first defense. However, you can expect the examiners to closely scrutinize those controls and procedures and the quality of audits. If necessary, the examiners will make recommendations to the board and senior management about improving internal controls so as to limit the bank's risk of loss.

EXAMINATION REPORT/RATINGS

Regulators communicate examination findings to the board of directors in a written report of examination. In addition, at the conclusion of the examination, the examiners meet with senior management to summarize the major examination findings. This is a good opportunity to hear first-hand what was found during the examination and to learn about the examiners' concerns and recommendations. As a director, you are encouraged to attend this informal meeting and to ask the examiners any questions you wish -- either in management's presence or in private. A formal meeting is held by the examiners with the entire board if the examination reveals that the bank is in less than satisfactory condition or if the bank has some alarming trends or activities. You should use the examination process, especially the examination report, as a tool to help you properly oversee the bank's activities, condition, and areas in need of attention.

All banks are assigned a composite rating, which is strongly influenced by the ratings of six component categories (capital, asset quality, management, earnings, liquidity, market sensitivity) and a separate risk management rating. This rating is known as the CAMELS rating.

The composite or overall rating, which is influenced by the component ratings, ranges from 1 (the strongest banks) to 5 (banks in serious danger of failing). Other ratings are assigned for fiduciary or trust operations, the information technology function, and consumer affairs compliance, and these ratings also influence the CAMELS rating.

SUPERVISORY ACTIONS

What happens if the condition of the bank turns out to be less than satisfactory? A rating of 3 or worse is considered to be less than satisfactory. Banks with composite or component ratings of 3 or worse are subject to more than normal supervisory attention. Those with an overall composite rating of 4 or 5 are identified as troubled banks and are subject to an array of more stringent supervisory and legal actions that might include more frequent examinations, additional reporting requirements, formal enforcement actions, or monetary penalties. In certain cases, regulatory authorities will seek removal or prohibition actions against some members of senior management or the board of directors.

A bank rarely goes from a satisfactory condition to a less-than-satisfactory condition overnight. Usually, there is a progression of deterioration. Sometimes, deterioration continues despite the best efforts of the regulators. Suffice it to say that the regulators use many tools of supervision in their attempt to prevent or halt the deterioration and, thereby, ultimately protect the bank insurance fund and the integrity of the banking system.

Regulators do not seek, either directly or indirectly, to perform the function of management. Instead, they prefer to work with management to correct noted deficiencies. Sometimes this includes entering into an informal agreement with the directors known as a Board Resolution or a Memorandum of Understanding. If those efforts fail and the institution continues to deteriorate or weak risk management practices continue, formal supervisory actions such as a Written Agreement or a Cease and Desist Order are generally implemented. If an institution is rated less than satisfactory, the board and management of that institution can expect an increased regulatory presence either through on-site examinations and visitations, or a combination of both.

CHAPTER IV LAWS AND REGULATIONS

Commercial banks, bank holding companies, and their insiders are governed by a variety of laws and regulations intended to ensure that the institutions serve their depositors and communities and are operated in accordance with sound banking principles. *Substantial sanctions or monetary penalties can be placed on or assessed against institutions or persons that violate banking laws and regulations.* This section gives directors a general overview of many of the laws and regulations affecting banks. It is not intended to cover all laws or regulations in detail. Examples have been used to help illustrate some laws and regulations. For specific details, refer to the laws and regulations themselves or consult with legal counsel or the regulatory agencies.

The items or areas covered in this section are the following:

- Director Qualifications
- Criminal Law
- Regulation O - Insider Loans
- Federal Reserve Act
- Financial Institutions Reform, Recovery and Enforcement Act
- Federal Deposit Insurance Corporation Improvement Act
- Bank Secrecy Act
- U.S.A. PATRIOT Act
- Sarbanes-Oxley Act
- Change In Bank Control Act
- Regulation L - Interlocking Management Officials
- Dividend Payment Limitations
- Gramm-Leach-Bliley Act
- Consumer Protection Laws
- Community Reinvestment Act.

DIRECTOR QUALIFICATIONS

Various laws govern the qualifications of directors, and qualifications can vary from state to state. Many states, for instance, require stock ownership and residency for a director. For new banks, troubled banks, or banks that have recently undergone a change in control, name checks and regulatory approvals are required before proposed new directors or senior officers may join the institution. Bank holding company directors are subject to limitations and requirements similar to those for bank directors.

Various regulatory and law enforcement agencies such as the Federal Bureau of Investigation, the Drug Enforcement Agency, and Customs investigate the name checks on proposed directors and senior executive officers. If the potential director is a naturalized citizen or foreign national, the Central Intelligence Agency and the Department of Naturalization and Immigration also perform these checks. The primary banking regulator reviews the results and determines whether to approve or deny a proposed appointment.

CRIMINAL LAW

Although obvious, it is worth mentioning that directors are liable for fines and imprisonment for willful or knowing violations of applicable criminal law. Directors should be aware that many criminal law violations could also serve as a basis for establishing civil law liability.

The following examples illustrate some prohibited activities:

- ❑ Offering a loan or a gratuity to an examiner who is examining or has ever examined the bank (it is also a crime for the examiner to accept a gratuity or a loan from a bank he or she has examined)

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- ❑ Receiving anything of value from a bank customer as a condition of any transaction or financial business with the bank
- ❑ Committing theft, embezzlement or misapplication of funds
- ❑ Falsely advertising or misrepresenting the bank's federal deposit insurance status
- ❑ Falsely certifying bank checks
- ❑ Making or permitting false entries in bank records, reports, or transactional documents.

REGULATION O – INSIDER LOANS

Regulation O is a rather complex regulation that addresses loans to insiders and their related interests. Insiders consist of directors, executive officers, and principal shareholders, and they often represent many of the best customers of the bank. Regulation O was NOT established to discourage lending to insiders, but instead to provide reasonable restrictions and reporting requirements to prevent abusive activities. Regulation O implements legislation intended to prevent insiders from using their positions and authority to obtain loans at more favorable terms and conditions than are otherwise available to other customers of the bank. Limits on insider borrowings are also established, and reporting requirements for indebtedness of executive officers and principal shareholders to correspondent banks are outlined.

An executive officer is defined as anyone who participates in or has the authority to participate in major policymaking functions of the bank. The president and other members of senior management such as the chief financial officer, senior lender, and senior marketing officer are defined as executive officers. In most cases, the chairman of the board

is also considered an executive officer. Furthermore, for purposes of Regulation O, executive officers, directors, and principal shareholders include those of the company of which the member bank is a subsidiary and all other subsidiaries of that company.

The primary restrictions of Regulation O that banks are most likely to encounter are highlighted below. Civil money penalties can be substantial for violations of Regulation O.

SECTION 215.4. Five General Restrictions for Loans or Extensions of Credit in the Areas of (1) Terms and Creditworthiness, (2) Prior Approval, (3) Lending Limit, (4) Aggregate Lending Limit, and (5) Overdrafts.

Terms and Creditworthiness. This section prohibits executive officers, directors, and principal shareholders from borrowing unless the loans are made on substantially the same terms including interest rates and collateral as those for comparable loans to persons not covered by this section. Also, these loans cannot involve more than the normal risk of repayment or have other unfavorable features.

Example

The board of directors approves an unsecured loan to EVP Campbell at the prime rate, which conforms to the bank's loan policy. However, unsecured loans to other customers are made at prime plus 1 percent. This loan violates Regulation O even though the loan policy does not prohibit these types of loans because loans to executive officers, directors, and principal shareholders must be on substantially the same terms as loans to persons not covered by this section.

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Example

Director Seale has several loans with the bank that were classified by the examiners at the last examination. One of these loans matures, and Director Seale is able to pay only the interest and asks the directors to renew the loan for one year. This renewal would be a violation of Regulation O because the loan was classified as a problem credit by the examiners, indicating that it involved more than the normal risk of repayment.

Prior Approval. Proposed loans to executive officers, directors, and principal shareholders and all related interests of those individuals which, when aggregated with other outstanding loans, exceed the higher of \$25,000 or 5 percent of the member bank's unimpaired capital and unimpaired surplus (as defined in Regulation O) must receive prior approval by a majority of the board of directors of the bank, and the interested party must abstain from participating directly or indirectly in the voting. Loans to one insider together with loans to his or her related interests always require board approval if the loans in the aggregate exceed \$500,000.

Problem: Director Rivers owns a construction company that requires several loans each month to finance the business. It is very inconvenient for the board to meet every time Director Rivers needs a loan.

Solution: Approve a line of credit for Director Rivers or his or her related interests annually. However, participation in the discussion by Director Rivers or any attempt by Director Rivers to influence the voting by the board of directors regarding the extension of credit constitutes indirect participation and is a violation of Regulation O.

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Lending Limit. Extensions of credit to executive officers and principal shareholders or any of their related interests that are not fully secured are limited to 15 percent of the bank's unimpaired capital and unimpaired surplus. An additional 10 percent of the bank's unimpaired capital and unimpaired surplus can be extended when the loans are fully secured by readily marketable collateral having a market value, as determined by reliable and continuously available price quotations, at least equal to the amount of the loan. For state member banks, if state lending limits are more restrictive than the above, the state limits apply.

Examples of readily marketable collateral would be equities traded by one of the recognized stock exchanges, obligations of the U.S. government and its agencies, and corporate bonds, but NOT real estate.

Example

On June 30, 2001, Director Wise requested an unsecured loan of \$250,000. A related interest of Director Wise, ABC Manufacturing, already had a loan with a balance of \$500,000 secured by equipment and inventory, and this balance represented 15 percent of the bank's unimpaired capital and unimpaired surplus. The board of directors could not approve the \$250,000 loan to Director Wise because the combined loans would exceed the 15 percent lending limit. Even though the \$500,000 loan is secured, Director Wise is not eligible for the additional 10 percent lending threshold because the collateral pledged does not have a readily determinable market value.

Aggregate Lending Limit. The aggregate amount of outstanding extensions of credit by the bank to all of its insiders generally cannot exceed the bank's unimpaired capital and unimpaired surplus.

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Member banks with deposits of less than \$100 million may by annual resolution of its board of directors increase the general limit to a level not to exceed two times the bank's unimpaired capital and unimpaired surplus provided that specific conditions are met as outlined in the regulation. Certain loans based on types of collateral are exempt from this limit.

Overdrafts. This section states that no bank may pay an overdraft of an executive officer or director on an account at the bank unless the payment of funds is made in accordance with (1) a written, preauthorized, interest-bearing credit plan that specifies a method of repayment or (2) a written, preauthorized transfer of funds from another account of the account holder at the bank. Inadvertent overdrafts on an account totaling \$1,000 or less where the account is overdrawn five business days or less are excluded. The bank must charge the executive officer or director the same fee charged any other customer in similar circumstances.

Example

Director Huson has three checking accounts that require his signature. On one account, he is a cosigner with his daughter in college. She inadvertently writes an overdraft for \$50, which the bank pays. When she returns home two weeks later, she discovers the overdraft and immediately deposits money to cover it. The overdraft represents a violation of Regulation O because Director Huson signs on the account and the overdraft was outstanding more than five business days.

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Example

Director Gignoux has a personal account and a business account with the bank and signs on both accounts. The bookkeeper at the business inadvertently overdraws the account for \$5,000. The bookkeeper discovers the error two days later and makes a deposit to cover the overdraft. The overdraft has violated Regulation O because Director Gignoux signs on the account and the amount of the overdraft was more than \$1,000.

SECTION 215.5 - *Additional Restrictions on Loans to Executive Officers.* In addition to the restrictions on loans to insiders detailed elsewhere in Regulation O, this section places additional restrictions on loans to executive officers. However, banks may extend credit to executive officers (1) in any amount to finance the education of the officer's children, (2) in any amount to finance or refinance the purchase, construction, maintenance, or improvement of the executive officer's residence if the loan is secured by a first lien on the residence and the residence is owned (or will be owned after the loan is made) by the executive officer, and (3) for any other purpose when limited to the higher of 2.5 percent of the bank's unimpaired capital and unimpaired surplus or \$25,000, but never more than \$100,000. These limitations only apply to executive officers of the lending bank, but not to executive officers of an affiliate.

SECTION 215.22 - *Reports on Indebtedness of Executive Officers and Principal Shareholders to Correspondent Banks.* If during any calendar year an executive officer or principal shareholder of a member bank, or a related interest of either, has an extension of credit from a correspondent bank of the member bank, the executive officer or principal shareholder is required to make a written report on or before January 31 of the following year to the board of directors

of the member bank that includes the following items:

- The maximum amount of the indebtedness to each of the correspondent banks
- The amount of the debt existing ten business days before the written report required by this section is filed
- A description of the terms and conditions of each extension of credit including the original amount, maturity date, origination date, collateral, interest rate, and purpose.

FEDERAL RESERVE ACT

Congress passed the Federal Reserve Act in 1913. As stated in its preamble, the Act's purpose is in part to provide for more effective supervision of banking in the United States. The following sections focus on banking supervision.

SECTION 22. This section governs the conduct of directors and officers. When the bank purchases anything from directors, officers, or their related interests, or sells anything to these persons, these transactions must be made in the normal course of business and on terms not less favorable to the bank than terms offered to others. Where a vote of the directors is required, the director who is involved is required to abstain.

Banks are not allowed to pay to any director, officer, attorney of the member bank, or employee a greater interest rate on deposits than it pays to other customers on similar deposits.

SECTION 23A. This section applies to all state-chartered member banks and all FDIC-insured banks. It governs or establishes requirements for transactions (known as "covered transactions")

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between a bank and its affiliates subject to certain exemptions that are defined in the section.

Section 23A "covered transactions" include any loan or extension of credit by a bank to its affiliate; a purchase by the bank of securities issued by an affiliate; a purchase of assets from an affiliate; acceptance of securities issued by an affiliate as collateral for a loan; and issuance of a guaranty or letter of credit on behalf of an affiliate.

Examples

The bank and Landco are affiliates. The bank purchases real estate from Landco as the site for the bank's new branch. The purchase is a covered transaction between the bank and Landco.

Bank A and Bank B are affiliates. Bank A lends money to Mr. X for the purpose of buying newly issued stock from Bank B. This is a covered transaction between Bank A and Bank B.

Section 23A Affiliate Defined:

The following examples are the most common types of affiliates directors will encounter.

Any company in which a majority of its directors or its controlling shareholders constitute a majority of the directors of or have a controlling ownership interest in the bank.

Example

Four of your bank's five directors own 40 percent of the bank, and these same four directors own Company Z. Company Z would be an affiliate.

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Any company that controls the bank (i.e., a bank holding company), and any other company that is controlled by the company that controls the bank. Control typically is defined as a person or company that owns, controls, or has the power to vote 25 percent or more of any class of voting stock.

Examples

XYZ Holding Company owns 85 percent of the bank's outstanding stock. XYZ also owns 50 percent of Company Y. Both XYZ and Company Y would be affiliates of the bank because XYZ controls the bank and Company Y.

Principal Shareholder Morgan owns 25 percent of the stock of the bank. All companies or partnerships in which Ms. Morgan owns, controls, or has the power to vote 25 percent or more of the stock are affiliates of the bank.

Any company that the Federal Reserve System determines to be an affiliate because the bank may be adversely affected by the relationship with the company.

Example

President Lang decides that the bank should lend \$85,000 to Company A, which happens to be owned by his brother-in-law. Company A is insolvent, but the loan is within the president's lending authority. Company A could be determined to be an affiliate under Section 23A.

Section 23A General Restrictions:

Basically all extensions of credit to affiliates including overdrafts of affiliates must meet specific collateral requirements as defined in Section 23A. A common mistake that banks make is to pay an overdraft of its holding company, which is an affiliate under Section 23A. This is a violation of Section 23A because the payment is an extension of credit that is unsecured.

A bank may not enter into covered transactions with any one affiliate that, when aggregated, exceed 10 percent of the bank's capital stock and surplus.

A bank may not enter into covered transactions with all of its affiliates that, when aggregated, exceed 20 percent of the bank's capital stock and surplus.

Any extension of credit by the bank to an affiliate must be secured by collateral that meets specific requirements spelled out in Section 23A(c).

For the purposes of this section, any transaction by the bank with any person will be deemed to be a transaction with an affiliate if the proceeds of the transaction benefit the affiliate.

Example

Director Smith owns 30 percent of the bank's stock and is the sole owner of Company X. The bank lends money to an individual to buy a vacation home from Company X. This transaction would be considered a loan to an affiliate because the proceeds directly benefited Director Smith's company.

A bank may not purchase low-quality assets from an affiliate.

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Example

Your bank agrees to purchase a loan from an affiliate bank that examiners classified substandard at the affiliate bank's recent examination. Your bank would violate Section 23A if it purchases the loan because the loan is considered to be a low-quality asset because of the substandard classification.

Any transaction with an affiliate shall be on terms consistent with safe and sound banking practices. There is no exception to this provision.

SECTION 23B. This section is similar to Section 23A in that it also governs transactions with affiliates but it has a broader scope of activities that are considered "covered transactions." The section generally requires that transactions between affiliates must be on comparable terms and conditions as transactions with nonaffiliates. In the absence of comparable terms and conditions, the standard is that those transactions would have been made in good faith with non-affiliated companies. The following transactions are included:

- ✓ The sale of securities or other assets to an affiliate
- ✓ The payment of money or the furnishing of services to an affiliate under contract, lease, etc. (e.g., data processing, loan review, or internal auditing services)
- ✓ Any transaction where the affiliate acts as agent or broker and receives a fee for its services from the bank
- ✓ Any transaction with a third party if the affiliate has an interest in the third party
- ✓ Any transaction where the proceeds are used for the benefit of the affiliate.

Section 23B also prohibits a bank from guaranteeing the obligations of an affiliate or advertising that it will be responsible for the obligations of an affiliate.

SECTION 24A. This section limits (as a percentage of capital as defined in the section) a bank's investment in premises or a bank's investment in or loans to a company that holds the bank's premises.

FINANCIAL INSTITUTIONS REFORM, RECOVERY AND ENFORCEMENT ACT

Federal legislation of 1989 (in response to the savings & loan and banking crisis) that in part expanded the enforcement powers of banking regulators, authorized banking agencies to assess substantial civil and criminal money penalties, and added bank fraud to crimes covered by the Racketeer Influenced and Corrupt Organizations Act. For the purposes of this primer, the focus is primarily on Title IX of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), the enforcement provisions, and how FIRREA affects directors of financial institutions. The provisions of Title IX granted the regulatory agencies many enhanced enforcement powers over financial institutions and persons associated with them. The following is a brief summary of these provisions:

Regulatory agencies can undertake enforcement actions against a person for up to six years after the person has left the institution. This provision was implemented to thwart persons who resigned from the bank simply to avoid regulatory action.

FIRREA increased civil money penalties for banking violations. It established three tiers of maximum penalties: \$5,000 per day, \$25,000 per day, or \$1 million per day, depending on the seriousness of the violation. The maximum penalty would apply to persons who knowingly and recklessly violate laws or regulations, breach fiduciary duties, or engage in unsafe or unsound practices.

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FIRREA increased to 20 years the maximum prison term for various banking related offenses. It also increased the maximum penalty for violating a removal order (i.e., a person removed from banking) to \$1 million and 5 years in prison.

The regulatory agencies must publicly disclose formal enforcement actions (Written Agreements and Cease and Desist Orders) as well as any modification or termination of such action. Publication can be delayed for a reasonable time if the regulatory agencies determine that disclosure would threaten the safety and soundness of a financial institution. Informal supervisory actions (Board Resolutions and Memoranda of Understanding) do not have to be disclosed.

Regulatory agencies are required to review all new directors and senior executive officers who are proposed to be appointed or hired by new banks or bank holding companies, or for institutions that

- have capital below minimum capital standards
- have been designated as "troubled" institutions.

The agencies have the authority to issue a notice of disapproval to stop the appointment or employment of a person if the agency feels that appointing that person is not in the best interest of depositors or the public. The agencies consider a person's competence, experience, character, and integrity.

FIRREA expanded the universe of persons subject to enforcement under the Federal Deposit Insurance Act by specifying that an "institution-affiliated party" subject to enforcement is

any director, officer, employee, or controlling shareholder (other than a bank holding company) of, or an agent for, an insured depository institution

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any other person who filed or is required to file a Change in Control notice

any shareholder (other than a bank holding company), consultant, joint venture partner, and any other person as determined by the appropriate Federal banking agency who participates in the conduct of the affairs of an insured depository institution

any independent contractor (including attorneys, appraisers or accountants) who knowingly or recklessly participates in any violation of any law or regulation, any breach of fiduciary duty, or unsafe or unsound practice, which caused or is likely to cause more than a minimal loss to or have a significant effect on the institution.

FIRREA granted Temporary Cease and Desist authority. Specifically, if the regulatory agency determines that either an insured depository institution's books and records are so inaccurate so as to preclude the appropriate Federal banking agency from determining the financial condition of that institution or the details or purpose of any transaction that may have a material effect on the financial condition of that institution, the agency may issue a temporary order requiring

the cessation of any activity or practice which gave rise to the incomplete or inaccurate state

affirmative action to restore the books or records to a complete and accurate state until completion of the proceeding under the subsection.

Removal orders can be issued against institution-affiliated parties if it is determined that the party directly or indirectly violated any law or regulation, any Cease and Desist Order, conditions imposed in writing by the appropriate agency, or any Written Agreement between the depository institution and such agency.

No federally insured depository institution may discharge or otherwise discriminate against any employee with respect to compensation or terms, conditions, or privileges of employment because the employee provided information to any Federal banking agency or to the Attorney General. Any employee or former employee may file a civil action in the U.S. District Court within two years. The complainant shall also file a copy of the complaint with the regulators. If the court determines that a violation has occurred, it may order the institution to reinstate the employee to his or her former position, pay compensatory damages, or take actions to remedy past discrimination.

FEDERAL DEPOSIT INSURANCE CORPORATION IMPROVEMENT ACT

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) addressed new supervisory functions and responsibilities of the Federal banking agencies. The purpose of FDICIA is "To require the least-cost resolution of insured depository institutions, to improve supervision and examinations, to provide additional resources to the Bank Insurance Fund, and for other purposes." FDICIA affected many existing banking laws: the Federal Deposit Insurance Act (FDI Act), the Federal Reserve Act, the Bank Holding Company Act, FIRREA, and the International Banking Act of 1978. The following addresses the protection of the bank insurance fund including real estate lending standards, and prompt corrective action for problem institutions.

FDIC Risk-Based Insurance Premiums. The FDIC implemented a risk-based premium program whereby those institutions posing more risk to the insurance fund (e.g., institutions in less than satisfactory condition, not well capitalized, etc.) pay higher premiums on deposits as determined by the FDIC.

Brokered Deposit and Interest Rate Restrictions. The FDIC enacted a rule which increases the number of institutions that are subject to interest rate restrictions on brokered deposits. The rule separates banks and thrift institutions into three classes based on level of capitalization. The classes are well-capitalized, adequately capitalized, and undercapitalized (refer to the Prompt Corrective Action section below for definitions). Well-capitalized banks may accept, renew, or roll over brokered deposits. Adequately capitalized banks must obtain permission from the FDIC to use brokered deposits. When adequately capitalized institutions are permitted to accept brokered deposits, interest payments are limited to 75 basis points above the rate paid on similar deposits in the institution's normal market or the national rate for deposits accepted outside the normal market. Undercapitalized banks will not be able to accept brokered deposits or offer rates 75 basis points higher than prevailing rates.

Real Estate Lending Standards (Regulation H - Appendix C). The Federal banking agencies also adopted real estate lending standards, which include guidelines requiring the use of loan-to-value percentages. The regulation requires institutions to establish prudent policies governing real estate lending practices including underwriting standards and comprehensive loan administration requirements. The policies require annual review and approval by the board of directors.

Interagency guidelines contain directives on maximum loan-to-value (LTV) percentages, eligible exceptions, an allowance for non-conforming loans, and elements of good lending policies. The LTV guidelines

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(dollar amount of loan compared to the dollar amount of the collateral securing the loan) are outlined in the following table. Loans exceeding these LTV limits must be reported regularly to the board of directors.

Loan Category	LTV Limit
Raw Land	65%
Land Development	75%
Nonresidential Construction	80%
1-4 Family Residential	85%
Improved Property	85%

Prompt Corrective Action (Regulation H - Subpart D). Prompt Corrective Action establishes a framework of supervisory action for insured depository institutions that are not adequately capitalized. The principal purpose of Subpart D of Regulation H is to define for state member banks the capital measures and capital levels that are used for determining the supervisory action authorized under FDICIA.

Each institution is assigned to one of five capital categories based on its risk-based capital ratios: (1) well capitalized; (2) adequately capitalized; (3) undercapitalized; (4) significantly undercapitalized; and (5) critically undercapitalized. As required by FDICIA, minimum tier 1 leverage and risk-based capital ratios have been established for each level except the critically undercapitalized level. This level is based on a minimum tangible equity capital to total assets ratio of 2 percent.

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Summary of Prompt Corrective Action (PCA) Standards

Category	Total RBC Ratio		Tier 1 RBC Ratio		Tier 1 Lev Ratio		Additional Requirements
Well Capitalized	≥10.0	and	≥6.0	and	≥5.0	and	Not subject to any Written Agreement, Capital Directive, or PCA Directive
Adequately Capitalized	≥8.0	and	≥4.0	and	≥4.0	and	Does not meet the definition of a "well capitalized bank"
Undercapitalized	<8.0	or	<4.0	or	<4.0	or	Leverage ratio <3.0 percent if "1" CAMELS rated and no significant growth
Significantly Undercapitalized	<6.0	or	<3.0	or	<3.0		
Critically Undercapitalized	Tangible equity capital ≤ 2.0 percent of total assets.						

Most supervisory actions available under Prompt Corrective Action are triggered at the undercapitalized level. When an institution's capital ratios fall into the undercapitalized range, the bank is subject to the following actions: (1) a capital restoration plan is required within 45 days of notification, (2) dividends and management fees are restricted, (3) asset growth is restricted, and (4) agency monitoring of the institution is increased. In addition, a number of discretionary actions can further restrict the activities of the bank. Undercapitalized institutions that fail to submit or implement a capital restoration plan

are treated as significantly undercapitalized institutions. Some discretion is eliminated at the significantly undercapitalized level where there is a presumption in favor of requiring recapitalization or merger, restricting transactions with affiliates, and restricting interest rates paid on deposits. At the critically undercapitalized level, the FDIC is required to place stringent limits on the activities of the institution, and the institution could be placed in receivership unless other action is clearly preferable.

Although the requirements of Prompt Corrective Action are generally tied to a bank's capital levels, an institution may be dropped one capital category (e.g., treated as undercapitalized when its capital ratios qualify as adequately capitalized) based on the non-capital elements of the CAMELS rating used by examiners. An institution can also be reclassified if it is found to be operating in an unsafe and unsound manner. However, an institution cannot be reclassified as critically undercapitalized unless its tangible equity capital actually falls to or below the threshold of 2 percent of total assets.

Capital Restoration Plans. As noted before, a written capital restoration plan showing in part how the bank will become at least adequately capitalized is required to be filed with the appropriate Reserve Bank within 45 days from the date that the bank receives notice or is deemed to have been notified that the bank is undercapitalized, significantly undercapitalized, or critically undercapitalized unless the Federal Reserve notifies the bank in writing of a different time period. The capital restoration plan must be viable and include realistic assumptions to receive regulatory approval.

BANK SECRECY ACT

The Bank Secrecy Act (BSA) was enacted in 1970 and governs financial recordkeeping and the reporting of currency and foreign transactions (known as Currency Transaction Reports, or CTRs) to help prevent the use of currency in illegal transactions and to help uncover suspicious transactions or persons. Basically, all cash deposits, withdrawals, or transfers of \$10,000 or more must be reported. All banks are required to have an effective compliance program in place to ensure that the requirements of the BSA are being met. Specifically, the board of directors must approve a written program that establishes a system of internal controls to ensure ongoing BSA compliance, which includes independent testing of the program, designates a person who is responsible for day-to-day compliance, and provides for training. The program should include strong senior management commitment. An effective program also addresses Know Your Customer (KYC) or Enhanced Due Diligence (EDD) policies and practices to ensure that suspicious activity is identified by the bank and properly reported. Suspicious activity is reported in a Suspicious Activity Report (SAR), which is filed with the Financial Crimes Enforcement Network (FinCEN). The BSA program that includes KYC/EDD policies is one of the most effective deterrents to money laundering. Fines can be substantial for not complying with the Act.

U.S.A. PATRIOT ACT

This far-reaching law was enacted in October 2001. It contains strong measures to prevent, detect, and prosecute terrorist activities and international money laundering. The law includes numerous provisions for fighting international money laundering and blocking terrorist access to the U.S. financial system. The provisions affecting

banking organizations are generally set forth as amendments to the Bank Secrecy Act. In part, the U.S.A. PATRIOT Act, which applies to insured depository institutions as well as to the U.S. branches and agencies of foreign banks, requires certain additional due diligence policies, procedures and controls that are reasonably designed to detect and report instances of money laundering mainly through private banking and correspondent accounts.

SARBANES-OXLEY ACT

Otherwise known as the "Corporate Reform Act," it is a sweeping law enacted in 2002 covering SEC registered companies and addressing such items as financial reporting accuracy, conflicts of interest, corporate ethics, oversight of the accounting profession, and new civil and criminal penalties. Key provisions of the Act include but are not limited to (i) requiring the chief executive officer and chief financial officer of SEC registered companies to certify the accuracy of financial statements, including pro forma information; (ii) requiring management and independent auditor assessments/attestations regarding the effectiveness of the institution's internal controls; (iii) requiring companies to disclose whether or not at least one member of the institution's audit committee is a "financial expert;" (iv) restricting or limiting a securities issuer's purchase of other services, such as internal audit services, from its independent auditors; (v) setting restrictions and/or reporting requirements for insider stock transactions and insider loans; (vi) establishing protection, including the right to sue, for corporate whistleblowers; (vii) granting more time for investors to file securities fraud lawsuits; and (viii) increasing sentences for financial crimes.

CHANGE IN BANK CONTROL ACT

This Act, implemented by Subpart E of Regulation Y, addresses control of banks and bank holding companies and it gives federal regulatory agencies the authority to approve or deny ownership or control changes in banks and bank holding companies. The Act applies to individuals, partnerships, corporations, trusts, associations, joint ventures, ownership pools, sole proprietorships, and unincorporated organizations.

For any proposed control changes as defined in Regulation Y, a formal "Notice of Change in Control" must be filed, detailing the proposed acquisition, various types of personal and biographical information, financial information, information on any structural or managerial changes contemplated for the institution, and any other relevant information. The Federal Reserve is required to review the competitive impact of the transaction, the financial condition of the acquiring person, and the competence, experience, and integrity of that person and the proposed management of the institution. In assessing the financial condition of the acquiring person, the Federal Reserve considers and weighs any debt servicing requirements of that person. The Federal Reserve also considers the institution's earnings performance, asset condition, capital adequacy, future prospects, and the likelihood that an acquiring party will make unreasonable demands on the resources of the institution.

Persons contemplating an acquisition that would result in a change in control (as defined in Regulation Y) of a bank or bank holding company should request appropriate forms and instructions from the Federal Reserve Bank in whose District the institution is located. If there is any doubt about whether a proposed transaction requires a

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notice, the acquiring person should seek legal counsel or consult the Federal Reserve Bank for guidance. The Act places the burden of providing the notice on the prospective acquiring person, and substantial civil penalties can be imposed for willful violations.

It should be noted that Regulation Y includes several presumptions of control, i.e., situations where companies or individuals may own less than 10 percent of a bank in their own names, yet still trigger a filing requirement. For individuals this frequently occurs with regard to shares held by members of their "immediate family." Such shares are counted together so that family groups are often found to "control" a bank despite the fact that the individuals do not vote together or consider their family members as having any influence over their voting decisions. The term "immediate family" is defined quite broadly and includes, among other relatives, step-children, step-parents, and in-laws. Hence, as a director you should be mindful of related individuals who own stock in the bank or bank holding company.

REGULATION L - INTERLOCKING MANAGEMENT OFFICIALS

Regulation L was adopted to increase competition among financial institutions by generally prohibiting a director or other management official from serving two non-affiliated banks where such a structure could be anti-competitive.

The regulation applies to two types of trade areas. The first is a community, which is defined as a city, town, or village as well as adjacent or contiguous cities, towns, or villages. Also, community includes two towns that are within 10 road miles of each other. The second type of trade area is large cities, also known as metropolitan statistical areas.

Community. A management official of a depository institution may not serve at the same time as a management official of an unaffiliated depository institution if the TWO depository institutions in question (or a depository institution affiliate thereof) have offices in the same community.

Relevant Metropolitan Statistical Area (RMSA). A management official of a depository institution may not serve at the same time as a management official of an unaffiliated depository institution if the depository institutions in question (or a depository institution affiliate thereof) have offices in the same RMSA and each depository institution has total assets of \$20 million or more.

This regulation also prohibits, without regard to location, a management official of a depository institution with assets exceeding \$2.5 billion from serving as a management official of any unaffiliated depository institution with total assets exceeding \$1.5 billion. There are several exceptions to these prohibitions.

DIVIDEND PAYMENT LIMITATIONS (REGULATION H – SUBPART A)

A state member bank must receive Federal Reserve approval before declaring or paying cash or property dividends if the total of all dividends including the proposed dividend declared during the calendar year exceeds the sum of the bank's net income (as reported in its Call Report) during the current calendar year and the retained net income of the past two calendar years, less any required transfers to surplus or a fund for the retirement of any preferred stock. "Retained net income" in a calendar year is equal to the bank's net income less any

dividends declared during the year. Even if the bank can legally pay dividends under Regulation H, the board should ensure that any dividend payment is reasonable based on the bank's overall financial condition and operating trends.

GRAMM-LEACH-BLILEY ACT

The Gramm-Leach-Bliley Act (GLBA), which became effective in March 2000, allows for the most sweeping changes in the financial services industry since the Depression-era barriers were imposed by the Glass-Steagall Act of 1933. In part, by repealing Sections 20 and 32 of the Glass-Steagall Act and some sections of the Bank Holding Company Act of 1956, banks, insurance companies, securities firms and other financial institutions may now consolidate under common ownership and may provide a broad spectrum of financial services. For banks and bank holding companies, one of the main changes GLBA offers is the concept of a financial holding company (FHC).

A bank holding company meeting certain criteria can elect to become an FHC, enabling it to engage in expanded financial activities compared with other bank holding companies. A bank holding company that is not part of an FHC may engage only in the activities enumerated in Section 4(c)(8) of the Bank Holding Company Act. Regulation Y details the requirements or conditions that must be met for a BHC to elect and maintain FHC status. The Act also addresses other areas including the privacy of customer information.

CONSUMER PROTECTION LAWS

All state member banks are examined to determine compliance with consumer protection laws and regulations: Regulations B, C, D, E, G, H, M, P, Q, Z, AA, BB, CC and DD; the Fair Credit Reporting Act; the Fair Debt Collection Practices Act; the Fair Housing Act; the Homeowners Protection Act; the Real Estate Settlement Procedures Act; and the Right To Financial Privacy Act. The following is a summary of several key laws and regulations.

Regulation B - Equal Credit Opportunity Act. Although primarily concerned with consumer protection, this regulation applies to all loans, both business and consumer. This regulation prohibits creditors from discriminating against applicants on the basis of age, race, color, religion, national origin, sex, marital status, or income assistance. As a general rule, questions about these matters cannot be asked on credit applications. Certain exceptions apply for residential mortgage applications. Model forms are provided in the regulation to aid with compliance. Banks are required to give applicants written notice of rejection, the reason for the rejection, and a statement of the applicant's rights under the Equal Credit Opportunity Act.

Management must ensure that an institution's lending practices are not illegally discriminatory and that the policies and practices do not result in disparate treatment of applicants on a prohibited basis. Examiners perform a comprehensive review of each institution's underwriting standards, staff training, and marketing practices. Samples of accepted and rejected applications are also reviewed to determine whether standards are applied uniformly and fairly.

Regulation C - Home Mortgage Disclosure Act. This regulation provides citizens and public officials with information relevant to determining whether banks are meeting the housing credit needs of

their local communities. Banks located in a metropolitan statistical area must annually disclose information about the origination or purchase of each home purchase, improvement, or refinance loan. Data on rejected loans are also included.

Regulation E - Electronic Funds Transfers Act. This regulation covers electronic funds transfers (EFT) and prescribes rules for

- the solicitation and issuance of ATM (automated teller machine) and debit cards
- a consumer's liability for unauthorized electronic fund transfers (resulting from stolen or lost cards)
- disclosure of certain terms and conditions of EFT services
- documentation of electronic transfers (e.g., on periodic statements).

Regulation P - Privacy of Consumer Financial Information. This regulation governs the treatment of nonpublic personal information about consumers by the financial institutions. In particular, the regulation requires a financial institution to provide notice to customers about its privacy policies and practices; describes the conditions under which a financial institution may disclose nonpublic information about consumers to nonaffiliated outside parties; and provides a way for consumers to prevent a financial institution from disclosing that information to most nonaffiliated outside parties by opting out of that disclosure, subject to the exceptions listed in the regulation.

In addition to assessing adherence by the banks, each regulatory agency is required to establish appropriate "standards" for administrative, technical, and physical safeguards to ensure the security and confidentiality of customer records and information; to protect against any anticipated threats or hazards to the security or integrity of these records; and to protect against unauthorized access

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to or use of these records or information, which could result in substantial harm or inconvenience to any customer.

Regulation Z - Truth in Lending Act. This regulation outlines uniform methods of computing the cost of credit, disclosure of credit terms, and procedures for resolving errors on certain credit accounts. Consumer credit is generally defined as credit offered or extended to individuals for personal, family, or household purposes where the credit is repayable in more than four installments or for which a finance charge is imposed.

The major provisions of the regulation require lenders to

- provide borrowers with meaningful, written information on essential credit terms including an annual percentage rate
- respond to consumer complaints about billing errors on certain credit accounts within a specific time
- identify credit transactions on periodic statements of open-end credit accounts
- provide certain rights on credit cards
- inform consumers of the right to rescind within three days certain loans that are secured by their principal dwelling
- comply with special requirements when advertising credit.

Regulation AA - Consumer Complaints. This regulation establishes consumer complaint procedures and defines unfair or deceptive acts or practices of banks when extending credit to consumers. Any consumer complaint received by the regulatory agencies will be investigated. The regulatory agency acknowledges the complaint within 15 business days and sends a substantive reply within a reasonable period of time.

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Regulation AA - Credit Practices Rule. The regulation also prohibits unfair or deceptive acts or practices in or affecting commerce. In particular, this rule defines unfair or deceptive acts or practices of banks in connection with extensions of credit to consumers and prohibits certain contractual provisions in consumer loan agreements. It also requires a special notice to cosigners.

Regulation DD - Truth in Savings Act. This regulation prescribes uniform methods for computing interest on deposit accounts. It also requires that detailed disclosures reflecting deposit account terms be available to consumers and that certain information be disclosed on periodic statements. For interest-bearing accounts, the interest must be expressed as an "Annual Percentage Yield" (APY). The regulation also governs advertising for deposit accounts.

Liability for Violations. Most of the consumer laws and regulations provide for civil liability for violations of regulatory requirements. A good compliance program limits the bank's exposure to risk from lawsuits and the possibility of substantial penalties. In general, the civil liability provisions state that the bank is liable for a consumer's court costs and attorney's fees and in individual cases, punitive damages between \$100 and \$10,000. For class action suits, the liability can be up to the lesser of \$500,000 or 1 percent of the bank's net worth.

Director Responsibility. Directors are responsible for ensuring that compliance responsibility has been assigned appropriately within the organization. *Each bank should have a designated and qualified compliance officer, and that person should have the time and resources to effectively manage the compliance function.* A good compliance program includes written policies and procedures as well as provisions for internal review, audit, and training for employees. The compliance officer and loan administration should work together to ensure compliance with applicable consumer laws and regulations.

COMMUNITY REINVESTMENT ACT

Through the Community Reinvestment Act of 1977 (CRA), Congress and the regulatory agencies have tried to strike a balance between the competing interests and responsibilities of banks and community groups. Bankers have charged at times that the regulators show bias toward the community organizations by pressuring banks into negotiated settlements with groups filing CRA protests and delaying decisions on challenged applications. On the other hand, community organizations have criticized the regulators for lax enforcement and reluctance to grant protestants more time to research their case against banks. Criticism from both groups may be the best indication that the regulatory agencies have steered the proper course. Regardless, CRA is currently at the forefront of banking and will remain one of the hottest topics for bankers and regulators.

What is CRA? The Act "encourages" banks to help meet the credit needs of their local communities. CRA could be thought of as a social contract between a bank and the community it serves. It is a reaffirmation of the idea that banks are granted charters with the understanding that they will help meet the convenience and needs of the communities where they are located. Banks have a continuing and affirmative obligation to serve the public and especially to help meet the deposit and credit needs of the local communities in which they are chartered, but these practices need to be consistent with safe and sound operations. This obligation, which is a significant difference between banks and private businesses, exists because financial institutions have some special privileges including (a) deposit insurance and (b) access to the special borrowing privileges of the Federal Reserve Discount Window.

What is the role of the regulatory agencies? CRA requires federal agencies that supervise financial institutions to encourage institutions

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to help meet the credit needs of their communities including the needs of residents in low- and moderate-income neighborhoods. It also requires the supervisory agencies to assess an institution's record of community service during examinations and to consider that record when deciding an application involving that institution. However, an institution's efforts to meet community needs must be in keeping with principles of safe and sound operation.

How do banks comply with the requirements of the CRA? An institution is required to post a public notice about CRA in its offices and to establish a public file for comments about the bank's CRA performance.

What should you know about a CRA examination? Examiners will assess how well an institution has helped to meet the credit needs of its community and through the examination process will encourage it to respond to those needs if necessary. These assessments are made as part of the regularly scheduled examinations of the institution. The examiners prepare a written confidential report of the examination, which is given to the directors of the institution. The Act also provides for public disclosure of the bank's CRA rating and the regulator's assessment of the bank's performance. The rating system has four categories: Outstanding, Satisfactory, Needs to Improve, and Substantial Noncompliance.

What are the consequences of a poor CRA rating? A poor (needs to improve or worse) CRA performance record may result in denial of an application. Primarily expansion applications, whether for a branch opening, merger, or acquisition may be denied when an institution's record under CRA is found to be inconsistent with its obligations under CRA. In addition, prohibited discriminatory or other illegal credit practices, which are adverse factors under CRA, will also result in sanctions under the Equal Credit Opportunity Act, federal fair housing laws, or other consumer credit protection laws.

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The regulatory agencies consider it important that financial institutions act effectively to meet the requirements of CRA in a positive and ongoing manner. This can be done in a way that will not only benefit local communities, but also will be consistent with the safe and sound operation of financial institutions. Accomplishing this goal requires a concerted effort by the directors and senior management. Meeting the credit needs of a community requires first an understanding of those needs and second, an ongoing awareness of changes that may occur in those needs. However, through a sound management response to the challenges presented by CRA, banks can be agents of positive change.

Note

Please refer to the Glossary section under "Regulations" for a brief description of other regulations.

CHAPTER V GLOSSARY

In addition to the normal banking terms with which you are probably familiar, the following terms are frequently used either during examinations or in the commercial examination report.

AFFILIATE. A company related to the bank as a result of common ownership or control. Laws and regulations place restrictions or limitations on transactions between a bank and its affiliates.

ALCO. The Asset Liability Management Committee, which is responsible for aiding in and overseeing asset/liability management including liquidity and interest rate risk. Generally, this committee is composed of senior officers from various areas of the bank such as lending, investments, and operations, plus some outside directors.

ALLOWANCE FOR LOAN AND LEASE LOSSES (ALLL). (Formerly the reserve for bad debts.) An allowance set up by management based on the bank's level of problem and potential problem loans and past experience with loan/lease losses. As losses occur, they are charged against this allowance. For this reason, the allowance is counted as part of a bank's capital. Under risk-based capital guidelines, the allowance may be counted as tier 2 capital up to 1.25 percent of risk-weighted assets. As a general benchmark, a bank's ALLL should cover 100 percent of loss loans, 50 percent of doubtful loans, 10-20 percent of substandard loans, and a minimum of 1 percent of the remaining loan portfolio. Refer to the Federal Financial Institutions Examination Council (FFIEC) letters of guidance about the ALLL. Also see the definition for Provision Expense for Loan and Lease Losses.

ASSET/LIABILITY MANAGEMENT. The management of a bank's assets and liabilities to maintain adequate liquidity and to limit the sensitivity or exposure to interest rate changes. In part, management attempts to match the repricing of liabilities with the repricing of assets to maintain a stable net interest margin.

ASSET CLASSIFICATION CATEGORIES:

- ❑ **Special Mention.** These assets have potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the bank's credit position. Examples of credits that might be

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listed for special mention include loans in which the lending officer is unable to properly supervise the credit because of a lack of expertise, deviations from prudent lending practices, or adverse trends of an obligor that have not yet reached the point where a potential loss is predictable. This category is NOT included in a bank's total classified assets ratio (see below), but the amount of loans in this category is considered by examiners in determining asset quality.

- ❑ **Substandard.** An asset that is inadequately protected by the current sound worth and paying capacity of the borrower or of the collateral pledged. These assets have a well-defined weakness that jeopardizes the repayment of the debt. These assets are also characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.
- ❑ **Doubtful.** These assets have all the inherent weaknesses of a substandard asset in addition to the weakness that repayment or collection in full is highly questionable or improbable based on current facts, conditions, and values. An asset may be classified doubtful if there is a distinct likelihood that a loss is possible but the amount of the loss cannot be determined.
- ❑ **Loss.** These assets are considered uncollectible or of such questionable value that their continuation as bankable assets is not warranted. They should be eliminated from the bank's books.

AUDIT. Examination and verification of a company's books, records, and processes by someone with appropriate expertise such as an accountant. The internal audit function ensures the accuracy of financial data and reporting, adherence to laws and regulations, and adherence to bank-specific policies, procedures, and other internal controls.

BANKERS ACCEPTANCES. Also referred to as an "acceptance." A bank that accepts negotiable time drafts or bills of exchange assumes the obligation to pay the holder of the draft the face amount of the instrument on the maturity date specified. These instruments are used primarily to finance the export, import, shipment, or storage of goods.

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BANKER'S BLANKET BOND. Fidelity bond purchased from an insurance company that protects the bank against loss stemming from a variety of reasons including employee fraud, robbery, burglary, and forgery.

BANK HOLDING COMPANY. A company that owns or controls directly one or more banks. The Federal Reserve Bank regulates all commercial bank holding companies in the District in which the holding company is headquartered. Bank holding companies need to serve as sources of financial strength to their banks.

BANK HOLDING COMPANY ACT OF 1956, AS AMENDED. Act that defines a bank holding company and governs its activities.

BANK HOLDING COMPANY PERFORMANCE REPORT (BHCPR). A quarterly survey of financial information comparing a bank holding company with consolidated assets in excess of \$150 million to institutions with similar characteristics.

BASIS POINT. A unit of measurement. One basis point equals one one-hundredth of one percentage point. A ratio that has increased from 3.50 percent to 3.75 percent has increased 25 basis points.

BOARD RESOLUTION. Also referred to as a Resolution. An informal supervisory action representing a plan of action initiated by the directors (generally at the regulator's insistence) to correct reported deficiencies. See also Memorandum of Understanding, Written Agreement, and Cease and Desist Order.

BROKERED DEPOSIT. Any deposit that a bank receives from brokers or dealers for the account of others either directly or indirectly. Also, any deposit on which a bank pays more than 75 basis points over the prevailing market rate.

CALL REPORTS. Also known as the Reports of Condition and Income, these are filed quarterly with the regulatory authorities detailing a bank's balance sheet and income statement data.

CAMELS RATING. A rating based on (in order) Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to Market Risk. Each of these components is rated between 1 and 5. 1 is the best rating, and 5 is the worst rating. More specifically, ratings of 1 = strong, 2 = satisfactory, 3 = fair, 4 = poor, and 5 = unsatisfactory. These component ratings coupled with a separate "risk management" rating strongly influence the bank's composite rating.

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The lower a bank's composite rating, the less concern the regulators have. An example of a rating might be 222232/2 (a satisfactory rating overall). CAMELS ratings are disclosed to bank management but not to the general public.

CAPITAL. Measured through leverage and risk. The adequacy of the capital position and the related capital ratios depends on the overall condition and risk profile of the bank. A bank in strong financial condition with well diversified risk and without any significant supervisory, financial, or operational weaknesses can operate with lower capital ratios than banks that do not demonstrate these characteristics. Directors should refer to the capital thresholds detailed in the Federal Reserve's Capital Adequacy Guidelines and in the Prompt Corrective Action guidelines. Tier 1 capital for state member banks includes common equity, minority interests in equity accounts of consolidated subsidiaries, and qualifying noncumulative perpetual preferred stock, less goodwill. The Federal Reserve may exclude certain other intangibles and investments in subsidiaries as appropriate. Risk-Based Capital measures a bank's capital by assigning various risk weights to balance sheet categories. Also, off-balance-sheet items are considered. The Federal Reserve prefers that banks' capital ratios remain in the well capitalized range under the Prompt Corrective Action guidelines.

CEASE AND DESIST ORDER. Often referred to as a C&D or an Order, it is a legally binding formal supervisory action issued by the regulators mandating that a bank immediately cease conducting some activity in which it is engaging, has engaged, or is about to engage. This document is normally public information and would be disclosed in various public reports such as a 10-K, 10-Q, Federal Register, or annual report.

CHARTER. Legal authorization to conduct business as a bank granted by the Treasury Department's Office of the Comptroller of the Currency for national banks and by the state banking departments for state-chartered banks.

COMMERCIAL BANK. State bank or national bank owned by stockholders including a bank holding company that accepts deposits, makes commercial and industrial loans, and performs other banking services for the public.

CORE DEPOSIT. Deposits acquired in a bank's natural market area that count as a stable source of funds that have a predictable cost and are not significantly interest rate sensitive.

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CURRENCY TRANSACTION REPORTS. Internal Revenue Service report that banks are required by the Bank Secrecy Act to complete for a currency transaction (including aggregate currency transactions for the same customer) of \$10,000 or more.

DE NOVO BANK. A newly chartered bank, typically less than five years old.

DIRECTORS AND OFFICERS INSURANCE. Also known as D&O insurance, it is liability insurance protecting a bank director or officer against lawsuits.

EARNING ASSETS. The assets that generate income for the bank. The dollar sum of loans (less unearned income), investment securities, interest bearing accounts in other banks, and any other type of asset that generates interest or fee income, generally measured as a percentage of total assets.

ECONOMIC VALUE OF EQUITY. An analytical model to help management determine what effect changes in interest rates will have on the value of a bank's assets and liabilities (and therefore equity). Also see Income Simulation.

EFFICIENCY RATIO. The noninterest expense incurred by the bank to generate income. This measurement is calculated by dividing all noninterest expense by the sum of noninterest income and net interest income. The lower this measurement, the better.

ERRORS AND OMISSIONS INSURANCE. Liability insurance protecting a lender against losses due to negligence, improper documentation, and other errors.

FDICIA. The Federal Deposit Insurance Corporation Improvement Act of 1991. This act created many provisions that addressed new supervisory functions and responsibilities of the Federal banking agencies. Along with many other areas, this act addresses the safety and soundness of the bank insurance fund, increased regulatory supervision, and prompt regulatory (corrective) action.

FEDERAL DEPOSIT INSURANCE CORPORATION. Also referred to as the FDIC. The agency of the federal government that insures accounts at most financial institutions. This agency also has primary federal supervisory authority over insured, state-chartered banks that are not members of the Federal Reserve System.

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FEDERAL RESERVE BANK. One of the 12 regional banks in the Federal Reserve System. Activities include providing central bank services such as check collection, access to the Federal Reserve's Wire Network (Fed Wire), and credit advances through the Discount Window; establishing monetary policy with the Board of Governors of the Federal Reserve System; and regulating state-chartered member banks and bank holding companies.

FEDERAL RESERVE BOARD. Seven-member board governing the Federal Reserve System.

FINANCIAL HOLDING COMPANY. Also referred to as an FHC. The Gramm-Leach-Bliley Act allowed a bank holding company, under certain conditions, to engage in a broader range of financial activities including securities underwriting, insurance underwriting, and merchant banking. To become a financial holding company, an organization must declare that it wants to be an FHC; its depository institutions must be well capitalized, well managed (have a management rating of 2 or better and have a composite CAMELS rating of 2 or better), and have a satisfactory or better CRA rating; and it must file a declaration containing various data about the holding company and its depository institutions. Once named an FHC, the institution must adhere to various criteria or risk losing the advantages of being an FHC.

FIRREA. The Financial Institutions Reform, Recovery and Enforcement Act of 1989. This law enhanced enforcement power over financial institutions and persons associated with them. Substantial monetary penalties can be levied for non-compliance with this Act.

GAP ANALYSIS. Generally defined as the quantity of interest-sensitive assets that reprice within any given time period compared to the quantity of interest-sensitive liabilities that reprice in that same period, providing a general measure of how interest rate changes will affect net income. A positive gap means that more assets than liabilities reprice in the period. If more liabilities reprice, the bank has a negative gap. Several different types of GAP analysis exist including static, modified static, beta-adjusted, and dynamic.

INCOME SIMULATION. A more forward-looking analytical model to help management determine what effect changes in interest rates will have on the bank's net interest income and net income (i.e., earnings at risk, or EAR).

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INTERLOCKING DIRECTORATES. Regulation L prohibits a management official of a state member bank or bank holding company from serving as a management official of another depository organization if the organizations are not affiliated and are located in the same community or market area, or are very large. There are several exemptions provided in this regulation.

MEMORANDUM OF UNDERSTANDING. Commonly referred to as an MOU. An informal document signed by both the directors and the regulatory authorities, an MOU is a plan of action to correct noted weaknesses in the bank or in management.

NET INTEREST MARGIN. Often known as NIM, it is the bank's interest income less interest expense (tax adjusted), divided by the bank's average earning assets. The higher the NIM the better. It reflects the effectiveness of the bank's asset/liability management practices and strategies.

NONACCRUAL LOAN. Any loan (1) that is maintained on a cash basis because of the financial condition of the borrower, (2) for which payment in full of interest and principal is not expected or is in question, or (3) for which principal or interest has been in default for 90 days or more unless the debt is both well secured and in the process of collection.

NONCORE OR VOLATILE LIABILITIES. Funds that are normally less stable than other deposits, especially if the bank has significant financial deterioration or other problems. These liabilities consist of time deposits greater than \$100K, foreign office deposits, federal funds purchased and securities sold under agreement to repurchase, interest-bearing demand notes issued to the U.S. Treasury, and other liabilities for borrowed money. These sources of funds are typically more costly than other sources of funds and can adversely affect a bank's net interest margin if not maintained at reasonable levels. Owners of these funds typically are concerned with interest rates.

OFF-BALANCE-SHEET ITEMS. Contingent liabilities of a bank that do not appear on its financial statement. These items typically consist of unfunded loan commitments, standby letters of credit, financial futures and forward contracts, various option arrangements, foreign exchange contracts, participation in acceptances conveyed or acquired by the bank, and unfunded pension benefits.

OVERHEAD EXPENSES. Otherwise known as noninterest expense. The cost of maintaining the bank's payroll and physical facilities and other operating expenses. These expenses include such items as salaries and benefits, rent, operating lease

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payments, repairs and maintenance, insurance, property taxes, and utilities.

PEER GROUP. A grouping of banks or bank holding companies of similar characteristics for comparison; used primarily in the Uniform Bank Performance Report (UBPR) and the Bank Holding Company Performance Report (BHCPR). The factors considered include asset size, whether or not the bank has branches, and whether or not the bank or holding company is located in a metropolitan area. There are many different peer groups.

PROMPT CORRECTIVE ACTION. Establishes a framework of supervisory actions for insured depository institutions that are not at least adequately capitalized. The principal purpose is to define for state member banks the capital measures and capital levels that are used for determining supervisory actions.

PROVISION EXPENSE FOR LOAN AND LEASE LOSSES. The expense account that a bank uses to increase its allowance for loan and lease losses. From an accounting standpoint, to add money to the ALLL, provision expense is debited and the ALLL is credited. Deterioration in asset quality results in an increase in provision expense.

REGULATIONS

The following is a brief description of the regulations not specifically discussed elsewhere in this booklet.

- Regulation A:** Explains rules for borrowing from the Federal Reserve Discount Window.
- Regulation D:** Establishes uniform rules for maintaining reserves at the Federal Reserve Banks.
- Regulation F:** Sets limits on obligations of banks to other banks.
- Regulation G:** Implements certain provisions of the Gramm-Leach-Bliley Act as these provisions relate to fulfilling requirements of the Community Reinvestment Act.

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- Regulation H:** A broad regulation that governs state member banks and state-chartered banks seeking membership in the Federal Reserve System. It covers many items including prompt corrective action standards, dividend limitations, real estate lending/appraisal standards, requirements for compliance with the Bank Secrecy Act including filing Currency Transaction Reports and Suspicious Activity Reports, and rules governing banks' ownership and control of financial subsidiaries.
- Regulation I:** Details requirements for buying Federal Reserve Bank stock for banks joining the Federal Reserve System.
- Regulation J:** Defines rules for check collection and the handling of returned checks.
- Regulation K:** Defines rules for foreign or international bank operations in the United States and sets forth rules for foreign operations of U.S. banks.
- Regulation M:** Implements the leasing provisions of the Truth in Lending Act by requiring detailed disclosure of leasing terms.
- Regulation Q:** Prohibits interest payments on demand deposits.
- Regulation S:** Describes reporting requirements for banks making domestic and foreign wire transfers, and establishes rates for reimbursement to banks for providing customer records to a government agency.
- Regulation T:** Prescribes rules for loans by securities brokers and dealers.
- Regulation U:** Prescribes rules for banks when lending money to buy or carry margin stocks.
- Regulation W:** Implements Sections 23A and 23B of the Federal Reserve Act.
- Regulation X:** Makes borrowers subject to the provisions of Regulations T and U when obtaining credit outside or inside the U.S. to buy securities.

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- Regulation Y:** Covers many topics dealing primarily with bank holding companies. Topics include changes in control and permissible nonbank activities.
- Regulation BB:** Implements the Community Reinvestment Act.
- Regulation CC:** Governs the availability of funds deposited in checking accounts and the collection of returned checks.
- Regulation EE:** Details the banks that are covered by statutory provisions regarding netting contracts.

RETURN ON AVERAGE ASSETS. Also known as ROAA, it is the bank's net income as a percentage of the bank's average assets. If the ratio is not computed as of year-end, the net income for the period is annualized. The ratio measures how well the bank is using its assets to produce earnings. This is a key regulatory measurement.

RETURN ON AVERAGE EQUITY. Also known as ROE, it is net income as a percentage of average shareholders' equity. A key measurement used by shareholders to gauge the return on their investment.

RISK-BASED CAPITAL. See Capital.

STATUTORY BAD DEBT. Any debt due to a bank on which interest is past due and unpaid for a period of six months, unless the debt is well secured and in the process of collection.

SUPERVISORY ACTIONS. Formal (legally binding) and informal actions between a bank's board of directors and regulatory authorities. The intent is to effect a plan of corrective action to improve a bank's overall condition. Informal actions include Board Resolutions and Memoranda of Understanding; formal actions include Written Agreements and Cease and Desist Orders. (See individual definitions.) Although informal actions are normally between the bank and the local Reserve Bank, adherence to their provisions is just as important as adherence to the provisions of a formal action.

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TOTAL CLASSIFICATION RATIO. The sum of all classified assets divided by the sum of the bank's tier 1 capital plus the ALLL. A key measurement along with the weighted classification ratio (see below) used by the examiners in assigning a rating to asset quality and possibly other CAMELS components.

UNIFORM BANK PERFORMANCE REPORT (UBPR). A quarterly survey of financial information comparing banks with similar characteristics (peer groups). The data are compiled from Call Reports.

WEIGHTED CLASSIFICATION RATIO. The sum of 20 percent of substandard assets, 50 percent of doubtful assets, and 100 percent of loss assets divided by the sum of the bank's tier 1 capital plus the ALLL. The ratio measures the severity of the total classifications. Two banks could have the same total classification ratio but different weighted classification ratios.

WRITTEN AGREEMENT. A formal, legally binding document that outlines a specific plan of corrective action designed to return a bank to a satisfactory condition. The agreement addresses pertinent deficiencies in the bank or management and is entered into between the directors and the regulatory authorities. This document, like a Cease and Desist Order, is publicly disclosed.