

A top-down view of a dark brown wooden desk. In the top left corner, a portion of a silver laptop is visible. In the top right corner, a white ceramic coffee cup with a gold-colored rim is filled with black coffee. In the center, a black notebook is open, showing a white page with a blue header and a grid. A dark blue pen with a silver tip and clip lies diagonally across the bottom left of the notebook page. The text "Sixth Edition" is printed in a white serif font on the coffee cup. The title "BASICS for Bank Directors" is printed in a large, black serif font on the notebook page.

Sixth Edition

BASICS *for* **Bank
Directors**

FEDERAL RESERVE BANK *of* KANSAS CITY
Division of Supervision and Risk Management

BASICS *for* Bank Directors

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Federal Reserve Bank of Kansas City
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www.BankDirectorsDesktop.org

Bank directors serve a critically important role in the leadership and oversight of the institutions they govern.

At the Federal Reserve Bank of Kansas City we have consistently found a strong correlation between overall bank health and the level of director engagement. Generally, we have seen that the institutions that are well run and have fewer problems are under the oversight of an engaged and well-informed board of directors. Conversely, in cases where banks have more severe problems and recurring issues, it is not uncommon to find a disengaged board that may be struggling to understand its role and fulfill its fiduciary responsibilities.

With a goal of helping both directors and banks succeed, we began producing *Basics for Bank Directors* after the banking crisis of the 1980s— a time when I was one of many in bank supervision who saw firsthand the critical oversight role that a board of directors can play. Although banking and the financial system have changed much since that time, the connection that we see between director engagement and a bank's stability has remained.

We hope that this sixth edition can serve as a resource. Our goal is to not only help directors better understand their role, but to also provide information that reinforces the role of strong oversight. This book includes what we believe to be helpful insight for directors in understanding and evaluating a bank's operations and performance.

In connection with this volume, the Federal Reserve System also offers an online companion course that is accessible at no charge. It can be found at www.BankDirectorsDesktop.org.

We hope that these resources prove helpful and assist you in successfully leading your institution and serving your community.

ESTHER L. GEORGE

President

March 2016

Acknowledgments

Forest E. Myers, policy economist of the Federal Reserve Bank of Kansas City for more than 30 years, authored Basics for Bank Directors in 1993. Forest retired at the end of 2008, but his legacy lives on in this book and in its online companion course, *Bank Director's Desktop*.

We are confident that Forest's work has made better directors of those availing themselves of these two significant resources. For that, we are grateful for his efforts and the efforts of the many people who contributed to this book over the years.

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Introduction

In today's world, commercial banks are fighting hard to maintain their historic role as leaders of the financial community. They are faced with increasing pressures from competitive institutions which are eager to offer services that have heretofore been restricted to banks; ... A bank director, particularly a non-management director, has a greater opportunity and a greater responsibility today than at any period in recent history ...¹

These words, written in 1974, could just as easily describe challenges facing banks and bank leadership in the 21st century. If anything, events of the last three decades reinforce this earlier observation: Banks must work harder to meet shareholder profit expectations and more is expected from bank directors.

Increased competition from other financial service providers, increased regulatory compliance requirements, financial and technological innovations coupled with cybersecurity and third-party vendor concerns, and economic swings have made it difficult for bank management to steer a consistently profitable course. As a result, many banks have merged or been acquired by others. Today, slightly more than 4,700 commercial banks operate in the United States, compared with nearly 14,500 in the mid-1980s.

Additionally, legal changes and court actions have placed greater responsibility and accountability on bank directors. For example, the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) strengthened regulatory authority and increased penalties for directors and others responsible for problems at banks. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) required increased board oversight of bank affairs and placed greater responsibility on outside directors of larger banking organizations.

The focus on directors intensified with the massive corporate scandals and failures of the early 2000s (e.g., Enron), which propelled the passage of the Sarbanes-Oxley Act of 2002 (SOX). The financial crisis of 2008 resulted in the federal government adopting

the nearly \$1 trillion Troubled Asset Relief Program (TARP) and led to a renewed focus on the role of independent directors in evaluating corporate strategy, risk, and compensation. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) included many corporate governance provisions.

Dodd-Frank specifically prohibits incentive-based compensation that encourages inappropriate risk taking by an executive employee, director, or principal shareholder that would lead to material loss to the bank.

Subsequent court decisions have clarified what constitutes director negligence, making it easier for the Federal Deposit Insurance Corporation (FDIC) to pursue claims in some states against directors of failed institutions.

As the future unfolds, outside directors will play an increasingly important role in guiding their banks and serving as unbiased judges of their banks' operational performance. Outside bank directors differ from "inside" or "management" directors because they do not serve as officers and management officials of the bank and own less than 5 percent of its stock.

Fulfilling this role requires some diligence and can be challenging. Studies reveal that many failed banks were supervised by directors who received insufficient or untimely information or were inattentive to the bank's affairs. This impaired their ability to judge bank operations and to identify and correct problems.

For outside directors to meet the demands placed upon them, they must be knowledgeable, well-informed, and active in overseeing the management of their banks. In light of these challenges, you might ask, "Why serve as an outside bank director?" The answer is that banks play an important role in the economic lives of their communities. As a director, you can have influence over and help shape your local economy.

Further, many consider service as a bank director to be an honor. You may be asked to serve for a variety of reasons, including your business expertise or prominence in your community. Whatever the reason, your invitation to serve is testimony to the valuable contribution the bank's shareholders believe you can provide to its management.

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While a director's job is important and carries responsibility, it is not as daunting as it first appears. Basic management experience and skills necessary to succeed in other endeavors are equally applicable to banks. Thus, the knowledge and experience you have developed in your profession can be effectively used in your role as a director. Add to this an inquisitive attitude and willingness to commit time and energy to bank matters, and you have many of the attributes of an effective bank director.

The only things missing may be a basic knowledge of banking and what to consider in overseeing a bank. Many approaches could be followed to impart this knowledge. The approach used here employs many of the methods, techniques, and reports used by examiners to evaluate bank condition and compliance.

This is not to suggest that directors should behave as bank examiners. Rather, you, like the examiner, must be able to draw conclusions about your bank's condition in a relatively short time without intimate knowledge of its daily operations. An examiner-like approach allows you to focus on key bank operations and gives you an organized way to understand bank affairs.

Before we move into the main section of the book, we want to leave you with this thought on the need to learn the basics. The legendary Green Bay Packers football coach Vince Lombardi recognized the importance of teaching basics to his players. Even after winning championships and being surrounded by future Hall of Fame players, Lombardi had a tradition of beginning every preseason training camp by standing before his players, holding a football in one hand and saying, "Gentlemen, this is a football."² He assumed that his players were a blank slate at the beginning of each season. With that in mind, we begin in Chapter 1 with the very basic discussion, "Ladies and gentlemen, this is a bank."

Endnotes

¹Theodore Brown, "The Director and the Banking System," *The Bank Director*, ed. Richard B. Johnson, (Dallas: SMU Press, 1974), p. 3.

²David Maraniss, *When Pride Still Mattered: A Life of Vince Lombardi*, Simon & Schuster, New York, New York, 1999, page 274.

LADIES AND GENTLEMEN, THIS IS A BANK

What is a bank? This may seem like an elementary question, but it is important to start at the beginning of what being a bank director is all about and where you fit in.

The word “bank” evokes different mental pictures for different individuals. Some will think of the quintessential bank building with the big stone columns and a large vault. Others will envision a balance sheet showing a bank’s assets, liabilities, and capital. Still others will fall back on the regulatory definition of a bank, which is, generally, an organization that is chartered by either a state or the federal government for the purpose of accepting deposits. Banks also may make loans and invest in securities.

For your purposes, however, a bank is a financial intermediary—it acts as a financial go-between. People who save money put it on deposit in a bank. People who need money ask for loans. A bank lends out a portion of the deposits to qualified borrowers, hopefully for a higher interest rate than is paid on the deposits. The bank may also invest some of its deposits in U.S. government securities, municipal bonds, or other investments. This use of deposits, by the way, distinguishes banks from other industries that rely solely on capital to support their activities.

This intermediary role is what makes a bank so important to its community. Through loans and investments, a bank fosters economic development, job creation, and a system to easily transfer money between individuals or businesses. A bank is, in effect, a community’s economic engine.

However, that engine generates risk. Risk is generally defined as the potential that events—planned or unanticipated—may have an adverse impact on capital and earnings. The Federal Reserve has identified six categories of risk:

1. **Credit risk** arises from the potential that a borrower or counterparty will fail to repay the bank as agreed.
2. **Market risk** is the risk to a bank’s condition resulting from adverse movements in market rates or prices, such as interest rates, foreign exchange rates, or equity prices.
3. **Liquidity risk** is the potential that a bank may be unable to meet its obligations as they come due, because of an inability to liquidate assets or obtain other funding (referred to as “funding

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liquidity risk”) or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market disruptions (referred to as “market liquidity risk”).

4. **Operational risk** is the risk resulting from inadequate or failed internal processes, people, and systems or from external events.
5. **Compliance risk** is the risk of regulatory sanctions, fines, penalties or losses resulting from failure to comply with laws, rules, regulations, or other supervisory requirements applicable to a financial institution.
6. **Legal risk** is the potential that actions against the institution that result in unenforceable contracts, lawsuits, legal sanctions, or adverse judgements can disrupt or otherwise negatively affect the operations or condition of a financial institution.

Risk Management

Taking and managing risks are fundamental to the business of banking. Accordingly, the Federal Reserve emphasizes the importance of sound risk management processes and strong internal controls when evaluating the activities of the institutions it supervises.

Properly managing risks is critical to ensuring compliance with banking laws and regulations and meeting the needs of the bank’s customers. Risk management has become even more important as new technologies, product innovation, and the size and speed of financial transactions have changed the nature of financial services markets.

This is where you come in as a director. In addition to being a financial intermediary, a bank is also a corporate entity governed by a board of directors elected by the shareholders to represent and protect their interests. Thus, directors are an important part of a bank’s governance system, possessing ultimate responsibility for the conduct of the bank’s affairs.

A director’s major responsibility regarding risk is to provide a management structure that adequately identifies, measures, controls, and monitors risk. Examiners give significant weight to the quality of risk management practices and internal controls when evaluating management and the overall financial condition of banks. Failure to establish a risk management structure is considered unsafe and unsound conduct. Whenever you see or hear the term “unsafe and unsound” from a bank examiner, the issue is very serious and will require some immediate corrective action or response from the

board of directors and management. That action or response may be prescribed in something called an enforcement action, which is discussed in Chapter 5.

As a director, you won't be involved in day-to-day management of the bank, but you will be involved in the bank's strategic plan. This will determine the bank's direction, how it will conduct its business, and address acceptable products the bank may offer. The policies you adopt will set the risk limits for those products.

You also will participate in board of directors meetings, read the various reports that are reviewed at the meetings, supervise bank management, and know the bank's financial condition. In short, you and your management team will identify, measure, control, and monitor your bank's risk to achieve profitability.

This just covers a general description of your duties and responsibilities. A more detailed discussion occurs in the Management section of Chapter 3.

Before we move on, here is a word of caution. Directors are typically asked to serve on a board by the bank's chief executive officer (CEO). That often engenders some allegiance to that CEO; however, it is important to remember that management works for the board of directors, not the other way around. It is equally important for both the board and management to understand this concept.

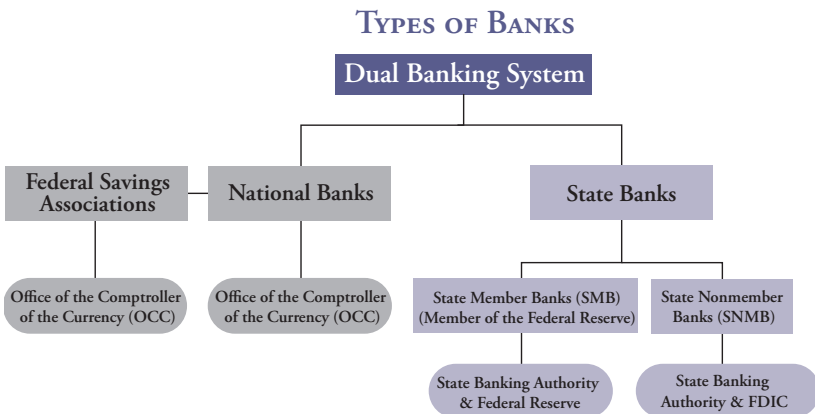
REGULATORY FRAMEWORK

Now that you know what a bank is and the associated risks, this chapter will describe the regulatory framework in which banks are created and supervised. A director's major duties regarding regulators include:

- knowing your bank's regulator;
- reviewing reports and other correspondence from the regulator;
- formulating corrective action of any issues identified in those regulatory reports and correspondence;
- assigning responsibility to appropriate bank management or staff for implementing corrective action; and
- monitoring and managing the progress of corrective action to its timely completion.

Your bank's regulator is determined by the charter of your bank. The United States employs what is called a dual banking system in which banks can be chartered by either one of the 50 states or the federal government. See Reference 2.1 depicting the dual banking system.

Reference 2.1. The Dual Banking System and Its Regulators



Regulatory Framework

Each state has its own department that charters banks. The departments have names such as the Financial Institutions Division, Department of Banking, the Banking Commission, or other similar names. Banks chartered by the states are called state banks, although the word “state” is not required to be in the bank name.

State banks have a choice whether to become a member of the Federal Reserve System (Federal Reserve). If they choose to join the Federal Reserve, these state member banks are supervised by their state banking agency and the Federal Reserve, with the Federal Reserve being the primary federal regulator. If they elect not to join the Federal Reserve, these state nonmember banks are supervised by their state banking agency and the FDIC, with the FDIC being the primary federal regulator. State and federal regulators coordinate their examination efforts, either rotating examination responsibilities or conducting joint examinations.

The federal banking authority that charters banks and federal savings associations is the Office of the Comptroller of the Currency (OCC), a bureau of the United States Department of the Treasury. National banks must have the word “national,” or the letters “N.A.,” meaning national association, in their names. For example, you will now know that First National Bank of Anywhere, or XYZ Bank, N.A., are chartered and supervised by the OCC as the primary federal regulator.

Banks and federal savings associations are often owned and controlled by other corporations called bank holding companies (BHCs) and savings and loan holding companies (SLHCs). BHCs and SHLCs were originally formed to avoid location and product restrictions on banks and federal savings associations. Later, they provided bank and federal association owners with certain tax advantages. BHCs and SHLCs are an important feature of the nation’s banking system, controlling the vast majority of U.S. financial assets.

The Federal Reserve exercises consolidated supervisory oversight of BHCs and SLHCs, meaning that it is the umbrella supervisor for these companies, regardless of which agency regulates the subsidiary banks. Functional regulators, however, retain supervisory responsibility for the portions of BHCs and SLHCs that fall within their jurisdiction. For example, the OCC supervises national bank subsidiaries, the FDIC and state banking agencies supervise state nonmember bank subsidiaries, state insurance commissioners supervise insurance subsidiaries, and the Securities and Exchange Commission supervises broker/dealer subsidiaries.

Purpose of Regulation

The laws and regulations that govern banking have evolved over the years and accomplish several broad purposes. These purposes include maintaining or promoting a banking system that is:

- safe, sound, and stable;
- efficient and competitive; and
- “even-handed” or “fair.”³

A safe, sound, and stable banking system

The promotion of a safe, sound, and stable banking system is one of the most basic reasons for bank supervision and regulation. A stable banking system provides depositors with a secure place to keep their funds. It provides businesses and individuals with a dependable framework for conducting monetary transactions. Finally, it provides the Federal Reserve with a reliable channel through which to conduct monetary policy.

Deposit insurance, access to the Federal Reserve’s discount window and payment system guarantees, and the implicit certification of soundness that counterparties believe accompanies federal supervision and regulation are all important tools for achieving banking stability. Together, they are a significant part of a federal safety net for banking, insuring deposits and giving solvent banks access to liquidity when the need arises.

To help reduce risk to the federal safety net, the government uses a system of bank regulation and supervision. Regulations place limits or prohibit practices that experience indicates may cause banking problems, including:

- inadequate or imprudent loan policies and procedures, poor credit analysis, weak loan administration, and poor loan documentation;
- inadequate supervision by the board of directors;
- heavy reliance on volatile funding sources;
- failure to maintain adequate capital or to establish an adequate loan loss reserve;
- insider abuse and fraud; and

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- the presence of a dominant figure on the board of directors, usually the CEO.

Through laws, regulations, and on-site examinations, regulators have the supervisory tools to address such issues. Supervision also includes off-site monitoring of a bank's financial trends and other actions taken by bank management that could affect the bank's condition.

An efficient and competitive banking system

Another important purpose of bank regulation is the maintenance of a competitive banking system. A competitive banking system provides customers with the lowest priced, most efficiently produced goods and services.

A number of laws and regulations influence banking competition. Chartering and branching laws and regulations establish minimum standards for opening new banks and bank branch offices and thereby influence banking competition. Additionally, other banking statutes prohibit merger and acquisition transactions that create undue banking concentrations in any part of the country. Banking law (the Management Interlocks Act) also prohibits management interlocks among unaffiliated institutions located in the same community in order to reduce possible anti-competitive behavior.

An evenhanded or fair banking system

Another important goal of regulation is consumer protection. Some laws, such as the Truth in Lending Act, the Truth in Savings Act, and Real Estate Settlement Procedures Act, require banks to disclose information that helps consumers evaluate product options open to them. The Equal Credit Opportunity Act and Fair Housing Act require banks to be evenhanded in their customer dealings, while the Community Reinvestment Act (CRA) encourages banks to meet community credit needs. Other laws, such as the Fair Credit Reporting Act, Fair Debt Collection Practices Act, GLBA, and Fair and Accurate Credit Transaction Act, provide consumer safeguards in the extension, collection, and reporting of consumer credit. They set out administrative, technical, and physical safeguards for customer records and information, including sharing of customer information.

Bank Examinations

Each regulator employs its own group of bank examiners to examine the banks it charters or for which it is otherwise responsible. Sometimes you will hear the words “regulate” or “supervise” used interchangeably with “examine.”

Bank examinations are an important supervisory tool. The agencies use examinations to periodically assess the overall condition of an institution, its risk exposures, and its compliance with laws and regulations. Depending upon circumstances, a bank is examined every 12 to 18 months.⁴

Over the years, the agencies have worked to make the examination process more effective to ease examination burdens on banks, make the examinations more consistent, and improve communication of examination findings. They have adapted the examination process in order to respond to rapid changes occurring at financial institutions.

For example, there was a time when examiners arrived unannounced at a bank to determine its financial condition and regulatory compliance by laboriously going through its books and records. Today, examinations are generally announced in advance, and the process used to determine an institution’s financial health focuses on the institution’s risk exposures and its risk control systems in addition to checking on its financial condition. Bank examiners still arrive together, but in smaller numbers, and much of the work can be done away from the bank itself, or off-site.

With the rapid change in financial products and activities, risk management systems are critical to institutions’ safe and sound operation. As a result, internal control systems receive greater examiner attention. This increased emphasis on controls provides the supervisory agencies with a better picture of an institution’s ability to effectively deal with future events and successfully enter new activities.

The federal and state banking agencies customize their examinations to suit the size and complexity of an institution and to concentrate examination resources on activities that may pose significant risk. This is called risk-based supervision.

Off-site, prior to an examination, examiners determine the institution’s significant activities and the types and amount of risk exposure these activities pose. Once this preliminary work is completed, the information is used to develop a strategy for directing examination resources

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to significant, high-risk areas of the bank's operations.

During this risk assessment process, examiners review previous examination reports and current financial data. They might interview bank staff via telephone or make a pre-examination visit to the bank.

At this time, examiners discuss with the bank's senior management matters such as:

- the bank's economic and competitive environment;
- recent or contemplated changes in personnel, procedures, operations, and organization;
- internal audit, monitoring, and compliance programs; and
- management's own assessment of the bank's risk areas. Additionally, they review:
 - internal policies and procedures;
 - management reports;
 - internal and external audit reports;
 - audit work papers;
 - strategic plans and budgets;
 - minutes of board of directors and committee meetings; and
 - other materials necessary to gain insights regarding the extent and reliability of the bank's internal and third party vendor risk management systems.

During this process, examiners form an initial assessment of the bank's management. They may also ask for basic information on individual loans in the bank's portfolio, e.g., original loan amount, current loan balance, borrower name, payment history, etc.

Later, the examiners review capital adequacy, earnings, liquidity, and market risk and formulate questions to be asked while at the bank, or on-site. They determine a sample of loans to be reviewed using an automated loan sampling program. In addition to randomly selected credits, the sample includes:

- all loans past due 30 days or more, or on nonaccrual status;
- all previously classified loans;
- all loans to insiders;

- all loans on the bank's watch or problem loan list; and
- a random sample of loans from the remainder of the loan portfolio with balances below the loan cut.

On-site, examiners review the riskier areas identified in their preliminary work. They also continue their assessment of the bank's risk management systems and its management team.

When on-site work is completed, examiners hold an exit meeting with senior management to discuss preliminary examination results. Matters discussed at this meeting may vary, but typically include:

- scope of the examination;
- condition of the bank;
- quality of management oversight and processes; and
- matters requiring the board's and management's attention.

As part of the bank's management team, directors may want to attend the exit meeting because it provides an advance look at any strengths or weaknesses identified by the examiners. In some instances, examiners may ask directors to attend, especially when significant problems have been discovered, although a separate meeting with the board of directors is usually scheduled in light of such issues.

Subsequent to on-site work, examiners prepare their report of examination (ROE), which goes through several layers of review or what examiners refer to internally as the vetting process. The completed report is forwarded to the institution's board of directors and senior management.

The ROE provides a rating for the institution's capital, asset quality, management, earnings, liquidity, and sensitivity to market risk. These are collectively referred to as the CAMELS ratings. Examiners also assign an overall, or composite, rating. In addition, the Federal Reserve will assign a risk management rating that is not assigned by state banking authorities.

Because the ROE represents a third-party assessment of your institution's condition, it is a valuable tool for overseeing the many aspects of your bank. The ROE will contain a letter to the board of directors, giving the examiner's overall assessment of the bank's condition and summarizing significant matters found during the examination.

Those significant matters will be prominently identified in the body of the ROE. You might see headings such as "Matters Requiring

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Immediate Attention,” “Matters Requiring Attention,” or “Violations of Laws and Regulations.” You may also see comments saying that you are “required” to do something, or “encouraged” do something, in response to an ROE item. You will want to pay particular attention to these items and the violations of law.

It is important to resolve significant issues in a timely manner, assigning a specific person in the bank to the task and periodically reporting all progress to the board. One of the biggest red flags to wave at bank examiners is lack of corrective action on the substantive items noted in your last ROE, as repeated issues may be indicative of an uncooperative or unresponsive management. The same diligence should be shown in responding to internal and external audits.

Endnotes

³Kenneth R. Spong, *Banking Regulation: Its Purposes, Implementation, and Effects*, Fifth Edition (Kansas City: Federal Reserve Bank of Kansas City, 2000), pp. 5-10.

⁴State guidelines on examination frequency vary. Section 10(d) of the Federal Deposit Insurance Act, codified as 12 USC 1820 and Federal Reserve Regulation H, 12 CFR 208.64, requires that every bank and savings and loan receive a “full-scope,” on-site examination every 12 months. However, this may be extended to 18 months if an institution:

- (1) has total assets of less than \$3 billion;
- (2) is well-capitalized as defined in Regulation H, 12 CFR 208.43;
- (3) is assigned a management rating of 1 or 2 at its most recent examination;
- (4) is composite rated 1 or 2 at its most recent examination;
- (5) is not subject to a formal enforcement proceeding or order; and
- (6) has not undergone a change in control during the previous 12 months.

There are different examination frequencies for consumer compliance examinations that are also based on bank total assets size and prior ratings.

BANK SAFETY AND SOUNDNESS

The term “safety and soundness” refers to the health, or condition, of banks individually and as a group, or systemically. To assess a bank’s safety and soundness, you must consider compliance and operational matters as well as the bank’s financial condition. This requires that you establish policies to set your bank’s risk limits, govern its operations, and safeguard its assets. It also requires that you periodically check bank performance to ensure policies are being followed and are achieving desired results.

The information to do this checkup can be obtained from internal reviews, directors’ audits, external audits, examination reports, operating budgets, and the bank’s financial reports. These resources can be used to judge the effectiveness of internal controls, identify weaknesses where controls need to be added or strengthened, and judge the bank’s financial soundness.

As we mentioned in the Introduction, we will use bank examiner methods and reports in imparting a basic way a director may evaluate a bank’s condition and compliance. This involves the use of the Uniform Financial Institutions Rating System that the regulatory agencies use to evaluate a bank’s condition in six areas:

- Capital
- Asset quality
- Management
- Earnings
- Liquidity
- Sensitivity to market risk

The first letter of each of these areas is where the term, or acronym, CAMELS ratings comes from. In addition to these components, the regulators also rate risk management, Bank Secrecy Act (BSA), information technology (IT), trust, consumer compliance, and Community Reinvestment Act (CRA) performance.

Each of these component areas is viewed separately and assigned a component rating. They are considered together to arrive at an overall, or composite rating. Most of these ratings are on a scale of one to five, with one being best. However, BSA is rated satisfactory or unsatisfactory, and

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CRA is rated outstanding, satisfactory, needs to improve, or substantial noncompliance. Composite and component ratings of three or worse are considered less than satisfactory. Additionally, as ratings go from one to five, the level of supervisory concern increases, the ability of management to correct problems is questioned, the presence of regulators becomes more pronounced, and the likelihood of failure increases.

The following sections of this chapter discuss the importance of each CAMELS component, review topics that often are considered in evaluating each component, and offer ideas on how each component can be evaluated. For more explanation of the CAMELS rating system, please see the Federal Reserve's Commercial Bank Examination Manual, section A.5020.1. You may find it by going to www.BankDirectorsDesktop.org and clicking on "Resources for Bank Directors." This manual may be a good resource for other examination-related topics.

CAPITAL

As a bank director, you are responsible for making sure your bank's capital is adequate for safe and sound operation. Fulfilling this responsibility entails evaluating and monitoring your bank's capital position and planning for its capital needs.

This section discusses capital adequacy, sources of capital, the need for bank capital planning, and how to judge a bank's capital position. It also describes regulatory requirements for bank capital and how regulatory capital is measured.

Bank capital serves the same purpose as capital in any other business: it supports operations. Capital is a source of funding for the bank's assets, it absorbs losses, and it protects depositors and creditors. Different industries have varying needs for capital. Relative to nonfinancial businesses, banks operate with small amounts of capital.

Many businesses with low capital would find it difficult to borrow funds to support their operations; however, banks are able to borrow funds in the form of deposits due to the protection afforded bank depositors by FDIC deposit insurance. This protection enables banks to operate with far less capital than other firms. A bank's thin capital provides little room for error. A large, unexpected loan loss or fraud may leave a bank with inadequate capital protection. Because of this, the adequacy of a bank's capital position is an important concern for both bankers and bank regulators.

Planning for the Bank's Capital Needs

Fulfilling your responsibility to maintain adequate capital encompasses more than ensuring the bank meets the minimum regulatory capital requirements. It requires the consideration of a wide range of events and circumstances that may place demands on the bank's capital resources. Additionally, it requires developing plans for building capital resources to meet these demands.

In order to assess your bank's capital needs, you need to know its current position and the adequacy of that position in protecting the bank, now and in the future. Accordingly, you need to be familiar with the level and trend of your bank's financial condition. Familiarity with the bank's strategic plan and risk profile, which affect capital adequacy, is necessary to assess capital needs.

If your bank's lending strategy results in a high exposure to a cyclical industry known for high levels of loan losses, additional capital will be required to compensate for the concentration and level of risk. If your bank plans to increase the loan portfolio, acquire other banks, start new business activities, or make material changes to facilities, additional capital will be needed to support these efforts.

In addition to determining capital needs, directors and management must develop credible plans to raise capital as needed. A bank may sell additional stock to existing or new shareholders, issue preferred stock or subordinated debt. A bank can generate capital internally through earnings retention, or use a combination of external and internal capital sources. Alternatively, plans may call for lessening the need for capital by selling assets or by replacing higher-risk assets with lower-risk assets.

External sources of capital

Whether a bank can raise capital from external sources depends upon a number of factors. Two of the most important are the bank's financial condition and its size. Financially sound banks generally can find purchasers for their equity and debt at a reasonable cost. On the other hand, banks that are in poor or deteriorating condition may find few takers for their equity and debt instruments. Capital can be difficult to obtain during economic downturns, regardless of an organization's condition.

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Size can be another important factor in funding capital needs from external sources. Larger organizations may have better access to capital markets, giving them more options for raising capital. Smaller institutions may have fewer options, requiring them to rely largely on current shareholders for capital injections. Shareholders, however, may not have the resources to contribute capital during an economic downturn.

Internal sources of capital

Another method for building capital is through earnings retention. Depending upon your bank's circumstances, this may require making some hard choices. Bank dividends may have to be reduced or eliminated in order to maintain or attain sound capital levels, even though this may cause financial hardship for shareholders who rely on dividends as an income source or to meet income tax obligations. Your bank could face regulatory restrictions on dividend payments, as discussed below. If your bank's earnings power is low, it may have to reduce asset growth, abandon planned acquisitions, or scale back branch additions and other facility improvements.

Selling assets and reducing credit risk

An alternative to raising additional capital is to reduce the need for capital by selling assets such as income producing loans, investments, or even branch facilities or by reallocating assets to those requiring less capital support under regulatory calculations. Note that this strategy of reducing assets will improve your bank's risk-based capital ratios, discussed below, but not necessarily the leverage ratio. Assets must be high quality to be marketable and not result in losses when sold.

Selling or reallocating assets to restore a bank's capital position can have negative consequences. The sale of loans may result in the loss of good customers to other banks. In addition, asset sales may leave a bank with poorer quality and less-liquid assets. A reallocation of assets from loans to securities will lower earnings as loans are generally higher-yielding than lower-risk investments, such as U.S. Treasury and agency securities.

In summary, evaluating and planning for a bank's capital needs is a major responsibility for directors. To carry out this responsibility, directors must actively monitor the sufficiency of their bank's capital position and identify factors that may influence the adequacy of this position over time. It also requires that the directorate work with management to develop strategies to meet identified needs.

Bank capital and its regulation

Regulation H along with other regulations define capital and spell out the minimum acceptable capital levels for banks also known as adequately capitalized; however, banks are expected to operate with capital well above minimum requirements. The purpose of these regulations is to protect depositors and the federal deposit insurance fund from losses resulting from bank failures. The three federal banking agencies use a risk-based approach, together with a more traditional leverage calculation, to measure bank capital. Under this approach, the agencies define what constitutes bank capital and establish minimum capital levels.

The three U.S. federal banking agencies are responsible for writing the capital rules for depository institutions. The Federal Reserve Board of Governors (the Board) is responsible for writing capital rules for state member banks and BHCs. This book focuses only on capital requirements for community banks.

A bank's largest risk is typically credit risk contained in its loan portfolio; however, a bank also faces liquidity, market, and operational risks, to name a few. Permanent capital absorbs these other losses and unexpected losses that exceed the allowance for loan and lease losses (ALLL). The capital regulations emphasize that common stock must be the predominate form of capital as it is the most stable source of funding that can absorb losses when a bank is a going concern.

The capital rules define what constitutes capital and how much capital is required in relation to assets. As mentioned above, common stock must be the dominant form of capital, as it is the highest quality capital instrument. It does not have a maturity date or required dividend payments, thus, it cannot trigger default, and is able to absorb losses when an organization is a going concern.

The capital regulations establish different components of capital (Reference 3.1): common equity tier 1 (CET1), additional tier 1 (AT1), and tier 2 capital. Capital instruments must be paid-in, are subordinated to depositors and general creditors, and cannot be secured. The capital rules further define the criteria for each type of capital.

There are four regulatory capital ratio requirements—a leverage ratio and three risk-based ratios. The leverage ratio uses average assets in the denominator of the calculation, and the risk-based ratios use a risk-based asset amount in the denominator.

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Reference 3.1. Components of Capital

Components	Minimum requirements
<p>COMMON EQUITY CAPITAL TIER 1 (CET1)</p> <ul style="list-style-type: none"> • Common stock and surplus • Retained earnings <p>Plus/Minus: Unrealized gains/losses in Accumulated Other Comprehensive Income</p> <p>Less: goodwill and other intangible assets</p> <p>Less: deferred tax assets from net operating losses</p> <p>Less: Threshold items that individually exceed 10 percent of CET1/in aggregate exceed 15 percent of CET1</p>	<p>CET1 must equal or exceed 4.5 percent of risk-weighted assets</p> <p>A CET1 instrument, such as common stock:</p> <ul style="list-style-type: none"> • Has no maturity date • Has no required dividend payments • Is subordinated to all other claims in a receivership or liquidation • Is classified as equity under generally accepted accounting principles (GAAP)
<p>ADDITIONAL TIER 1 CAPITAL (AT1)</p> <p>Example:</p> <ul style="list-style-type: none"> • Noncumulative perpetual preferred stock and related surplus 	<p>CET1 plus AT1 must equal or exceed 6.0 percent of risk weighted assets</p> <p>An AT1 instrument:</p> <ul style="list-style-type: none"> • Has no maturity date and no incentive to redeem it • Has no required dividend payments • Is subordinated to depositors, general creditors, and subordinated debt holders in a receivership or liquidation • Is classified as equity under GAAP
<p>TIER 2 CAPITAL</p> <p>Example:</p> <ul style="list-style-type: none"> • Subordinated debt • ALLL up to 1.25 percent of risk-weighted assets 	<p>The total amount of tier 2 capital is not limited</p> <p>A tier 2 instrument:</p> <ul style="list-style-type: none"> • Is subordinated to depositors and general creditors • Has a minimum original maturity of at least five years
<p>TOTAL CAPITAL</p> <p>(CET1 - Deductions + AT1 + Tier 2)</p>	<p>Must equal or exceed 8 percent of risk-weighted assets</p>

The leverage ratio calculation does not distinguish between an asset with low credit risk, such as a U.S. Treasury note, and one with a higher amount of credit risk, such as a commercial loan. The risk-based capital ratios differentiate the credit risk of different types of assets. The risk-based calculations convert a bank's assets, including some off-balance sheet items, to risk-weighted assets by multiplying an asset by a specific weight. A bank needs to have a certain amount of capital allocated for off-balance sheet items that are likely to be funded, such as loan commitments that cannot be cancelled, and obligations that potentially pose risk to a bank, such as standby letters of credit.

Assets that pose little risk, such as cash held at the bank's offices and U.S. government securities, are weighted zero, meaning that no capital support is required for these assets and they will be excluded from the denominator of the ratio. Assets that pose greater risk are weighted at higher percentages of their dollar value, indicating the level of capital support they require.

In addition to minimum capital ratios, the capital rules require banks to maintain a capital conservation buffer. The buffer is designed to limit capital distributions, such as dividends, as a bank's regulatory capital declines. The buffer is intended to help organizations maintain capital above regulatory minimum ratios during times of stress by limiting the amount of eligible income that may be paid in dividends. The agencies also caution that banks should keep their capital above regulatory minimums for other reasons, such as increased risks from significant asset growth or unexpected losses. Reference 3.2 presents Minimum Capital Requirements and the Capital Conservation Buffer.

Prompt Corrective Action Bank Standards

In addition, to the minimum capital ratio requirements, banks that are insured by the FDIC are subject to Prompt Corrective Action (PCA) standards under FDICIA. BHCs are not subject to PCA as they are not insured depositories. The main purpose of PCA requirements is to promptly resolve capital deficiencies at insured banks to reduce bank failures. There are five PCA categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. Reference 3.3 presents PCA capital adequacy categories used by the federal banking agencies to trigger supervisory actions at the bank. You'll notice that the minimum capital ratio requirements outlined in reference 3.4 match those of an adequately capitalized bank.

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Reference 3.2. Minimum Capital Requirements and the Capital Conservation Buffer

Regulatory Capital Ratio	Minimum Capital Requirement	Minimum Capital + Capital Conservation Buffer
Tier 1 Leverage Ratio	4 percent	Not applicable
CET1 Risk-Based Capital Ratio	4.5 percent	7 percent
Tier 1 Risk-Based Capital Ratio	6 percent	8.5 percent
Total Risk-Based Capital Ratio	8 percent	10.5 percent

Reference 3.3. Prompt Corrective Active Categories

PCA Categories				
Capital adequacy category	Total risk-based ratio	Tier 1 risk-based ratio	Common equity tier 1 risk-based ratio	Tier 1 leverage ratio
Well-capitalized ⁶	10 percent or more and	8 percent or more and	6.5 percent or more and	5 percent or more
Adequately capitalized	8 percent or more and	6 percent or more and	4.5 percent or more and	4 percent or more
Undercapitalized	Less than 8 percent or	Less than 6 percent or	Less than 4.5 percent or	Less than 4 percent ⁸
Significantly undercapitalized	Less than 6 percent or	Less than 4 percent or	Less than 3 percent or	Less than 3 percent
Critically undercapitalized	Tangible Equity/Total Assets less than 2 percent			

Reference 3.4. Sample Risk-Weighted Asset Calculation

Bank Asset	Asset amount	Risk weight	Risk-weighted asset
Cash	\$5,000	.00	\$0
Balances at domestic banks	\$5,000	.20	\$1,000
Loans secured by first lien on 1-to-4 family residential property	\$5,000	.50	\$2,500
Loans secured by high volatility commercial real estate	\$20,000	1.50	\$30,000
Loans to private corporations	\$65,000	1.00	\$65,000
Total	\$100,000		\$98,500

Under PCA, banks that are inadequately capitalized face a variety of mandatory and discretionary supervisory actions. For example, “undercapitalized banks” must restrict asset growth, obtain prior approval for business expansion, and have an approved plan to restore capital. “Critically undercapitalized banks” must be placed in receivership or conservatorship within 90 days unless some other action would result in lower long-term costs to the deposit insurance fund.

In addition to mandatory actions, the agencies have discretion to require inadequately capitalized banks to, among other things, limit dividend payments, limit deposit rates paid, replace senior executive officers, and elect new directors.

The capital conservation buffer mentioned previously is not part of the PCA standards. The buffer is set slightly above the well-capitalized PCA category to help prevent a bank from unexpectedly falling below this level.

Calculating Capital Ratios

Reference 3.4 presents a sample calculation of risk-weighted assets and shows the effect of risk weighting. Risk-weighted assets may be lower than total assets, unless a bank has significant off-balance sheet activities or assets that are weighted greater than 100 percent, such as certain higher-risk acquisition, development and construction loans, and certain loans that are 90 days or more past due or on nonaccrual status.

Reference 3.5 shows a sample bank capital structure, and reference 3.6 walks through the calculation of the regulatory capital ratios using the amounts in references 3.4 and 3.5.

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Reference 3.5. Bank Capital Structure

Bank Regulatory Capital	
Common equity tier 1 capital	\$10,000
Additional tier 1 capital	\$1,000
Tier 1 capital	\$11,000
Tier 2 capital	\$500
Total capital	\$11,500

Reference 3.6. Regulatory Capital Ratios

	Leverage Ratio	CET 1 Capital Ratio	Tier 1 Capital Ratio	Total Capital Ratio
Numerator	\$11,000	\$10,000	\$11,000	\$11,500
Denominator	100,000	98,500	98,500	98,500
Ratio	11.00 percent	10.15 percent	11.17 percent	11.68 percent

Monitoring Capital Adequacy

A useful tool for evaluating your bank's capital position, as well as other areas of performance, is financial ratio analysis. A principal benefit of using ratios to analyze performance is that they provide information that dollar values may not. For example, if during the course of a board meeting you were told that your bank's equity capital doubled during an operating period, you may conclude that the bank has strengthened its capital position. However, if over the same period the bank's assets tripled, you would conclude that capital support actually declined. Financial ratios facilitate making these comparisons.

Current-period values for financial ratios do not provide a complete picture and need to be viewed in context. The trend of a bank's performance indicates whether the direction is positive or negative. With this information, you can see changes in the bank's capital position over time and evaluate whether your bank's capital will be sufficient for safe and sound operation.

Comparison with budget and peer information can be helpful. The Uniform Bank Performance Report (UBPR) is a valuable source of peer information. This report shows financial information for your bank and

a peer group of comparable banks. The report is generated from reports of condition (balance sheet) and income, also known as call reports, submitted by all FDIC-insured banks at the end of each calendar quarter. The information is fed into a database located at the Federal Financial Institutions Examination Council (FFIEC), an interagency bank supervision body that promotes consistency among the federal and state banking regulators. UBPRs may be obtained from the FFIEC website. See Chapter 6, Other Resources for Bank Directors, or select Resources for Bank Directors at *www.BankDirectorsDesktop.org*.

The comparisons allowed by the UBPR can help answer such questions as “Is the bank’s capital position where we planned it to be?” or “Is our capital position on par with similarly situated banks?”

Reference 3.7 presents ratios commonly used to monitor bank capital. The first four are used to assess compliance with regulatory capital adequacy requirements. Asset growth and capital growth information allow you to see whether one is keeping pace with the other. The ratio of cash dividends to net income, known as the dividend payout ratio, gives an indication of a bank’s ability to fund asset growth internally through earnings retention.

Certainly, bank capital serves many of the same purposes as capital in any other business. However, because bank capital protects depositors and reduces the loss exposure of the federal safety net for insured deposits, bank capital levels are subject to regulatory guidelines. It is an important director responsibility to make sure that cushion remains strong. This requires monitoring the bank’s capital position closely, anticipating capital needs, and planning ways to meet those needs.

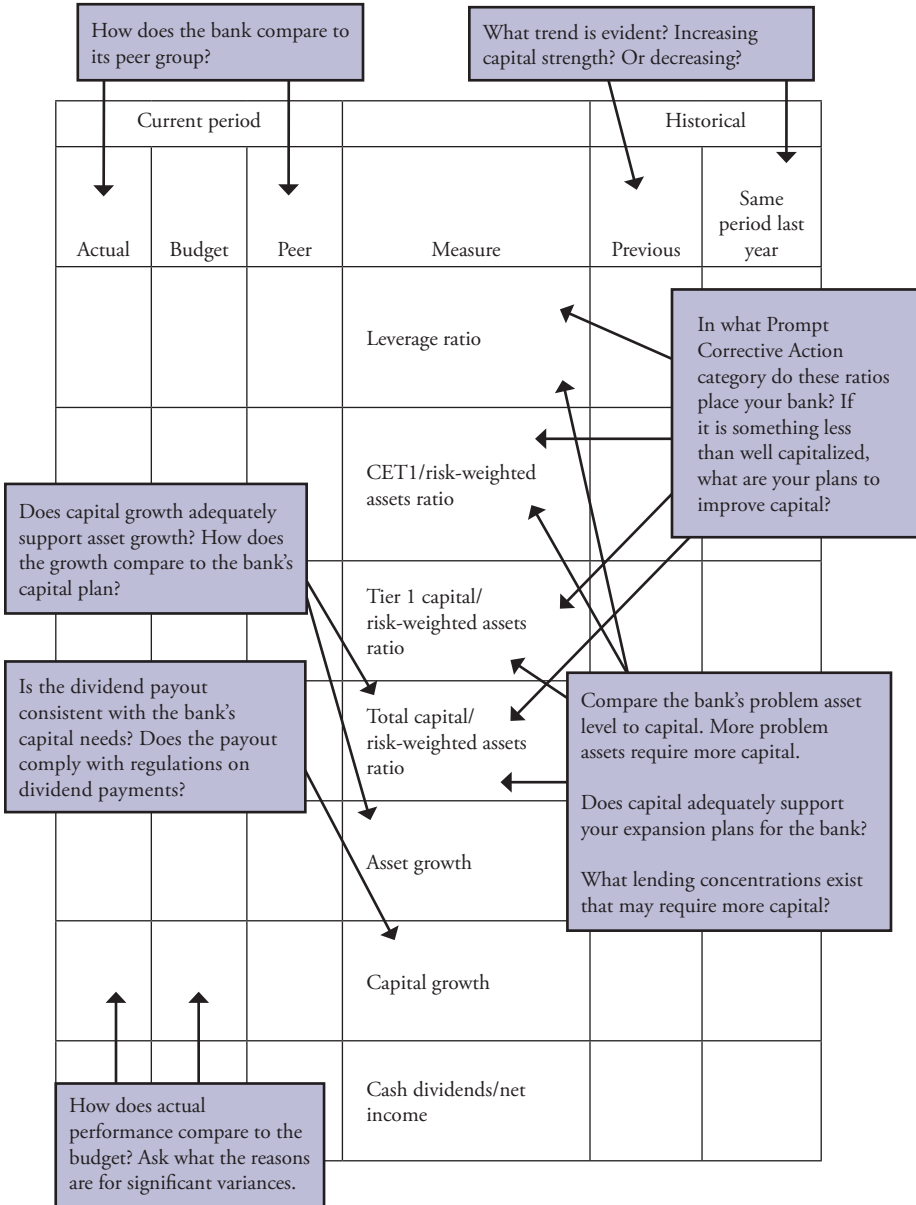
ASSET QUALITY

Your responsibilities regarding asset quality are to provide a basis for responsible lending, oversee management’s maintenance of an adequate ALLL, and retain qualified lending personnel.

You will do this through your involvement in developing and approving your bank’s lending policies. Through policies, directors set the risk limits for the bank by specifying the type of loans they want the bank to make and methods to determine an adequate ALLL.

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Reference 3.7. Ratio Analysis — Capital



Directors may also occasionally participate directly in making significant lending decisions, or reviewing, approving, and monitoring the loan decisions of others.

Asset quality refers to the amount of risk or probable loss in a bank's assets and the strength of risk management processes to control credit risk. Where these losses are judged to be small and risk management processes are strong, asset quality is considered good. Where losses are large and risk management processes are weak, asset quality is considered poor. A comprehensive evaluation of asset quality is one of the most important components in assessing the current condition and viability of a bank.

A bank can suffer asset losses in many ways. For example, it may experience loan losses because of borrower unwillingness or inability to repay. The bank may see a decline in the value of its repossessed or foreclosed collateral, like other real estate owned, because of poor market conditions. It may suffer depreciation in its securities holdings, because of market interest rate changes or issuer default. Additionally, it may experience losses from theft or incur losses on deposits held at other financial institutions that fail.

Of these losses, the greatest concern is with credit quality in the loan portfolio. This is because historically most bank failures occur because of loan problems.⁵ Loans typically constitute a majority of a bank's assets, and interest earned on loans is an important revenue source. Consequently, even relatively small problems in a bank's loan portfolio can quickly reduce earnings, deplete capital, and cause insolvency.

This section discusses bank asset quality, focusing on the quality of the loan portfolio. It discusses possible causes of loan problems and methods typically used by banks to manage loan quality. It also discusses some tools you may find useful for monitoring asset quality.

Sources of Asset Quality Problems

Over time, various lending practices have been associated with greater credit risk for banks. For example, studies show that lax lending policies, failure to follow the tenets of sound lending (including proper analysis of the borrower's ability to repay and maintaining appropriate loan documentation), excessive loans to insiders, and concentrations of credit can lead to loan problems and bank failure.

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Because of this, laws and regulations address many of these known lending troubles, and examiners during the course of their review look for compliance with these laws and regulations. Additionally, they scrutinize loan policies, loan review, loan documentation and administration, and loan monitoring, looking for weaknesses in the lending function. Despite restrictions, banks have considerable latitude in their lending.

Besides making good loans that will be repaid, it is important for the bank to judge credit risk and price it appropriately. This is the principal business of banks. Pricing appropriately means that the greater the risk, the higher the interest rate should be on the loan. How well an individual bank does this job largely determines its profitability and viability.

The Loan Policy

Decisions regarding extensions of credit, loan review, ALLL, and charge-offs are all important matters that should be addressed by written policies approved by the board of directors. Policies provide objective criteria for evaluating individual credit decisions and help promote consistency and stability in the lending function. In doing so, lending policies help a bank avoid pitfalls that may lead to loan problems.

Because a bank's lending function has ramifications for its overall financial condition, it is important that lending policies take into consideration the total bank. In this regard, the bank's lending orientation, trade area, size, facilities, personnel, and financial resources deserve consideration. The bank's trade area and customer base, competition, and the state of the local and national economy also need to be taken into account. The bank's liquidity position and its sensitivity to interest rate movements are additional factors to consider.

It is easy to see why close attention to these matters is important in guiding a bank's lending decisions. For example, if a bank's strategy is to be a consumer bank, then its lending policies should emphasize installment lending with less attention given to commercial or real estate lending. If the bank's strategy is to pursue a specialized type of lending activity, then it should make sure it has the facilities and the qualified staff necessary to support this type of lending.

Today, almost all banks operate with written loan policies. The details covered in these policies vary from bank to bank, depending upon individual needs and circumstances. Despite this, bank loan policies tend to have

common elements. For example, policies usually set out objectives to be accomplished. Basic objectives often include:

- granting loans on a sound and collectible basis;
- investing the bank's funds profitably for the benefit of shareholders and the protection of depositors; and
- serving the legitimate credit needs of the bank's community.

Additionally, most policies spell out the scope of the bank's lending activities (for example, where it will make loans, maximum size and types of loans it will make, and the terms on which it will make those loans) and how loans will be made, serviced, and collected. Additionally, they address "who will grant credit, in what amount, and what organizational structure will be used to ensure compliance with the bank's guidelines and procedures."⁶ Reference 3.8 summarizes many of the factors covered by loan policies.

ALLL

Besides the loan policy, an important consideration in managing bank asset quality is the ALLL. The ALLL was formerly called the reserve for bad debts or reserve for loan losses, so you might still hear someone refer to the ALLL as "the reserve."

The ALLL is a bank's best estimate of the amount it will not be able to collect on its loans and leases based on current information and events. To fund the ALLL, the bank takes a periodic charge against earnings. Such a charge is called a provision for loan and lease losses.

When loan losses occur, the bank charges them to the ALLL. Thus, the ALLL provides a protective cushion for bank capital and an additional layer of depositor protection.

A bank should have a defined method, or ALLL policy, for determining an adequate level for the ALLL. This may be a separate bank policy or included in the loan policy.

If the ALLL method is nonexistent or materially flawed, loans on a bank's books will be carried at inflated values. Until the proper provision is charged, earnings and capital will be overstated. This may lead to the filing of inaccurate call reports of condition and income, for which there could be monetary penalties.

Reference 3.8. Matters to Consider in Developing a Loan Policy

- Acceptable types of loans and loan collateral
- Guidelines and methods to determine ALLL adequacy
- Proportion of loans by type (agriculture, commercial, consumer, real estate) in the loan portfolio and the maximum amount the bank will commit to a single borrower, groups of borrowers, or industries
- Geographic area in which the bank will ordinarily lend
- Documentation requirements, acceptable financial ratios, and other factors considered by the bank in credit decisions
- Collateral appraisal standards and who can perform appraisals
- Pricing, structure, and other loan terms, including maximum loan term
- Limits on renewals and extensions, including specific criteria for additional lending to problem borrowers
- Periodic review, inspection, and administration of loans after disbursement
- Criteria for collecting delinquent loans and charging off loans
- Procedures for exceptions to the loan policy
- Requirements and limitation on loans to “insiders” and their related interests
- Compliance with consumer protection laws, including related to fair lending and community reinvestment
- Internal loan review program
- Reports to the board of directors
- Loan policy review by the board of directors

Generally, the ALLL policy establishes:

- lines of responsibility for determining an appropriate reserve for the bank;
- the bank's loan loss methodology;
- the bank's loan review system, including its loan grading system, and responsibilities for its implementation;
- criteria and procedures for charging-off and collecting on charged-off loans;
- reports and communication channels among those involved in the ALLL determination process;
- periodic independent review of the ALLL determination process for compliance with policy, adequacy with respect to the bank's charge-off history, changes in the size and complexity of its lending, and consistency with accounting and supervisory guidance; and
- the periodic review of the ALLL policy by the board of directors.

Because of the importance of ALLL, the federal banking agencies issued updated policy guidance on ALLL methodologies and documentation in late 2006.⁷ The guidance sets out board and management responsibilities for ensuring a bank has an appropriate reserve and requires that the ALLL be determined in accordance with generally accepted accounting principles (GAAP) and supervisory guidance.

In response to the financial crisis of 2008, the Financial Accounting Standards Board (FASB), which establishes GAAP for companies in the United States, has worked to enhance the accounting for credit losses. The crisis exposed weaknesses in the methodologies currently used to estimate losses, resulting in losses being recognized "too little, too late." As a result, the FASB is implementing a new standard of accounting for the ALLL known as Current Expected Credit Losses (CECL) that will require significant changes to financial institutions' methodologies. Given the complexities of gathering data and altering systems needed to comply with the new standard, the FASB's effective date for implementing the standard was extended several years. As a result, bank management is responsible for calculating the institution's ALLL under existing guidance while also preparing for the transition to the new standard. Reference 3.9 summarizes both the existing and updated frameworks for appropriately accounting for

Reference 3.9. Framework for Determining an Adequate ALLL

Current supervisory guidance and accounting standards require the ALLL balance to be computed based on an “incurred loss” model. Under this model, losses are recognized when an event probably will result in the borrower being unable to repay all, or a portion of the loan. Future accounting standards for the ALLL will require losses to be recognized using a “current expected credit losses” model, which requires recognition of expected losses over the life of the loan portfolio based on current information and reasonable forecasts of future events. Bank management must comply with existing guidance until the effective date of the new standard, after which management must implement the new methodology.

the ALLL in accordance with GAAP.

In overseeing management of the ALLL, you are responsible for:

- reviewing and approving the bank’s written ALLL policies and procedures at least annually;
- reviewing management’s assessment and justification that the loan review system is sound and appropriate for the size and complexity of your bank;
- reviewing management’s assessment and justification for the amounts estimated and reported each period for the ALLL; and
- requiring management to periodically validate and, when appropriate, revise the ALLL methodology.

It is unlikely you will actually develop the data for the components that make up your bank’s ALLL. However, basic information about the general framework on which the ALLL methodology is based may help you establish your ALLL policy. The policy can provide staff guidance for determining an appropriate reserve, assist in your quarterly review of the reserve’s adequacy, and aid in determining if changes should be made in the bank’s reserve methodology and its supporting documentation.

Years ago, a general benchmark was often used for ALLL adequacy. The benchmark was 1 percent of total loans. However, the use of such a benchmark is wholly inappropriate for an ALLL that is calculated in accordance with GAAP.

Monitoring Bank Asset Quality

Given the significance of credit risk to a bank's financial condition, it is important that you monitor the level and trend in loan quality and assess the adequacy of the ALLL at your bank to judge the effectiveness of policies in managing asset quality. To do this, you can draw upon a number of information sources.

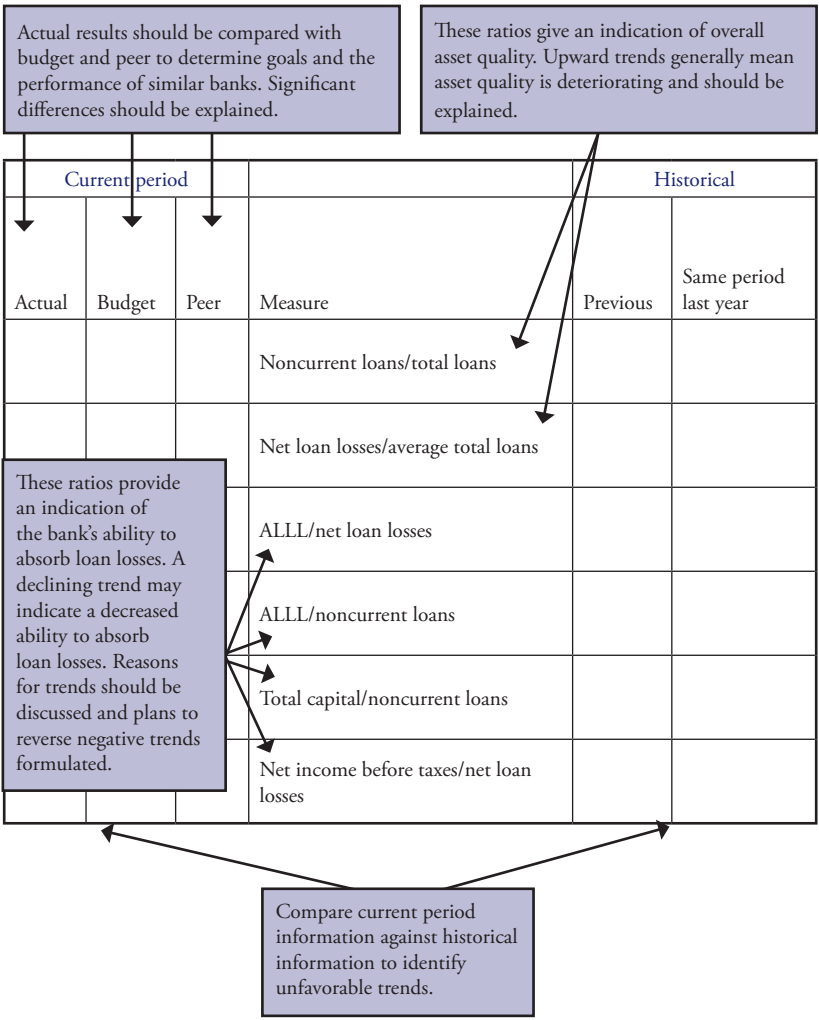
These sources include financial statements prepared by the bank; reports developed by the bank's lending, loan review, and internal audit functions; and reports developed by independent parties, external to the bank. The bank's financial statements can be used to construct broad asset quality measures for comparing its current loan quality with planned and historic figures and with quality at other banks. Reference 3.10 provides frequently used ratios to judge asset quality and reserve adequacy.

In addition to financial statements, there is other information you can use to assess credit risk management. For example, during a bank examination, assets such as loans and investments are reviewed by the examiners and assigned a classification. Those assets with no concerns are given a "pass" rating. Those with concerns may be classified into one of the following categories:

- **Substandard:** An asset inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral. It has a well-defined weakness that if not corrected could jeopardize the liquidation of the debt. In lay terms, this often means that the primary source of repayment is no longer viable, but secondary sources, including the collateral, cover the value of the loan.
- **Doubtful:** An asset with all the weaknesses exhibited in the substandard asset, but the weaknesses make collection or liquidation in full highly questionable. Again, in lay terms, this typically means that the primary source of repayment is no longer viable and there is some question as to the viability or value of the secondary sources of repayment. The viability or value of the secondary sources is subject to some event transpiring that brings them into better focus.
- **Loss:** The asset is considered uncollectable and of such little value that its continuance as a bank asset is no longer warranted. In other words, they should be charged off the bank's books as keeping it

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Reference 3.10. Ratio Analysis — Asset Quality



would be a misrepresentation of the bank's financial position and condition. This classification does not mean the asset has no recovery or salvage value, or that the bank must cease collection efforts.

Banks should have an internal loan review system to maintain an ongoing review of their credit risk and asset quality. Your bank's internally graded loans⁹ can be used to create a "problem loan" or "watch list" of credits that may pose above-normal credit risk that deserve special attention by management.

You should review this list periodically and consider these questions:

- Is the list growing or shrinking with time?
- If it is growing, what is the reason behind the increase?
- Is there a written plan to fully collect or minimize the bank's loss on each listed credit?
- Is progress being shown in collecting credits listed?
- Does the list show signs of poor problem loan identification? (For example, are loans listed in one period and charged off the next?)

When you hear bank examiners speak about asset quality, you may hear them use the term "total classified assets" and relate it as a percentage of capital. You can use your watch list information to construct two benchmark ratios used by examiners as part of their assessment of your bank's asset quality:

- Total classified assets ratio
 - > The sum of watch list loans graded substandard, doubtful and loss divided by the sum of the bank's Tier 1 capital and ALLL. If your bank uses numerical ratings, ask management to translate these ratings into the substandard, doubtful, and loss classifications used by examiners. Federal and most state banking agencies use this ratio.
- Weighted classified assets ratio
 - > Used by the Federal Reserve, it is a ratio that is useful in a self-assessment of your bank's asset quality.
 - > Problem loans are weighted according to their severity:
 - loss loans are multiplied by 1.0;
 - doubtful loans are multiplied by 0.5; and

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- substandard loans by 0.2.
- > The weighted sum is divided by the sum of the bank's Tier 1 capital and ALLL.

See Reference 3.11 for sample calculations of the total classification and weighted classification ratios.

A total classified assets ratio nearing 40 percent or a weighted classified assets ratio approaching 8 percent may be indicators of less-than-satisfactory asset quality. However, you should not wait until ratio values reach these levels before asking management about its plans for addressing loan quality at your bank. The fact that the ratios are rising and moving toward these values should be enough to trigger your concern and questions to management.

Although the sample calculation includes loss loans, the amount of loss loans should be relatively small, if not zero, at any given point. The reason for this is that when a loss is recognized in a loan, the bank should promptly charge it off.

Besides the watch list, there are reports on new loans, delinquent credits, nonaccrual loans, restructured loans, charge-offs, overdrafts, and transactions with insiders and their related interests that may give you insights regarding potential loan problems and management's speed and effectiveness in addressing the problems. In looking at these reports, ask management to explain sudden and large movements in items listed. You may also want to compare reports, looking for borrowers that appear on multiple reports, or you may want to track reports over time to see if the same borrowers reappear. Once again, you may ask management to explain circumstances pertaining to these borrowers.

Internal and external audit reports are another useful source for keeping abreast of asset quality at your bank. The federal banking agencies encourage all institutions to establish some form of internal audit function to inform directors and senior management of the adequacy, effectiveness, and efficiency of accounting, operating, and administrative controls and to provide an assessment of the quality of ongoing operations. This function may identify weaknesses in and noncompliance with lending policies and procedures and recommend corrections.

In addition, the directorate is sometimes required by the bank's bylaws or by state banking laws to perform a directors' examination to keep it informed about the bank. This examination may include an evaluation of the bank's financial condition and the adequacy of its reserves.

Reference 3.11. Weighted Classification Ratio

Loan Classifications x		Loss Weighting =	Weighted \$Amount
Substandard	\$200	.2	\$40
Doubtful	\$800	.5	\$400
Loss	\$150	1.0	\$150
Total	\$1,150		\$540
Tier 1 Capital + ALLL			\$4,400
Total classified assets ratio			26.14 percent
Weighted classified assets ratio			12.27 percent

Similarly, audits and asset/operational reviews performed by accounting firms, consulting firms, and others may help identify policy compliance weaknesses, provide data on loan quality, furnish an assessment of the bank's loan review system, determine the adequacy of its loan administration, and give an indication of loan documentation inadequacies. Annual full scope external audits are required for all banks with more than \$500 million total assets.

Bank examination reports are another valuable source of information on the bank's lending function. Among other things, examiners review asset quality, ALLL adequacy, loan review adequacy, loan policy adherence, and credit administration effectiveness. They also provide an overall assessment of a bank's ability to identify, administer, and collect problem credits.

In using your bank's examination reports to gauge its asset quality, you can compare the level and severity of loan classifications with internally generated loan grades as a reality check. You may want to ask management to address any examiner comments calling for increased reserves and for improving loan policies and credit administration. If you see repeat criticisms on matters pertaining to the lending function in the bank's examination reports, you should ask management for specific plans to address the criticisms and monitor implementation of plans to correct them.

Finally, another method by which to monitor credit risk is to stress test the loan portfolio. An institution's lending policies should prescribe meaningful stress testing of the loan portfolio. Portfolio stress testing allows management to quantify and assess the bank's ability to withstand the impact of changing economic conditions—such as a change in

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interest rates—on asset quality, earnings, and capital. Banks should consider stress testing portfolio segments that possess common risk characteristics to potential market conditions, such as commercial real estate loans. The sophistication of stress testing practices and sensitivity analysis should be consistent with the size, complexity, and risk characteristics of a bank's loan portfolio.

Bank directors are responsible for asset quality and for ensuring their banks maintain an adequate reserve to absorb loan losses. To do this, you and other board members should establish a policy to guide the bank's lending activities. Additionally, you should put in place policies and processes to determine probable loss in the loan portfolio and to maintain an adequate reserve to cover these losses. Finally, you should monitor asset quality and the adequacy of the reserve to ensure that the policies in place are effective in preserving bank asset quality and cushioning the bank against foreseeable losses.

MANAGEMENT

A director's main responsibilities regarding management are to:

- provide competent management for the bank;
- participate in board meetings;
- develop the bank's strategic plan;
- establish clear policies and monitor the bank's operations; and
- know where the bank stands.

The term "management" refers to a host of factors necessary to operate a bank in a safe and sound manner. It includes the quality and character of individuals, who guide and supervise the bank, encompassing their:

- knowledge, experience, and technical expertise;
- leadership, organizational, and administrative skills;
- planning skills and adaptability; and
- honesty and integrity.

"Management" also encompasses the policies, procedures, and controls these individuals have put in place to protect the bank from excessive risk and the systems they have installed to provide feedback on the bank's financial and operational status. This section discusses the director's role as part of the bank's management team. It sets out director responsibil-

ities as part of this team and suggests matters to consider in judging bank management performance.

Director's Role

Your bank is a corporation organized and chartered under state or national law. Like other corporations, it is managed under the oversight of a board of directors that is elected by its shareholders. The board normally delegates the authority and responsibility for running the bank to its officers (See Reference 3.12). Despite this, you, as a director, ultimately remain accountable to the bank's shareholders and other stakeholders—employees, depositors, community, and regulators—for its safe, sound, and efficient operation.

In discharging these responsibilities, you owe your bank the duties of care, obedience, and loyalty. Duty of care means that you will devote time, exercise ordinary diligence, and use reasonable judgment to ensure your bank is run prudently and with due regard for the bank's stakeholders. It also means that you will act in good faith, and not misuse your position or confidential bank information for personal benefit.

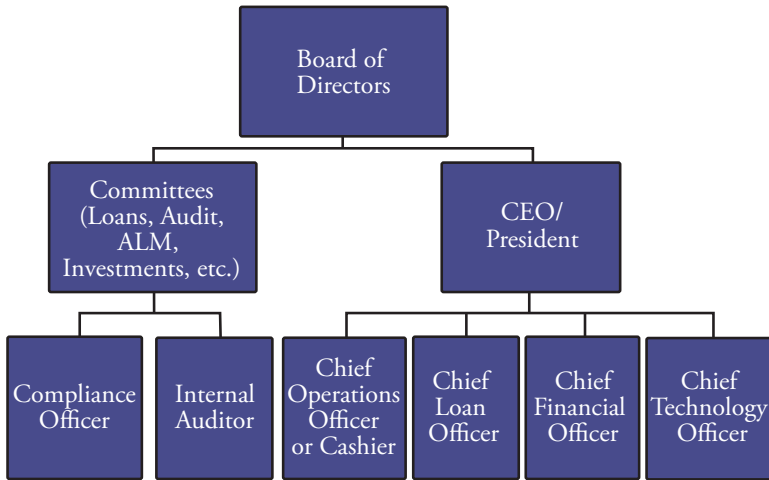
Duty of obedience means you will obey applicable laws in your personal dealings with the bank and ensure that your bank complies with laws and regulations. Duty of loyalty means you will not engage in activities or make use of information obtained as a director that benefits you or benefits you at the expense of your bank. All of your dealings with the bank should be at arm's length and not on preferential terms.

Your bank should follow a board-approved policy on insider transactions that address a code of conduct, ethics, and conflicts of interest. On such matters that come before the board, the affected director should be excused from the meeting so that he or she does not participate in discussions or vote on those matters.

The policy on the code of conduct should address the board's response to misdeeds or misfortunes of the individual directors. This is to protect the bank's reputation. For example, in the unfortunate circumstance that a director's financial situation becomes tenuous, such as a filing for bankruptcy or defaulting on a loan to the bank or they are charged with a crime of mistrust, the policy should address the expectation for the director to suspend, voluntarily or otherwise, his or her involvement with the board. The policy should specify the circumstances under which the director will be removed, absent voluntary resignation, when such is in the best interests of the bank.

Reference 3.12. Bank Governance

In simple terms, governance is how corporations organize themselves to accomplish their goals. This chart shows the governance structure typically found at many banks, outlining reporting relationships and job responsibilities. As such, it shows the importance you, as a director, have as part of the bank's management team.



At the top of the structure is the board of directors. The board of directors is ultimately responsible to the bank's shareholders and other stakeholders for its profitable operation and its compliance with all applicable laws and regulations. The board is led by a chairperson who heads the bank and has responsibility for the effective functioning of the board.

Reporting directly to the board is the bank's chief executive officer (CEO). The CEO is responsible for running the bank on a daily basis.

Reporting to the CEO are a number of officers who have responsibility for the daily management of various facets of the bank's operations. For example, the chief lending officer is

responsible for the bank's lending function. The chief operating officer or cashier is responsible for all aspects of the bank's daily operations. The chief financial officer is responsible for all financial aspects of the bank's operations. The chief technology officer is responsible for oversight and maintenance of the bank's investments in technology.

The chart also shows board committees. Committees do work for the board and make recommendations to the board on matters under the committee's purview. They distribute the board's workload, making possible more in-depth analysis and discussion of issues confronting a bank and its management. Consequently, they play an important role in helping boards be more effective in their oversight.

Reporting directly to a board committee, most likely the Audit Committee, is the head of internal audit and, perhaps, the compliance officer. An important job of internal audit is to look for the presence, adequacy, and compliance with the bank's financial and operational controls, processes, and procedures (collectively controls). Because the CEO has responsibility for the bank's controls, most boards have the head of internal audit report to the Audit Committee or the board. This is to avoid conflicts of interest and to help obtain an unbiased evaluation of the bank's controls.

Beyond these basic obligations, there is no definitive list of the basic responsibilities for the board of directors and its members. However, several key responsibilities are commonly cited and are discussed below.

Provide the bank with competent management

Directors are charged with providing the bank with capable management. If management is poor, all areas of the bank's operations suffer. Moreover, you and other board members will have to spend considerable time and effort to correct problems in order to restore the bank to a satisfactory condition. Because of this, providing the bank with competent management is often listed as job number one for bank directors.

Providing the bank with competent management does not mean that individual board members take responsibility for running the bank's daily operation. That is not a director's job. Instead, board members are charged with the responsibility of providing a bank with a competent CEO to manage its daily operations, advising that management, and making sure succession plans are in place to provide for the bank's future management.

Hand-in-hand with this responsibility is the job of periodically evaluating management to make sure it is meeting the board's expectations in running the bank.

*"[It is an] inescapable responsibility of directors to see that management is doing its job. The wise choice of capable management and the removal of management that fails the responsibility are true central and culminating responsibilities of the board."*¹⁰

While a formal performance appraisal process is not required, it is highly recommended as it provides for a regular, documented discussion of the CEO's performance. This is true for all bank employees, although directors usually evaluate the CEO, with management evaluating the remainder of the staff.

Evaluating management calls for the consideration of many factors, requiring you to draw on a number of different sources of information. Among these sources are the bank's financial statements, internal and external audit reports, other reviews conducted or commissioned by the board, and supervisory reports of examination.

An important part of the evaluation will be a review of the bank's financial statements. Declines in financial performance and unfavorable comparison with peer banks may be indicators of management inadequacies.

However, some boards fall into the trap of thinking that financial performance trumps all else when evaluating the CEO. Financial performance should not be the sole measure of management performance.

Bad management practices can be masked by such things as a strong economy or a strong competitive position. Once conditions reverse or competition strengthens, poor practices are revealed. Your review should look behind the numbers to the organizational and operational matters that produced the bank's operating results. This means understanding the reasons for the bank's performance and determining if it is sustainable. It also requires an analysis of the level of risk the bank has assumed, whether it is reasonable and within the board's risk tolerances, and determining if management is aware of the risks being taken.

You can glean information on these and other matters relating to the management of your bank from a number of sources. One source is the director's packet, which is described later in this section under *Know where the bank stands* on page 49. Another source is information gathered from the board's own oversight of bank operations. At many banks, directors review loans and other major decisions made by bank officers. At smaller banks, one or more board members may be responsible for conducting these reviews and making periodic reports to the full board. At larger banks, board committees may carry out this review role.

Of the review tools available to the board, the audit is probably the most valuable. The OCC and many states require directors to commission an examination of their banks. Additionally, federal and state banking authorities encourage banks to establish an independent audit function that reports directly to the board of directors. Moreover, federal banking law¹¹ requires certain insured institutions to establish an independent audit committee made up of outside directors who are independent of management. For larger institutions, the audit committee must include members who have banking or related financial institution expertise. In certain instances, the law requires insured depository institutions to have their financial statements audited by independent public accounting firms in accordance with GAAP.

Bank examination reports are another important information source for judging management. Examination reports discuss adequacy of policies, procedures, and controls, and specifically address the matter of management adequacy, pointing out areas that need improvement.

Bank Safety and Soundness

Quality of risk-management practices and internal controls is an important element in an examiner's evaluation of bank management. One element of those controls is to provide business contingency planning for the bank. Reference 3.13 provides matters to consider in your reviewing the adequacy of your plan, which will help in your plan, which will help in your evaluation of management.

Together, board reviews and examination reports will help you piece together an accurate, qualitative picture of management at your bank. As you look over these materials, consider some of the ideas presented in Reference 3.14. It is important to note that the checklist is not meant to be all-inclusive of the things to consider in your review of management. There may be other standards of performance adopted by the board at your bank for evaluating management.

Before closing this discussion on management evaluations, one last matter deserves consideration. Directors are part of the bank's management team. As such, the board should evaluate its own performance and that of its members. Many boards feel uncomfortable doing this because of the collegial nature of boards.

However, peer review is an important ingredient in ensuring the board remains effective in its bank oversight. Such reviews identify individuals who provide little, if any, meaningful contribution to the bank's management, or who try to dominate the board's decision making. These individuals may not regularly attend board and committee meetings or they may habitually arrive late or leave meetings early. They may not prepare for meetings by reviewing reports and other materials to be discussed. They may remain nearly silent throughout meetings, or they may be combative and disdainful of others' views. They may dominate all discussions and limit the free interchange of ideas. Reviews, therefore, become a tool for changing behavior or for providing a basis for not reappointing a director. In the end, reviews make the board stronger and its oversight more effective.

Reviews can help strengthen boards in other ways. For instance, they may help identify knowledge gaps that need to be filled to better align board expertise with the bank's activities. Reviews may help show

the need for changes in board committee structure to better support the board in managing its workload.

Reference 3.13. Operational Risk Management: Business Contingency Plan (BCP)

One aspect of operational risk is business contingency planning. The purpose of a BCP is to return the bank to an operational mode in the aftermath of some uncontrollable event until permanent operations can be restored, minimizing the consequences of such events.

Once a BCP is in place, it is just as important to determine if it works. The best way to make this determination is to test the BCP and adjust it to fill any gaps revealed by the test. Critically important components for any test are the set of assumptions used in it, the scope of the test, and the time period simulated.

If test assumptions are unrealistic, then the results may provide a misleading picture of the bank's ability to operate subsequent to an adverse event. For example, if the test does not incorporate appropriate assumptions regarding staff availability and ability to reach contingency sites, it may not reveal operations being impaired due to inadequate staff resources. Similarly, if the test's scope only involves selected functional areas of the bank, rather

than the whole bank, it may miss key interactions with other parts of the bank. A whole-bank test may be more revealing because it simulates the interaction of all departments and functional areas of the bank under adverse conditions. Finally, if the time period assumed for operation under the BCP is too short, test results may not show the depletion of resources critical to operations, e.g., diesel fuel to run backup generators.

Here are some questions to keep in mind as you review your BCP:

- Has the plan been updated to reflect operational changes at the bank, e.g., opening new offices, organizational, product, personnel changes, etc.?
- What triggers the plan?

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- Who communicates with the public about the bank response to an event?
- Who has responsibility for what under the BCP?
- Has the plan been tested recently?
- Was the test for the whole bank or a department or functional test?
- What assumptions were made in conducting the BCP test, and were they realistic?
- Have shortcomings from BCP tests been addressed?

Answers to these and other questions will help you assess the adequacy of the bank's risk-management processes for identifying, measuring, monitoring, and controlling operational risk.

Basics for Bank Directors

Reference 3.14. Matters to Consider in Evaluating Management

	Yes	No
Is the bank operated in a safe and sound matter?		
Is the bank operated in compliance with laws and regulations?		
Does the bank compare favorably with other banks in major performance areas, such as capitalization, asset quality, earnings, liquidity, and sensitivity to market risk?		
Does management respond quickly to address shortcomings identified in audits and supervisory examinations?		
Does management keep the board informed and provide sufficient and timely information on the bank to enable the board to judge the bank's operational and financial status?		
Are decisions made by management consistent with goals, plans, and policies set out for the bank?		
Is management responsive to requests, directives, and questions from the board, including complying with board-approved policies?		
Does management have the knowledge and expertise to supervise the affairs of the bank effectively, instill confidence, and demonstrate an ability to lead the bank?		
Is management informed about the affairs of the bank and knowledgeable about events in the community that may affect the bank?		
Are management's presentations and recommendations to the board done so on a timely basis, of high quality, and accurate?		
Has management put in place a corporate structure that establishes lines of authority and accountability; provides for delegation of authority and monitoring of delegated responsibilities; and permits open communication and free flow of information within the bank?		

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	Yes	No
Has management seen to the staffing needs of the bank: established job descriptions, hired qualified staff, offered competitive compensation, provided training, and planned for management succession?		
Has management established information systems to provide timely information on the status of the bank in order to identify evolving problems quickly?		
Has management put in place sufficient procedures to direct the bank's operation and instituted sufficient internal controls to protect the bank's resources?		
Does management plan for the bank and develop reasonable strategies for carrying out these plans?		
Does management, in conjunction with the board, develop budgets for the bank and keep the board informed of the bank's progress in meeting budget goals?		

Participate in board meetings

To remain knowledgeable about the bank's affairs, it is crucial that you attend regular and special board and committee meetings. When attending, you should participate in the deliberations and ask questions if you do not understand what is being presented. For example, if the bank is going to engage in a new lending activity, make "high-risk" investments, or enter into some new nonbanking activity, you might ask at the meeting:

- Do we really understand the activity and its risks?
- What analyses have been done to quantify the risks?
- Do we have the personnel and control systems necessary to protect or lessen the bank's exposure to these risks?
- Does it make sense for our bank given its size, location, and expertise?
- Is the activity or investment consistent with our bank's long-term objectives?

It is important to not blindly accept management's recommendations, or assume "they know what they are doing" or "it's OK" on issues you don't understand. As a director, you need to be an independent thinker and a good questioner, not a rubber stamp. Where your knowledge is limited on

matters before the board, ask for explanations to improve your understanding. If you don't understand an answer, ask more questions until you do, for you cannot exercise effective oversight of the bank until you understand the matters being discussed.

It is important to record the board's deliberations and those of its committees in meeting minutes. You should review the minutes from meetings you attend for accuracy and completeness before you approve them. Minutes are an official record of a bank and play an important role in the supervisory assessment of your bank.

During the course of an examination, examiners review all board minutes since the last examination. In broad terms, they use this review to determine if the board of directors is meeting its oversight responsibilities. Among other things, examiners note attendance at board meetings and if the board has:

- approved business strategies for the bank;
- approved and reviewed policies that articulate risk tolerances and set exposure limits for its important activities; and
- periodically reviewed the bank's performance in order to monitor its risk exposures and effectiveness of its risk management.

Additionally, examiners note discussion and resolution of issues on introducing new products, serving new customers, or entering into new geographic areas. They watch for the creation of new committees and the responsibilities given to these committees. They are also interested in major board actions that are not part of the normal monthly meeting and in board actions that violate the bank's bylaws or banking laws and regulations.

Another use of board minutes is to determine which individual directors may be responsible or liable for substantive violations of law or actions that harm a bank. For example, if a bank exceeds its legal lending limit to an individual borrower, the approving directors may be exposed to personal liability should any loss incur on the loans.

This is why it is important for directors to voice their opinions, concerns and dissenting votes in board meetings and for those to be appropriately documented in the board minutes. Review them before approving them. This review may pay dividends later if the bank encounters problems and the board's diligence is questioned. Otherwise, the record will not be there when you need it most. As one examiner put it, "If it's not in the minutes, it didn't happen."

Plan for the bank

The board sets the long-term direction and goals for a bank to make sure there is an orderly transition from where the bank is today to where it will be tomorrow. Providing long-term direction helps the bank identify financial and personnel resources and technological and organizational capabilities needed to meet its goals. It provides management a guide that can be used to compare shorter-term decisions with the bank's longer-term goals for consistency. Additionally, planning helps management budget resources to move the bank progressively toward long-term objectives. Because of this, decisions that represent major changes in direction or philosophy from the bank's established plan should be given careful consideration because they often carry resource implications for the bank.

In addition to long-term planning, the board has responsibility for making sure the bank has adequate plans and backup procedures in place to address operational contingencies, such as destruction of its building or failure of its automated systems. Those plans should be tested periodically to identify any weaknesses and to ensure they work as intended. Preferably, tests should be done bank-wide in order to identify any weaknesses in the bank's many functions.

Establish clear policies and monitor the bank's operations for compliance

Another key responsibility of directors is to establish written operating policies covering such facets of the bank's operations as lending, ALLL, investments, asset/liability management, ethics and conflicts of interest, and, especially in today's high-tech environment, cybersecurity. These policies establish risk limits and an operating framework for guiding the bank's operation. Whenever a bank has trouble, it is often due to the lack of adequate, written operating policies or frequently ignoring or overriding its policies.

Besides establishing policies, it is important that the board, in conjunction with senior management, establish the necessary internal controls to provide feedback on compliance and adequacy of policies. Where deficiencies are noted, the board should ask for management's plans to address them and track management's progress in completing its plan.

According to the 2014 FFIEC Cybersecurity Assessment General Observations, “Today’s financial institutions are critically dependent on IT to conduct business operations. This dependence, coupled with increasing sector interconnectedness and rapidly evolving cyber threats, reinforces the need for engagement by the board of directors and senior management, including understanding the institution’s cybersecurity inherent risk; routinely discussing cybersecurity issues in meetings; monitoring and maintaining sufficient awareness of threats and vulnerabilities; establishing and maintaining a dynamic control environment; managing connections to third parties; and developing and testing business continuity and disaster recovery plans that incorporate cyber incident scenarios.”

In addition to cybersecurity inherent risk, the Cybersecurity Assessment reviewed financial institutions’ current practices and overall preparedness, focusing on the following:

- Risk management and oversight
- Threat intelligence and collaboration
- Cybersecurity controls
- External dependency management
- Cyber incident management and resilience

Know where the bank stands

To be effective, it is important you remain knowledgeable about the bank’s financial regulatory compliance conditions and the adequacy of its internal controls. Studies show that many failed banks were governed by inattentive, uninformed, or passive directorates. As a result, many trouble signs went unrecognized until it was too late.

Keeping up with the bank requires the board to specify reports it needs for tracking the bank’s progress and to study these reports. You should request and review meeting materials far enough in advance of a board meeting to give you the knowledge necessary to actively participate. The following outline of a board packet is not all-inclusive, but should contain:

- An agenda
- Minutes from the previous meeting
- Key financial information, such as:
 - o Balance sheet
 - o Income statement

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- o Capital and dividends
- o Comparisons to peer banks
- o Off-balance-sheet items

Reports in the packet will generally address:

- Lending:
 - o Loan volume
 - o Problem loans
 - o Past-due and nonaccrual loans
 - o Watch list loans
 - o Loan charge-offs and recoveries
 - o Other real estate owned (OREO)
 - o New and large loans, renewals and participations
 - o Lending limit
 - o Analysis of the ALLL
 - o Summary of internal loan reviews
 - o Loans to insiders and affiliates
 - o Overdrafts
- Asset/liability management, or funds management:
 - o Analysis of interest rate sensitivity
 - o Liquidity position
 - o Funding needs and sources
- Investments:
 - o Quarterly investment reports, possibly showing securities designated held-to-maturity and available-for-sale
 - o Maturity breakdown by type of investment
 - o Market values and depreciation/appreciation
 - o Current investment ratings
 - o List of securities purchased, sold and matured
 - o Yield analysis

- Planning:
 - o Policies for review and approval
 - o Strategic planning materials
- Operations:
 - o Risk assessments
 - o Internal/external audits
 - o Insider activities
 - o Compliance with laws and regulations
 - o Marketing
 - o New products and services
 - o Human resources and personnel matters
 - o Training plan
- Regulatory matters:
 - o Recently completed reports of examination
 - o Assigned ratings
 - o Status of corrective action on previously noted deficiencies
- Other significant items:
 - o Legal actions taken by or against the bank

For more guidance, please see the OCC's *Detecting Red Flags in Board Reports: A Guide for Directors*. The Web link is in Chapter 6, Other Resources for Bank Directors. It offers detailed suggestions on what to look for in your reports and identifies red flags that should prompt questions from you.

Additionally, it is important that the board independently verify the information it receives through internal and external audits and examination reports. This is not to imply that management is dishonest or lacks integrity. It is simply a good business practice, or internal control, and a source of protection for the board.

One of the tenets of internal controls, by the way, is to evaluate the position a person is in, not the person in the position. What that means is even those who we trust can be driven to perpetrate a significant fraud

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when faced with a strong motive and opportunity in the absence of controls to detect such a fraud in a timely manner.

Make sure the bank serves the credit needs of the community

Banks have been and will continue to be vital sources of credit and the engines of economic growth for their communities. As a result, you have a responsibility for making sure your bank is an unbiased source of credit to the entire community. In this regard, you and other board members need to be aware of the economic environments in which your bank operates, the special credit needs of the communities it serves, and the lending patterns within those communities.

In summary, the board of directors has many obligations and responsibilities with respect to its oversight of the bank. The most important of these is to provide the bank with competent management, to evaluate management's performance, and to remove management that fails in its performance.

EARNINGS

Your primary duties when it comes to bank earnings are to oversee and understand the bank's business performance and know the key areas that impact bank performance.

Besides being concerned with how much your bank earns, you should also concern yourself with the quality of the earnings. Earnings quality refers to the composition, level, trend, and sustainability of bank profits. For bank directors and managers, earnings quality represents a financial report card on how well the bank is doing. When earnings quality is good, the bank has sufficient profits to support operations, provide for asset growth, and build capital. Moreover, depositors are given an extra margin of protection, and shareholders receive a competitive return on their investment. When earnings quality is poor, the bank may be unable to adequately serve the credit needs of the community, provide for losses, or build capital. Depositors may be at greater risk, and shareholder returns may be inadequate.

For you, as a bank director, information on your bank's earnings performance and the factors contributing to that performance are invaluable in ascertaining the effectiveness of its risk management. This information helps pinpoint strengths and weaknesses and is essential to your success in governing the bank and meeting your responsibilities to its stakeholders.

Your board packet should contain sufficient financial information to allow you to:

- compare the bank's performance to budgeted goals;
- understand why goals are or are not being met;
- review the consistency of earnings; and
- determine if earnings are from planned bank strategies or from one-time, or extraordinary, transactions.

This section looks at the composition of bank earnings and discusses matters that influence earnings performance. It also presents some tools for monitoring and evaluating bank earnings quality.

Composition of Bank Earnings

Bank net income is the difference between revenues and expenses, taking into account various gains, losses, and taxes. Bank revenues come from interest and noninterest sources. As expected, interest income from loans and investments makes up most of bank revenues. However, noninterest income from such things as fees, service charges, and commissions is an important and growing source of bank revenues. Likewise, bank expenses are comprised of interest and noninterest components.

Besides these revenue and expense components, bank net income is affected by other items. These include the provision for loan and lease losses, securities gains and losses, extraordinary items, and taxes.

Factors That Influence Bank Earnings

The level and quality of bank earnings depend upon a host of factors both external and internal to the bank. External factors relate primarily to the environment in which the bank operates and pertain to conditions that are largely beyond its control. They determine the relative ease or difficulty a bank encounters in turning a profit. Included among external factors affecting bank earnings performance are economic conditions, competition, laws, regulations, and technological change.

Instances where external factors have influenced profitability are fairly easy to find. For example, in the 1980s, declines in the agriculture, energy, and commercial real estate sectors in various regions across the country contributed to high loan losses at many banks, causing earnings to plunge.

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In the early 1990s, the downward slide in interest rates improved margins at many banks, causing earnings to surge. During the early part of the new millennium, the prolonged drop in interest rates that ended near a 40-year low, and a nearly flat yield curve, pinched earnings. Recent real estate loan losses and turmoil in the financial markets have made the task of earnings growth more challenging.

Despite the importance of external events on bank performance, internal factors often play an even more important role. One federal regulator noted that "... while poor economic conditions make it more difficult to steer a profitable course, [a bank's] policies and procedures ... have the greater influence on whether [it] will succeed or fail."¹²

From an internal perspective, bank earnings quality depends heavily upon a number of factors. Important among these are the bank's business strategy, asset/liability mix, asset quality, and operating efficiency. As you monitor your bank's performance, keep these factors in mind and think about how they, along with external factors, have and will influence earnings performance.

*Monitoring Bank Earnings*¹³

Return on average assets (ROAA), defined as bank net income divided by average assets, is one of the most often used measures to judge bank performance. Reference 3.15 shows the derivation of ROAA from bank revenues, expenses, and other items. By looking at the items that make up ROAA, it is possible to isolate areas that lie behind poor or deteriorating performance.

From there, you can delve deeper into these areas, searching out root causes of bottom-line performance changes. Thus, the information in the reference should be considered a beginning step in monitoring bank earnings performance. The following sections discuss the individual components included in the reference in more detail, suggesting additional matters to consider as you review your bank's performance.

Interest income

Interest income consists of revenues from earning assets adjusted for tax benefits on tax-exempt loans, leases, and municipal securities. This revenue component is influenced by a number of factors. Some of the more important factors are a bank's business strategy, the interest rate environment in which the bank operates, the proportion of earning assets on its balance sheet, and the distribution of its asset holdings.

Reference 3.15. Earnings Analysis

Current Period			Measure	Historical	
Actual	Budget	Peer		Previous	Same period last year
			Interest income (TE)*/ average assets		
			Interest expense/average assets		
			Net interest income to average assets		
			Noninterest income to average assets		
			Provision for loan loss/ average assets		
			Net income before gains, losses, and taxes (TE)/ average assets		
			Realized gains/losses on HTM and AFS securities/ average assets**		
			Taxes and extraordinary items/average assets		
			Net income/average assets		

Compare actual results with budget and peer to see if bank is performing according to plan and in line with similar types of banks.

Compare current period with historical results. If unfavorable trends exist, ask for explanations.

*Because interest income on some bank assets may be tax-free, (for example municipal bonds), interest income from these assets is restated to a tax equivalent (TE) amount. This is done to improve the comparability of reported income among banks.

**HTM means held-to-maturity; AFS means available for sale. See ASC 320, Investments—Debt and Equity Securities on page 61 for definitions of the terms.

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Consequently, if you see an adverse trend in your bank's interest income, check for changes in the character of its business. For example, there could have been a change in the types of loans, or loan mix, or a move from higher-yielding assets, such as loans, to lower-yielding assets, such as securities. Changes in national and local interest rates could be a factor. Review for increased competition in the bank's market that, perhaps, has put pressure on loan rates or entrance into new products. Also, determine if nonearning assets, such as fixed assets, real estate taken in foreclosure, or nonaccrual loans, have increased, causing interest income to fall.

Interest expense

Interest expense consists of interest payments made by the bank on deposits and other borrowings. This expense item depends heavily upon the interest rate environment the bank faces and the strategy management follows to fund bank assets. Bank capital also affects interest expense. Because capital is a source of funds, using it to support assets reduces interest expense. Additionally, because it acts as a source of repayment, strong capital may reduce a bank's interest cost on other borrowings.

If this ratio shows an upward trend, look at the trend of national or local market deposit interest rates. Also, check for changes in the way management funds bank assets. For example, has the bank moved away from using low-cost core deposits, like demand and savings deposits, to using higher-cost large CDs (\$250,000 or more), brokered deposits, and other borrowings to fund bank assets?

Net interest margin

Net interest margin (NIM) is the difference between interest income and interest expense. It represents the spread or gross margin on the bank's loans and investments. Beyond the factors discussed previously that can influence bank interest income and expense, the size of this spread depends upon the relative responsiveness of rates received and paid on a bank's assets and liabilities to changes in market interest rates.

Among the tools banks use to help gauge the possible effects of interest rate movements on NIM are gap analyses and earnings-at-risk simulation models. These tools for judging a bank's interest rate exposure and other aspects of market risk will be discussed later in the Sensitivity to Market Risk section.

Noninterest income

This revenue component consists of such things as fees, service charges, and commissions. Like other revenue and expense components, it also depends upon such factors as the bank's business strategy and the market conditions in which the bank operates. For example, a decline in this item may indicate a shift away from activities that produce noninterest income. Bank management may have decided that certain fee-generating activities are not profitable given competition in the market or that they entail too much risk for the bank relative to income generated.

Provision for ALLL

As noted in the section on asset quality, the provision for loan and lease losses is the amount set aside by a bank to maintain the ALLL at a level sufficient to absorb estimated loan losses. The ALLL is increased through charges to current earnings called provisions for loan and lease losses.

Whether a high or low provision is appropriate depends upon a bank's asset quality. If loan volume is growing, loan losses and nonperforming loans are increasing, and the ALLL balance is declining or estimated losses in the portfolio exceed the bank's existing ALLL balance, then a high provision may be necessary. If loan growth and losses are low, nonperforming loans are small and declining, and the bank's ALLL methodology indicates that the existing loan loss reserve balance appears adequate to absorb probable loan losses, a low provision may be appropriate.

Noninterest expenses

Noninterest expenses consist of salaries, depreciation, management fees, losses on asset sales, legal fees, and other overhead of the bank. Many of these expenses are affected by the operational efficiency or cost-effectiveness of the bank in providing deposits, loans, and other services to its customers. They may also be affected by the cost of resolving loan problems and losses from disposing of troubled assets.

If you see an increasing trend in this ratio, you may want to look at individual expense items to see which have shown large increases over time. For example, if personnel costs have risen substantially, you may want to see if salary ranges are in line with comparable positions in the regional jobs market. You also may want to compare the bank's number of employees with peer banks to see if productivity has fallen.

Net realized securities gains, losses, taxes, and extraordinary items

These items are largely one-time gains, losses, and charges (for example, securities gains/losses, accounting adjustments, gains/losses on sales of assets, etc.). They play a role in determining the bottom-line performance of every bank. However, they should not be relied upon as a significant or continued earnings source because they normally are not sustainable.

If these items remain a significant part of your bank's earnings for long periods, review them more closely. One place to focus is on securities gains. It may be that your bank is selling off its high-yielding securities to record gains to boost current earnings. This is called gains trading, and it could sacrifice long-term profitability because the bank may not be able to reinvest the funds in instruments that carry a comparable interest rate.

Another concern with gains trading pertains to the source of the gains. Banks are required to segregate their securities holdings according to the purpose for which they are held—for trading, available-for-sale, and investment.¹⁴ These purposes determine how the securities are to be valued for financial reporting. If the bank is registering gains by selling investment securities, then it is likely that these securities are not being held for long-term investment and, as a result, may not be valued appropriately. This may cause the bank's financial statements to be misstated, exposing the bank, directors, and others to monetary penalties.

Earnings quality refers to the composition, level, trend, and stability of bank earnings. For you, the director, and bank management, bank earnings quality is a financial report card. It tells how the bank has managed its risk exposure. Where risk management is good, earnings will be consistently strong and earnings quality will be good. Where risk management is poor, the opposite will be the result. In such cases, dissecting earnings into its component parts provides insights regarding areas needing attention.

LIQUIDITY

Directors are responsible for adopting a funds management, or asset/liability management, policy that sets liquidity risk tolerances within which it expects management to operate. Procedures for identifying, measuring,

monitoring, and controlling liquidity risk should be included. The policy should state what products will be used to manage interest rate risk and liquidity and include a liquidity contingency plan in the event of unusual liquidity pressures.

Bank liquidity refers to the ability of a bank to raise cash quickly at a reasonable cost. Banks must have adequate liquidity in order to serve their customers and to operate efficiently.

Those with adequate liquidity are able to pay creditors; meet unforeseen deposit runoffs; accommodate sudden, unexpected changes in loan demand; and fund normal loan growth without making costly balance sheet adjustments. Banks with poor liquidity may not be able to meet these funding demands and, in extreme cases, may be closed due to what is called liquidity insolvency.

Providing for a bank's liquidity needs can present many practical challenges. One reason is that funding demands may change suddenly and unexpectedly in response to the bank's financial condition or economic and other events. Thus, like the magician's coin, ample liquidity may be there one minute and gone the next. As a result, a liquidity position thought adequate for one set of circumstances may not be enough to support a bank's funding needs for another.

This section reviews bank liquidity needs. It discusses bank liquidity sources, describes monitoring and planning for bank liquidity needs, and discusses ways to analyze a bank's liquidity position.

Sources of Liquidity

Banks can fund their operations in variety of ways:

- Sell assets
- Attract short-term and long-term deposit liabilities
- Increase short-term and long-term borrowings
- Increase capital funds

The way a bank meets its funding needs depends upon the cost and availability of its funding options. Costs, which include losses on forced asset sales as well as higher interest charges, depend upon such matters as asset and liability maturity mix and marketability of asset holdings. Available funding options depend largely upon the bank's overall financial condition and creditworthiness.

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Assets

Bank assets are storehouses of liquidity. Theoretically, any asset item can serve as a liquidity source. How well a particular asset serves in this capacity depends upon the length of time it takes to dispose of it and the price the asset brings when it is sold. Assets that can be sold at a moment's notice without any appreciable loss to the bank are ideal candidates for meeting unexpected liquidity demands. As a practical matter, few bank assets meet this ideal. For example, a bank could not quickly dispose of its building, furniture and fixtures, loans, and real estate to meet depositor demands for funds, except at considerable loss.

In most instances, banks use their investment portfolio as a source of liquidity. Even securities, however, may have to be sold at a loss if an unexpected demand for funds should occur. Because of this, it is important that banks plan for future liquidity needs.

An important part of this planning process is designating the purpose served by the bank's securities holdings. Prior to 1993, banks held securities either for investment or trading purposes. With the application of market value accounting to banks' balance sheets, banks were required to designate their investment securities as "held-to-maturity" securities (HTM securities) and "available-for-sale" securities (AFS securities).

HTM securities are those that a bank purchases with the intent (and it has the ability) to hold until maturity. Because the bank's intent is to hold its HTM securities until they mature, they are reported on a bank's balance sheet at amortized cost—the bank's cost adjusted for premium paid or discount received.

A bank may decide to hold investment securities as HTM securities for a variety of reasons. For example, if securities offer a high yield, the bank may decide to purchase and hold them until maturity simply because they provide a good return. If the securities are issued by state and local political subdivisions (for example, county and city government, water districts, school districts, etc.), the bank may purchase them as a gesture of community support. Besides return and community support motives, HTM securities purchases may play a role in the bank's liquidity management by being "pledged" or used as collateral against government deposits.

AFS securities are those that a bank purchases with the intent of selling if the need arises. AFS securities are reported on the bank's balance sheet at

fair value—the value the bank could obtain for the securities at the time the balance sheet is prepared. Any difference between this value and the book value of a bank’s AFS securities is reported as an unrecognized gain or loss and is shown as an adjustment to its reported capital position.

It is important to note that the federal banking agencies currently do not explicitly take into account unrecognized losses in determining capital adequacy. However, these losses can raise supervisory concerns if the liquidity position of a bank is strained and it has large unrecognized losses in its AFS securities. In the event the bank was forced to sell its AFS securities in order to meet liquidity needs, previously unrecognized losses would have to be taken, and this would negatively affect the bank’s capital position.

AFS securities serve as an important source of liquidity for banks, and approximately 98 percent of U.S. banks’ investment securities are held as AFS securities. Thus, when a bank needs cash for liquidity purposes, it can sell some of its AFS securities. This raises the question, “What happens if these securities are not sufficient to meet liquidity needs and the bank must sell some HTM securities?” The answer is the bank “taints” its HTM securities portfolio, and it must reclassify all of these securities as AFS securities (see Reference 3.16).

The ramification of this reclassification is that the reclassified securities must be valued at current market price. Any unrecognized gains/losses must be taken into account in the bank’s capital position, once again raising supervisory concerns if the reclassified securities have large embedded unrecognized losses within them and the bank’s liquidity position is strained.

Liabilities

A bank also can meet its funding needs through liability management. Historically, deposits have been the predominant and lowest-cost funding source for a great majority of banks. However, banks of all sizes have seen low-cost core deposits (demand, money market, NOW, time, savings accounts, and small denomination certificates of deposits) decline in response to increased competition for these funds from other financial service providers. Consequently, banks today depend more heavily on expensive noncore sources, such as large denomination CDs, brokered deposits, federal funds purchased, and Federal Home Loan Bank (FHLB) advances, to meet their funding needs.

Reference 3.16.

ASC 320, Investments—Debt and Equity Securities

This statement from the Financial Accounting Standards Board subjects banks to an element of market value accounting by requiring them to designate investment securities held for liquidity purposes as available-for-sale (AFS). Because these securities can be sold at any time to meet liquidity needs, they must be reported on bank balance sheets at fair or market value. Held-to-maturity (HTM) investment securities are reported at amortized cost.

With the exception of seven circumstances set out in FAS 115, no HTM security can be sold 90 days prior to maturity without “tainting” the entire HTM securities portfolio. Tainting means that all HTM securities would then be reported at their fair value and capital adjusted for any gain or loss from cost. This requirement would take effect over the entire HTM portfolio, even if just one of many investment securities is sold.

Because of this, it is important that banks carefully consider their liquidity needs before designating securities as held-to-maturity. The seven circumstances under which HTM securities may be sold are

- deterioration in the issuer’s creditworthiness;
- changes in tax law that eliminate or reduce the tax-exempt status of interest paid on the issuer’s debt securities;
- major business combination or asset sale that requires transfer of held-to-maturity securities to maintain the bank’s existing interest rate risk position or meet its credit risk policy;
- regulatory changes that modify the permissibility or the maximum level of investment in a specific security;
- changes in regulatory capital requirements that cause a bank to downsize by selling held-to-maturity securities;
- significant increase in risk weights applied to debt securities for risk-based capital purposes; and
- unanticipated, isolated, nonrecurring, and unusual events that may cause the bank to sell held-to-maturity securities.

The seven circumstances are events largely out of the control of bank management. It is important to note that selling HTM securities to meet the liquidity needs of a bank is not considered an “unanticipated, isolated, nonrecurring, and unusual” event—the last item on the list. Bank management is to plan for the bank’s liquidity needs.

Additionally, for either AFS or HTM securities, banks need to determine if a decline in fair value below amortized cost is other than temporary. If it is “other than temporary impairment,” or OTTI, then the amortized cost basis of the security must be written down to fair value. That write-down is reflected in earnings as a realized loss.

Federal funds are reserves held in a bank’s account with its Federal Reserve Bank. Reserve Banks have paid interest on those reserves since November 2008. If a bank has more reserves in its account than is required by the Federal Reserve, it can loan the excess reserves to other depository institutions. When a bank borrows federal funds, they are fed funds purchased. Most fed funds transactions are done on an overnight basis. However, longer-term arrangements can be made. For example, there are term fed funds that generally mature between two days and one year. Typically, fed funds purchased are viewed as a short-term funding source.

The Federal Reserve discount window is a credit source that provides borrowing banks time to make orderly adjustments in their assets and/or liabilities to meet liquidity needs. Since January 2003, the discount window offers three permanent credit programs: primary, secondary, and seasonal credit.

- Under the primary credit program, healthy institutions can borrow to meet short-term liquidity needs. To qualify for the program, an institution must be at least “adequately capitalized” under the federal banking agencies’ capital guidelines and have a CAMELS composite rating of 3 or better. The interest rate charged for primary credit is typically 100 basis points above the targeted federal funds rate, although the spread was temporarily reduced to as low as 25 basis points above the targeted fed funds rate in 2008 in response to market conditions.
- For those institutions that do not qualify for primary credit, secondary credit is available. Secondary credit also can be obtained to facilitate an orderly resolution of a troubled institution. Among

other things, discount window staff reviews requests under this program to ensure that a borrowing institution can return to market funding. The rate for the secondary credit program is 50 basis points higher than the primary credit program.

- The seasonal credit program is available for longer periods (generally up to nine months) to assist smaller institutions in meeting regular funding needs arising from expected movement in their deposits and loans. The interest charged for seasonal credit is set by a formula tied to short-term market rates.

Beginning in late 2007, the Federal Reserve began offering temporary discount window programs, such as the Term Auction Facility (TAF), to address elevated pressures in short-term funding markets. Like the primary credit program, TAF credit is only available to healthy institutions. TAF credit is typically available for 28-day and 84-day terms. Other temporary programs were also introduced to address particular market issues.

A longer-term funding source is the FHLB. A bank can be an FHLB member and, if it qualifies, make use of a regional FHLB's lending programs. These programs have a wide range of maturities and interest rate terms and can be used to fund residential loans and, in the case of smaller banks, fund small business, small farm, and small agribusiness loans.

An important issue in using the liability side of the balance sheet as a liquidity management tool is the stability of a bank's liabilities. Often, fed funds, noncore deposits, and FHLB advances are available only as long as a bank is willing and able to pay for their use. Furthermore, a bank's access to these funds may be limited if its financial condition comes under question or its capital slips below satisfactory levels. Because of this, banks that rely heavily on noncore deposits and nondeposit liabilities may be particularly vulnerable to liquidity pressure in times of trouble.

Until the passage of the FDICIA, the liability side of the balance sheet, especially deposits, was an almost limitless funding source for a bank. As long as it was willing to pay higher interest rates, perhaps even above the rest of the market, a bank could attract deposits.

FDICIA, however, changed this by instilling greater depositor discipline over banks and by tying the use of purchased funds to bank capital. FDICIA increased depositor discipline by making it illegal for the FDIC to take any action that would increase insurance fund losses by protecting depositors for more than the insured portion of their deposits. Because

depositors risk losing all or part of the uninsured portion of their deposits, they will be less apt to keep large uninsured amounts at banks unless they are in good financial health. As a result, banks in poor or deteriorating condition may find it more difficult to retain uninsured deposits to fund their operations, and thus, may be more prone to liquidity problems.

FDICIA also made it more difficult for problem banks to use purchased money, such as brokered deposits, as a funding source. Under the law and implementing regulations, well-capitalized banks (refer to Reference 3.X for capital definitions) that are not in troubled condition face no restrictions on their use of brokered deposits. Any insured depository institution that is less than well-capitalized is restricted in the effective yield it can pay on deposits and/or its ability to accept, renew or rollover any brokered deposit. Because of these restrictions, undercapitalized banks have fewer liability options to address liquidity needs.

FDICIA also altered the availability of the Federal Reserve's discount window to meet funding needs. Discount window advances are available to banks and other insured depository institutions to meet liquidity needs that may arise from such things as unexpectedly large withdrawals of deposits, seasonal fluctuation in deposits and loans, or exceptional circumstances. Under FDICIA, the Federal Reserve is limited on how long it may lend to undercapitalized banks without incurring any liability. Additionally, FDICIA made the Federal Reserve liable for any increased loss to the FDIC insurance fund resulting from any outstanding loans to banks five days after they have become critically undercapitalized. Consequently, some banks may find discount window borrowing a more-limited funding source.

Capital

A bank may use sales of new equity and debt capital instruments to help meet its funding needs. However, because raising capital requires considerable planning and can be both time consuming and costly, banks seldom use capital sales as a short-term funding source. Instead, these sales play a more important role in restoring capital and reopening other funding sources to banks.

Establishing Policies

As you can see, banks have a variety of balance sheet resources to draw upon to meet expected and unexpected funding needs. However, because

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of law and regulatory changes, some sources of liquidity may not be as readily available as they once were. Moreover, in times of trouble, some funding avenues simply may not be open.

As a result, it is essential that you and other board members establish policies that address how your bank will provide for adequate liquidity. For example, the investment policy should define how the bank's liquidity requirements are considered in determining the type and maturity of securities purchased. The asset/liability management policy should spell out asset and liability mix and maturity and set operating limits (for example, maximum loans-to-total deposits ratio that helps preserve the bank's funding options). You also must monitor the bank's liquidity position and, with management, develop plans to meet expected and unexpected funding needs.

Monitoring and Planning for Bank Liquidity

Ratio analysis

Reference 3.17 presents some liquidity measures and offers thoughts on matters to consider in reviewing your bank's liquidity. The ratios included in the reference, however, focus primarily on the bank's current liquidity position and trends in that position. It also is important to know your bank's future liquidity needs so you can help plan for those needs. Knowing in advance when liquidity pressure points might occur makes it possible to explore alternative ways to deal with them in advance. This advanced planning permits a more reasoned, less frantic, and less costly approach to raising funds to meet the bank's liquidity requirements. A useful tool for looking at your bank's future liquidity position is a liquidity forecast.

Liquidity forecasts

A forward forecast of the bank's liquidity needs is helpful in ensuring the bank's funding needs are met regardless of what the future holds. Reference 3.18 provides a sample of a worksheet that might be used to forecast your bank's funding needs. This worksheet divides funding into what controls the decision regarding sources and uses of bank funding: is it customer- or management-driven?

A cash-flow-projection worksheet describes an institution's liquidity profile under an established set of assumptions about the future. The set of assumptions used in the cash-flow projection constitutes a scenario to

Reference 3.17. Ratio Analysis—Liquidity

Current period			Measure	Historical	
Actual	Budget	Peer		Previous	Same period last year
			Loans/deposits		
			\$250,000 deposits/total deposits		
			Brokered deposits/total deposits		
			Net noncore fund dependence*		
			Fed funds purchased/total assets		
			FHLB advances/total assets		
			Pledged securities/total securities		

High actual values relative to budget and peer should be explained.

High value may mean:

- Lower cost funds to support additional loan growth are nearly exhausted.
- Liquidity is being sacrificed for earnings.

High positive value may indicate few, short-term investments that can be easily liquidated are available to meet the sudden loss of noncore funding.

High value may mean that few investment securities remain that can be sold to raise cash.

High value may indicate an overreliance on a funding source that may not be available to the bank if its capital or financial condition deteriorates. It also may mean reduced earnings due to the high cost of these funds.

$$\text{Net noncore dependence} = \frac{\text{noncore liabilities less short-term investments}}{\text{long-term investments}}$$

This shows a bank's ability to fund its assets in the event of noncore liability loss. For large banks that rely more heavily on noncore funding, this ratio is typically positive. For community banks that rely more heavily on core deposits, this ratio often will be negative. See pages III-5 of *A User's Guide for the Uniform Bank Performance Report*, March 2006, for a description of the balance sheet items that make up this ratio.

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Reference 3.18. Example Cash Flow Projection Worksheet

	Day 1	Week 1	Week 2	Week 3	Month 1	Month 3	Months 4-6	Months 7-12
<i>Customer-driven cash flows</i>								
Consumer loans								
Business loans								
Residential mortgage loans								
Fixed assets								
Other assets								
Noninterest-bearing deposits								
NOW accounts								
MMDAs								
Passbook savings								
Statement savings								
CDs < \$250,000								
Jumbo CDs								
Net noninterest income								
Miscellaneous and other liabilities								
Other								
Subtotal								
<i>Management-controlled cash flows</i>								
Investment securities								
Repos, FFP, other short-term borrowings								
FHLB and other borrowings								
Committed lines								
Uncommitted lines								
Other								
Subtotal								
Net cash flow gap								
Cumulative position								

- Are the underlying assumptions for each scenario well-documented?
- What assumptions are made for the values included under each scenario presented?
- What is the underlying basis for those assumptions? Are they realistic and tailored to the market and economic environment in which the bank operates or could operate?
- Are the assumptions consistent with the scenario presented? For example, if the scenario is triggered by asset problems at the bank, do funding sources remain available?
- Are the assumptions for each scenario consistent with the bank's liquidity management strategy and any liquidity contingency plan established by the board and management?
- Are there plans to address funding shortfalls? Do those plans change with scenario severity?

forecast the bank's funding needs. Often, banks generate multiple forecasts based on different scenarios. For example, they make cash-flow projections for normal-course-of-business scenarios; short-term, institution-specific stress scenarios; and more-severe, intermediate-term, institution-specific stress scenarios. Each scenario requires assessing the likelihood of funding needs and planning for potential funding shortfalls.

Importantly, no single cash-flow projection reflects the range of liquidity sources and needs required for planning purposes. Normal-course-of-business scenarios are used to establish benchmarks for the normal behavior of cash flows of the institution. These scenarios are those the institution expects under normal conditions, reflecting among other things seasonal fluctuations in loans or deposit flows and expected growth in assets and liabilities.

Adverse, institution-specific scenarios simulate the institution under constrained liquidity conditions. For example, they might simulate the bank's cash flows under a bank specific event such as credit quality problems. Others scenarios might analyze liquidity issues arising from external events that somehow disrupt the payments system. Scenarios may differ regarding the severity of problems encountered. They might vary in duration, from short to long. In the end, these simulations help identify the timing, nature, and magnitude of liquidity issues the bank is likely to encounter. As such, simulations done under a variety of scenarios are a useful tool for developing contingency plans to deal with funding problems that could arise.

A bank's liquidity position can change quickly, and directors are responsible for ensuring that their banks can effectively deal with these changes. This requires establishing policies that address the bank's liquidity needs, monitoring its liquidity position, and planning for its future funding needs.

SENSITIVITY TO MARKET RISK

As part of the bank's management team, you are responsible for understanding the nature and level of your bank's interest rate risk and how that risk fits into your overall business strategy. You are also responsible for ensuring necessary processes are in place to identify, measure, monitor, and control your bank's interest rate exposure. How detailed and formal these processes are depends upon the size, complexity, and risk profile of your bank.

Your responsibilities include adopting a funds management, or asset/liability management policy. In the case of sensitivity, though, you will

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set risk tolerances to preserve the bank's ability to maintain earnings and protect capital in the face of changing interest rates. Management information systems should allow you to review management's sensitivity strategies so that you can be alerted to those that could compromise the bank's earnings potential. Various modeling software is available that can help directors monitor interest rate exposure.

Sensitivity to market risk reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. For some large institutions, foreign operations can be a significant source of market risk. Trading activities, where the institution buys and sells investment securities or foreign currencies hoping to profit on price movements, also can be a significant source of market risk. For most institutions, however, the primary source of market risk stems from the effects of interest rate changes on bank earnings and capital. It is this aspect of market risk that is the focus here.

Banks are large holders of financial assets. Because of this, interest rate movements can have significant effects on their financial condition and operating performance. This is due to the inverse relationship between market interest rates and market values of investment securities. For example, when market interest rates rise, the value of currently held investment securities will decline.

There have been periods in our history when market interest rates have risen after a long period of decline. In a rising rate environment, banks can experience significant market value declines in their securities portfolios. Collectively, this can amount to billions of dollars in unrecognized losses on AFS securities.

These unrecognized losses are important, even though an actual loss does not occur until the securities are, in fact, sold. Unrecognized losses matter because they indicate that bank assets are not earning current market returns and that earnings would be higher if the bank could invest its assets at higher market rates. For banks with publicly traded stock, the lost earnings translate into lower stock prices because investors are less willing to purchase stock in banks with such losses.

The unrecognized losses present a potential liquidity issue if securities must be sold to meet funding needs. They can also pose a capital adequacy issue if they are large enough to trigger bank examiner concerns regarding the bank's safety and soundness.

This section reviews your bank's exposure to interest rate changes. It discusses how interest rate changes can affect bank earnings and capital and the need to establish controls over a bank's interest rate risk-taking. Additionally, it describes tools to monitor bank interest rate exposure and discusses matters to consider when reviewing output from these tools.

Interest Rate Changes and Their Effects on Earnings and Equity

When speaking of interest rate risk, you might hear terms such as re-pricing risk, basis risk, yield curve risk, and options risk. These are components of interest rate risk. You may read more about them in the regulatory supervisory manuals that are referenced in Chapter 6, Other Resources for Bank Directors, and are available at www.BankDirectorsDesktop.org.

These risks can affect a bank's income and equity value. Because of this, it is important that the directors and senior management establish policies and procedures to control the bank's interest rate risk exposure and establish monitoring and reporting systems to track compliance with established limits.

Asset/Liability Management Policy

The asset/liability management (ALM) policy is the primary tool for controlling interest rate risk. Although ALM policies vary from bank to bank based on individual need, they typically:

- establish risk limits;
- delineate lines of authority for managing interest rate risk;
- set out procedures, documentation requirements, and analyses that are required prior to acquiring specified financial instruments and for managing the bank's investments;
- indicate appropriate methods for controlling the bank's aggregate interest rate exposure;
- specify the reports required by the board to monitor the bank's interest rate risk exposure and the frequency these reports are provided to the board;
- establish the process for handling policy exceptions;

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- establish time frames for the board's periodic review of the ALM policy to keep it current; and
- enumerate audit requirements for the bank's ALM function.

Monitoring bank interest rate risk

Once the board has established interest rate risk boundaries, it is important that appropriate risk measurement systems are put in place to monitor policy compliance. As previously noted, interest rate changes present a risk to both bank earnings and capital. Because of this, the federal banking agencies encourage banks to put in place systems capable of measuring earnings and capital at risk.

Typically, banks use models to assess their exposure to interest rate changes. These models combine bank financial data, interest rate assumptions, behavioral assumptions for the bank and its customers, and finance concepts to judge a bank's potential interest rate exposures.

- In general, models can be grouped into two broad categories based on the focus of the risk analysis they provide: Earnings at risk (EAR) models focus on possible changes in a bank's net interest income, noninterest income, and bottom-line profit ability from interest rate movements. This risk assessment approach is sometimes referred to as a "short-term view," an "accounting approach," or an "earnings perspective" to judging interest rate risk.
- Capital-at-risk or economic valuation and duration models focus on possible changes in the market value of a bank's assets, liabilities, and off-balance sheet items due to interest rate movements and the impact these changes have on the bank's equity capital position. This approach is sometimes referred to as a "long-term view" or an "economic approach" for determining interest rate risk.

Earnings at Risk

Banks may develop their own EAR models or purchase models developed by others. The models they use vary with respect to their features and to what they will allow you to include, assume, and change in the model. Two EAR models commonly used by banks are gap analysis and income simulation.

Gap analysis

Gap analysis was one of the first analytical methods developed to assess banks' interest rate exposure. It remains one of the most frequently used methods.

Gap analysis looks at timing differences between the re-pricing of interest rates on a bank's assets and liabilities to determine its interest rate exposure, making it a good tool for judging re-pricing risk. When these timing differences are large, the bank faces greater net income exposure than when these differences are small (see Reference 3.19).

Gap, unfortunately, is not a very good tool for judging basis, yield curve, and options risk in a bank's assets and liabilities. Accordingly, many banks use income simulation to judge their interest rate risk exposure.

Income simulation

Income simulations are generally computer-based models that use information on a bank's current balance sheet position and assumptions about future interest rate movements, management strategies, customer behavior, and new business and reinvestment plans to project future cash flows, income, and expenses. These projections, or simulations, can be run for a variety of interest rate scenarios and can be used to perform "what if" analyses on the effects of interest rate changes under alternative business strategies. Often, however, analyses are done for a base-case scenario—the bank under no interest rate change—and for rising and falling rate scenarios. In some instances, other scenarios may be presented (for example, a most-likely rate change scenario).

Capital at Risk

Like EAR models, banks generally use two broad categories of models to judge their equity exposure to interest rate changes: duration analysis and economic value of equity simulation.

Duration

Duration is a time measure that can be used to assess a bank's capital exposure to small changes in interest rates. As an analytical tool, duration analysis can provide valuable insights regarding the effects of interest rate changes on the value of a bank's assets and liabilities, and hence its capital position. However, it has a number of weaknesses, which leads many insti-

Reference 3.19. Gap and Interest Income Exposure to Changing Interest Rates

Gap analysis is one tool used by a bank to determine the possible effects of interest rate movements on net interest income and profitability. The table below presents a sample gap calculation for two banks and shows how a bank's gap position can influence its earnings. Normally, a gap report shows a bank's interest-bearing assets and liabilities according to when they re-price—the period when the interest rate received or paid on them can change.

To simplify the analysis here, re-pricing horizons are limited to 12 months, and interest-bearing assets and liabilities are grouped and shown as totals rather than being shown individually. After the totals, interval gaps are presented. These are calculated by subtracting total rate-sensitive liabilities from rate-sensitive assets for each bucket. The cumulative gap, the next item, is the sum of the interval gaps across the buckets. The last item, RSA/RSL, is a summary measure to give the reader some perspective on the bank's interest rate exposure. It is calculated using cumulative rate-sensitive assets and liabilities across the re-pricing intervals. Most banks try to keep this ratio close to 1.0, implying a neutral interest rate risk position—an equal amount of interest-sensitive assets and liabilities re-price, resulting in interest income and interest expense changing by the same amount, leaving net interest income unchanged.

Bank 1 (\$millions)

Measure	Re-pricing Interval				
	0-30 days	31-60 days	61-90 days	4-6 months	6-12 months
Total rate-sensitive assets	\$5	\$10	\$5	\$4	\$16
Total rate-sensitive liabilities	\$10	\$20	\$10	\$10	\$10
Interval Gap	\$(5)	\$(10)	\$(5)	\$6	\$6
Cumulative Gap		\$(5)		\$(15)	
RSA/RSL		0.50		0.50	

Bank 2 (\$millions)

Measure	Re-pricing Interval				
	0-30 days	31-60 days	61-90 days	4-6 months	6-12 months
Total rate-sensitive assets	\$10	\$20	\$10	\$10	\$10
Total rate-sensitive liabilities	\$5	\$10	\$5	\$4	\$16
Interval gap	\$5	\$10	\$5	\$6	\$(6)
Cumulative gap	\$5	\$15	\$20	\$26	\$20
RSA/RSL	2.00	1.67	2.25	2.63	1.50

At one year, the focus of many gap analyses, Bank 1 is negatively gapped by \$20 million—rate-sensitive liabilities exceed rate-sensitive assets by \$20 million. Bank 2 is positively gapped at one year—rate-sensitive assets exceed rate-sensitive liabilities by \$20 million.

If market interest rates rise by 200 basis points (2 percent) from 5 percent to 7 percent, interest expense for Bank 1 will rise faster than interest income, causing its net interest income to fall. Using simplifying assumptions, the amount of this fall would be \$400,000 (0.02 x \$20 million). If it is assumed that the bank's net interest income was originally \$1.2 million, net interest income would decline 33 percent to \$800,000.

The effect on Bank 2 would be just the opposite. If the bank originally had net interest income of \$1.2 million, its net interest income would rise by \$400,000 to \$1.6 million, an increase of 33 percent.

As this example shows, a bank's gap position tells you how interest rate changes may affect its net interest income—a negatively gapped bank is hurt by market interest rate increases; a positively gapped bank is helped. Conversely, a negatively gapped bank is helped by a rate fall; a positively gapped bank is hurt. Thus, a bank's gap position provides information on the vulnerability of its net interest income to interest rate changes.

tutions to use an economic value of equity simulation model as a tool to judge their capital exposure to interest rate changes.

Economic Value of Equity Simulation (EVE)

EVE analysis attempts to forecast the effects of interest rate changes on the value of a bank's capital. This is done by looking at the net effects of interest rate changes on the market value of a bank's assets and liabilities.

Unfortunately, many bank assets and liabilities are not actively traded on organized markets. This makes it difficult to value the assets and determine changes in their market values resulting from interest rate movements. As a result, market value changes are often estimated using present value analysis.

With present value, the market price of an income-producing asset or an expense-causing liability is equal to the present value of its discounted cash flows over the life of the asset or liability. Therefore, by making assumptions regarding cash flows and yields, EVE models can determine the effect of interest rate changes on the market value of a bank's assets and liabilities and, hence, its capital.

Like income simulations, EVE simulations draw information from a large number of sources internal and external to the bank and rely heavily on assumptions. Also like income simulations, EVE simulations can be run for a wide variety of business strategies and interest rate scenarios, and simulation results are generally presented to directors and senior management in summary form. The content and the format of these summaries depend upon what the board needs to judge the bank's risk profile. Reference 3.21 presents an example of a summary report you might see.

As the designations "short-term" and "long-term" denote, both EAR and EVE models should be used to obtain a complete picture of a bank's interest rate risk exposure.

Model results often are presented to the boards of directors and senior management in summary tables and graphs in time frames spelled out by the ALM policy. Reference 3.20 presents one type of summary report you might see. In the report, the effects of a 200 basis point increase and decrease in interest rates on net interest income is compared with a no change, base case. Columns 2, 3, and 4 show how much net interest income changes under the different rate scenarios.

Reference 3.20. Earnings at Risk Simulation

Period	Net interest income change		
	No rate change (2)	Interest rates rise 200 basis points (3)	Interest rates fall 200 basis points (4)
Quarter 1	\$400	\$(20)	\$20
Quarter 2	\$200	\$(20)	\$20
Quarter 3	\$500	\$(80)	\$100
Quarter 4	\$600	\$(90)	\$120
Total	\$1,700	\$(210)	\$260

Reference 3.21. Economic Value of Equity Simulation (\$Thousands)

Interest rate change	Market value of equity	Percent change in market value
-200 basis points	\$2,512	(18.77)
-100 basis points	\$2,819	(8.87)
Base case—no change	\$3,093	0
+100 basis points	\$3,348	8.25
+200 basis points	\$3,601	16.43

Bank Safety and Soundness

Because model results are in summary form, you may not be aware of the many complexities associated with their use. This causes the whole interest rate risk measurement process to be viewed as a “black box.” Data are input into the black box, i.e., the model, where something happens. After blinking of lights and grinding of gears, results come out.

However, models make use of a lot of financial data, rely on many assumptions, and use innumerable finance theories to measure a bank’s interest rate risk. If there were ever a process where the old computer maxim “garbage in, garbage out” is particularly apropos, it is the interest rate risk measurement process. Therefore, if you are to have confidence in the interest rate risk exposure information you are presented, it is important that you become familiar with your bank’s models, the assumptions used in them, and the accuracy of their output.

Although no one expects you to be a finance wizard or a modeling expert, it is important that you are generally familiar with the capabilities of the models your bank uses and satisfied that they meet the bank’s needs. As one expert put it, make the “black box” a “glass box.” By doing so, you can gain perspective on the suitability of models used by your bank and your bank’s ability, given its level of expertise, to effectively use them.

Banks use models to assess their earnings and capital vulnerability to changes in interest rates. EAR models provide a short-term perspective on a bank’s net interest income and bottom-line profitability. EVE models provide a long-term view on its capital exposure. The two approaches to risk measurement complement one another and can be viewed as two sides of the interest rate risk coin.

Endnotes

⁵Lynn D. Seballos and James B. Thompson, “Underlying Causes of Commercial Bank Failure in the 1980s,” *Economic Commentary*, (Cleveland: Federal Reserve Bank of Cleveland, September 1, 1990), p. 3. Fred C. Graham and James E. Homer, “Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks,” in *The Financial Services Industry in the Year 2000: Risk and Efficiency – Proceedings of a Conference on Bank Structure and Competition May 11-13, 1988*, (Chicago: Federal Reserve Bank of Chicago, May 1988), pp. 408-413.

⁶*Commercial Bank Examination Manual*, (Washington, D.C.: Board of Governors of the Federal Reserve System, March 1994, updated through October 2008), Section 2040.1, Loan Portfolio Management.

⁷Federal Reserve System SR Letter 06-17, *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, December 13, 2006.

⁸Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) section 310, receivables, and section 450, contingencies.

⁹Federal Reserve System SR Letter 06-17, *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, December 13, 2006, Attachment 1 re: Loan Reviews.

¹⁰Robert H. Fabian, “Some of the Legal Responsibilities of Bank Directors,” *The Bank Director*, ed. Richard B. Johnson, (Dallas: SMU Press, 1974), p. 66.

¹¹FDICIA, codified as 12 CFR 363, Annual Independent Audits and Reporting Requirements, is generally applicable to banks, thrifts, and holding companies with at least \$500 million in assets.

¹²*Bank Failure, An Evaluation of the Factors Contributing to the Failure of National Banks*, (Washington, D.C.: Office of the Comptroller of the Currency, June 1988), p. 1.

¹³This section draws heavily on information taken from *A User’s Guide for the Uniform Bank Performance Report*, (Washington, D.C.: Federal Financial Institutions Examination Council, March 2004). For an alternative presentation on earnings performance, see Section I of that guide.

¹⁴See ASC 320, Investments—*Debt and Equity Securities*, for definitions of the terms.

REGULATORY COMPLIANCE

Directors are responsible for providing their banks with a compliance risk management program that includes preventive, detective, and corrective measures to ensure compliance with banking laws and regulations. Preventive measures are those that help prevent violations from even occurring, which may include:

- policies
- procedures;
- internal controls; and
- training.

Detective measures are those that identify undesirable events that have occurred, such as errors or violations of law. Detective measures may include:

- audits or other operational reviews;
- active board and management oversight; and
- risk monitoring and management information systems (MIS).

Corrective measures prescribe actions taken when errors or violations are detected and may include:

- corrective action plans that assign responsibility for correction to a specific individual or group, with a specific due date for completion, and a requirement for status reports showing progress of corrective action; and
- quality assurance or control processes that identify and correct conditions that led to the error or violation.

A compliance program is necessary, as banking is a heavily regulated industry. There are two main reasons for this. One is that banks offer deposit products insured by the federal government through the FDIC. The other, as explained in Chapter 1, is that banks put these insured funds at risk through the loans and investments they make.

Regulations and regulators are necessary in order to protect the depositors' money as well as the federal deposit insurance fund. Banking laws and regulations, among other things:

- address matters such as who owns, controls, and manages banks;
- delineate the services banks can provide;

Regulatory Compliance

- limit the activities in which a bank can engage (e.g., taking deposits, making loans, and activities incidental to both);
- specify minimum capital levels for a bank;
- limit the maximum amount of capital invested in bank premises;
- limit the size of loans to a single borrower and to insiders;
- require regulatory approval of acquisitions, mergers, and new branch locations;
- prohibit discriminatory lending; and
- require uniform disclosures regarding loan and deposit products.

Failure to establish a compliance program can result in directors being held personally liable and perhaps being subjected to monetary penalties or other sanctions (see Chapter 5). To fulfill this responsibility, you must have a basic understanding of the regulatory framework under which your bank operates and a general knowledge about the rules and regulations to which it must adhere. The discussion that follows helps build this knowledge.

The Director's Responsibility for Regulatory Compliance

As a director, you are responsible for your bank's regulatory compliance though you need not be an expert on bank regulation to carry out this responsibility. Instead, you should adopt policies and procedures for your management team to follow in identifying and implementing the necessary controls and processes that will result in regulatory compliance. This includes training bank personnel on how to comply with the laws and regulations within their specific duties. You should receive periodic reports that address the bank's level of compliance.

There are some laws with which you should be familiar, as they may:

- apply directly to you as a director;
- carry significant penalties for noncompliance; or
- provide you with knowledge to ask questions and evaluate responses.

Reference 4.1 highlights some of these laws and regulations, their purposes, and compliance tips. Because of their importance, you should have some familiarity with these, as well as any rulings your bank's primary supervisor may have issued on them. This basic information will help you spot potential trouble areas that your bank may need to address to ensure its regulatory compliance.

Reference 4.1. Laws and Regulations of Particular Interest to Directors

LAW/REGULATION	COMPLIANCE REMINDERS
<p>The Bank Secrecy Act/ Anti-Money Laundering (BSA/AML), Federal Reserve Regulation H (12 CFR 208.62 and 208.63; 31 U.S.C. 5311 et seq.; and 31 CFR Part 103)</p> <p><i>Assigns specific responsibilities to banks to know their customers and to detect and report large currency transactions and suspicious activities. These responsibilities are important to ensure that banks are not used as intermediaries for transferring funds obtained from criminal activities or to hide the transfer of money derived from those activities. The BSA also sets out record keeping requirements in order to provide a paper trail that law enforcement can use, if necessary.</i></p>	<p>Banks must have a written BSA/AML compliance program that includes these four components:</p> <ol style="list-style-type: none"> 1. Internal controls to assure ongoing program compliance 2. Periodic independent testing for BSA/AML compliance (a sound practice is to do this every 12-18 months, depending on the bank's level of risk) 3. A designated individual responsible for coordinating and monitoring day-to-day compliance 4. Training for appropriate personnel <p>A Customer Identification Program (CIP) must be included as part of the BSA/AML compliance program.</p> <p>The board of directors must approve the BSA/AML program, with the approval noted in board minutes.</p> <p>Currency Transaction Reports (CTRs) are required for cash transactions (deposit, withdrawal, exchange or other payment or transfer) greater than \$10,000. Customers meeting certain criteria may be exempted from such reporting.</p> <p>Suspicious Activity Reports (SARs) are required with respect to transactions that are inconsistent with what is known about a customer and that have no identifiable business purpose or support.</p> <p>The board of directors must be notified of SAR filings.</p> <p>Information in SARs is confidential and may not be divulged to people outside of the bank or to people who may be the subject of a SAR.</p> <p>Account opening procedures, also known as customer due diligence, are critical to a bank's ability to identify suspicious activity. Those procedures should be designed to obtain necessary information by which to effectively and efficiently serve the customer while giving you the ability to know when a transaction does not make business sense for the customer.</p>

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<p>Management Official Interlocks, Federal Reserve Regulation L (12 CFR 212)</p> <p><i>Prohibits common directors and management officials among unaffiliated institutions in the same community to maintain competition between institutions.</i></p>	<p>There are limits on your service as a director or management official at other unaffiliated financial institutions and bank holding companies, particularly if:</p> <ul style="list-style-type: none"> • your bank has assets greater than \$2.5 billion; • any office of your bank is located within the same large metropolitan area as the other institution or one of its offices; or • any office of your bank is located within 10 miles of an office of the other institution.
<p>Loans to Executive Officers, Federal Reserve Regulation O (12 CFR 215)</p> <p><i>Places limits on loans to insiders and prevents bank insiders (directors, management officials, and principal shareholders) from obtaining credit on more favorable terms than other bank customers.</i></p>	<p>Combine insiders' credit extensions with those of their immediate family and businesses to make sure that loans to insiders stay within lending limits specified in the regulation.</p> <p>There is a limit on loans to a single insider and an aggregate limit on total loans to all insiders.</p> <p>Overdrafts are extensions of credit and are specifically addressed by the regulation.</p> <p>Be alert to loan transactions where insiders may receive, directly or indirectly, some benefit. Be mindful that an insider's endorsement, or guarantee, can be considered an indirect extension of credit to the insider.</p>
<p>Privacy of Consumer Financial Information, Consumer Financial Protection Bureau (CFPB) Regulation P (12 CFR 216)</p> <p><i>Governs treatment of consumer nonpublic, personal information by financial institutions. Requires institutions to provide customers with a notice of their privacy policies and practices.</i></p>	<p>The regulation requires the bank to notify customers about its policy on sharing customer information with nonaffiliated third parties.</p> <p>If your bank shares customer information with some types of nonaffiliated third parties, it must give customers the ability to prevent their information from being shared, also known as the ability to "opt out."</p> <p>Make sure the bank's policies and consumer disclosures regarding its information sharing are consistent with its current sharing practices.</p>

<p>Fair and Accurate Credit Transaction Act (FACTA) amendments to Fair Credit Reporting Act, SFPB Regulation V (12 CFR 1022)</p> <p><i>Deals with several customer information issues such as the accuracy of data reported to credit bureaus, privacy, customer rights disclosures, records destruction, use of medical information when making credit determinations, and customer information sharing. An important aim is to address identity theft.</i></p>	<p>Regulation V requires the bank to have a written, board-approved policy to address the detection, prevention and mitigation of identity theft related to the types of accounts covered by FACTA. This includes implementing a system to identify and respond to red flags that may indicate a compromise of customer data as well as performing and documenting risk assessments.</p> <p>The policy should take into account and be consistent with other bank programs and policies, e.g., information security program, Bank Secrecy Act program.</p> <p>The bank must also have a process for notifying credit bureaus when the address information in its records does not match the address information in the credit report.</p>
<p>Transactions with Affiliates, Federal Reserve Regulation W (12 CFR 223)</p> <p><i>Implements sections 23A and 23B of the Federal Reserve Act, establishing certain restrictions on and requirements for transactions between a member bank and its affiliates. The intent is to prevent misuse of bank resources resulting from non-arm's-length transactions with affiliates.</i></p>	<p>Your bank cannot buy a low-quality asset from an affiliate, except under very limited circumstances.</p> <p>Be alert to parent bank holding company expenses and overdrafts paid by the bank, because such payments could constitute illegal, unsecured credit to the holding company.</p> <p>Be sure the bank receives its share of refunds and benefits from joint tax filings.</p> <p>Tax payments to the parent should not be made too far in advance of when they are due, or they may be considered a loan to the parent company.</p> <p>Watch for transactions between the bank and firms controlled by insiders to ensure that their terms are no less favorable than terms the bank would receive on similar transactions with an outsider.</p> <p>Management fees paid by the bank to its parent bank holding company should be appropriate to the services received.</p>

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<p>Transactions with Affiliates, Federal Reserve Regulation W (12 CFR 223) CONTINUED</p>	<p>Asset purchases, rental agreements, and lease contracts between the bank and firms owned by insiders must be on equivalent terms to those with outsiders.</p> <p>Maintain documentation to demonstrate that all transactions with insiders and affiliates take place at market value.</p>
<p>Community Reinvestment, Federal Reserve Regulation BB (12 CFR 228)</p> <p><i>Implements the Community Reinvestment Act (CRA), which encourages banks to meet the credit needs of their communities, including the needs of low- and moderate-income (LMI) areas within those communities, in a way that is consistent with safe and sound operation.</i></p>	<p>The bank's most recent CRA rating and performance evaluations are public information and must be made available to the public upon request.</p> <p>CRA performance is considered when the bank applies to the Federal Reserve System for mergers, acquisitions or the establishment of a branch.</p> <p>The bank defines the assessment areas (geographies) against which its CRA performance will be judged. How assessment areas are defined are often key to the evaluation of the bank's record of meeting community credit needs. In some cases, a bank's assessment areas are not the same as its markets or trade areas.</p> <p>Review the bank's assessment areas to make sure they include all the bank's branches, deposit-taking ATMs and a substantial portion of its loans. Also, ensure that the assessment areas meet other regulation requirements, such as not illegally discriminating or arbitrarily excluding low- and moderate-income areas (i.e., no "redlining").</p> <p>To avoid surprises at your next CRA examination, perform a self-assessment of your CRA performance. The assessment should include identifying whether the bank is making loans in low- and moderate-income geographies, to low- and moderate-income individuals and to small businesses and farms within its assessment areas.</p>

Basics for Bank Directors

<p>Notice of Change in Directors and Senior Executive Officers, Federal Deposit Insurance Act Notices, Financial Institutions Reform, Recovery, and Enforcement Act Notices (12 USC 1831i (a) and Federal Reserve Regulation Y, 12 CFR 225.71 et seq.)</p> <p><i>Requires notification to the appropriate banking regulator of senior management changes at banks in troubled condition. The intent is to prevent changes that are detrimental to the bank.</i></p>	<p>Applies to banks that are deemed to be in troubled condition as defined in Federal Reserve Regulation Y, 12 CFR 225.71.</p> <p>Requires a 30-day prior notice for any changes to the board of directors or employment of new senior officers.</p>
<p>Golden Parachutes and Indemnification (12 USC 1828(k) and 12 CFR 359)</p> <p><i>Limits severance payments and indemnification in order to safeguard bank assets; limits rewards to institution-affiliated parties that may have contributed to a bank's less-than-satisfactory condition or may have otherwise harmed the bank.</i></p>	<p>The limitation on indemnification applies to all banks. The limitation on severance payments applies only to banks that are in a troubled condition as defined in Federal Reserve Regulation Y, 12 CFR 225.71.</p> <p>Generally, a bank cannot indemnify an insider against the liability or legal expenses of an administrative proceeding by the bank's regulator. Indemnification for the payment of civil money penalties is not permitted.</p> <p>Golden parachute payments or agreements cannot be made without the prior written approval of the bank's primary federal regulator and the FDIC. A state member bank that is in a troubled condition would need to consult with its Reserve Bank before making or entering into any agreement to make severance payments.</p> <p>For additional information on golden parachute payments, please see the Federal Reserve Board's SR 03-6.</p>

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<p>Change in Bank Control Act (12 USC 1817(j)); Bank Holding Company Act (12 USC 1841 et seq.); and Federal Reserve Regulation Y (12 CFR 225)</p> <p><i>Requires shareholders to receive prior regulatory approval before taking a controlling position in banks and bank holding companies.</i></p>	<p>Stock transactions, such as treasury stock redemptions, may take a shareholder's ownership over 10 percent of the outstanding shares of the bank or its parent bank holding company, which may require a change-in-control notification.</p> <p>Prior notification is required, unless otherwise grandfathered under the regulation, if a share purchase would take a shareholder's ownership to 25 percent or more of the bank's or its parent bank holding company's voting shares.</p> <p>A transaction that takes a shareholder's ownership over 10 percent of any voting class of stock may require filing a notification.</p> <p>A shareholder's ownership may be combined with others, as indicated in the regulation (e.g., immediate family members), in determining the need for a notification.</p> <p>Placing 10 percent or more of bank or holding company stock in a trust or shareholder agreement may raise control or bank holding company issues and require filings under the Change in Bank Control Act or the Bank Holding Company Act.</p> <p>If the bank or its bank holding company is being sold, terms of purchase options may give buyers control of the bank or company and require prior notification.</p>
<p>Lending Limits</p> <p><i>Promotes diversification in a bank's loan portfolio by limiting loans to a single, noninsider borrower.</i></p> <p><i>The general lending limit to a single borrower for national banks is 15 percent of their capital and surplus, plus an additional 10 percent of capital and surplus if the loan is fully secured by readily marketable collateral.</i></p>	<p>Be cognizant of the bank's statutory lending limit and its internal lending limits.</p> <p>Loans and investments that approach these limits represent significant exposure of the bank's capital and should receive scrutiny.</p> <p>Loans in excess of the legal lending limit may expose approving directors to potential liability.</p> <p>Overdrafts are loans to be included in the calculation of a borrower's legal lending limit.</p> <p>Banks often establish a lower, internal or "in-house" lending limit to further diversify their credit risk and to avoid potential legal lending limit violations.</p> <p>The level at which the board of directors sets the internal limit depends upon its risk tolerance. At many banks, the board sets the in-house limit at 50 percent or less of the bank's legal lending limit.</p>

Basics for Bank Directors

<p>Office of Foreign Asset Control (OFAC)</p> <p><i>The Office of Foreign Assets Control (OFAC) is an office within U.S. Treasury that administers laws that impose economic and trade sanctions against hostile targets to further U.S. foreign policy and national security objectives.</i></p>	<p>Make sure that the bank has an OFAC compliance program, staff is trained on the program, the board reviews the program annually, and internal audit periodically reviews the program.</p> <p>Of particular note regarding OFAC compliance, the program should have a process that ensures the bank has an updated list of specially designated individuals and other blocked persons.</p> <p>The OFAC program should include steps for reporting blocked transactions to OFAC within 10 days after the occurrence.</p>
<p>Safeguarding Customer Information, Federal Reserve Regulation H (12 CFR 208.3(d)(1))</p> <p><i>Requires banks to protect customer information by implementing a comprehensive written information security program that ensures the security and confidentiality of customer information; protecting the security and integrity of this information; and providing safeguards against the bank's unauthorized access or use.</i></p> <p><i>The information security program is to identify internal and external risks associated with information technology systems and activities; ensure the implementation of risk-mitigating controls; and establish periodic tests of key controls, systems, and procedures.</i></p>	<p>Periodically test the key controls set out in the bank's information security program.</p> <p>Supervisory guidance on controlling information security risks extends to third-party service providers.</p>

Regulatory Compliance

<p>Equal Credit Opportunity, CFPB Regulation B (12 CFR 1002)</p> <p><i>Prohibits lenders from discriminating against credit applicants on prohibited bases, establishes guidelines for gathering and evaluating credit information, and requires written notification when a borrower's credit request is denied. Borrowers requesting credit secured by a dwelling must be given a copy of the appraisal report used in connection with the loan request.</i></p>	<p>Ensure that policies are in place prohibiting illegal credit discrimination. As appropriate, test whether credit decisions are consistently based on objective information regarding a borrower's ability to pay rather than any of the prohibited bases.</p> <p>Notify loan applicants of action taken within 30 days after receiving a completed credit application.</p> <p>On credit primarily for the purchase or refinancing of a dwelling occupied or to be occupied by the applicant as a principal residence, and secured by the dwelling, collect the required government monitoring information (i.e., applicant ethnicity, sex, marital status, and age).</p>
<p>Loans in Special Flood Hazard Areas, Federal Reserve Regulation H (12CFR 208.25)</p> <p><i>Implements the National Flood Insurance Act, which makes federally backed flood insurance available to owners of improved real estate or manufactured (mobile) homes located in high flood risk areas.</i></p>	<p>Banks may not make, increase, extend, or renew a loan on improved property located in a special flood hazard area (SFHA) and in a community that participates in the National Flood Insurance Program, unless the improvements are covered by flood insurance. The property must be insured for the entire term of the loan.</p> <p>If a loan will be secured by property in a SFHA, the borrower must be informed of such and whether flood insurance is available.</p> <p>Failure to comply with the flood insurance provisions may lead to civil money penalties and enforcement action.</p>

<p>Truth in Lending, CFPB Regulation Z (12 CFR 1026)</p> <p><i>Prescribes uniform methods for computing the cost of credit, disclosing credit terms, and resolving errors on certain types of credit accounts. Also contains restrictions on “high cost” and “higher-priced mortgage loans” rules requiring appraisal valuation independence, and limitations on private education loans.</i></p>	<p>Depending on the type of credit transaction, Regulation Z requires the disclosure of loan costs (i.e., annual percentage rate (APR), finance charge, etc.) and terms before and after loan consummation.</p> <p>Regulation Z is one of the most detailed and complex federal consumer protection regulations and requires staff knowledgeable of the portions of the law applicable to the products the bank offers. Inaccurate disclosure of credit terms, particularly understating the APR of interest or the finance charge, can result in reimbursements to the customer and civil liability.</p>
<p>Real Estate Settlement Procedures (RESPA), CFPB Regulation X (12 CFR 1024)</p> <p><i>Generally covers consumer real estate loans that are secured by a mortgage on a one-to-four family residential property.</i></p>	<p>After receiving certain mortgage loan applications, the lender must give the applicant a good faith estimate (GFE) of loan closing costs, and detailed information to help the consumer understand the transaction.</p> <p>The bank should understand all of its affiliate and nonaffiliate relationships to ensure compliance with the disclosure requirements. It should also understand the prohibition against kickbacks (a person giving or accepting anything of value for referrals of settlement service business related to a mortgage loan).</p> <p>RESPA prohibits a person from giving or accepting a charge for services that are not performed.</p> <p>The bank should ensure that it has solid mortgage servicing procedures in place that include handling mortgage servicing transfers, error resolution, force placed insurance, and loss mitigation.</p>

WHEN THINGS GO WRONG

Having discussed the various areas of examination, we'll now cover what happens in the event the bank examiners find problems in a bank. Banks that have significant problems or shortcomings may be exposed to the following consequences:

- **Supervisory Findings**

If issues are identified as a result of a supervisory activity, a finding may be issued in the form of a Matter Requiring Immediate Attention (MRIA) or Matter Requiring Attention (MRA). MRIs are matters of significant importance and urgency that are required to be addressed immediately. MRAs are matters that while important can be addressed over a reasonable period of time because the threat to safety and soundness is less immediate.

- **Violations of banking laws or regulations**

Violations may be indicative of a pattern or practice and are considered potential areas of concern, particularly if the violations are either numerous or repetitive. The pattern or practice could lead to escalated regulatory supervision and the other consequences listed below.

- **Monetary cost**

This can come from employee time spent on file searches requested by regulators trying to determine the extent of a violation or from hiring a consultant to fix a problem. Other monetary costs can include civil money penalties (CMP) and reimbursements or restitution to customers.

- **Enforcement actions**

The Federal Reserve may choose to take actions to correct specific, significant issues at a bank, such as violations of law, rules or regulations, unsafe or unsound practices, breaches of fiduciary duty, and violations of final orders.

Actions typically specify what the bank needs to do to correct identified problems, such as improving lending practices, instituting proper policies and procedures, or correcting specific violations of law.

- **Reputational risk/damaged reputation**

Failure to comply with laws and regulations can affect a bank's reputation in a couple of ways. First, violations often involve some kind of error requiring contact and disclosure with customers. If errors occur frequently, customers will soon have the word out to the community that the bank does not operate very effectively.

Second, if the violations necessitate the use of a formal enforcement action, those actions are public information, disseminated by the regulators and available on their respective regulatory websites. Again, news of a bank's inefficient operations may be widely communicated and known to the public via customer word of mouth

In most cases, issues identified by the examiners are resolved through discussions with bank management or management's response to findings outlined in the report of examination. For more severe issues, the banking regulators use the aforementioned enforcement actions. The terms "administrative action" or "supervisory action" are often used synonymously with "enforcement action."

Enforcement actions

Enforcement actions may be formal or informal. Informal actions include:

- board resolutions;
- commitment letters; and
- memoranda of understanding.

Informal actions are the least severe of the various supervisory actions available to regulators. They are usually used for issues that, while considered substantive, can be corrected relatively easily due to management's cooperation and ability to effect corrective action.

Formal actions are for more severe problems, including failure to comply with informal enforcement actions. These actions are legally enforceable in the federal courts and are available to the public for review. Formal actions include:

- written agreements;
- consent orders;
- cease and desist orders (C&D);
- capital directives;
- prompt corrective action directives;
- safety and soundness directives;
- civil money penalties (CMPs); and
- prohibition and removal actions.

Should examiners discuss enforcement action with you, be assured that they have serious issues with the bank, warranting your full attention. As with any other topic covered by examiners, ask questions until you fully understand their concerns. For example:

- What is the problem?
- What is the root cause of the problem?
- Why is an enforcement action necessary?
- What is expected of you and your management team in effecting corrective action?

That last point is probably the most important one. Failure to adequately respond to an enforcement action can result in the escalation of enforcement actions to more severe actions, such as CMPs. CMPs are typically levied against banks or responsible individuals for egregious or repetitive conduct, which can include ineffective corrective action taken in response to an enforcement action.

For more information about enforcement actions, please refer to any of the examination handbooks mentioned in Chapter 6, Other Resources for Bank Directors, which is available at www.BankDirectorsDesktop.org.

OTHER RESOURCES FOR BANK DIRECTORS

This book highlights many matters that directors might consider in governing their banks. It includes discussions on bank supervision and regulation and points out common regulatory compliance pitfalls. Additionally, it discusses bank financial soundness, covering topics on capital, asset quality, management, earnings, liquidity, and sensitivity to market risk, and suggests areas to consider in judging bank performance.

Besides this book, there are other resources that you may want to consult to further your study of banking. For example, there are many educational programs and publications designed to help directors better supervise their banks. Banking associations at the national and state levels sponsor seminars and training sessions for interested directors. Additionally, these associations often have information on other training opportunities open to directors. There also are numerous publications and webinars that can help directors supplement or build their banking knowledge. A sampling of these is grouped together in the next sections.

Bank Director's Desktop

Bank Director's Desktop is the Federal Reserve's home page for director training and resources that can be accessed free at www.BankDirectorsDesktop.org.

From this site, you may access:

- Training for Bank Directors—an online course that covers director duties and responsibilities with an ability to dig deeper into certain topics of interest. The course is the successor to our Insights for Bank Directors course.
- Basics for Bank Directors—an electronic copy of this book.
- Resources for Bank Directors—other resources that can help you in your career as a bank director, such as supervision manuals and links to relevant websites.

Bank Supervision Manuals

The most definitive information on matters to consider in evaluating a bank can be found in the examination manuals used by banking agencies. The manuals used by examiners at the federal banking agencies are available to the public and can be ordered directly from the agencies or their representatives.

Additionally, they can be obtained electronically from the agencies at their websites:

- CFPB
www.consumer finance.gov → Law & Regulation → Examination Manual
- Comptroller of the Currency
www.occ.gov → Publications → OCC Supervisory Policies and Procedures → Select the appropriate manual
- Federal Reserve
www.federalreserve.gov → Banking Information and Regulation → Supervision → Supervision Manuals
- FDIC
www.fdic.gov → Regulations and Examinations → Bank Examinations → Select the appropriate manual
- CSBS
www.csbs.org → Data and Tools → Industry Resources

The manuals are lengthy and discuss matters in more detail than typically needed by directors. However, you can access them electronically to search for key words and phrases on topics in which you have an interest. Regardless of how you access the manuals, they can be invaluable reference tools in helping you understand matters that may come before the board.

Banking Associations

Banking associations are another important educational resource. Many provide seminars, classes, webinars, online courses, and written materials that are invaluable to bank directors and

banking personnel in learning about bank operations and regulatory and supervisory matters. Usually the associations' offerings can be found by clicking "Education" on their home page. The "Events"-section is another handy place to look.

Classroom Training

Banking associations, consultants, and supervisory agencies provide many services and programs that are of great value to outside directors. One of these programs, offered by a number of the Federal Reserve Banks, is Basic Training for Bank Directors. This is a half-day program based on this book and offered onsite at your bank. Directors wanting this training should check with the Reserve Bank in their District. The training is targeted to directors of state chartered banks that are members of the Federal Reserve.

Director Guides

The resources included here summarize matters of importance to bank directors, differing in the emphasis given to individual topics.

- *Director's Corner*
www.fdic.gov → Regulations and Examinations → Resources for Bank Officers and Directors → Director's Corner
- *Pocket Guide for Directors*
www.fdic.gov → Regulations and Examinations → Resources for Bank Officers and Directors → Pocket Guide for Directors
- *The Director's Book*
www.occ.gov → Publications → Tools and Guidance for Bankers and Directors → The Director's Book—The Role of the National Bank Director
- *The Director's Primer: A Guide to Management Oversight and Bank Regulation*
www.frbatlanta.org → Banking Information → Director's Primer

- Detecting Red Flags in Board Reports: A Guide for Directors (also available in pocket guide)

www.occ.gov → Publications → Tools and Guidance for Bank Directors → Detecting Red Flags in Board Reports: A Guide for Directors

- *Banking Regulation: Its Purposes, Implementation, and Effects* *www.KansasCityFed.org* → Banking Supervision → Banking Publications → Banking Regulation.

Other Websites

- Conference of State Bank Supervisors—*http://www.csbs.org*
- Federal Financial Institutions Examination Council—*http://www.ffiec.gov*
→ Uniform Bank Performance Report home page—*http://www.ffiec.gov/ubpr.htm*

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