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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Bank Director's Guide to Corporate Governance

The FDIC recently published a community bank director's guide to corporate governance which offers commentary on the Pocket Guide for Directors issued in 1988 and highlights key governance concepts, roles and responsibilities of directors and senior management. To be effective, corporate governance requires a high level of cooperation between a community bank's board of directors and senior management as well as a common understanding and awareness of the bank's risks. For purposes of the guide the term "community bank" refers to insured depository institutions whose business models reflect a focus on traditional lending and deposit gathering activities within a fairly limited geography, rather than to banks below a particular asset size cutoff.

The responsibilities of directors and officers requires them to administer the affairs of the bank with candor, personal honesty and integrity which is known as the duty of loyalty. They are prohibited from advancing their own personal or business interests, or those of others, at the expense of the bank. When administering the affairs of the bank, directors and senior management should be candid, open and direct. They should voice their opinions without hesitation, give direct instruction, and most importantly, do so with honesty. The interest and welfare of the bank should take priority over the interests of directors, officers, their family members and their beneficial interests.

Directors and officers are required to act as prudent and diligent business persons in conducting the affairs of the bank which is known as the duty of care. Directors and senior management must act in good faith, with the level of care that an ordinarily prudent person would exercise in similar circumstances, and in a manner they reasonably believe is in the best interests of the bank. The duty of care requires directors and senior management to acquire sufficient knowledge of the material facts related to a proposed transaction, thoroughly examine all information available to them with a critical eye, and actively participate in the decision making process.

The guide notes that directors need not generally be actively involved in the day-to-day operations of the bank. However, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures and practices have been established. Senior management is responsible for developing and implementing policies, procedures and practices that translate the board's goals, objectives and risk limits into prudent operating standards.

The board and its members should establish and maintain independence. In order to provide independent judgment, community bank directors should make every effort to attend and be prepared for board meetings and assigned board level committee meetings. Directors should strive to understand reports and summaries and to ask questions if they do not understand. Community bank directors should not act a "rubber stamp." In hiring and retaining qualified senior management, the board is ensuring that the right people are in place to carry out the board's vision, policies and strategic plan.

The board should have a management succession and talent development plan to build strength and maintain continuity in the chief executive and other key senior management positions. The succession and talent development plan should start with an assessment of potential successors who may be groomed from within, along with the training, mentoring and developmental resources needed to do so. Sound planning by the board also addresses the process of identifying potential successors from outside the bank, when necessary. A management succession and talent development plan should generally cover at least a three to five year horizon.

The board has the responsibility of working with senior management to set the future direction of the bank by establishing both long term and short term business objectives. In order to set appropriate business objectives, bank directors should have a solid understanding of the bank's risk profile which includes assessing the riskiness of the bank's business model and growth plans and considering potential external threats from the bank's operating environment. The board should have a strategic planning process in place to guide the direction and decisions of both the board and senior management. Strategic planning by the board should be able to answer these questions: Where are we now, where do we want to be, how do we get there, and how will we know we are successful? As part of this strategic planning process, it is important, that the board and senior management address the need to maintain adequate capital and liquidity as the operating environment evolves in potentially unpredictable ways. The board should ensure that all major operational areas and activities are covered by clearly communicated policies that can be readily understood by all employees and that are appropriate for the bank's size.

The board should make sure that the bank's senior management provides periodic reports and summaries of the bank's financial position and in conformance with its policies and procedures. The board should review the bank's periodic reports of examination. The FDIC encourages directors to participate in the examination process by meeting with examiners and asking questions. Although bank directors are not expected to have detailed knowledge of applicable laws, regulations and regulatory expectations, they should make sure that the bank has appropriate policies, procedures and training programs to ensure that directors, officers and employees are familiar with applicable laws, regulations and regulatory expectations. The board should be aware of the bank's responsibilities and requirements in meeting the credit needs of the community in which it operates, including low and moderate income neighborhoods consistent with safe and sound banking practices.

Directors should never use their influence with senior management for personal advantage or wrongfully use confidential information concerning the bank's customers. The basis for decisions by the board relating to any insider transactions must be fully documented. Directors and senior management officials who permit preferential treatment of insiders breach their responsibilities and may expose their bank to a greater than ordinary risk of loss.