CORPORATE GOVERNANCE FOR FINANCIAL INSTITUTION DIRECTORS

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TABLE OF CONTENTS

Page

A. What is Corporate Governance? 1
- 1. Underlying Principles 1
- 2. Corporate Governance Areas and Items 2
  - a. Oversight 2
  - b. Policies and Procedures 2
  - c. Controls 2
- 3. Sources of Corporate Governance Principles and Requirements 2
  - a. Corporate Law and Structure 2
  - b. OTS 2
  - c. SEC/Sarbanes-Oxley 2

B. Corporate Governance is about Running a Successful Business 2

C. Role and Mandate of the Board 3
- 1. Responsibilities and Duties of Individual Directors 3
- 2. Choice and Oversight of CEO and Senior Management 4
- 3. Approval of Actions (Including Loans) that are Outside Policies 5
- 4. Business Planning 5
- 6. Oversight of Operations 5

D. Board Committees 5
- 1. Audit Committee 5
- 2. Compensation Committee 5
- 3. Nominating Committee 5
- 4. Executive Committee 5
- 5. Other Committees 5
- 6. Special Committee 5

E. Board and Committee Meetings 6
- 1. Agenda and Board Packages 6
- 1. Executive Sessions of Outside Directors 6
- 3. Management Reports 6
- 3. Minutes – Records of Actions 6

F. Strategic Planning 7
- 1. What is a Strategic Plan 7
- 2. Form of a Strategic Plan 7
- 3. How to Conduct a Strategic Planning Session 7

G. Business Plan and Budget 8
- 1. Relationship to Strategic Plan 8
- 2. Deviations 8

H. Oversight of Operations 8
- 1. Policies and Procedures – Deviations 8
- 2. Specific Areas Requiring Special Attention 9
- 3. Internal and External Reviews, Audits and Controls 10

I. Ethics 10
- 1. Conflicts of Interest 10
- 2. Insider Loans and Transactions 10
- 3. Recusals 10
- 4. Code of Ethics 11

J. Regulatory Sources on Corporate Governance 11

K. Issues for Consideration or Discussion 12

A. What is Corporate Governance?

Corporate governance is the creation and maintenance of structures and procedures to provide appropriate oversight of the Bank's operations and enhance accountability, profitability and ethical conduct. A proper governing structure assigns appropriate levels and scope of responsibilities and oversight from the board of directors, through the chief executive officer and senior managers to all levels of employees. Good corporate governance should create an atmosphere of ethical conduct, financial accountability and constituency attention. These constituencies include depositors and borrowers, the communities in the bank's market area, shareholders, the OTS and the FDIC.

1. Underlying Principles

Corporate governance involves the mechanisms and controls to:

- Improve operations and manage risks;
- Reduce inefficiencies and improve responsiveness;
- Provide internal review and oversight;
- Allocate decision-making, responsibilities and reporting appropriately up and down the organization;
- Establish the appropriate flow of information up and down the organization; and
- Promote ethical conduct and good corporate behavior.

The relationship between the Board and senior management is particularly critical to maintaining good corporate governance. This involves careful consideration of the determination of those matters that are the board's direct responsibility and those that are subject to board oversight. In order for any oversight function to be effective, information in appropriate amount and form needs to be reported to the board. The corporate governance system involves a healthy balance of honesty and trust with accountability and skepticism. The board must be sensitive to the type of information that evidences increased risks or negative trends that warrant its further attention.

Strong corporate governance encourages and requires ethical conduct on the part of the individual board members and all officers and employees.

"The first step both the board and individual directors should take is to establish and maintain the board's independence. Effective corporate governance requires a high level of cooperation between an institution's board and its management. Nevertheless, a director's duty to oversee the conduct of the institution's business necessitates that each director exercise independent judgment in evaluating management's actions and competence. Critical evaluation of issues before the board is essential. Directors who routinely approve management decisions without exercising their own informed judgment are not adequately serving their institutions, their stockholders, or their communities." [*From* <u>FDIC Pocket Guide For Directors</u> (March 2005)]

2. Corporate Governance Areas and Items

   a. Oversight.

   b. Policies and Procedures – Deviations

   c. Controls

3. Sources of Corporate Governance Principles and Requirements

   a. Corporate Law and Structure

   b. OTS

   c. SEC/Sarbanes-Oxley

      In May 2003, OTS CEO Letter 174 stated that the banking agencies did not expect to take steps to apply board composition, director independence, audit committee, auditor independence and other corporate governance requirements of Sarbanes Oxley to non-public banking organizations. Five years later, it appears that this expectation has been abandoned in many respects.

B. Corporate Governance is about Running a Successful Business

Because corporate governance is driven so much by legal and regulatory concerns, it is easy to forget that at the core of corporate governance is operating a healthy and profitable bank.

The decisions made and actions taken within a well-constituted corporate governance structure must still make business sense. Not only must the corporate governance structures of the bank produce good business decisions, but it also must explore preventative and curative measures to employ if errors or economic downturns occur. The appropriate analysis of risks and the creation of procedures when things go wrong are critical for survival.

To address this aspect of corporate governance, the board must understand the essentials of the bank's business. No new areas of business should be pursued prior to adequate education of the directors on the new activity and its attendant risks. In addition, appropriate policies, procedures and review systems must be in place before the bank engages in the new activity.

Directors must spend appropriate time on the aspects of the bank's operations that contribute most to income or that involve the highest risks.

Contingency planning is not limited to management succession or information technology.

Directors must remember to: ask questions, be wary of jargon answers; admit they do not understand; and seek multiple sources of information, including from outside consultants.

C. Role and Mandate of the Board

1. Responsibilities and Duties of Individual Directors

a. Basic Responsibilities

"Today's board of directors must take an active role in shaping and controlling a savings association's business operations and risks. The following are some basic responsibilities the board has in actively overseeing the association's affairs:

- Establish business goals, standards, policies and procedures and operating strategies and understand the risks involved in following certain strategies.
- Approve standards for ensuring that the savings association's transactions with affiliates are sound, and are considered solely from the association's interests.
- Establish a compliance program emphasizing the importance of regulatory compliance as an inherent part of business operations ensuring compliance with external standards, such as laws and regulations, and the association's own policies and procedures.
- Hire and retain executive officers with the skills, integrity, knowledge, and experience appropriate for the nature and scope of their responsibilities and periodically evaluate management's performance.
- Establish and maintain appropriate committees that have written charters delineating the committee's functions, responsibilities, and membership qualifications.
- Ensure that the association maintains a corporate existence that is separate from its affiliates, subsidiaries, holding company, and sister banks.
- Ensure that the association serves the credit needs of its community or communities and meets responsibilities under the Community Reinvestment Act (CRA).
- Review operating results, compliance performance and performance of new and existing activities.

In fulfilling these responsibilities, the board of directors should observe the following standards:

- Operate independently from management.
- Stay well informed and be attentive to risk.
- Attend board meetings regularly.
- Conduct business affairs ethically; avoid conflicts of interest and self-serving practices." [*From* OTS Examination Handbook – Management Section 310: Oversight by the Board of Directors]

b. Staying Informed

c. Duties of Loyalty and Care

"The duty of loyalty requires directors and officers to administer the affairs of the bank with candor, personal honesty and integrity. They are prohibited from advancing their own personal or business interests, or those of others, at the expense of the bank.

The duty of care requires directors and officers to act as prudent and diligent business persons in conducting the affairs of the bank.

This means that directors are responsible for selecting, monitoring, and evaluating competent management; establishing business strategies and policies; monitoring and assessing the progress of business operations; establishing and monitoring adherence to policies and procedures required by statute, regulation, and principles of safety and soundness; and for making business decisions on the basis of fully informed and meaningful deliberation.

Officers are responsible for running the day to day operations of the institution in compliance with applicable laws, rules, regulations and the principles of safety and soundness. This responsibility includes implementing appropriate policies and business objectives.

Directors must require and management must provide the directors with timely and ample information to discharge board responsibilities. Directors also are responsible for requiring management to respond promptly to supervisory criticism. Open and honest communication between the board and management of the bank and the regulators is extremely important." [*From* FDIC Statements of Policy – Statement Concerning the Responsibilities of Bank Directors and Officers (April 1997)]

d. Corporate Opportunity

2. Choice and Oversight of CEO and Senior Management

a. Retain qualified management

b. Supervise management

c. Internal controls

d. Management succession

3. Approval of Actions (Including Loans) that are Outside Policy Limits

In any situation where management feels it is in the best interests of the bank to take an action that is outside the limits or guidelines of a bank policy, such as making a loan that is not within the bank's lending policy limitations, the proposed action should be brought to the board. The reason for the proposed action should be explained and justified and the specific deviation from policy should be pointed out. If the board agrees the action is in the best interests of the bank and is consistent with safety and soundness guidelines, a specific resolution should be adopted noting the exception to the policy and approving the action.

4. Business Planning

5. Oversight of Operations

   a. Managing risk

   b. Policies and procedures

   c. Internal controls to help ensure that bank personnel carry out board and management directives.

D. Board Committees

"You may delegate assignments, but **must never delegate your responsibilities as a director**." [*From* OTS Directors' Responsibilities Guide (September 2006)]

Today, this delegation to committees is often done through the use of written committee charters. All material actions by committees must be reported to the full board promptly, which is generally the next board meeting.

1. Audit Committee

2. Compensation Committee

3. Nominating Committee

4. Executive Committee

5. Other Regular Committees

6. Special Committee

E. Board and Committee Meetings

1. Agenda and Board Packages

These should be provided sufficiently far in advance of meetings to allow adequate time for the review of the information. While no particular format or medium is required, we recommend that hard copy be utilized to enable board members to refer to the materials and any notes they may have made while in attendance at the board meeting.

2. Executive Sessions of Outside Directors

It is critical for the outside directors to meet alone amongst themselves. Outside directors should meet alone with compliance officers, internal auditors and external auditors and should obtain outside assistance from lawyers or consultants, if deemed necessary.

3. Management Reports

"**Adequacy of management's reports to the Board** – Management reports submitted to the board should be thorough and accurate and cover all aspects of the association's operations. Management should provide such reports to the directors before regular board or committee meetings to allow adequate time for review before the meetings." [*From* OTS Examination Handbook – Management Section 310: Oversight by the Board of Directors]

a. Capital

b. Asset Quality and Credit Risk

c. Allowance for Loan and Lease Losses

d. Earnings

e. Liquidity

f. Interest Rate Risk

g. Growth

h. Investment Portfolio

3. Minutes – Records of Actions

"Board minutes should be a complete and accurate representation of meeting discussions, including dissenting opinions or votes. Minutes should indicate that the directors studied pertinent documentation and based their decisions upon such documentation. Each director should have the opportunity to review and, if appropriate, modify the minutes before the board ratifies them. However, board minutes should never be altered to distort facts. [*From* OTS Examination Handbook – Management Section 310: Oversight by the Board of Directors]

Board minutes should not be a transcript of the meeting.

F. Strategic Planning

1. What is a Strategic Plan?

A strategic plan defines the strategy or direction of an organization over the long-term, often three to five years. It becomes the framework for the production of a business plan.

Strategic planning considers the environment in which the association operates, including the law, the economy and competition. It decides how best to address these external factors by carefully selecting long-range goals and determining available and appropriate methods for achieving these goals. Benchmarks for measuring progress should be incorporated into the business plan and budget and measured against long-term strategic plan goals.

The strategic plan should not be a long document and should be reviewed regularly by senior management and the board to be certain the company is staying on course. It must be a living document subject to periodic review.

2. Form of a Strategic Plan

There is no one way to formulate a strategic plan. Many organizations start with a Vision, Mission and Values statement, followed by a reasonable number of long-term goals and annual objectives to achieve those goals. The business plan, budget and personnel goals and objectives are all in line with the goals and objectives of the strategic plan.

3. How to Conduct a Strategic Planning Session

Good strategic planning cannot be accomplished in the midst of the day-to-day responsibilities of the board and management. It needs to incorporate input from all levels of the organization and take into account all the constituencies served by the organization. It is often useful to conduct a senior level (board and senior management) strategic planning session off-site, after lower level strategy sessions are conducted throughout the organization. It requires a stepping back to see the big picture of who you are, and what are your strengths and weaknesses. It is helpful to bring different types of outside advisors and consultants into the process, and it is often helpful to use a facilitator. It is an opportunity to encourage raising new ideas in brainstorming sessions, followed by analysis of the practicality of these ideas. In setting forth a strategy for the organization, it is important to consider the available resources and expertise and determine if these are sufficient to meet the defined goals.

G. Business Plan and Budget

1. Relationship to Strategic Plan

The strategic plan sets forth the overall direction and long range goals of the institution. The business plan and budget set forth the more detailed explanation of how the institution anticipates meeting those goals and a detailed annual budget. This information should be reviewed by management and the board on a monthly basis to monitor progress and provide information on the performance of the institution compared to the business plan and budget, prior performance of the institution and the performance of a carefully selected peer group.

2. Deviations

Deviations from the business plan and budget should be clearly noted and the reasons for any significant deviations should be discussed between management and the board. If significant deviations occur over a period of time, consideration should be given to revising the business plan and budget. Any long-term inability to meet budgeted performance targets should be discussed with the board and consideration given to modifying the strategic plan.

H. Oversight of Operations

"Well-planned, properly structured, and effective audit and internal controls are essential to manage risk properly and to maintain a safe and sound bank. The board of directors must establish and maintain effective audit functions. An effective internal auditing process meets statutory and regulatory requirements as well as other audit-related supervisory guidelines and standards. Directors cannot delegate their responsibility for oversight of the auditing function. However, they may delegate the design, implementation, and monitoring of specific internal controls to management and the testing and assessment of internal controls to others. [*From* OCC – Detecting Red Flags in Board Reports – A Guide for Directors (October 2003)]

1. Policies and Procedures – Deviations

The OCC conducted a study of banks that failed during the 1980s. The study showed that policies and procedures adopted by the board had a greater influence on whether the bank succeeded or failed than economic conditions. The following deficiencies were common in the failed banks.

- Uninformed or inattentive board of directors
  - Nonexistent or poorly followed loan policies.
  - Inadequate systems to ensure compliance with policies or law.
  - Inadequate controls or supervision of key bank officers or departments.
  - Inadequate problem identification systems.
  - Decisions made by one dominant person.
  - Poor judgment in the decision-making process.

- Negative influence from insiders
  - Lack of policies or inadequate audits, controls, and systems.
  - Insiders of poor integrity.

- Overly aggressive activity by board or management
  - Liberal lending policies.
  - Excessive loan growth compared with management or staff abilities, cost systems, or funding sources.
  - Undue reliance on volatile liabilities.
  - Inadequate liquid assets/secondary source of liquidity.

- Other
  - Excessive credit exceptions.
  - Over lending.
  - Collateral-based lending and insufficient cash-flow analysis.
  - An emphasis on earnings over sound policies, procedures and controls.
  - Inadequate due diligence when acquiring a business, such as a mortgage lender.
  - Failure to establish adequate policies, procedures and controls before entering into a new business (i.e., credit cards and payday lending).
  - Unwarranted concentrations of credit."

[*From* OCC – Detecting Red Flags in Board Reports – A Guide for Directors (October 2003)]

2. Specific Areas Requiring Special Attention

a. Information Technology/Management Information Systems

b. Asset/Liability Management

Asset/liability management is one of the more difficult areas to oversee, because it involves matters that require technical knowledge, including interest rate risk management. The board needs some summary knowledge of what is involved in this area and should receive in-house and outside training as appropriate. The board needs to establish parameters of risk, receive regular reports on compliance with those parameters and interest rate trends and take immediate action if those parameters are exceeded.

c. Non-homogeneous Loans and Credit Underwriting

Non-homogeneous loans include commercial business, commercial real estate and construction and development loans. The board needs to be informed of large loans and lending relationships. If there are reported problems with loans of this type (of concern, delinquencies or classification) immediate board review is appropriate due to the higher risk and size of these loans. The board needs to be particularly careful when it is asked to approve loans of this type, which are outside the limits of the board's policies. In that regard, it is important for the

board to receive useful information and appropriate time before being asked to approve a loan which is outside existing policy limitations.

d. Consumer Lending

e. Compliance

The board should review internal and outside compliance reviews for cited weaknesses and concerns. The board's and senior management's failure to take action, particularly in the following "hot-button" areas, can lead to enforcement action -- Consumer Compliance, Fair Lending, CRA and BSA

3. Internal and External Reviews, Audits and Controls

The board must establish a mechanism for independent review of adherence to board policies and procedures and applicable laws and regulations and of the accuracy of information provided to the board by management. The board should review the results of theses reviews, go over them with management and monitor management's corrective efforts.

I. Ethics

1. Conflicts of Interest

A fundamental part of directors' and officers' fiduciary duty to the bank is to avoid conflicts of interest or the appearance of a conflict of interest. This includes not advancing one's personal or business interests (or those of another third party) over those of the bank and not taking advantage of a corporate opportunity that belongs to the bank.

2. Insider Loans and Transactions

The fiduciary duties owed to the bank by its directors and executive officers become particularly critical when the director or officer engages in a personal transaction with or receives a loan from the bank. Regulation O prescribes limits and requirements for loans to insiders. Regulation W prescribes limits and requirements for bank loans to and bank transactions with entities with certain affiliations with the director or officer. These transactions are governed by the conflict of interest and corporate opportunity standards referred to above.

3. Recusals

A director should not participate in the board's deliberations or decision on any matter in which the director has a personal interest. In order to abide by this rule, the director must leave the board meeting during all deliberations and actions on the matter. The director also must take care not to influence officers or other employees who are reviewing the matter prior to submission to the board. Also, do not promote your interests or those of the related party over those of the institution. The one exception to this rule is when the director has negative information regarding the matter, which the director has an obligation to report to the board. For example, if a loan being

considered by the board is to a borrower related to or represented in some capacity by the director and the director has information that would support a denial of that loan, the director must provide this information

4. Code of Ethics

A financial institution should have a code of conduct for all directors, officers and employees addressing duties and responsibilities to the institution and covering conflicts of interest, corporate opportunity, insider transactions and reporting improper conduct. The code of ethics should include standards to deter wrongdoing by the principal executive, financial and accounting officers and promote honest and ethical conduct, compliance with applicable laws and regulations, and an accountability system.

J. Regulatory Sources on Corporate Governance

The following regulatory sources are recommended for further information on Corporate Governance for OTS Regulated Institutions. These sources cover the special responsibilities and requirements of directors of financial institutions.

OTS Regulations:

- 560.130 Prohibition on loan procurement fees
- 563.33 Directors, officers and employees.
- 563.41 Transactions with affiliates – Section 23A and 23B of the Federal Reserve Act and Regulation W
- 563.43 Loans by savings associations to their executive officers, directors and principal shareholders – Regulation O
- 563.200 Conflicts of interest
- 563.201 Corporate opportunity

OTS Examination Handbook – Management Section 310: Oversight by the Board of Directors

OTS Directors' Responsibilities Guide (September 2006)

OTS Directors' Guide to Management Reports (September 2006)

FDIC Statements of Policy – Statement Concerning the Responsibilities of Bank Directors and Officers (April 1997)

FDIC Pocket Guide For Directors (March 2005)

OTS Compliance: A Self-Assessment Guide – Introduction and Components of an Effective Compliance Program (October 1999)

OCC – The Director's Book; The Role of a National Bank Director (March 1997)

OCC – Internal Controls – A Guide for Directors (September 2000)

OCC – Detecting Red Flags in Board Reports – A Guide for Directors (October 2003)

K. Issues for Consideration or Discussion

1. How has the corporate governance systems at your bank changed in recent years? How has that impacted board compensation?

2. Who should take the lead on establishing the bank's corporate governance structure?

3. Does your board have a lead director? What are that person's special responsibilities?

4. Does a separate corporate governance committee make sense? If yes, should its membership be limited to outside directors?

5. How does a holding company structure impact corporate governance at your institution?

6. Is it better to have a staggered board or to have all directors elected annually?

7. Is board self evaluation a good idea? Should it be conducted on an individual basis?

8. Should board members rotate through committees?

9. Can the board receive too much information from management?

10. What helpful outside sources have you used for education as a director?

11. Do you find it necessary to receive oral presentations of executive summaries in the board package?

12. Do you have a board succession program? Who should be responsible for finding director candidates?

13. What does it mean to be independent? Why is that independence so important? Does independence reduce with time spent on the board?

14. Is there any value to board term limits?

15. Have the independent directors of your bank ever asked to meet with the regulators alone?

16. How should the board react to serious regulatory criticism?

17. How does your bank conduct strategic planning? Is that plan alive or does it collect dust?

18. What process does your board use to set executive compensation?

19. How much conduct do you have with middle management and other employees?

20. What procedures are used at your bank for insider transactions?