

# The Bank Director Handbook



## "The Director's Role: Reward and Responsibility"

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## **THE DIRECTOR'S ROLE: REWARD AND RESPONSIBILITY**

Service as a bank director is an honor and can be quite rewarding in terms of helping one's community and the satisfaction one gets from a job well done. However, the position bears serious responsibilities and the potential for personal civil and/or criminal liability. Directors are charged to make decisions and take actions that will produce a safe, sound, and profitable bank. The state regulator depends upon the Board to properly administer the business affairs of the bank and may take actions against directors and officers for improper conduct. The Federal Deposit Insurance Corporation (FDIC), responsible for managing the federal deposit insurance fund, also looks to directors for appropriate bank oversight.

For purposes of this handbook, assume there are two categories of directors: "outside" and "inside." Outside directors serve only as board members, while inside directors are also active in running the day-to-day operations of the bank. (These definitions are not to be confused with the use of the term "insiders" in law and regulatory issuances, which encompasses all directors and executive officers.) Inside directors, due to their daily participation in the operation and management of the bank and subsequent knowledge about its affairs, are given less leeway for error in decision making.

The prosperity of a bank is of importance to its shareholders but is of greater importance to its depositors and the community at large. The law fixes on the bank's board of directors the responsibility of administering the business and affairs of this special enterprise. Thus, persons serving as directors must have the ability, experience and integrity to direct affairs affecting the community. Selection to serve as a director requires the individuals chosen to have reputations of being honest, prudent and successful in their own affairs, public spirited, and entitled to confidence in the care of funds entrusted to the bank by depositors.

The Financial Institutions Code of Georgia (Code) declares that bank directors must discharge their duties "in good faith and with the diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." (O.C.G.A. §7-1-490). This "ordinary negligence" standard of performance has been required for years by Georgia courts. They regard directors as agents of the bank "clothed with fiduciary character" — that is, owing a fiduciary duty of good faith and due care to the corporation. Any failure to meet this legal responsibility subjects the bank director to personal liability for any resulting losses to the bank, its depositors or other creditors. Since the Financial Institutions Code specifically addresses the standards of care for directors of banks and trust companies, it should be the primary source for guidance. The Georgia Business Corporation Code may also be a source of law on standards for directors. This code was revised in 1988 to be generally consistent with the 1984 Revised Model Business Corporation Act (Model Act). Comments after O.C.G.A. § 14-2-830 may be helpful in understanding the provisions of the corporate code. Directors of a bank holding company should pay particular attention to this law.

Two Supreme Court cases after the Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA) found that state law governs with respect to the standard of care for directors of federal and state chartered banks. They are O'Melveny & Myers v. FDIC (1994) and Atherton v. FDIC (1997). Prospective directors may wish to review these complex issues with their own counsel to become fully aware of their legal duty, responsibility and liability. The attitude of the Georgia courts toward the

director's responsibility is exemplified in the following statement:

"The general rule in this State is that directors of a bank must exercise ordinary care and diligence in the administration of its affairs. The active management of the bank may be delegated to certain officers authorized to manage its business. The directors, however, must exercise a reasonable supervision over such officers." Woodward v. Stewart, 149 Ga. 620, (1919).

The presence of Federal Deposit Insurance does not relieve a director of responsibility. When a bank closes and the Federal Deposit Insurance Corporation (FDIC) makes payments of insured amounts to depositors, the FDIC, by law becomes subrogated to the rights and claims of the depositors against the bank. These include any rights that may develop against directors of the bank for losses that result from their failure to exercise the care and diligence required by law in the operation of the bank. The FDIC freely asserts these rights when investigations covering a period of years prior to the closing indicate lapses in prudence, diligence and care on the part of directors. The FDIC's publication titled "Pocket Guide for Directors" summarizes the responsibilities of bank directors. The FDIC Pocket Guide can be found at the following website: <http://www.fdic.gov/regulations/resources/directors/index.html>.

The legal obligations of bank directors are real, but not onerous. If they act in good faith, directors may rely on financial information concerning the bank represented to them to be correct by the bank president, or the officer responsible for the bank's books, or contained in a written report of an independent certified public accountant. Directors may not, however, blindly rely upon information provided by bank officers or others without asking prudent questions under the circumstances. Further, directors who possess information or knowledge that indicates the presence of troubling circumstances or "red flags" may be held liable for failure to consider such information when making decisions or taking actions on behalf of the bank.

Directors must do their job in a prudent, competent, and responsible manner. Directors who foster a safe, sound, and profitable financial institution need not fear regulatory actions or personal liability. Liability is normally confined to cases where directors permit continued statutory violations or fail to ensure that basic controls and administrative procedures are maintained. It is to these matters that the remainder of this handbook is addressed.

## **SPECIFIC STATUTORY PROVISIONS**

### **Directors' Qualifications**

The Georgia Code requires that 75% of a bank's directorate be citizens of the United States and at least a majority shall: (1) reside in Georgia; or, (2) reside within 40 miles of any banking locations authorized to offer complete banking or trust services. **NOTE:** Items (1) and (2) do not apply to banks having branches in states other than Georgia, provided the residency of directors is consistent with the bank's articles of incorporation and bylaws.

The statute does not require that directors own stock in the bank, but the exclusion of this technical requirement is not intended to discourage directors from purchasing the bank's stock. A salaried officer of the bank may serve as a director (an "insider" as explained above); however, such directors should not constitute a majority of the board. **NOTE:** Georgia law does not require any officer to be a board member.

Except for the original directors who are designated to serve temporarily by the bank's articles of incorporation, the directors must be elected annually by vote of the shareholders. By law, the directors must number not less than five and not more than 25, as may be specified in the bank's articles or bylaws. The law allows the board to increase or, upon vacancies, to decrease the number of directors by not more than two in any one year. The remaining directors may fill vacancies occurring during the year.

Before assuming office, directors must sign an oath or affirmation that: (1) they will diligently and honestly perform their duties in the administration of the affairs of the bank, (2) they will not permit a willful violation of law by the bank, and, (3) they meet the eligibility requirements for directors established by the Code and the bank's articles and bylaws. The executed oath must be placed into the minutes of the meetings of the directors.

The Code expressly allows the board of directors to bestow the title "honorary director" or "director emeritus" on an individual deemed worthy of such honor by the board. Similarly, an individual may be named to an advisory board. Persons so selected may be compensated by the bank but are not legally directors and do not have the powers or the responsibilities of directors.

### **Directors' Meetings and Actions**

The Code requires a bank's board of directors to meet regularly at times fixed in the bylaws and also requires meetings to be held at least once during ten different months of each calendar year. The Code also provides that the board may meet less frequently if an alternative schedule is approved in writing by the Department, but in no event may the board meet less frequently than once in each calendar quarter.

Directors assigned to committees authorized to act for the board will probably have to meet more frequently to perform the required duties of the committee, especially the loan and investment committees. The chairman of the board, president of the bank, or any two members of the board may call special meetings. Unless otherwise provided in the bank's articles or bylaws, a majority of all the directors in office constitutes a quorum and actions of a majority of all those at a meeting where a quorum is present are the actions of the board. This is not the case when the board is deliberating making a loan to or performing certain other types of transactions with a director or executive officer. See the heading

below "Personal Borrowings and Other Dealings With the Bank" for quorum requirements under Regulation O of the Federal Reserve System.

Under the Code, the board of directors may also act through an executive committee or other committee composed of three or more directors and empowered by resolution of the board to act in its name.

The law requires that minutes of all meetings of the board and its committees be maintained. Specific board functions and actions to be taken at board meetings are discussed later in this handbook. Directors who are present at a board meeting at which action on any corporate matter is taken are deemed to assent to the action unless their dissent is entered in the minutes, or filed in writing with the secretary before adjournment of the meeting (assuming the directors did not vote), or sent to the secretary by registered or certified mail within 24 hours after such adjournment.

A director who disagrees with any action of the board that appears imprudent, ill advised, or harmful to the bank should vote against the action and make sure the opposing vote is recorded in the minutes. Abstinance or an undocumented vote opposing an action is regarded as supporting the action. If a director believes an action to be illegal or improper, he or she should contact the Department. There have been cases where as few as one director notified the Department of improper actions approved or carried out by the Board.

### **Lending Restrictions**

One of the director's most important duties is to assure that the bank's loans and other financing activities comply with statutory restrictions. The Code restricts the aggregate amount of financing that a bank can extend in favor of a given borrower in order that the bank's future is not dependent on the success of one entrepreneur or enterprise. The restrictions are formulated in terms of the bank's Statutory Capital Base (SCB). Assuming that the bank's capital has not been impaired, its SCB is equal to the sum of the capital stock, the paid-in capital, the appropriated retained earnings, and the capital debt of the bank. In lieu of the limitations that follow, a bank may petition the Department for approval to utilize limits permissible for national banks regarding obligations of a single person or corporation. Georgia law states that:

1. A bank cannot extend total financing to one obligor in excess of 15% of its SCB unless each financing transaction above the 15% limit is approved in advance by the board of directors or a committee of directors authorized to act for the board. There are no exceptions to this provision,
2. A bank cannot extend total financing to one obligor in excess of 15% of its SCB unless the entire amount of such financing is secured by good collateral or other ample security, and,
3. A bank cannot extend total financing to one obligor in excess of 25% of its SCB.

There are some exceptions to the second and third provisions above with regard to designated financing enjoying a high degree of safety. Among these exceptions are:

- Purchases or discounts of commercial paper secured by existing values, which may occur without restriction to the extent of 25% of SCB.

- Certain loans on the security of readily marketable products or livestock where the loan does not exceed 80% of the market value of the collateral.
- Obligations of and obligations guaranteed or secured by the United States, the State of Georgia, and other designated public agencies, and obligations secured by the lending bank's own deposit obligations.

In figuring whether loans made directly or indirectly to any one natural person, partnership or corporation exceed any of these restrictions, all loans made to firms and partnerships of which the borrower is a member are *generally* included, as are loans to others on which the borrower is co-maker. In addition, loans or extensions of credit to one borrower will be attributed to another person and each person will be deemed a borrower when the proceeds of the loan or extension of credit are used for the direct benefit of the other person, to the extent of the proceeds so used, or when a common enterprise is deemed to exist between the persons (Rule 80-1-5-.11). The Department may determine that a group of persons or corporations are to be regarded as a common enterprise upon evaluation of the facts and circumstances of particular transactions. In order to demonstrate that the direct benefit and common enterprise provisions have been satisfied, management must maintain adequate financial, operational, cash flow and ownership structure information relative to the borrower to support that the requirements are fully met.

The banking laws have specific requirements regarding loans made on the security of real estate. Each insured bank must adopt and maintain written policies that establish appropriate limits and standards for extensions of credit that are secured by liens or interests in real estate, or that are made for the purpose of financing permanent improvements to the real estate. Such policies should be: (1) consistent with safe and sound banking practices; (2) be appropriate for the size and complexity of the institution; and (3) be reviewed and approved by the Board of Directors annually. Additionally, the lending policies should provide sufficient loan portfolio diversification standards, establish prudent underwriting standards (including loan-to-value limits consistent with supervisory guidelines) that are clear and measurable, establish loan administration procedures for the real estate loan portfolio, and require monitoring to ensure compliance with the real estate lending policies. Management must monitor conditions in the real estate markets in its lending area to ensure that policies continue to be appropriate for the current market conditions. Real estate lending policies should incorporate guidance established in the *Interagency Guidelines for Real Estate Lending Policies* issued by the Federal bank and thrift supervisory agencies.

Management must ensure appropriate repayment plans are established prior to originating the loan. Amortization requires that there will be a reduction of the principal of the debt during the life of the loan sufficient to repay the loan. Such reduction must occur at regular intervals and must amortize the loan over a period not to exceed 40 years. However, exceptions to the 40-year amortization schedule are made in the case of any mortgage contract that might result in negative amortization or extended repayment periods due to fluctuations in interest rates or to graduated payments, provided that the terms of the contract contemplate full amortization of the loan.

## **Diversification in the Lending Portfolio**

While diversification within the lending portfolio is not a statutory or regulatory requirement, it is a matter of safe and prudent banking practice. Maintaining large loan concentrations to individual borrowers, individual industries, or concentrations by loan type can result in elevated risk levels in a bank. Recent experience has reflected that mitigating control features cannot always eliminate the risks presented by large lending concentrations. It is therefore prudent for the Board of Directors to establish written policy limitations for loan concentrations and to require Board action if loans are approved and funded in excess of these policy limitations. The federal banking agencies have established guidelines on concentrations in Acquisition, Development and Construction (ADC) lending and Commercial Real Estate (CRE) lending of 100% and 300% of total equity capital respectively. While these are guidelines and not regulations, banks that materially exceed these limitations may be subject to greater regulatory scrutiny than banks that do not exceed these guidelines and may be expected to maintain higher levels of capital in order to mitigate this heightened risk profile.

## **Dividends and Distributions**

The Code declares that directors who vote for or assent to the declaration of any dividend or other distribution to shareholders not authorized by the Code or contrary to the articles of the bank are jointly and severally liable for the amount of payments in excess of the legal limits. There are a number of circumstances in addition to the item (4) below that would require prior approval before payment or otherwise be prohibited by the Department. Prohibitions would usually be imposed on a new bank or a bank under some type of regulatory enforcement action. The Code imposes the following limitations on dividends in the form of cash or property other than shares in the bank:

1. Dividends may only be declared and paid in cash or property from the bank's retained earnings.
2. Dividends may not be declared or paid at any time the bank does not have the paid-in capital and appropriated retained earnings required by law (Section 7-1-411 of the Official Code of Georgia).
3. Dividends may not be declared if payment thereof would render the bank insolvent or when the declaration or payment thereof would be contrary to any restrictions contained in the bank's articles.
4. Dividends may not be paid without the prior approval of the Department where they exceed limitations specified by Department regulation (Rule 80-1-12-.01).

Stock dividends are subject to limitations 2-4 above and, in addition, must be accompanied by a transfer to capital stock equal to the aggregate par value of the distributed stock. The Department must approve distributions to shareholders upon a reduction of capital stock. The Code explicitly declares that directors who vote for or assent to a distribution to shareholders as a part of the voluntary liquidation of the bank without making provision for payment of all liabilities of the bank are liable for any resulting debts that are not paid.

## **Personal Borrowing and Other Dealings with Bank**

State and Federal banking laws restrict borrowing from the bank by its directors and executive (policy-making) officers and principal shareholders, as they are defined in Regulation O of the Federal Reserve System. All financing for a director, an executive officer or principal shareholder must be approved in advance by a majority of the entire board of directors. A director must abstain from voting on a loan to himself and, ideally, should not be present during the Board discussion. Loans to directors and officers must be made on the terms, including interest rates, repayment requirements, and collateral, as loans to individuals not employed by the bank. Insider loans must not involve more than the normal risk of repayment or present other unfavorable features.

Law and regulation limit the total dollar amount of loans to directors and executive officers, both on an aggregate basis as well as for individual directors and officers. Federal Reserve Regulation O contains limitations on borrowings to insiders including aggregate limitations, prior approval requirements, and limitations regarding extensions of credit through overdrafts. Because requirements differ for directors and executive officers, all directors and executive officers should review Regulation O to make certain that their borrowings are in compliance with the regulation. Essentially, compliance with Regulation O satisfies the requirements of Georgia law and Department regulations with regard to prior approvals of extensions of credit to insiders which must be accorded when aggregate extensions to one person amount to or exceed \$25,000.

The aggregate maximum lending limitations of the Georgia statute may not always be the same as the limitations of Regulation O due to different definitions of "capital " of the bank upon which the limitations are based. The more restrictive requirements will apply when the requirements differ. Regulation O refers to "Tier 1 and Tier 2 Capital" and Georgia law uses the term "Statutory Capital Base (SCB)". Both State and Regulation O limits are generally 15% unsecured and 25% secured of the respective definitions of "capital." Aggregate borrowing limitations in Georgia law for insiders are the same as for any other customer.

Directors, officers and employees of the bank are subject to legal restrictions in their business dealings with the bank and its customers. They are barred from receiving anything of value for procuring or attempting to procure any loan or investment from the bank. They may not directly or indirectly purchase from the bank promissory notes or other evidences of debt issued by the bank for less than their face value. Moreover, directors, officers and employees may not purchase assets from the bank or sell assets to the bank at terms less favorable to the bank than those offered to other persons or corporations. The board of directors, or a board committee authorized to act for it, must approve any purchase or sale outside the ordinary course of business. The Code expressly recognizes the liability of directors who are involved in the waste of the bank's assets or the appropriation of its business opportunities to themselves contrary to responsibilities owing to the bank.

## **Investments**

Generally speaking, the Code prohibits a commercial bank from owning shares of stock issued by other corporations. However, the following investments may be made without limitation: (1) shares of stock of a Federal Reserve Bank, (2) shares of stock of the Federal Home Loan Bank (FHLB) - provided the investment is for the purpose of utilizing the services of the FHLB, and (3) stock or interest in an

entity where the activities of the entity could be legally performed by the bank. The bank's investment may not exceed 10% of SCB where the activities of the entity go beyond those the bank could legally perform.

A bank may hold investment securities in the form of bonds, notes or similar debt instruments to the extent and under such regulations as are promulgated by the Department of Banking and Finance, but securities issued or guaranteed by the United States or which are general obligations of any state are not subject to statutory limitation.

A commercial bank is also limited in regard to real estate holdings, subject to Department approval requirements. A bank may own real estate that it occupies or intends to occupy for the transaction of its business, the business of any subsidiary, or for the recreational use of its employees. A bank may also own real estate that it partly occupies and partly leases, which is acquired for the purpose of providing parking facilities, and which it acquires with others for data processing facilities. A bank may also acquire and hold property to avoid loss on a loan, subject to certain Department approval requirements.

In addition, a bank or trust company may acquire, directly or indirectly, an ownership interest in real estate which is incidental to the financing of the purchase, development, or improvement of such real estate subject to regulations of the Department, provided such ownership interest shall not exceed 25% of the appraised value of the real estate. The book value of the ownership interest must be included in calculating total extensions of credit to one borrower for purposes of legal lending limitations. Divestiture of the ownership interest is required when substantial repayment of the related financing has been made.

## **Audits**

As required by the Code, the bank's board of directors must ensure that a comprehensive audit of the bank is conducted on an annual basis. The audit must be made in accordance with generally accepted auditing standards by independent certified public accountants and a copy of the audit report must be filed with the Department. Banks must also designate an internal auditor with the responsibility for following up on audit and examination exceptions for the board and for implementing the bank's internal audit program. The internal auditor should provide the board with timely progress reports on eliminating exceptions noted in audit reports and on the status of the internal audit program. Audit programs are discussed in more detail below under "Audits and Controls."

## **GENERAL SUPERVISORY DUTIES**

Apart from assuring compliance with express statutory provisions, bank directors have the general duty of supervising the administration of the bank. In the reported cases this duty has particular relevance in regard to care taken to protect the bank from bad loans and defalcation by employees.

As to loans that do not require director approval, the Georgia Court of Appeals has stated:

"It is nevertheless incumbent upon the directors in the exercise of ordinary care and diligence, to retain a general supervision over the acts and doings of such agents and officers in making such loans, and to keep sufficiently informed about them to pass intelligently on the value of such loans and the condition of the bank which they are charged with supervising. Accordingly,

directors are not justified in absolutely relinquishing to any officer or agent unlimited discretion, and thereafter acquiescing blindly in all that they do, but under the general duty devolving upon them to manage the bank's affairs, they must retain and exercise reasonable control and supervision over such officers, amounting to the exercise on their part of ordinary care and diligence.

Thus should it appear that the directors had absolutely surrendered and relinquished their control and supervision . . . in the making of such loans, there would be a failure on their part to perform the functions devolving upon them by law, which would necessarily amount to a lack of ordinary care and diligence on their part as directors."

Likewise, directors must take care to protect the bank from embezzlements. In this connection the directors are charged with the responsibility of approving the form and amount of the surety bond of the bank officers and employees and assuring that an annual audit is conducted.

# A PROGRAM FOR DIRECTORS

## Introduction

Directors derive their authority from the stockholders and should act collectively as a board, although each director must exercise independent judgement in carrying out such authority. A board's effectiveness depends in large part on how well its members work together to identify and address important issues. It is true that most bank directors are principally occupied with their own businesses, and except for those few directors who are also active officers of the bank, directors can spend only limited time at the bank. They cannot be expected to see to details of the bank's operations, but they should have a general knowledge of the bank's activities without hampering the day-to-day management of the bank.

Directors should act collectively to direct and set the bank's policies, and executive management should execute the policies and carry out the details. The most effective tools any directorate can utilize in overseeing bank operations are flexible, up-to-date written policies. Refer to the Department's publication titled "Guidelines for Policy Development" for recommendations concerning the content of various bank policies. This publication is available on the Department's website at: <http://dbf.georgia.gov/>.

## The Individual Director

A number of bank directors, when first elected, may have little technical knowledge of banking and feel dependent on someone who does. This should lessen with experience and through study and attendance at any number of available seminars and training courses. Department personnel may always be consulted if there are questions or concerns. It is incumbent upon the directors to become educated in banking in order to effectively serve. The managing officers of the bank must be supported and supervised by directors who are thoroughly familiar with the bank's affairs and who will take an active part in making policies and decisions. This helps to keep the bank progressive, sound, and profitable.

Generally speaking:

1. Directors should have thorough knowledge of the duties and responsibilities of their office. Directors must take a pro-active approach in learning how to become competent in all areas requisite to effectively serve.
2. Directors should have a genuine interest in their office, attend all meetings regularly, and keep well-informed as to the affairs of their bank at all times.
3. The director should be well known and respected in the community and with an unquestioned reputation for integrity.
4. Directors should give undivided loyalty to their office and not split loyalty with some interest adverse to the bank. In the case of a bank owned by a parent holding company, bank directors must be cognizant that their first responsibility is the sound condition of the bank.
5. Directors should possess the integrity not to use their office for personal benefits through information gained by virtue of their position.

6. Directors should be capable of retaining confidences and refrain from divulging confidential information gained through their position.
7. Directors should be successful business persons in their own right and leaders in the community as demonstrated by affiliation with such community projects as growth, development and civic affairs.
8. The director must be capable of recognizing facts as distinguished from prejudices or personal interest in reaching sound, independent decisions.
9. Directors should not lose sight of their primary responsibility, which is to protect the depositors who have placed their trust in them.

### **Board Committees**

As a practical matter, it is advisable for the directorate to appoint board committees to carry out specific functions. As a minimum in a small bank, there should be a Loan Committee, an Investment Committee, an Asset Liability Management Committee, and an Audit Committee. The number of committees increases with the size of the bank, the diversity of its activities and additional departments or operational units (e.g., a trust department). Any Board Committee must be constituted of at least three outside directors. Active officers who are not directors may serve on the committees and vote with the exception of the Loan Committee. Such officers are allowed to advise the Loan Committee.

The Loan Committee can be given authority to pass upon loans exceeding 15% of SCB of the bank, loans to officers and employees not requiring full board approval, and such other loans of amounts and types as the board sees fit. Approvals and disapprovals should be in writing and a report of the actions taken should be made to the board at each meeting and recorded in the minutes. The Loan Committee or any individual member can take over the making of appraisals of real estate and other property offered as security to loans if the loan is less than the de minimis level established by Federal law. A licensed or certified appraiser must make appraisals on loans greater than the de minimis level. All appraisals, whether made by the Loan Committee, or individual member, or an outside appraiser, should be in writing and placed with other papers pertaining to the loans. Appraisals performed by the Loan Committee or an individual director or officer should be closely reviewed by the full board. Appraisals should be realistic and not tailored to fit the size of the loan under consideration. Needless to say, every loan application should be considered within the restrictions imposed by the banking law as previously outlined and in conformance with the specific requirements of the board's written loan policy.

The Investment Committee should oversee the bank's investment account, approve purchases and sales of securities, and periodically consider whether investment holdings are consistent with the bank's written policies for quality, safety, liquidity, income, secondary reserves, and tax considerations. The relative size and composition of the investment account varies greatly from bank to bank depending on the type of community, deposit structure, availability of good loans, degree of liquidity and turnover in the loan account, and seasonal and other fluctuations in deposits. Other committees are discussed later in this handbook. Both committees discussed on the previous page should keep in mind the statutory restrictions as to types and amounts permitted for the loan and investment accounts as well as the written policies established by the board.

## **Board Functions**

Specific functions of the Board of Directors include, but are not limited to:

1. Formulation and implementation of the bank's strategic plan, including both short-term and long-term goals.
2. Establishing and tracking the bank's budget, considering earnings, expenses, losses to be taken, bonuses, dividends, transfers to surplus, adequacy of loan loss reserves, adequacy of capital funds, and adequacy and suitability of banking quarters.
3. Establishing written policies and standards for loans, investment, asset liability and interest rate risk management, liquidity, and other areas of importance.
4. Appointment of officers designating their duties and fixing salaries, appointing the chairman and secretary of the board, designating the committees of the board, deciding on fees for board attendance and compensation for committee members who devote considerable time to their duties.
5. Setting the amount of bankers blanket bond coverage and periodically considering the adequacy of coverage for fidelity, burglary, robbery, and other risks.
6. Fixing interest rates to be charged on various types of loans and those paid on time and savings deposits.
7. Ensuring that internal routines and controls are in place and that the Board or a Committee thereof is provided with the findings of audit reports (whether internal or external).
8. Considering and taking measures for management succession to assure adequate replacement of officers retiring or leaving the employ of the bank.
9. Considering advisability of setting up pension benefits for retiring officers and employees and contributing to life insurance and health insurance programs.
10. Taking measures to insure good public relations, to consider advertising services, to contribute to civic welfare, financial progress, and community development.

## **Directors' Meetings**

Performance of directors cannot be adequate if they are uninformed or if they tend to be easily intimidated by, or otherwise defer unduly to other directors, the chief stockholders or the managing officers or if there is not an orderly and systematic program adopted for directors' meetings. Under these circumstances, board meetings are apt to take on the character of social gatherings while the executive officer is left free and perhaps encouraged to assume prerogatives of the directors and make all policies and decisions and carry them out. To an extent, this can be avoided if a regular program is followed at all meetings.

The program/agenda should include, but is not limited to:

1. Reading and approving minutes of the preceding meeting;
2. Receiving reports of committees and individual directors;
3. Receiving reports of the bank's condition with analysis and comparison with condition of previous dates;
4. Receiving and/or reviewing reports on criticized loans identified by the bank's internal loan review system, delinquent loans and other loans of which collection is doubtful, large loans, loans to directors and officers, and all loans made since the previous meeting;
5. Reviewing securities transactions in the investment account;
6. Receiving and/or reviewing a report and analysis of bank expenses and income;
7. Considering and taking action on reports of examination and correspondence from regulatory authorities;
8. Analyzing reserve adequacy; and
9. Any other matters of importance, such as those listed under "Board Functions" on previous pages.

## **Board Reports**

The board of directors must have accurate and timely reports to adequately perform their responsibilities. The sections that follow provide a detailed description and discussion of information that is generally found in management reports that can be utilized by directors to carry out their fiduciary responsibilities. Directors should be alert to apparent "red flags" that could signal existing or potential problems that require further investigation.

Due to the increasing complexity of risk exposure in the financial services industry, it is important that directors understand and assess the possible impact of identified or potential risks to the bank. To properly manage risk, directors and management must have the tools to accurately measure and monitor risk. Management must also understand the implications that those risks present and must ensure that appropriate safeguards are in place to minimize any negative impact on the bank's capital and earnings.

To control risk and mitigate its impact on the bank's financial performance, all banks must have risk management systems that identify, measure, control, and monitor risks. Strong risk management systems are particularly important when introducing new products or services or when the bank experiences strong growth. Because market conditions and organizational structures vary, there is no single risk management system that works in all banks. Each institution should tailor its risk program to its needs and circumstances.

The board uses management reports and other information systems to stay informed and assess risk within an institution. Board decisions based upon ineffective, inaccurate, or incomplete reporting may increase risk within the bank. The board must do more than merely accept and review management reports; it must be confident of their accuracy and reliability.

To be effective, directors should ensure that management provides adequate and timely financial data and other information that can answer questions such as:

- Is management meeting established goals and objectives?
- Are the bank's strategic goals and objectives consistent with the directors' tolerance for risk?
- Does the bank have sufficient capital to support its risk profile and business strategies?
- Is the level of earnings consistent or erratic?
- Do earnings result from the implementation of planned bank strategies or from transactions that increase longer-term risk?
- Is the bank being adequately compensated for the risks it is taking in its various product lines and activities?
- Are the reports accurate, or do they reflect an incomplete evaluation of the financial condition of the bank?

To assist the board in assessing risk, the following sections identify various indicators of increasing asset and credit quality, liquidity, and interest rate risk that are generally a part of regular board reports. Other reports and performance measures outlined are useful to directors in assessing the bank's current condition.

### **Financial Performance**

Reports of financial performance can help directors assess the bank's condition, determine whether the level of risk taken by the bank conforms to the board's policies, and identify potential areas of concern. To use financial information effectively, directors should look at the trend and level of individual measures and the interrelationships among capital, asset quality, earnings, liquidity, sensitivity to market risk, and balance sheet growth. Financial reports should focus on comparative financial statements and key financial performance ratios.

Comparative financial statements generally include:

1. Balance sheets for the month and year-to-date with comparison of balances at the same dates the previous year and with projections, if appropriate; and,
2. Income statements for the month and year-to-date with comparison to budget projections and to the previous years performance.

In reviewing these items, directors should identify any item that has changed significantly or that varies significantly from the budget and should ask management to explain significant deviations. Generally, a deviation of 10 percent or more should be explained.

Directors should review management reports that contain key financial performance ratios and trends on a regular basis in order to effectively monitor risk and financial performance. Many performance ratios referred to in this booklet can be found in the quarterly Uniform Bank Performance Report (UBPR), while others will be computed from internal bank records. The UBPR, which is computer generated from

bank Call Report data, contains both historical and peer group information. A bank's peer group includes banks of similar size, type, and location. The board should realize, however, that peer group averages are not necessarily a benchmark, but merely an analytical tool. There are no model ratios or numbers that guarantee success. The UBPR can help directors evaluate a bank's current condition, trends in financial performance, and comparisons with its peer group. Directors should determine the reason for significant variances in the bank's performance when compared to the peer group.

## **Capital**

Capital protects banks and their customers and shareholders against loss resulting from the assumption of risk; accordingly, the adequacy of capital is very closely related to the bank's risk profile. Overall capital adequacy of a bank is measured both quantitatively and qualitatively. The quantitative analysis focuses on risk-based and leverage ratios. The qualitative assessment considers the quality and level of earnings, the quality of assets, the bank's business strategy, the effectiveness of risk management, and management's overall ability to identify, measure, monitor, and control risk.

Although banks must maintain minimum capital ratios established in risk-based capital guidelines, most banks are expected to maintain a capital ratio higher than those minimums. This determination of capital adequacy may change over time based on the risk inherent in the bank's business profile, dividend expectations of the bank's shareholders, economic variables that affect the bank's market or customer base, and other factors.

The following ratios can help directors evaluate the bank's capital adequacy and monitor compliance with regulatory minimum requirements:

- **Tier 1 capital/adjusted average assets:** The amount of capital supporting the bank's assets. Tier 1 capital includes the most stable components of capital. This ratio is commonly referred to as the leverage ratio.
- **Tier 1 capital/risk-weighted assets (Tier 1 risk-based ratio) and total capital/risk-weighted assets (total risk-based ratio):** The amount of capital in relation to the amount of credit risk associated with assets, including off-balance sheet assets.
- **Equity growth rate versus asset growth rate:** Measures the extent to which capital growth keeps pace with asset growth.
- **Cash dividends/net income:** The percentage of net income paid out to shareholders in dividends.

All insured depository institutions are subject to certain statutory capital guidelines. Reference should be made to the Department's publication titled "Statement of Policies" for a more detailed discussion of capital adequacy requirements for banks. This publication is available on the Department's website at: <http://dbf.georgia.gov/>.

### **Potential Red Flags:**

- Ratios below "adequately capitalized."

- Declining capital levels or ratios.
- Capital growth rate is less than total asset growth rate.
- Dividend payout ratio is significantly higher than peer ratios.
- Ratios significantly different from peer ratios.

### **Earnings, Expenses, and Dividends**

To be sound, a bank must be profitable in its operations. Directors should be concerned with a reasonable return to shareholders and this involves consideration of operating income, expenses, net income, and their interrelation. Aside from interest income, there are other important sources of income that are often overlooked.

Official statistics show that banks collect a substantial portion of operating revenue from deposit account service charges. Service charge arrangements should be reviewed periodically to ascertain that expenses are covered and changes are competitive. A reasonable system of service charges/fees should be imposed against overdrawn accounts with the aim that they either be put on a profitable basis or be closed. The bank should pay particular attention to those customers who continuously attempt to draw against uncollected funds deposited on out-of-town banks. If this occurs and the bank allows withdrawal, the bank is actually advancing money to the depositor though no overdraft is shown on the bank's books. There is always the danger that these out-of-town checks may be returned unpaid, leaving the bank with the liability. In some instances, this liability has been so significant that the bank has been declared insolvent and closed.

Other opportunities for legitimate income or absorbed costs are in the fields of collection, fees, payroll services, and safe deposit box rentals. There are, no doubt, others to be found by investigation. Proper board supervision calls for careful scrutiny of all expenses. Expenses can be reviewed in four major categories.

The largest expense item is interest expense. The deregulation of interest on deposits has allowed banks to more effectively compete for funds but, on the other hand, it forces banks to price more effectively to control cost of funds. The opportunities for profitable employment of these funds and competitive pricing should always be considered in the bank's goals for better earnings.

Overhead expenses represent the costs of opening for business each day. The largest item of overhead expense is salaries and employee benefits. Salaries should be competitive in order to attract and hold good people. Another important overhead expense is occupancy, use and maintenance of banking quarters and equipment. Banking quarters can be adequate, suitable, and dignified without being lavish and handicapping earnings due to excessive amounts of nonearning asset investment. Fixed asset expansion must take future growth and income potential into consideration. Fixed asset costs are limited by statute, but costs may be exceeded with the prior approval of the Commissioner. Where such approvals are given, they are conditioned on agreement for annual special transfers to surplus and tax-allowable cost recovery rates until book values are within the statutory limit. Banks contemplating new quarters in the foreseeable future would do well to set aside a fund from earnings with the view to its use in absorbing land and building costs and reducing the carrying values.

Other expenses included in overhead that deserve scrutiny by directors are: data processing expenses, office supplies, stationery, advertising, insurance, legal fees, dues, and donations. Excessive expense

charges for attendance at conventions, entertainment, and the like should also be scrutinized.

The third major expense category is provision for loan loss expense, which represents the cost of credit quality risk. Directors should make sure that the current operating provision accrued for loan loss expense is appropriate for the newly recognized credit quality risks in the loan portfolio. Loan losses represent a current expense of doing business.

Income taxes are, of course, an important expense category though they can vary greatly from bank to bank. Tax planning should be an integral part of each bank's accounting system. State, county, and municipal investment securities can be used to minimize taxes if the bank is in the position to utilize this tax reducing benefit without compromising overall after-tax investment portfolio yield.

Banks with limited capital funds, considering the volume of business, will do well to limit or omit cash dividends until additional earnings correct the situation. Those experiencing growth and having growth prospects should do the same. This might be objectionable to some stockholders, but the advantages of accumulating surplus to be used for future stock dividends should be explained to the individual stockholder. Stock dividends are exempt from federal income taxes while cash dividends are not. The alternative may be that stockholders will face capitalization of the bank in the future after having paid income taxes on the cash dividends during the intervening period.

As a final thought, pertaining both to the bank's income tax liabilities and to the payment of dividends, all items on the bank's books that can be considered worthless or doubtful of collection must be charged off before the close of each tax year and before declaration of dividends. This is particularly important for directors whose names appear on the bank's published statements certifying all assets to be stated at reasonably sound values.

The boards' review of earnings focuses on the quantity, trend, and quality of earnings. When a bank's quantity or quality of earnings diminishes, the cause is usually either excessive or inadequately managed credit risk or high levels of market risk. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may also be adversely impacted by uncontrolled or unplanned operating expenses, improperly executed or poorly planned business strategies, and poorly managed or uncontrolled exposure to other risks.

The level and trend of the following ratios, compared with the bank's previous performance and the current performance of peer banks, are important in evaluating earnings:

- **Net income/average assets:** How efficiently the bank's assets generate earnings. This ratio, commonly referred to as *return on average assets* (ROAA), is a primary indicator of profitability.
- **Net income/average total equity:** The rate of return on the shareholders' investment. This ratio is commonly referred to as *return on equity* (ROE).
- **Net interest income/average earning assets:** The difference between interest and interest paid compared with average earning assets. This ratio is commonly referred to as the *net interest margin* (NIM), which has historically been most banks' largest source of earnings.

- **Noninterest income/average assets:** The bank's reliance on income derived from bank services and sources other than interest-bearing assets.
- **Overhead (noninterest) expense/average assets:** Efficiency of the bank's operations.
- **Provision expense/average assets:** The relative cost of increasing the ALLL. Loan losses erode capital and reduce earnings.

Potential Red Flags:

- Significant variances from budgeted amounts on income and expense items and balance sheet accounts.
- Significant variances in the ROAA, ROE, or NIM from prior periods and as compared to peer group.
- Significant increases or decreases in noninterest income.
- Significantly higher or lower average personnel expenses than peer banks.

**Growth**

Directors should also evaluate the effect of growth on the bank's asset quality, earnings, capital, liquidity, and exposure to risk. Rapid growth may harm the bank as the bank may assume more risk than expected. Managing additional risk or a new risk profile can be costly and strain resources. Management should ensure that personnel handling new lines of business have the appropriate level of expertise to perform their duties. The bank must also have control and information systems that are adequate to handle the bank's increase in size and its greater exposure to risk.

Directors identify growth patterns by comparing historical and budgeted growth rates for assets, capital, loans, volatile liabilities, core deposits, and income and expenses. Comparing the bank's growth rates with those of its peers may also indicate whether the bank is growing inordinately.

Potential Red Flags:

- Growth that is not accompanied by an increasing level and sophistication in risk management controls.
- Introduction of new products or activities with little or no expertise or inadequate risk management controls.
- Growth that is not consistent with the bank's budget or strategic plan.
- Declining capital levels or ratios.
- Growth that is significantly greater than that of peer banks, even if projected in the bank's budget or strategic plan.

**Loan Portfolio Management and Loan Policies**

The board should oversee the management of the loan portfolio to control risks and maintain profitable lending operations. While lending traditionally has been at the core of a bank's activities,

providing the greatest single source of earnings and accounting for the largest volume of assets, it also has posed the greatest single risk to the bank's safety and soundness.

In order for loan policies to be effective, they should be set with the goal of having every loan payout within a timeframe that is mutually understood and agreed upon between the borrower and the lender - taking into consideration the purpose of the loan, how the proceeds are to be used, the source of repayment of the loan and whether the project is practical, sensible, and represents good judgment. With every approved loan application, these considerations should be evaluated and documented. Refer to the Department's "Guidelines for Policy Development" for recommendations concerning the content of the bank's lending policies.

Assuming that the appropriate credit analysis has been made, there still is the matter of supervising the loan's performance pursuant to the established agreements. Loans that are well made can deteriorate and become problems if frequently renewed without further analysis of the debtor's current financial position.

Banks considering new types of lending on a considerable scale should look into proper methods and standards of setting up and administering such programs. Take, for example, automobile floor plan loans. Without any particular plan, without standards, and without trained personnel and systems of records and supervision, banks have entered into loans with bad results and particularly so in those banks which floor planned for dealers without prearranged curtailment programs.

Credit files should be maintained on borrowers, particularly in connection with sizeable, unsecured loans. Current financial statements should be on hand and analyzed before loans are approved. In the case of business concerns, operating statements should be available and be kept up to date. Judgement on a loan application can be no better than the information on hand. General knowledge of borrowers can be faulty and misleading and is no substitute for a detailed statement of their assets and liabilities.

While conservative loan policies are to be adopted and carried out, this does not mean that reasonable risks should not be taken. Lending operations involve risks that are necessary in properly serving the community. There have been cases where refusal to meet local credit needs have resulted in successful moves to organize new banks in competition.

The Allowance for Loan and Lease Losses account (ALLL) is management's estimate of the potential loan losses in the loan portfolio. The board should review the adequacy of the loan loss reserve prior to each quarter end and make appropriate provisions to the reserve to properly reflect the risk in the loan portfolio prior to filing quarter end financial statements. The results of the review should be recorded in the minutes of the board meeting at which the review was undertaken.

To effectively manage the loan portfolio, directors need to understand and control the bank's credit risk profile. The directors should understand the portfolio's industry and geographic concentrations, average risk ratings, and other lending characteristics. They should also ensure that the bank has appropriate staffing and expertise for all of its lending activities and that management is capable of effectively managing the risks being assumed.

Directors identify adverse trends in the loan portfolio and judge the adequacy of the ALLL by reviewing the loan reports. The board, or a loan committee of directors, also receives various other loan-

related reports to ensure that management is operating within written policy guidelines.

### **Loan Quality**

Normally, the most readily available information for directors concerning loan quality comes from management's internal risk rating reports, reports on past due and nonaccrual loans, and policy exception reports.

Reviewing these reports can help directors identify negative trends early. Directors should review the following management reports:

- **Risk rating reports:** Summarizes the total dollar amount of loans in each risk rating category, often by division or product. This report is especially useful to monitor deterioration in the loan portfolio. In addition to the problem loan categories, the banks may develop multiple pass (non-problem) rating grades so negative trends in overall loan quality can be identified quickly.
- **Problem loan reports:** Identifies problem or watch list credits and usually quantifies the bank's potential loss on each significant problem credit. Directors should be able to determine what steps management is taking to strengthen identified problem or watch list credits.
- **Past-due and nonaccrual reports:** Identifies seriously delinquent borrowers and usually shows the percent of loans past due by loan category (i.e., commercial, installment, and real estate).
- **Renegotiated and restructured loan reports:** Identifies loans whose original terms or structure have been modified. High levels of renegotiated or restructured loans could signal an attempt to mask the true number and amount of past-due loans.
- **OREO reports:** Details efforts to dispose of each piece of other real estate owned and usually indicates the latest date the properties were appraised.
- **Exception reports:** Lists exceptions to loan policies, procedures, and underwriting standards. Directors should require that management explain these exceptions and determine if procedures or policy changes are needed.

### **Allowance For Loan and Lease Losses**

The allowance for loan and lease losses is a valuation reserve charged against the bank's operating income. Directors should ensure that the estimates are reasonable and sufficient to cover potential loan and lease losses.

The board should review the following information to determine the adequacy of the ALLL:

1. Management's quarterly evaluation of the adequacy of the ALLL, prepared as of Call Report dates.
2. Any independent analysis of the ALLL (e.g., external loan review).

3. Management's problem loan list.
4. Charge-off and recovery experience.

#### Potential Red Flags:

- Loans remaining on the problem loan list for extended periods of time without improvement.
- Delinquent internal loan reviews or late identification of problem loans.
- Excessive out-of-territory lending.
- Loans to borrowers who appear on the overdraft or uncollected funds reports.
- Nonperforming or problem loans as a percentage of total loans increasing at a greater rate than the ALLL.
- Large concentrations of credit to individuals or industries with or without prior board approval.
- Large or increasing volume of loans granted or renewed with policy exceptions.
- Large or increasing volume of credit/collateral exceptions.
- Extremely rapid growth in total loan volume or particular types of lending.
- Loan officer compensation that is tied to growth or volume targets.
- Significantly high or rapidly increasing yield on the loan portfolio.
- Growth in the ALLL that is significantly less than the percentage growth in total loans over a given period.
- Significant shifts in the bank's risk rating profile or increase in the number or dollar amount of problem or watch loans as a percent of loans, in aggregate, or for loan types.

### **Liquidity Policies and Interest Rate Risk Management**

#### **Liquidity**

When evaluating liquidity, directors compare primary and secondary sources of liquidity with funding needs, and they determine whether funds management practices are adequate. Bank management should be able to manage unplanned changes in funding sources, as well as react to changes in market conditions that could hinder the bank's ability to quickly liquidate assets with minimal loss.

The board and senior management are responsible for understanding the nature and level of liquidity risk assumed by the bank and the tools used to manage that risk. The board and senior management should also ensure that the bank's funding strategy and its implementation are consistent with their expressed risk tolerance; including the degree of reputation risk, if any, associated with the various sources of funding utilized by the bank (i.e., is the risk to earnings or capital arising from negative public opinion).

Directors (or Board Committee) should regularly review the following ratios for signs of increasing liquidity risk:

- **Target Liquidity Level or Range:** A certain level of core liquidity, excluding loans and other assets not immediately convertible to cash, should be maintained to meet the immediate needs of the bank. The bank should set its target liquidity level to fit its operating environment and business plan.

- **Net loans/deposits:** Indicates the extent to which a bank's deposit structure funds the loan portfolio. The higher the ratio the more reliance that a bank has on non-deposit sources to fund the loan portfolio.
- **Net non-core funding dependence\*\*:** This ratio indicates the degree of reliance on funds from professional money markets to fund earning assets. Professional markets are generally credit and price sensitive and these funds generally move out of the bank in the event of real or perceived asset quality or other fundamental problems at the bank.
- **Net short-term liabilities/total assets:** The ratio indicates the degree of exposure assumed by funding assets with short-term liabilities. Generally, the higher the number, the more vulnerable the bank is to rollout of funding sources.

The following ratios can also help directors determine the current liquidity position and can be found on the UBPR:

- **Net loans/core deposits:** The percentage of the loan portfolio funded by core deposits.
- **Short-term investments/total assets:** The percentage of bank assets that can be readily converted into cash.
- **Short-term investments/short-term non-core funding:** The percentage of the bank's short-term non-core liabilities that are matched by short-term assets.

The following reports, if appropriate, can assist directors in assessing the bank's liquidity risk:

- **Funds flow analysis:** Reflects trends of balance sheet line items, in dollar terms, which have a significant impact on liquidity. Changes over time can be useful in developing a "source and use analysis" to more clearly show where money is coming into and going out of the bank or banking company.
- **Cash flow or funding gap report:** Shows future time frames when funds may be needed to pay for deposit withdrawals, or other decreases in liabilities, or increases in assets. The funding gap is a shortfall (or excess) of funds that is caused at certain points in time by a funding mismatch.
- **Contingency Funding Plan (CFP):** Forecasts funding needs and funding sources under varying market scenarios.

Potential Red Flags:

- Significant increases in large certificates of deposit, brokered deposits, or deposits with interest rates higher than the market.
- Rapid asset growth funded by wholesale, volatile liabilities, or brokered deposits. This could indicate poor credit underwriting standards.
- Mismatched funding -- funding long-term assets with short-term liabilities or short-term

assets with long-term liabilities.

- Significant increases in borrowings.\*\*
- Significant increases in dependence on funding sources other than core deposits.\*\*
- Declines in levels of core deposits.
- Increases in cost of funds.
- Significant decreases in short-term investments.
- A negative trend or significantly increased risk in any area or product line, particularly a decline in indicators of asset quality, or a decline in earnings performance or projections.
- Eliminated or decreased credit line availability from correspondent banks, causing the bank to make larger purchases in the brokered funds or other potentially volatile markets.

**\*\*NOTE:** In today's rapidly changing and competitive financial services environment, it is increasingly common for banks to utilize non-core funding and borrowings (such as FHLB advances) as part of their funding. The board should make sure the bank's policies and practices provide guidelines for diversifying assets and funding sources and for specifying how much reliance is to be placed on such sources.

### **Sensitivity to Market Risk**

A sound, well-managed bank should have definite policies for interest rate risk management to minimize the effects that volatile interest rates have on bank earnings, capital formation, and liquidity. Refer to the Department's "Guidelines for Policy Development" for recommendations concerning the content of policies pertaining to asset/liability management, interest rate risk, and liquidity.

Interest rate risk management is a planning and control process for matching the mix and maturities of assets and liabilities in ways that maximize net interest margin (net interest income divided by gross average earning assets) on an on-going basis. The board must understand the nature and level of the bank's interest rate risk, determine whether that risk is consistent with the bank's overall strategies, and assess whether the bank's methods of managing interest rate risk are appropriate. The directors establish the bank's tolerance for interest rate risk and monitor the bank's performance and overall interest rate risk profile. The directors also ensure that the level of interest rate risk is maintained at prudent levels and is supported by adequate capital.

The risk measurement system should be able to identify and quantify the major sources of the bank's interest rate exposure. Reports to the board should measure the bank's current interest rate risk position relative to earnings at risk and capital at risk limits. Interest rate risk can be monitored with various modeling methods available in the industry. The complexity and volatility of the interest rates on the bank's assets and liabilities will determine the type of modeling system needed.

The two most common risk measurement systems used to quantify a bank's interest rate risk exposure are gap reports and simulation models. Gap reports calculate the difference between rate-sensitive assets and rate-sensitive liabilities at various intervals or time periods. Gap reports are generally used to evaluate how a bank's net interest income will be affected by a change in interest rates. Simulation models may be used for measuring interest rate risk arising from current and future business scenarios. Earnings simulation models evaluate risk exposure over a period of time, taking into account projected changes in balance sheet structures, pricing, maturity relationships, and assumptions about new business and growth. Reports generally show future balance sheet and income statements under a number of interest rate and business-mix scenarios. Some banks also utilize economic value sensitivity models.

To assess the bank's sensitivity to market risk, directors should determine how changes in interest rates, foreign exchange rates, commodity prices, or the value of equity can reduce the bank's earnings or capital. For many banks, the primary source of market risk is interest rate risk, i.e., the sensitivity to changes in interest rates. In some larger institutions, foreign operations and/or trading activities can be a significant source of market risk.

The following ratios can help directors (or Board Committee) evaluate the bank's sensitivity to changes in interest rates:

- **Long-term assets/total assets:** A higher ratio generally suggests that a bank has a sizeable amount of assets that cannot be repriced for a long period of time. If interest rates rise, such assets generally lose value and depreciate since they will be paying lower yields relative to prevailing market rates.
- **Nonmaturity deposits/long-term assets:** Estimates the degree that nonmaturity-funding sources cover long-term assets on the balance sheet. Banks with high ratios should be less vulnerable to increases in interest rates.
- **Residential real estate mortgages, mortgage-backed securities, and structured notes/total assets:** Indicates the magnitude of short options risk (also called negative convexity) in the balance sheet. With short options positions, the bank has provided their customers the option of either prepaying the asset when rates are low or not pre-paying when rates rise.

Short options increase a bank's interest rate risk by compressing margins in both rising and falling rate environments.

- **Asset depreciation/Tier 1 capital:** Measures the proportion of capital offset by estimated depreciation in the available-for-sale and held-to-maturity investment portfolios, plus an estimate of potential depreciation in the residential loan portfolio.

Potential Red Flags:

- Capital falling below the level established by the board to support interest rate risk.
- Significant changes in net interest income.
- Significant increases or decreases in the percent of long-term assets to total assets.
- Significant decrease in the percent of nonmaturity funding sources to long-term assets.
- High or increasing percent of asset depreciation to Tier 1 capital.
- The inability of management to provide reports that identify and quantify the major sources of the bank's interest rate risk in a timely manner and describe assumptions used to determine interest rate risk.
- Noncompliance with the board's established risk tolerance levels and limits.
- Unauthorized exceptions to interest rate risk policy.
- Changes in the level and trends of aggregate interest rate risk exposure.

## **Investment Policies**

No less than with loans, a bank's investment policy is the responsibility of the board of directors, though authority for specific transactions may be delegated to the Investment Committee and officers in charge of investments. Every bank should have a written investment policy agreed to and approved by the board of directors. Refer to the Department's "Guidelines for Policy Development" for recommendations concerning the content of the bank's investment policies.

The investment account represents what is available for investment after deducting loans and discounts, cash reserves and fixed assets. A portion of the account should be designated as secondary reserves and invested in highly liquid securities that can be quickly turned into cash with minimum risk of market loss. These usually consist of U.S. Treasury obligations maturing in less than a year. The amount of secondary reserves to be carried will vary with deposit structure, the degree of liquidity in the loan account, and seasonal variations.

The remainder of the investment account can be placed in quality securities of longer maturities and higher yields. The maximum maturity is a matter to be determined and set forth in the investment policies of the board and will depend on a number of factors. Such factors, to name a few, include the amount of cash reserves and secondary reserves normally carried, the degree of liquidity in the loan account, deposit structure, and yield requirements for paying interest on time and savings deposits.

As a general rule, investments that cannot be clearly explained to the Board of Directors or for which directors cannot understand the investment strategy, source of investment return, or investment risk, should be avoided. Management of a sizeable investment account, to get the best results, requires skills and knowledge of the money market not ordinarily present in smaller banks. For this reason, it is recommended that the bank have an investment counsel in setting investment policies and also in individual transactions.

## **Investment Reports**

Directors (or Board Committee) may find the following reports helpful in assessing the overall quality, liquidity, and performance of the investment portfolio:

- **Maturity breakdown and average maturity:** Shows each sector of the investment portfolio (Treasuries, municipals, etc.) and the portfolio as a whole.
- **Distribution of credit ratings (by a major rating service) for all municipal and corporate securities:** Shows the percent of the portfolio in each rating category. This report provides useful information on the overall credit quality of the portfolio.
- **Purchases and sales:** Indicates the type of security, its par value, maturity date, rate, yield, cost and sales prices, as well as any profit or loss.
- **Sensitivity analysis of the value of the portfolio in different interest rate environments:** Compares the value in each interest rate scenario with the current portfolio value, illustrating the amount of portfolio risk. This report also provides a means of assuring that management has complied with the board's tolerance for risk.

- **Summary of investments by obligor, industry, related obligor, geographic area, etc.:** Shows concentrations of investments that directors should review.

#### Potential Red Flags:

- Purchase of individual securities that do not meet board guidelines on risk, quality, or quantity.
- Large numbers of below-investment-grade (lower than BBB or Baa) or unrated bonds.
- Significant changes in the type, quality, or maturity distribution of the portfolio.
- Sale of securities previously designated held-to-maturity, or transfer of securities from the held-to-maturity account to the available-for-sale account.
- Securities purchased without pre-purchase analysis.
- High volume of purchases and sales.
- Investment purchases from securities dealers not approved by the board of directors.
- Investment returns that are well above or below the market or peer group average.
- Significant depreciation in the market value of investments.
- Purchase of securities in excess of concentration limits.
- Significant amounts of securities pledged for repurchase agreements or public deposits.

### **Financial Derivatives and Off-Balance-Sheet Activities**

Banks have increased utilization of financial derivatives and off-balance-sheet activities to manage financial risk and increase income. Financial derivatives and off-balance-sheet activities can include financial contracts such as structured debt obligations, swaps, futures, options, caps, floors, credit derivatives, asset securitizations, and loan commitments. Each type of product presents unique risks that must be identified, measured, and monitored.

#### **Financial Derivatives**

Financial derivatives derive their value from the performance of underlying interest rates, foreign exchange rates, equity prices, or commodity prices. Like all financial products, derivatives present risk, and directors should make sure that this risk is managed and that the bank has appropriate expertise to manage all products used.

The following reports, if appropriate, can assist directors in assessing financial derivatives activity:

- **Compliance with policies and risk limits:** Details compliance with all board-approved derivative limits.
- **Current aggregate risk exposure:** Identifies what the counterparty owes the bank today plus an estimate of what the counterparty might owe in the future based upon possible changes in interest rates, commodity prices, or equity prices.
- **Trends in aggregate risk:** Presents the bank's aggregate risk exposure over a period of time. This report may include board-specified limits that will show not only the trend in aggregate risk but also limit usage.

- **Trends in credit exceptions:** Tracks the level of credit exceptions over time. This report assists the board in evaluating the level of compliance with sound underwriting practices and credit administration. During the normal course of business there may be temporary exceptions to board-approved counterparty credit limits. However, an increasing volume of credit exceptions over time may indicate unintended or unwarranted relaxation of bank policies.
- **Concentrations of credit:** Includes internal and external factors. Boards can assess common characteristics among counterparties that may become a source of weakness and pose a risk to earnings and capital.
- **Results of stress testing:** Enhances the bank's risk measurement process by changing market variables to determine which scenarios may pose significant risk to the derivative portfolio. Reports to the board should include the major assumptions used in each scenario. Stress testing is important for both market and credit risk.
- **Summary of current risk management techniques and management practices (annually):** Details the risk measurement techniques and why they are appropriate for the size and complexity of the bank's derivative portfolio.

### **Asset Securitization**

In asset securitization, interests in loans and other receivables are packaged, underwritten, and sold in the form of asset-backed securities. It is essential that the board determine whether the bank has the necessary resources and expertise to effectively engage in this business. Directors should ensure that transactions are supervised and monitored over the duration of the bank's involvement.

The board of directors and bank management should ensure that:

- Independent risk management processes are in place to monitor securitization pool performance on an aggregate and individual transaction level.
- Management uses conservative valuation assumptions and modeling methodologies to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis.
- Audit or internal review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets retained by the institution. The findings of such reviews should be reported directly to the board or an appropriate board committee.
- Management maintains accurate and timely risk-based capital calculations, including recognition and reporting of any recourse obligation resulting from securitization activity.
- Internal limits are in place to govern the maximum amount of retained interests as a percentage of total equity capital.

- The institution has a realistic liquidity plan in place in case of market disruptions.

#### Potential Red Flags:

- Participation in transactions without appropriate knowledge of derivatives or experience in the market.
- Advancing funds to borrowers in financial difficulty, noncompliance with covenants, or other circumstances that make lending to them imprudent.
- Inadequate funding sources for anticipated usage of loan commitments and lines of credit.
- Underestimating the impact of derivative or off-balance-sheet products on the bank's risk-based capital position.
- Substantial exposure to a counterparty whose ongoing ability to meet its obligations is uncertain.
- Accounting errors for certain derivative or off-balance-sheet products.
- High levels of off-balance-sheet activity relative to the bank's size.

### **Insurance and Annuities**

Georgia state-chartered banks are eligible to sell annuities and/or insurance products to the public, provided regulatory and licensing requirements are met. Additionally, banks located anywhere in this state may engage in the underwriting and sale of credit life and credit accident and sickness insurance. All sales of annuities and/or other types of insurance must be made by agents who may either be licensed employees of the bank or insurance agencies under contract with the bank. A bank selling such financial products through licensed employees is considered to be an agency and must be licensed as such. Banks selling annuities and insurance are subject to laws and regulations of the Department of Banking and Finance and the Office of the Commissioner of Insurance.

### **Nondeposit Investment Products**

In addition to annuities, banks are eligible to sell other types of retail nondeposit investment products such as mutual funds, securities, and self-directed Individual Retirement Accounts that invest in securities, etc. A bank may sell such products itself or through arrangements with a third party. Sales must be handled by a properly licensed securities representative, either a bank employee or outside agent. Sales activities for such products should ensure that customers for these products are clearly and fully informed of the nature and risks associated with these products. The customer must know and acknowledge in writing that he or she has been informed that these products are not FDIC insured deposits. Such sales and recommendations must be conducted in an office or a clearly distinct dedicated area separate from deposit taking areas of the bank. Such an office or area must be clearly identified as to its function. No banking transactions may be handled in these spaces. The Department has issued applicable policy statements and the Federal Financial Institutions Examination Council has issued several interagency policy statements pertaining to the requirements that must be met in order to participate in such activities. Banks intending to engage in these activities should consult with their attorney and CPA prior to commencing the proposed activities.

The Department recommends that all commissions and fees resulting from the sale of insurance, annuities and other nondeposit investment products be retained in the income of the bank. This forestalls possible conflicts of interest and charges by minority shareholders that the bank is not being compensated for activities carried on by officers or employees while in the employ of the bank and that corporate opportunity is being expropriated to the detriment of other shareholders. The Internal Revenue Service has on occasion ruled such commissions to be dividends or salary resulting in an additional tax liability for the bank. If the Board of Directors desires that certain individuals should receive additional compensation, then salaries should be adjusted accordingly, but these commissions and fees should be taken into bank earnings.

## **Trust Department**

A soundly managed trust department calls for a high degree of legal and technical competence. The amount of detail work and the costs are such that the department may lose money unless an adequate volume of trust business is available. Some smaller banks feel they are losing deposit business by not being in a position to accept trust accounts and are inclined to undertake to qualify for trust powers. Before applying for trust powers, all aspects of maintaining a trust operation should be thoroughly investigated. One alternative may be to establish an arrangement with a correspondent bank to direct local trust business to the correspondent with your bank acting as intermediary carrying out local contacts and getting the related deposit business associated with the accounts.

## **Personnel**

The directors are responsible to the stockholders, to the depositors, and to the regulatory authorities to see that the bank is operated with prudence, diligence, care, and a reasonable degree of ability. The directors elect the president and other officers, but ordinarily delegate authority to the officers to select the other personnel. The latter, however, are also employees of the board and accountable to it. The directors should, therefore, take an interest in the bank's personnel.

In numerous embezzlement cases, it developed that the embezzler had been living beyond their means, had been gambling, had been speculating, had excessive business activities outside the bank or had been leading an immoral lifestyle. All of these created personal financial problems and, in some cases, brought on blackmail. In small communities where many of these cases arose, it should have been simple and easy for the directors to know that all was not well with the individual and to take steps to develop the full facts. In larger banks, the personnel officer can take steps to keep well enough posted on the personal life and habits of employees to know of any serious financial and other problems.

The directors should see to it that the bank pays salaries that compare favorably with those elsewhere in the area for similar kinds of work. The best people available should be employed and promotions should be on the basis of performance rather than family relationships.

There should be a set policy for annual vacations for personnel. Banking authorities recommend that each officer and employee be continuously absent from the bank's premises for a minimum period of two consecutive weeks each year. Aside from the well being of the individual, this is also an important item in safeguarding against manipulation of customers' accounts or other bank records. However, such safeguards fail if an employee's work remains for their return. In smaller banks, the limited number of

employees may preclude two-week absences. In such cases, there should at least be a program of surprise rotation of duties and other compensating control measures in order to mitigate the risk of insider fraud and abuse.

To promote incentive, well being, good morale, and the feeling of security, banks now offer a variety of fringe benefits to officers and employees. These are mainly retirement plans, medical and hospitalization programs, and life insurance. These can be provided outright by the bank or a share of the cost can be contributed. Health and life insurance can be set up on a group basis with cheaper rates than to an individual. As to retirement or pension plans, these can be set up on a collective basis. A bank with a small or medium number of employees might consider using the services of the trust department of its correspondent bank in devising the plan and operating it.

Along with the other benefits of the establishment of a retirement plan, the plan generally includes the establishment of a normal retirement age for officers and employees. This has been a difficult and delicate matter in many banks with the result that some banks have continued under management that has passed the age of effectiveness.

While on the subject of retirement, directors should retire gracefully from active participation (in accordance with the established board policy) and make way for selection of active and vigorous successors. It is acceptable for retired members to continue their association by being designated "honorary director" or "advisory director," attending such board meetings as they wish, but having no vote and no legal liability.

Banks can greatly benefit by providing officers and employees the advantage of continuing education in bank related areas. The American Institute of Banking (AIB) has chapters set up in several Georgia cities where classroom based courses are offered. The AIB courses offered in Georgia, as well as additional education opportunities, are made available by AIB through correspondence from New York. These courses are specialized by subject and cover the entire field of banking. The Graduate School of Banking provides graduate study at various locations around the country.

The bankers associations in Georgia, the Georgia Bankers Association (GBA) and the Community Bankers Association (CBA) also offer frequent schools and seminars on current developments in the banking industry. These schools and seminars offer special opportunities to Georgia bank personnel, which strengthens the banking community in Georgia. CBA and GBA also offer schools and seminars for bank directors.

In addition to in-house personnel, each bank should have a regularly retained legal counsel and accountant. The legal and tax environment in which banks operate is quite involved, and bank management should have an established dialogue with professionals in these fields to assure that they maintain full awareness of new laws and regulations and the potential impact on the bank's operations. Banks are also becoming increasingly vulnerable to consumer legal action and should have legal counsel readily available to protect the rights of the bank as an institution as well as the rights of the directors as they administer the affairs of the bank.

## **Audits and Internal Controls**

### **Audits**

Although official governmental examinations include some elements of audit and verification, they are not audits of the bank's operations. Their purpose is rather to determine whether the bank's assets are adequate to cover all liabilities and that all laws applicable to the bank and its operations are being observed. Bank directors cannot meet their duties and responsibilities in the field of audits and controls by reliance on governmental examinations. Nor can they rely on fidelity bond coverage to guard the bank against any losses that result from lax audit procedures. Many boards of directors do not include anyone sufficiently competent to perform an audit. In larger banks, it is not practical for directors to perform audits considering the time involved, though directors with accounting experience can well represent the board on an Audit Committee to oversee audit functions. Refer to the Department's "Guidelines for Policy Development" for recommendations concerning the content of policies pertaining to audit policies.

Because it is generally impractical or inefficient for the directors to conduct audits, the Code has placed the responsibility on directors to have independent certified public accountants audit the books and affairs of the bank or trust company on an annual basis. An audit of a bank holding company performed in accordance with Section 7-1-487 of the Code may be made in lieu of individual audits of subsidiaries of the bank holding company. The accountants making the report should sign the annual audit report, and a signed copy of the report should be submitted to the board for approval or rejection. The bank should maintain the original audit report in its files and should submit a copy of the audit report to the Department in accordance with Department regulations.

In addition to compliance with this requirement for external auditing, a primary responsibility of the bank's directors is to adopt a sound internal audit program. They cannot delegate this duty. They can appoint an auditor, audit control officer, or firm of independent accountants to carry out the technical details of such a program, but the ultimate accountability for the degree of effectiveness with which the program functions is their responsibility. It is clear that neither supervisory examinations nor insurance or a combination thereof, can properly take the place of an audit program.

The primary objective in any bank audit program is to discourage fraud, not necessarily to discover its existence. Fraud detection, while a worthy objective, should be regarded as a secondary aim. The internal controls must be sufficiently strong to overbalance fraudulent tendencies of the few who would otherwise succumb to temptation. A program of safeguards must be implemented to meet this primary objective. Regardless of the method followed in the development of the audit program, there will be incidental costs that must be absorbed. While the control of operating costs is extremely important, the bank that questions the adoption of an audit program solely on the basis of its costs does itself a serious injustice. It is somewhat incongruous that banks spend considerable sums for banking house and vault facilities that provide physical protection from external sources and at the same time fail to provide themselves with internal security. An audit program is not something to be afforded; it is an integral part of bank operations.

In order to obtain the maximum protection economically feasible, it is necessary that all concerned be continually aware of the fundamental principles with respect to sound internal checks and control, internal auditing, and external auditing. As a point of reference these principles are set forth along with comments with respect to the regular conduct of internal audit and external audit functions.

## **Internal Auditing**

The function of Internal Auditing is: (1) to determine by continuous review of the system of operating procedures and accounting methods that the internal checks and controls provide adequate safeguards and maximum operating efficiency; and, (2) to determine by sufficient test-checking of a selective nature whether the established operating procedures, policies, and accounting methods are being properly performed. The internal auditor is not, and should not be, responsible for the correctness of each individual transaction. Since it is obviously uneconomical to audit each and every transaction, a reasonable degree of exposure must be recognized. A sound internal auditing program includes periodic surprise audits of all departments and accounts at reasonably frequent, but irregular, intervals. The determination of a degree of testing in each case requires careful thought, as the extent of the test will vary as conditions change. The test made should comprise a representative sampling of the bank's records and transactions and the extent should be sufficient to indicate their overall condition.

The position of internal auditor is required to be filled by the Board of Directors of any state-chartered bank in Georgia, regardless of the fact that the bank relies on an external audit. The internal auditor, who may be a bank employee, an outside consultant, or a CPA firm, should be directly responsible to the Audit Committee of the Board of Directors or the Board of Directors and the President. The internal auditor should be completely independent of all other officials so as to be able to perform the audit functions effectively without being subject to undue pressures. This individual should make certain that bank management properly acts upon audit and examination exceptions and recommendations.

Audit reports should be regularly submitted to the Board of Directors or Audit Committee. It is also advisable for the auditors to appear personally before the directors and/or the Committee to report their activities and findings. Such reports must be properly supported by documentation to enable supervisory examiners and independent auditors to evaluate the effectiveness of the internal audit program.

## **External Auditing**

Each bank must be audited annually by independent certified public accountants that perform the audit in accordance with Generally Accepted Auditing Standards. The primary objective of such an audit of bank financial statements by an independent certified public accountant is the expression of an opinion on the fairness with which those statements present the financial position of the bank and the results of its operations. To accomplish this objective, the independent accountant reviews and test checks the internal audit and the internal control efforts of the bank and adjusts the scope of work accordingly in order to perform only sufficient audit work and to express an opinion on the financial statements. It follows that a sound system of internal control and internal audit program can decrease materially the nature and extent of auditing procedures required by an independent public accountant to express an opinion on the financial statements of a bank. Thus, the work of the independent public accountant gives bank management and the board of directors of the bank an objective professional appraisal of the effectiveness of the internal audit and internal control program of the bank, with constructive recommendations for improvement, and provides an independent opinion of the financial statements of the bank.

## **Internal Routine and Control**

A sound system of internal routine and control is the bank's primary protection against irregularities. Internal control can be described as a plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

A system of control generally involves two types of controls - Accounting Controls and Administrative Controls.

- Accounting Controls comprise the plan of organization and all methods and procedures that are concerned mainly with and relate to (1) safeguarding its assets and (2) the reliability of the financial records.
- Administrative Controls comprise the plan of organization and all methods and procedures that are concerned with (1) operational efficiency and (2) adherence to managerial policies. They usually relate only indirectly to financial records.

A sound system of internal routine and controls should include: (1) a system or plan that provides for appropriate segregation of functional responsibilities; (2) an adequate system of authorization and record procedures that provides reasonable accounting control over assets, liabilities, revenues, and expenses; (3) sound practices to be followed in performance of duties and functions of each of the bank's departments or business units; and, (4) a degree of quality of personnel commensurate with job responsibilities.

The operating procedures and accounting methods adopted by the bank should contain a system of automatic internal checks and controls to serve as the primary safeguard against possible irregularities. The responsibility for the proper functioning of the methods and procedures adopted in order to insure that the internal checks and controls are maintained effectively should rest directly with operating management.

### **Potential Audits and Internal Control Red Flags:**

- Any indications that management is trying to control or inhibit communications from internal audit staff to the board of directors.
- A qualified, adverse, or disclaimer opinion from an external auditor.
- Unreconciled differences between trial balances, subsidiary ledgers, and the general ledger.
- Significant internal control or other deficiencies noted in audit reports that have not been corrected.
- Audit reports that do not address identified internal control weaknesses.
- An external auditor or audit firm that has a financial interest in the bank, loan from the bank, or other conflict of interest.
- The inability of management to provide timely and accurate financial, operational, and regulatory reports.
- Internal audit staff reporting to other than the board of directors or its audit committee.
- A significant decrease in the audit budget.
- A reduction or increased turnover in internal audit staff.
- Unexplained or unexpected changes in external auditor or significant changes in the audit

program.

- Employees in key or influential positions who were not on vacation or otherwise absent for two consecutive weeks during the year.
- Internal or external auditors relying heavily on the other's conclusions.

## **Management Information Systems (MIS)**

The sophistication and reliability of the bank's information systems often has a significant correlation to business decisions made by bank management. For example, many banks must either forgo offering certain new products or go to the expense of upgrading their information systems. One of MIS's most important functions is to help management assess the bank's risk. Management decisions based on ineffective, inaccurate, or incomplete MIS may increase risk in all areas.

Because technological advancements are increasingly changing the character of day-to-day banking activities, directors should learn as much as possible about their bank's information systems and be involved in any significant proposals for changes to those systems.

Not all of a bank's transactions are processed inside the bank. If vendors play important roles in the bank's information systems, the board must ensure that the vendor's services and reports meet the same standards as those generated within the bank.

To assess a bank's information systems, the board considers whether the MIS process provides the information necessary to manage the organization effectively. A reliable MIS ensures that the bank maintains basic control over financial record keeping.

The MIS should also support the institution's longer-term strategic goals and objectives. The following MIS characteristics ensure prompt and well-informed decision making:

- **Accuracy** - A reliable system of automated and manual internal controls must exist for all information system processing activities. Information should receive appropriate editing, balancing, and internal control checks.
- **Consistency** - Consistency in how data is collected and reported is extremely important. Differences in these activities can distort trend analysis and information reported to the board.
- **Completeness** - Decision-makers require complete information in a summarized form. Reports should be designed to eliminate clutter and voluminous detail to avoid information overload.
- **Timeliness** - The systems should be able to expedite the reporting of information. The systems should be able to promptly collect and edit data, summarize results, and correct errors.
- **Relevance** - MIS information should be relevant to the management needs and the operational needs of the bank.

### Potential Red Flags:

- MIS reports that are untimely, incomplete, or inaccurate.
- Inconsistency of information contained within MIS reports.
- MIS reports that lack relevance or are too detailed for use as an effective decision-making tool.
- Management is unable to provide a basic diagram of the system architecture or a comprehensive list of service providers.
- A lack of system audits or unresolved audit deficiencies.

### **Blanket Bond Coverage**

Protection against dishonest acts of officers and employees is afforded by coverage in a standard form of Bankers Blanket Bond which also insures against loss from burglary, robbery, theft, forgery, and certain other risks common to financial institutions. Fixing the amount of coverage is the responsibility of the board. The amount of the blanket bond coverage should be based on risks evident from external hazards and, if no Excess Employee Dishonesty Blanket Bond Coverage is desired, potential losses from employee dishonesty. External hazard risk can be estimated from average amounts of exposure, but there are no ready measures or variables to estimate potential losses from employee dishonesty.

Many years ago, following a number of embezzlements of bank-breaking size, there evolved the Excess Bank Employee Dishonesty Blanket Bond (commonly termed "umbrella coverage"). This is excess coverage available if the bank has the minimum recommended or larger basic coverage as discussed above. With this bond, a bank can acquire, at a moderate cost, \$1,000,000 dishonesty coverage over and above the basic coverage.

No directors anticipate dishonesty shortages of that range in their bank. At the same time, they do occur and, as often as not, they occur in banks where the system of internal routine and control is inadequate, thus allowing one person to exercise single control of transactions from origination of an entry to final posting, thereby providing greater ease of concealment.

The standard form of bankers blanket bonds all include one provision that should not be forgotten. It is to the effect that the bond becomes canceled as to any employee "as soon as the Insured shall learn of any dishonest act on the part of such employee". Some years ago, the directors of a small bank in Georgia learned that the Assistant Cashier had converted several hundred dollars of the bank's funds to her personal use. She replaced the funds by borrowing from relatives, was permitted to remain in her position, and no information of the matter was given to anyone outside the bank. Several years later, the Assistant Cashier was detected short in a heavy amount. Claim was made against the surety company and, in its investigation of the shortage; the company learned of the previous shortage and denied liability for the large one. Thereupon, the Commissioner called on the directors to make good the amount and they did so recognizing their responsibility for the loss. Had they not done so, it would have been necessary to obtain new capital funds from the stockholders or place the bank in liquidation.

In any case of misappropriation, however small, the offending employee must be relieved and the bonding company notified, whether claim for loss is made or not. A committee of the Board or an independent third party should review Bond coverage at least every three years to determine that coverage is adequate and protects the bank and its officers and directors.

## **Overall Assessment of the Bank's Condition**

The board of directors reviews the report of examination to obtain the Department's (or federal regulatory agency's) assessment of the bank. The report of examination addresses the bank's safety and soundness, the quantity of risk, the quality of risk management, and the level of supervisory concern. Directors should pay particular attention to weaknesses and adverse trends identified during an examination and to the actions management plans to take or has already taken to address those weaknesses. These topics are generally addressed in the "Matters Requiring Attention" and "Overall Conclusions" sections of the report of examination.

## **CAMELS**

The Department as well as other state and federal banking regulatory agencies use the Uniform Financial Institutions Rating System (UFIRS) to assign composite and component ratings to an institution. This system is a general framework for uniformly evaluating the safety and soundness of banks. A bank's CAMELS composite rating integrates ratings in six component areas: the adequacy of capital (C), the quality of assets (A), the capability of management (M), the quality and level of earnings (E), the adequacy of liquidity (L), and the sensitivity to market risk (S).

Composite and component ratings range from 1 to 5. A composite or component rating of 1 is the highest and best rating, indicating the strongest performance and the best risk management practices relative to the institution's size, complexity, and risk profile. A bank rated 1 poses the least supervisory concern. A 5 rating is the lowest and worst rating, indicating the most critically deficient level of performance and inadequate risk management practices relative to the institution's size, complexity, and risk profile. A bank rated 5 poses the greatest supervisory concern.

## **Problem Banks And Bank Failure**

While poor economic conditions make it more difficult for a bank to sustain profitability, the policies and procedures adopted by the board of directors have a greater influence on whether a bank will succeed or fail. Improperly functioning boards of directors and management have generally been the primary internal cause of problem and failed banks. The quality of a bank's board and management depends on the experience, capability, judgment, and integrity of its directors and senior officers. Common oversight or management deficiencies identified in failed banks are listed as follows:

1. 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.
  - Failure to promptly recognize and correct problem areas identified by examiners or auditors.
  - Decisions made by one dominant individual.
  - Poor judgment in the decision-making process.

2. Negative influence from insiders.
  - Lack of policies or inadequate audits, controls, and systems.
  - Insiders of poor integrity.
  - Self-dealing and fraud.
  
3. 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.
  
4. Other.
  - Excessive credit exceptions.
  - Overlending and/or out-of-territory lending.
  - Collateral-based lending and insufficient cash-flow analysis.
  - Unwarranted concentrations of credit.

## **OTHER MATTERS**

Directors should remain cognizant of the most recent edition of the Department's "Statement of Policies" publication. This publication covers expansion through branching, expansion or extension of existing facilities, conversions, mergers, and domestic operating subsidiaries. The publication also covers fiduciary powers, title changes, location changes, changes in capital structure, change in control, and capital adequacy. Bank holding company formations and acquisitions are also covered. The Department, and in most cases, the appropriate federal regulatory authority, must be contacted before the bank may proceed with any of the above actions. The Department also has a written Applications Manual that provides information on all applications, notifications, and registrations. The Statement of Policies and Applications Manual are available on the Department's website at the following address: <http://dbf.georgia.gov/>.

## **CONCLUSION**

Service as a bank director can be a rewarding experience and a compliment to the primary business or professional pursuits of the individual; but, while it is an honor to be selected to serve as a director, the position carries significant responsibility and the potential for personal liability. A prudent director acting in good faith and in keeping with the sound principles of bank management as outlined herein need not fear the responsibility or liability. The Department of Banking and Finance, the Commissioner, the Deputy Commissioners, the District Directors, the Supervisory Managers, and the examiners who examine your bank remain ready to discuss the duties and responsibilities of bank directors and to assist in resolving any problems which may come to the attention of the director.