Board of Directors: The Essential Roles of Governance and Oversight

Part 1

“Leadership and learning are indispensible to each other.” ~ John F. Kennedy

This quote by former President Kennedy addresses one of the essential elements of effective leadership: knowledge. In the context of leading a financial institution, not only are its leaders expected to establish tone at the top of the organization for high ethical standards and embody commitment to the service of communities and membership, but board members must fulfill the essential role of establishing a safe and sound governance framework and providing active oversight to their bank or credit union. While it is not the board of directors’ role to run day-to-day operations of an institution, the board does:

1. Appoint the chief executive officer (CEO);
2. Establish strategic direction for the financial institution;
3. Develop compensation packages that align the CEO’s goals to that strategy; and
4. Establish policies and the control framework within which management operates.

In carrying out its governance and oversight roles, the board of directors serves as an indispensible check and balance without which our financial system as currently designed could not operate in a safe and sound manner. To be effective leaders, board members must not only develop a full understanding of their governance and oversight roles, but they must have a basic understanding of what the bank or credit union does, what risks it faces, and how those risks are measured, monitored, and controlled. To understand their governance and oversight roles, new board members should undergo initial orientation training at the time that they are elected to the board. As the financial services industry and financial products evolve and become increasingly complex, maintaining a basic understanding of the activities, products, and services offered by a bank or credit union requires ongoing training throughout a board member’s term of service.

Return to a healthy, stable financial services industry in Georgia, essential to economic recovery and long-term prosperity, will require leadership from informed and engaged boards of directors that understand and practice the principle set forth by former President Kennedy: “Leadership and learning are indispensible to each other.”

Board of Directors: Leadership Exemplified by Tone at the Top

Part 2

“Example is not the main thing in influencing others, it is the only thing.” ~ Dr. Albert Schweitzer

This quote by theologian, philosopher, physician, and Nobel Peace Laureate Dr. Albert Schweitzer illustrates the importance of leading by example and setting a proper tone. In last month’s Bulletin article titled “Board of Directors: The Essential Roles of Governance and Oversight”, we asserted that financial institution leaders are expected to establish a tone at the top of the organization for high ethical standards and embody commitment to the service of their communities and membership. As summarized in a 2004 speech on “Current Issues in Corporate Culture” by then Federal Reserve Governor Susan Schmidt Bies:
“The board and senior management are obligated to deliver a strong message to others in the firm about the importance of integrity, compliance with the law, fair treatment of customers, and overall good business ethics. Leaders should demonstrate their commitment through their individual conduct and their response to control failures.

While the ethical tone of a financial institution comes from the top, a successful ethics program must be demonstrated by staff at all levels and throughout the organization. The environment should empower any employee to elevate ethical or reputational concerns to appropriate levels of management without fear of retribution. In other words, the culture of the organization should raise issues to senior management that they may not be aware of; management can then demonstrate their commitment by responding appropriately.”

During this period of extraordinary economic stress, the Department has seen increased incidents of board members and executive officers experiencing personal financial challenges. Consistent with setting an example of high ethical standards and good business ethics, boards should take proactive steps to remove or place in an advisory capacity those directors that have classified assets or caused loss to a financial institution until such time as those directors restore their finances to a satisfactory condition. Board members are reminded that an inability to manage personal finances or related business affairs in a fiscally responsible, diligent, or lawful fashion is grounds for removal under O.C.G.A. Section 7-1-71. This Code Section further provides statutory remedies for dishonesty or recklessness in management of the affairs of the financial institution, persistent violation of laws, or indictment for crimes involving moral turpitude or breach of trust. The standards set forth in Ms. Bies’ speech align to the elements of this Code Section, and the strength of statutory remedies affirms the expectation of high standards of responsible and ethical conduct by the leaders of financial institutions in Georgia.

Strong leadership from informed and engaged boards of directors is an essential element in returning Georgia’s financial services industry to a healthy, stable condition. Tone at the top of a financial institution must be clearly communicated and openly demonstrated to influence others throughout the organization and engrain a culture of high ethical standards through leadership by example.

**Board of Directors: The Importance of Planning**

**Part 3**

“*In preparing for battle I have always found that plans are useless, but planning is indispensable.*”

*Dwight D. Eisenhower*

In Part 1 of this series, we identified four key areas of responsibility for a financial institution board of directors. The second of those four responsibilities was: “Establish strategic direction for the financial institution.” The quote listed above from Dwight D. Eisenhower, Supreme Commander of the Allied Forces in Europe during World War II, United States Army Chief of Staff, Commander in Chief of NATO forces, and 34th President of the United States, illustrates the importance of preparation and planning as a cornerstone of any successful endeavor. The more complex the endeavor, the more essential planning becomes not only in identification of the desired outcome but the strategies to best achieve that desired outcome. Perhaps most importantly, effective planning involves identification of potential impediments and contingencies that may arise to disrupt achievement of that desired outcome. As the quote implies, plans become stale the moment that they are finalized while events unfold and circumstances change.
but effective planning should be dynamic and iterative with frequent evaluation of results against expectations, reconsideration of strategies, revalidation of desired outcomes in light of the changing environment, and reassessment of impediments and contingencies.

Consider the changing regulatory and competitive landscape that Georgia’s financial institutions currently face under extensive rule writing mandated by the Dodd-Frank Act, high levels of unemployment, depressed real estate values, and the local impact of unrest in European markets. When developing your financial institution’s 3 to 5 year strategic plan in 2005, did it anticipate and factor in events that unfolded during the subprime meltdown and ripple effects that led to major dislocations and disruptions in financial markets which occurred during 2007 and 2008? If so, yours was one of the very few because none of us has perfect foresight and circumstances changes as events materialize and unfold. An effective and dynamic planning process captures these material events and evaluates their impact on strategies prompting recalibration or outright change for the purpose of keeping the financial institution and all of its personnel focused on the desired outcome, the board of directors’ stated objectives as set forth in the strategic plan.

Strong leadership from informed and engaged boards of directors is an essential element in returning Georgia’s financial services industry to a healthy, stable condition. Effective and proactive planning by directors and executives of Georgia’s financial institutions, particularly in this period of economic and regulatory uncertainty, is a fundamental leadership responsibility. Boards of directors demonstrate their commitment to principles of sound leadership through active engagement with management in the strategic planning process. Remember, a plan stuffed in a chief executive’s drawer and not clearly communicated and engrained into the culture of a financial institution is unlikely to achieve the desired outcome.

Board of Directors: Appointing, Incenting, and Overseeing the Chief Executive

Part 4

“In this world, you get what you pay for.” - Kurt Vonnegut (Cat’s Cradle)

In Part 1 of this series, we identified four key areas of responsibility for a financial institution board of directors. Two of those four responsibilities were: “Appoint the chief executive officer (CEO)” and “Develop compensation packages that align the CEO’s goals to that strategy.” The strategy referenced is the financial institution’s strategic plan as approved by the board of directors.

One of the most crucial decisions that a board of directors makes is to appoint the CEO. To be effective, the CEO must possess the leadership qualities, integrity, and motivation to implement board approved strategies within risk tolerances established and clearly communicated through board approved policies. In this context, the quote listed above which was taken from the novel “Cat’s Cradle” by author Kurt Vonnegut is meant to convey that the way in which you incent people can be expected to have significant impact on the results produced. In short, you generally get what you pay for or incent. As a practical matter, after the CEO selection process itself, perhaps the most important role that the board of directors plays in promoting a healthy and successful financial institution is ensuring the establishment of an incentive structure that clearly aligns executive compensation to board approved strategies designed to
achieve objectives of shareholders/members and other key stakeholders in the institution. From a regulatory perspective, the importance and benefit of properly designed incentive structures was expressed by former Federal Reserve Governor Randall Kroszner in a speech at Boston College delivered on June 6, 2008:

“A final fundamental area, governance and risk control, has been a key factor differentiating performance across financial institutions during the recent turmoil. Firms that operated with the two main ingredients for solid governance and controls--thorough information about potential risks provided to a senior management team that is engaged and willing to act and strong incentives throughout the organization--have come through this tumultuous period in better condition. Incentive structures are most effective when clearly and consistently articulated and when they take into account a longer-horizon view of risks to the organization.”

Having appointed a CEO possessing leadership qualities with a clearly defined and aligned incentive structure, the board of directors’ role becomes one of ongoing and engaged oversight. It is not the role of a director to manage the day-to-day affairs of the financial institution, but rather to establish a clearly defined framework within which the CEO is allowed to operate and execute. The board oversight role involves serving as a resource to the CEO for advice and guidance along with serving as a check and balance; a point of accountability to ensure achievement of board approved objectives.

Strong leadership from informed and engaged boards of directors is an essential element in returning Georgia’s financial services industry to a healthy, stable condition. Boards of directors demonstrate leadership through the appointment of qualified and capable CEOs who are allowed to execute within clearly articulated board approved strategies designed to achieve well defined objectives under an incentive structure that is properly aligned. A final but crucial element is actively engaged oversight of the CEO with mechanisms to ensure accountability.

**Board of Directors: Policies and Controls**

**Part 5**

“Surround yourself with the best people you can find, delegate authority, and don’t interfere as long as the policy that you have decided upon is being carried out.” Ronald W. Reagan

In the April 2011 Bulletin article titled “Board of Directors: The Essential Roles of Governance and Oversight”, we identified four key areas of responsibility for a financial institution board of directors. The fourth and final of those four responsibilities was: “Establish policies and the control framework within which management operates.” The quote shown above by Ronald W. Reagan, 40th President of the United States, conveys this message clearly and concisely. While this quote promotes the idea of hiring qualified, capable people of integrity and delegating authority to execute board approved policies, a key element in the quote implies the importance of an effective system of verifying conformity with approved policies. Divergence from policies prompts interference and a heightened level of engagement by the board of directors as necessary.

Having appointed the chief executive officer and aligned incentives to the board approved strategic plan, effective governance and oversight is implemented by establishing an effective system of controls through policies, limits, and verification functions. Policies and limits should align to the strategy and risk
tolerance of the board of directors establishing the framework within which management is expected to operate. Verification functions such as internal audit, loan review, and in some cases the compliance department, serve as the board of director’s eyes and ears across the institution providing reasonable assurance that day-to-day operations are being conducted in accordance with the board approved strategy, policies, and limits. In this context, effective and independent verification functions staffed by experienced, well trained, and capable individuals serve to protect the board from a disconnect between the articulated strategy / risk tolerance and the actions of institution personnel. Effective and independent validation functions support proactive oversight and position the board to direct corrective actions in a timely manner to minimize disruptions to the institution’s operations and position the institution for successful accomplishment of board approved goals and objectives. The FDIC’s Risk Management Manual of Examination Policies emphasizes the role of boards of directors in ensuring an effective control environment:

“The control environment begins with the ... board of directors, which is responsible for the development of objectives and policies and for monitoring adherence to such. The policies established should ensure that decision-making authority is vested at the proper management level and that management decisions and policies are properly implemented throughout the organization.”

Strong leadership from informed and engaged boards of directors is an essential element in returning Georgia’s financial services industry to a healthy, stable condition. Boards of directors implement effective governance and oversight by approving policies and limits that align to the board’s strategies and risk tolerance and by establishing verification functions to provide reasonable assurance of conformity.
The Control Environment: Standards for Safety and Soundness
Part 1

“Many of the companies that have been the center of recent governance failures demonstrate some similar characteristics... a focus on sales growth and support and inadequate time spent building the control infrastructure.” — Federal Reserve Governor Susan S. Bies (October 8, 2002)

In 1995, pursuant to Section 39 of the FDI Act, the Federal banking agencies jointly adopted “Guidelines Establishing Standards for Safety and Soundness” while simultaneously adopting regulations to enforce these standards. For non-member banks, these standards are enforceable through Part 364 of FDIC Rules and Regulations and may be found in Appendix A to that regulation. The stated purpose of these standards is to identify and address problems at insured depository institutions before capital becomes impaired, without dictating how institutions must be managed and operated. Though the standards are not specifically enumerated in Georgia law, the Department has similar authority to enforce standards of safety and soundness at financial institutions (banks, credit unions, etc.) through Section 7-1-91 of the Financial Institutions Code of Georgia.

In a prior series of Bulletin articles titled the “Board of Directors: The Essential Roles of Governance and Oversight”, we identified four key areas of responsibility for a financial institution board of directors. The fourth and final of those responsibilities was: “Establish policies and the control framework within which management operates.” While the enumerated standards embedded in Federal agency regulation are designed to guide regulators in assessing a financial institution’s safety and soundness, they also represent a foundational framework underpinning the financial institution control environment. Several operational and managerial standards as well as compensation practices considered to be unsafe and unsound are listed in the guidelines, but specific elements to be further expanded upon in subsequent Bulletin articles on this topic include:

1. Effective systems of internal controls;
2. Independent internal audit function; and
3. Asset quality standards – underwriting, credit administration, and loan review.

As noted in last month’s Bulletin, effective governance and oversight is implemented in part by establishing an effective system of controls through policies, limits, and verification functions. A systematic approach to verifying conformity with approved policies and limits is an essential element of an effective control environment. Independent internal audit and loan review functions, when properly staffed with experienced and well trained professionals, provide boards of directors with reasonable assurance that policies and limits are being adhered to as part of the day-to-day operation of a financial institution. Accordingly, effective internal audit and loan review functions are an important element in support of a director’s ability to meet the fiduciary duties of that office. The nearly decade old quote from Governor Bies, prior to the banking crisis, is still valid today. An effective control environment is fundamental to the safety and soundness of individual banks and credit unions, just as it is to a healthy banking system.
The Control Environment: Effective Systems of Internal Controls
Part 2

“Internal control can help an entity achieve its performance and profitability targets, and prevent loss of resources…. In sum, it can help an entity get to where it wants to go, and avoid pitfalls and surprises along the way.” “Internal Control – Integrated Framework” - The Committee of Sponsoring Organizations of the Treadway Commission (COSO)

COSO was formed in 1985 to develop guidance on enterprise risk management, internal control, and fraud deterrence for the purpose of improving organizational performance and governance. COSO describes the control environment as setting the tone of an organization thereby reflecting direction provided by the board on standards of integrity, ethical values, delegation of authority, and operating style. Control activities (including approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties) should align to board approved policies and limits and occur throughout the organization. When policies and limits align to the board’s risk appetite (the level of risk the board is willing to accept in order to achieve stated financial objectives) and the financial institution’s strategic plan, management has a clearly defined framework within which it is authorized and empowered to operate on a day-to-day basis.

The importance of an effective system of internal controls is reflected in the prominent role that this evaluation factor plays in the regulatory assessment of financial institution boards of directors and management. The Uniform Financial Institutions Rating System (UFIRS), better known by the acronym CAMELS for banks and CAMEL for credit unions, states in part that “The capability and performance of management and the board of directors is rated based on, but not limited to … the adequacy of audits and internal controls to promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies.”

With escalating regulatory and legal requirements along with challenges associated with a financial institution’s growth, complexity of operating environment, and marketplace dynamics, it is easy for boards of directors to become overwhelmed by the volume of information, including policy review and approval requirements. Recognizing that an overwhelmed board will generally not be an effective board, it’s increasingly important to prioritize and implement a high-level approach when it comes to the board’s involvement in the review and approval of policies. In some instances, legal and regulatory requirements will dictate which policies and issues receive board level approval, while in other instances the subject matter itself may be so essential to the safe-and-sound operation of a financial institution that board approval is necessary. An example of a subject matter fundamental to the safe-and-sound operation of a financial institution is a capital policy for banks and a net worth policy for credit unions. In determining which other policies and issues require board-level approval and attention beyond those required by law, regulation, or fundamental safety-and-soundness considerations, management is encouraged to exercise prudent discretion. A thoughtfully crafted, overarching, comprehensive, high-level set of policies and limits may be reviewed and approved at the board level while more detailed management level policies or procedures designed to align to the overarching board policies flesh-out in-depth guidance to financial institution personnel for use in day-to-day activities. Management level policies and procedures serve as a complete roadmap of standards and expectations, which when effectively and faithfully implemented, promote achievement of the board’s objectives as set forth in the strategic plan in addition to compliance with risk tolerance as articulated in board policies, limits, and the statement of risk appetite.
In the next article, we will begin addressing control functions that provide reasonable assurance that a financial institution’s controls are designed effectively; adhered to and implemented appropriately; and thereby support the identification, measurement, monitoring, and control of risks.

The Control Environment: Internal Controls and Verification
Part 3

“Boards of directors and audit committees are responsible for ensuring that their organizations have effective internal controls that are adequate for the nature and scope of their businesses and are subject to an effective audit process .... Supporting functions such as ... internal audit, ... credit review, compliance, and legal should independently monitor and test the control processes to ensure that they are effective.” – Federal Reserve Governor Susan S. Bies (May 17, 2004)

In previous articles we discussed elements of the control environment as defined in a respected industry resource and regulation. This article describes common internal controls found in every financial institution, without regard to size or complexity, and introduces the roles of internal audit and independent loan review (also referred to as credit review) in promoting an effective control environment.

Two basic forms of internal control are segregation of duties and joint custody. The FDIC Risk Management Manual of Examination Policies (Exam Manual) describes segregation of duties as requiring the participation of two or more persons or departments in a transaction thereby causing the work of one to serve as proof of the accuracy of another. Duties should be arranged so that no one person dominates any transaction from inception to termination in order to diminish the likelihood of fraud or unidentified errors. Common examples of segregation of duties include designing the loan process so that the approving loan officer is not the same person disbursing loan proceeds, an individual authorized to sign official checks is not also reconciling correspondent bank accounts, source records are reconciled to the general ledger by someone other than the person originating general ledger entries, confirmation from the sale or purchase of investment securities are routed from the broker/dealer directly to a person without authority to conduct securities transactions, and the person taking wire transfer instructions from customers does not also have the authority to approve and transfer funds. The FDIC Exam Manual describes joint custody as charging two or more persons with equal accountability for the physical protection of certain items or records. Joint custody may involve maintaining two sets of keys or combinations, under the separate control of two different people, required to access vaults, files, or other storage devices. Common examples of joint custody include maintaining cash or check stock and other negotiable instruments in a secure location inaccessible by any one person. Internal controls are communicated through well defined policies and supporting procedures with the intent to safeguard financial institution assets and reputation, from neglect, fraud, or abuse.

Internal audit and independent loan review functions provide reasonable assurance to boards of directors by validating that the financial institution’s policies and supporting procedures contain controls that are reasonably designed to achieve the goal of safeguarding shareholder, customer, and member assets. In addition, internal audit and independent loan review verify that controls are being appropriately adhered to by financial institution personnel in the day-to-day course of their duties. Effective internal audit and independent loan review functions minimize the likelihood of unpleasant surprises and promote early identification of risks; thereby improving the capacity for management to take steps to reduce losses and
implement timely corrective actions before they become a regulatory or legal issue.

Robust internal audit and independent loan review functions staffed by experienced, knowledgeable, well trained individuals (whether in-house or outsourced) provide an independent assessment and serve as the board of director's eyes and ears across an organization. They are an indispensable check and balance. Well designed, targeted reporting from these functions informs sound decision making by executives and boards of directors; thereby promoting healthy, successful financial institutions.

In the next article, we will begin to outline regulatory standards and expectations for the internal audit and independent loan review functions.

The Control Environment: Regulatory Standards for Internal Audit
Part 4

"Reality is merely an illusion, albeit a very persistent one." - Albert Einstein

The quote from Albert Einstein implies that perception and reality are not always one and the same, but reality persists because it is based on facts that we all have to face at some point. An effective internal audit function helps the board of directors align perception of a financial institution's condition to the facts. This article will focus on regulatory standards and expectations for an effective internal audit function.

The FDIC Risk Management Manual of Examination Policies (Exam Manual) outlines basic regulatory expectations for the control environment, including an effective internal audit function. The Exam Manual states that the board of directors and senior management should have reasonable assurance that the system of internal controls prevents or detects significant inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial reporting (which includes regulatory reporting); and deviations from laws, regulations, and the institution's policies. The board and senior management are responsible for ensuring that the system of internal controls operates effectively (this responsibility cannot be delegated to others, either within or outside the institution), and the internal audit function is an important element in assessing effectiveness of the internal control system. The internal audit function of each institution should be appropriate to its size, complexity, and nature of operations. An effective internal audit function provides clear, concise, and timely information on weaknesses so that management can implement prompt and appropriate corrective actions. Minimum standards for safety and soundness are codified in Part 364 of FDIC Rules and Regulations, which includes the following requirements for internal audit:

1) Adequate monitoring of the institution’s internal control system;
2) Independence and objectivity;
3) Qualified personnel;
4) Adequate testing and review of information systems;
5) Adequate documentation of tests and findings of any corrective actions;
6) Verification and review of management's actions to address material weaknesses; and
7) Review by the audit committee or board of directors of internal audit effectiveness.

Similar standards for credit union supervisory committee audits are addressed in Part 715 of NCUA Rules and Regulations and Rule 80-2-6 of the Department of Banking and Finance. Each of the required
elements listed earlier is important, but elements #2 and #3 deserve additional comment. An internal audit function is only as good as the quality of personnel staffing that function. To be effective, internal audit should be staffed by personnel with background, experience, and training capable of timely identification of material risks embedded within the financial institution's unique operating model; with ability to clearly communicate the corrective actions needed; and stature within the organization to ensure that timely and appropriate corrective actions are implemented. To be effective, independence and objectivity of the audit function is crucial. The internal audit function should be positioned so that the board of directors, audit committee, and/or supervisory committee (oversight body) has confidence that internal audit will perform its duties with impartiality and not be unduly influenced by managers of day-to-day operations. The oversight body should oversee the internal audit function, evaluate its performance, and assign responsibility for design and execution of the audit program to a member of management independent of conflicting operational responsibilities. Ideally, the internal audit manager should report directly and solely to the oversight body regarding both audit issues and administrative matters, including resources, budget, appraisals, and compensation.

An effective internal audit function serves as an indispensible check and balance. Well designed, targeted reporting from this function informs sound decision making by executives and boards of directors thereby promoting healthy, successful financial institutions. In the next article, we will outline regulatory standards and expectations for the independent loan review function.

The Control Environment: Regulatory Standards for Loan Review Part 5

“We took risks. We knew we took them. Things have come out against us. We have no cause for complaint.” - Robert Frost

“Risk comes from not knowing what you’re doing.” - Warren Buffett

These quotes reflect the importance of having a complete understanding of the nature and extent of risks. Banks and credit unions are in the business of prudent risk taking, including credit risk taken through loans made to consumer and business borrowers. For the typical bank or credit union, credit risk through the lending process is by far the most material source of risk facing the institution. In the current cycle, excessive levels and/or poorly managed credit risk have been the primary killers of virtually every failed bank and the majority of failed credit unions across the country. An independent loan review function assesses the nature and extent of credit risk embedded in the loan portfolio with summary reporting providing the board of directors and senior management with critical information to implement timely course corrections when needed; it is a fundamental, essential component of an effective control environment and sound financial institution governance. This article focuses on regulatory standards and expectations for the independent loan review function.

An “Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)” (Policy Statement) was issued on December 13, 2006, containing an attachment outlining regulatory expectations for an independent loan review function. The Policy Statement is applicable to all federally insured banks and credit unions. It specifies that the board of directors is responsible for “Reviewing management's assessment and justification that the loan review system is sound and appropriate for the size and complexity of the institution.” While the Policy Statement itself focuses on maintaining an
adequate ALLL, Attachment 1 to the Policy Statement goes into depth on regulatory standards for the loan review function due to its important connection to ALLL adequacy. It states that regardless of the structure, the loan review function should, at a minimum, be based on the following objectives:

1) Prompt identification of loans with potential credit weaknesses;
2) Appropriate grading or classification of loans promoting timely action to minimize credit losses;
3) Identification of adverse trends in the loan portfolio, as well as isolated segments of the portfolio, that affect collectability or potential problems;
4) Assess adequacy of, and adherence to, internal loan policies as well as compliance with applicable laws and regulations;
5) Evaluate activities of lending personnel including compliance with internal loan policy and approval processes;
6) Provide an objective and timely assessment of overall loan portfolio quality; and
7) Provide accurate and timely credit quality information for financial and regulatory reporting, including determination of an appropriate ALLL.

Similar to internal audit, loan review is only as good as the quality of personnel staffing the function. To be effective, loan review should be staffed by personnel with background, experience, and training capable of timely identification of material risks embedded within the financial institution’s unique lending activities and strategies; with ability to clearly communicate the corrective actions needed; and stature within the organization to ensure that timely and appropriate corrective actions are implemented. To be effective, independence and objectivity of the loan review function is crucial. Some financial institutions may choose to outsource loan review activities to an independent outside party; an acceptable option, but responsibility for maintaining a sound loan review cannot be delegated. The loan review function should report directly to the board of directors, or a committee thereof, to ensure that loan review will perform its duties with impartiality and not be unduly influenced by managers of day-to-day operations.

An effective loan review function serves as an indispensable check and balance for the most material source of risk to banks and credit unions. Well designed, targeted reporting from this function informs sound decision making by executives and boards of directors thereby promoting healthy, successful financial institutions.