FINANCIAL INSTITUTION

DIRECTOR'S HANDBOOK

OFFICE OF FINANCIAL REGULATION FINANCIAL SERVICES COMMISSION STATE OF FLORIDA

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~~Ten~~ Eleven Commandments of a Prudent Bank Director

I. Be prepared to resign.

II. Be independent.

III. Select the best Chief Executive Officer and then give him/her your support and assistance.

IV. Regularly review the performance of the bank.

V. Avoid self-dealing and all conflicts of interest.

VI. Insist on good audits and follow-up on the recommendations made.

VII. Insist on the value of proper and accurate documentation.

VIII. Follow banking laws, rules and regulations.

IX. Treat all bank matters with confidentiality.

X. Realize that you are always, and in every place, representing the bank.

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XI. Communicate frequently and directly with your regulators.

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FINANCIAL INSTITUTION DIRECTOR'S HANDBOOK

The board of directors of a financial institution is ultimately responsible for the conduct of the institution's affairs. The board controls the institution's direction and determines how the institution will operate. The board must hire capable management to ensure board-adopted policies are fully implemented and strictly adhered to. While day-to-day operations are delegated to management, the board is responsible for making sure operations are carried out in compliance with applicable laws and regulations, and consistent with safe and sound practices. The board monitors the institution's operations and makes sure management can meet the challenges created by growth, increased competition and a changing marketplace.

This book is designed to provide financial institution directors with a brief overview of their fiduciary duties, as well as significant legal, administrative and policy issues affecting financial institutions.

I. RESPONSIBILITIES OF THE BOARD OF DIRECTORS

A. Select Competent Management

Management

Quality management is the single most important element in a profitable and soundly run institution. Capable management has the industry expertise to assist the board in long-term planning in a changing marketplace. Management must have the technical expertise to design and administer the necessary systems and controls to carry out the board's policies and to ensure compliance with applicable laws and regulations. The quality of an institution's management team may mean the difference between success and failure in difficult economic times. The importance of quality management increases as financial institutions face the challenges of an increasingly competitive and highly complex marketplace. Occasionally, the board may find it necessary to dismiss officers for poor performance, dishonesty, or other reasons. In these circumstances, the failure to act timely and prudently may represent a breach of the board's responsibilities to the institution, its shareholders, the OFR, and the deposit insurance fund.

B. Formulate Appropriate Plans and Policies

Plans

The board should develop a long-term strategic plan that contains a statement of the board's general philosophy and defines the board's vision for the future. Short-term business plans must also be formulated, translating goals into specific, measurable targets. Adherence to the business plan should be evaluated at regular intervals. Any significant departures from the plan should be carefully considered and approved in advance by the board.

Policies

The board should adopt specific operational policies concerning areas such as loans, AML/BSA, personnel administration, and investments. The policies must be consistent with the institution's long-term and short-term strategic plans. By adopting policies, the board defines what practices and levels and types of risk are acceptable. Policies direct management on selecting risks and rewards and are implemented by management through internal operating procedures. Clear written policies are especially important in the increasingly competitive financial service marketplace. All major activities must be covered by policies and new activities should not be undertaken without appropriate policies in place.

Loan Policy - A loan policy should establish parameters for the overall loan portfolio. The policy should define what portion of the institution's funding sources may be used for lending, what types of loans may be made and what percentage of the overall portfolio each loan type should be. Geographic lending areas should be identified and limits should be established on purchased loans. Guidelines governing loans to insiders also need to be adopted.

The loan policy should address credit requirements, loan underwriting criteria and loan application requirements. Approval authority needs to be defined and delegated based on individual loan officer expertise. Guidelines for loan administration should also be established.

The board should be particularly aware of circumstances such as the following when considering the institution's lending activities:

- ❖ Failure to have systems that properly monitor compliance with legal limits;

- ❖ Inadequate loan administration;

- ❖ Relaxed standards or terms on loans to insiders;

- Over-reliance on character or collateral factors resulting in poor selection of credit risks;
- Uncontrolled asset growth or increased out of area loans especially if fueled by non-local deposits; and
- Purchase of participations in out-of-area loans without independent review, evaluation, and documentation.

Internal Review

Loan Review Program - A comprehensive independent internal loan review program is critical to the board's ability to monitor the quality of the institution's assets and to protect against losses. The loan review program should provide for periodic reviews of the loan portfolio by persons who are not responsible for the institution's credit decisions and who report their findings directly to the board or the loan committee. A loan watch list should be developed and regularly updated listing past due loans and other loans with identified weaknesses.

The loan review function serves as an early warning system helping to identify poor loan administration and problem loans. It assesses the adequacy of and adherence to internal loan policies and procedures, identifies potential problem loans, and provides the board and management with an objective assessment of the overall quality of the loan portfolio.

Reserves

Allowance for Loan and Lease Losses - Financial institutions are required to maintain adequate loan and lease loss reserves (LLLR). To ensure an adequate reserve for loan and lease losses, the board should adopt a system that requires at least a quarterly review of the LLLR level to determine whether it is sufficient to absorb projected losses, including identified exposures to losses and an estimate of unidentified potential losses. Information received from the internal loan review should be used to determine identified losses. Unidentified losses should be estimated based on factors such as economic conditions, portfolio growth, past collection rates, exposure concentrations, environmental, and other factors that might have an impact on the ultimate collectibility of certain credits.

The use of a loan grading/rating/classification system to ensure monitoring of problem loans and permit more accurate quarterly assessments of the adequacy of the loan valuation reserve and provision for loan losses is imperative. The loan grading methodology must be governed by a written policy, which is reviewed annually by the board and revised when circumstances warrant. It is guided by a definitive written procedures manual or set of review instructions, that outline minimum standards for setting reporting documentation and loan grading criteria. Since the board is responsible for the accuracy of the institution's financial statements, it is imperative that the LLLR be reviewed regularly for adequacy and maintained at a level determined in accordance with Generally Accepted Accounting Procedures (GAAP). The Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) is a document that should become familiar to every director.

One of the primary methods used to gage potential losses within the loan portfolio is through a credit grading system. Generally, each credit is graded (by the loan officer but an independent third-party reviewer is preferred) on a numerical scale ranging from 1 (the highest quality) to 7 (considered a loss and uncollectible). An effective loan classification or credit grading system provides important information on the collectibility of the portfolio for use in determining an appropriate level for the ALLL.

Anti-Money Laundering

Anti-Money Laundering Policy - The Bank Secrecy Act (BSA) is a comprehensive anti-money laundering statute which was enhanced by the enactment of the USA PATRIOT Act (Act). Title III of the Act is the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001. The Act is far reaching in scope, effectively expanding BSA standards, and applying to a broad range of financial activities for institutions not previously included. The BSA requires depository institutions and other industries vulnerable to money laundering to take a number of precautions against financial crime, including reporting cash transactions over $10,000 (CTR) and filing suspicious activity reports (SAR).

Banks must have policies and procedures in place to achieve compliance. The board must determine the level of risk they will tolerate in the bank's customer base, manual or automated systems in use, and standards provided in implementing regulations. Further, policies must set criteria for customer identification, documentation requirements for know your customer (KYC), customer due diligence (CDD), and enhanced due diligence (EDD) based on the level of risk identified.

Each bank must have a designated BSA compliance officer for: day to day operations; internal policies, procedures and controls; appropriate training for all staff and directors; and independent testing of all facets of the program. The Office of Financial Regulation requires de novo banks to submit a qualified BSA officer for approval prior to opening.

In addition to filing CTRs and SARs, the BSA establishes several prohibited practices such as opening, maintaining, administering, or managing correspondent accounts with "shell" banks; requires anti-money laundering records to be maintained and available for review and use by regulatory and law enforcement agencies; and implements appropriate due diligence for private banking and correspondent accounts of non-United States persons.

A comprehensive interagency examination manual was released in 2005 (an update was released in September 2007) within which directors may find extensive additional information on BSA issues and practices. It can be found on the FFIEC website at *http://www.ffiec.gov/bsa_aml_infobase/default.htm*. Other sources include *www.fincen.gov* and *www.fatf-gafi.org*.

Asset-Liability Management

Asset-Liability Management or Funds Management Policy - Asset-liability management refers to the overall control of the composition of balance sheet accounts to attain key objectives. These key objectives are to generate optimum levels of quality earnings and to maintain adequate liquidity to meet both predicted and unexpected cash needs. The increasing volatility in funding sources and market rates resulting from the removal of interest rate limitations and rapid fluctuations in the economy have made effective funds management essential to successful operations.

The policy should establish parameters within which management can pursue earnings and growth objectives. In addition, the policy should address the institution's off-balance sheet activities and a contingency plan that specifies how the institution will raise necessary cash in case of unusual liquidity pressures.

The following practices or conditions should trigger board scrutiny:

- ❖ Excessive growth objectives;
- ❖ Heavy dependence on volatile liabilities or borrowed funds;
- ❖ Gaps between asset and liability maturities or between the volume of rate sensitive assets and rate sensitive liabilities at various maturity time frames;
- ❖ Asset/liability expansion (on or off-balance sheet) without an accompanying increase in capital support;
- ❖ Failure to diversify asset risks or funding sources;
- ❖ Inadequate controls over securitized asset programs; and
- ❖ Lack of expertise or control over highly technical risk reduction techniques, such as swaps, futures and options.

Risk Management

Risk Management Policy - Although banks are in the business of taking risks in order to make a profit, the board of directors is expected to manage and control the amount of risk the bank is willing to accept. The board should establish policies that set standards for the nature and level of risk the bank is willing to assume. Because market conditions and bank structures vary, no single risk management system works for all banks. Each bank should develop its own risk management program tailored to its needs and circumstances. A risk monitoring system should also be established so the board can hold management accountable for operating within established policy levels. The risk areas the board should identify include:

- Liquidity risk - from the bank's inability to meet its obligations when they come due;

- Price risk - from changes in the value of portfolios of financial instruments;

- Transaction risk - from problems with service or product delivery;

- Compliance risk - from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, or ethical standards;

- Strategic risk - from adverse business decisions or improper implementation of those decisions; and

- Reputation risk - from negative public opinion.

When a bank accepts risks that are excessive or not properly managed the regulators will strive to assist the board and bank management so that the bank may, again, be managed in a safe and sound manner.

Investments

Investment Policy - A typical investment policy should identify the yield, quality, quantity and maturity structure of specific types of investments to be purchased and specific risk diversification guidelines. Legal restrictions on the types of investments financial institutions may hold must also be observed. While the advice of external sources may be sought, the board may not delegate its responsibility for supervising the investment portfolio. The board should review the investment portfolio periodically to ensure the level of risk remains acceptable and consistent with previously approved portfolio objectives.

Some common areas of concern that relate to investment portfolio activities include the following:

- Failure to carefully select securities dealers or brokers;
- Trying to obtain yields from the investment portfolio without regard for other portfolio objectives, such as risk reduction;
- Failure to consider pledging requirements in investment decisions;
- Lack of investment diversification;
- Trading in the investment portfolio;
- Lack of technical expertise in new investment vehicles; and
- Concentrations.

Ethics

Code of Ethics/Conflict-of-Interest Policy - Each director is in a position of fiduciary responsibility and has a fundamental duty to avoid conflicts of interest or even the appearance of a conflict of interest. The board must assume a leadership role in this area by adopting and enforcing clear conflict-of-interest policies to govern insider activities with the institution, as well as the conduct of officers and employees.

The policy should address guidelines for insider lending; procedures for disclosing actual and potential conflicts of interest; procedures for handling confidential information; requirements for arm's-length dealings; prohibitions on the use of insider information in investment transactions; and restrictions on the acceptance of gifts or other things of value from customers or other persons having a business relationship with the institution.

Other

Other Policies - The policies listed above are not intended to be inclusive. Other policies the board may consider adopting include, but are not limited to, the following: trust; internal controls; capital planning; charge-offs; management information systems; and confidentiality.

C. Monitor Operations

Reports

The board is responsible for ensuring the institution's operations are properly controlled and comply with board policies and applicable laws and regulations. One mechanism for monitoring the institution's operations is regular management reports to the board. These reports should be structured in a form that is meaningful to the board and may include such topics as:

- Income and expenses and actual versus budget comparisons;
- Capital outlays and adequacy;
- Loans and investments made;
- Overdrafts and past due, renegotiated, and troubled loans and investments;
- Problem loans, their present status and workout programs;
- Loan and lease reserve, charge-offs;
- Concentrations of credit;
- Losses and recoveries on sales, collections, or other dispositions of assets;
- Funding activities and the management of interest rate risk;
- Performance in all of the above areas compared with past performance, as well as to peer group performance;
- All insider transactions that benefit, directly or indirectly, controlling shareholders, directors, officers, employees or their related interests;
- Activities undertaken to ensure compliance with applicable laws and any significant compliance problem; and

- ❖ Any extraordinary developments likely to impact the integrity, safety, or profitability of the institution.

Audits & Examinations

The board cannot rely exclusively on periodic management reports. Another oversight tool is to insist that a sound system of internal controls be established in day-to-day operating procedures. The board should also periodically review all aspects of the institution's operations through both internal and external audits. Whether the institution relies on internal audit staff or hires outside auditors, the auditors should always report directly to the board of directors. The audit engagement should include all operational areas and must specifically include an appropriate review of account monitoring required by the BSA.

Periodic examination reports prepared by regulatory agencies are also an important oversight tool. Examination reports identify weaknesses with institution operations and provide recommendations for improvement. Each member of the board should thoroughly review each regulatory examination report and be prepared to discuss the contents of the report at the next board meeting.

Periodic Review

The board should ensure that all policies adopted by the board are implemented and procedures should be established for periodic board review of the implementation and effectiveness of each policy. This review also gives the board the opportunity to assess management's performance, as well as the need to revise policies that have proven ineffective.

D. Oversee Business Performance

Performance Review

Sound business performance will be one of the board's primary objectives and may also be a key indicator of management's success. Although most directors are not professional bankers, each board member should know enough to discern poor operating performance, poor asset quality and poor funds management activities. Each director should also be able to evaluate performance in relation to the institution's own targets, its competition and peers.

In addition to the reports described in the Monitor Operations section, the board may require that management provide them with certain key financial ratios such as:

- Return on average assets;
- Return on equity;
- Net interest margin;
- Net non-interest expense to average assets;
- Leverage capital (net worth) to average assets;
- Non-performing loans to total loans;
- Net losses to average total loans; and
- Classified loans to total capital.

II. DIRECTORS' INDIVIDUAL RESPONSIBILITIES

A. Be Aware of the Institution's Operating Environment

Environment

Directors should keep themselves informed of internal and external factors affecting the institution, including the business environment and the legal and regulatory framework. Directors should also be aware of local, regional, national, and international financial trends and any statutory and regulatory changes affecting the institution.

B. Be Diligent in Performing the Job

Knowledge

Directors have a duty to not only physically attend meetings, but to arrive prepared having thoroughly reviewed meeting materials beforehand. Management reports should be provided in advance of meetings to allow for meaningful review. Management should be asked to respond to any questions raised by the reports and each director should require explanations of any unfamiliar activities.

Directors who are unable to regularly attend board meetings, for whatever reason, should consider removing themselves from the board. Regulators find it extremely difficult for directors to perform their fiduciary duty to the institution when they fail to regularly attend board meetings. Unsatisfactory attendance is cause for removal from the board.

Directors should also review internal and external audits, supervisory examinations, and related communications and be aware of their significance. Any findings and recommendations should be carefully reviewed and considered.

C. Exercise Independent Judgement

Independence

Directors must act independently and objectively. They should not permit themselves to be influenced by another director, by management, or by outside interests. A critical evaluation of the issues before the board is essential to the effectiveness of each member of the board. Directors must ask management questions to satisfy themselves that management's recommendations are feasible and in the best interests of the institution. If a director disagrees with board action, the director should say so, and ensure the minutes reflect the disapproval. Thoughtful disagreement among members is often a sign of a strong, independent board.

D. De Novo Training Requirement

The Office of Financial Regulation requires all directors of de novo banks to complete sixteen hours of financial institution training within the first year of the new bank’s operation. All directors are strongly encouraged to participate in continuing education.

III. LEGAL LIABILITIES

A. Duty of Care

Care

This duty is a common law standard that holds directors to that degree of care, which prudent and diligent individuals would exercise under similar circumstances. This means that directors must participate actively and to the best of their ability in the work of the board to assure themselves that all financial arrangements are safe, that all employees operate in a legal and ethical manner, and that all activities are within the laws and regulations imposed on the institution.

B. Duty of Loyalty

Loyalty

This is a general responsibility that prohibits directors from putting their personal interests above those of the institution. This would include respecting the confidentiality of information received during the course of board meetings to transacting their personal business with the institution at arm's length.

The duty of loyalty does not mean that directors may not conduct business with the institution. However, it does mean that directors must fully disclose to the board any personal interest they may have in matters affecting the institution and voted on by individual members.

C. Indemnification/Insurance

Indemnification

Directors may be named as defendants in lawsuits, and a certain amount of protection against large financial losses can be gained by purchasing indemnification insurance as well as director and officer (D&O) liability insurance. Directors should be familiar with any insurance coverage provided by the institution and the indemnification statute (Section 607.0850, F.S.). Directors should also periodically review the adequacy of the D&O insurance coverage.

D. Statutory and Regulatory Liability

Legal Liability

Financial institutions are subject to a complex framework of federal and state statutes and regulations. A director who fails to comply with applicable regulations may be held personally liable, be subject to monetary penalties, or prohibition and removal proceedings.

Directors are responsible for ensuring their institution complies with all applicable laws, regulations and statutes. These provisions cover a wide range of financial issues.

The board might find it helpful for institution counsel to periodically review statutory and regulatory provisions for the board, and to brief the board, as necessary, on statutory and regulatory developments of particular relevance to their institution's activities. Areas that merit special attention because of their importance and potential liability include:

Financial Institutions Generally

- ❖ Unsafe and unsound banking practices (Sections 655.005, 655.033, 655.037, 655.0385, 655.045, and 655.948, F.S.)
- ❖ Reporting requirements (Sections 655.045 and 655.948, F.S.)
- ❖ Conflicts of interest (Sections 655.0386 and 607.0832, F.S.)
- ❖ Removal of financial institution affiliated parties (Sections 655.037 and 655.053, F.S.)
- ❖ Prohibited acts and practices (Sections 655.0322, 817.16, F.S.)
- ❖ Cease and desist orders (Section 655.033, F.S.)
- ❖ Security for public deposits (Chapter 280, F.S.)
- ❖ Directors responsibilities (Sections 607.0801 - 607.0850, F.S.)
- ❖ Lending practices (Chapter 687, F.S.)

Banks, Associations, Trust Companies and Savings Banks

- ❖ Lending limitations (Sections 658.48, 665.013, 667.003, and 667.010, F.S.)
- ❖ Investment powers and limitations (Sections 658.67, 665.013, and 667.003, F.S.)
- ❖ Directors' oath (Sections 658.33, 667.003, and

667.010, F.S.)

Credit Unions

- Directors, officers, others (Sections 657.021, 657.022, 657.026, 657.0265, 657.027 and 657.028, F.S.)

- Lending limitations (Sections 657.038 and 657.039, F.S.)

- Investment powers and limitations (Section 657.042, F.S.)

- Reserves (Section 657.043, F.S.)

International Banking

- Reporting requirements (Sections 655.045, 663.02, and 663.09, F.S.)

- Lending limitations (Sections 658.48, 663.02, 663.083, 663.302, and 663.314, F.S.)

- Investment powers and limitations (Sections 658.67, 663.02, and 663.315, F.S.)

- Prohibited activities (Section 663.309, F.S.)

Note: The Florida Financial Institutions Codes can be found online at www.flofr.com.

Administrative Rules

- Financial Institutions Generally (Chapter 69-U-100)

- Licensing & Chartering (Chapter 69-U-105)

- State Credit Unions (Chapter 69-U-110)

- Banks, Trust Companies, Savings Bank & Associations (Chapter 69-U-120)

- International Banks (Chapter 69-U-140)

- Savings Associations (Chapter 69-U-150)

Note: Administrative rules for state financial institutions can be found online at www.flofr.com.