BankDirector

Breakout 1:
Bank Director 101: Risk Primer

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#BBTF23

Risky Business – Introduction for Newer Board Members

Presented By: TruStage™ Compliance Solutions

About the Presenter

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Bill Franks has been with TruStage Compliance Solutions since September 2019 and is responsible for ensuring that the content of TruStage Compliance Solutions' lending products comply with federal and state laws and regulations and industry best practices. Before joining TruStage, Bill was assistant in-house counsel with a community bank in West Michigan and prior to that was in private practice for 13 years, representing financial institutions and businesses in the areas of banking and commercial lending, state and federal compliance and licensing, and commercial litigation. Bill graduated with a B.A. in Political Science and Philosophy from the University of Michigan and obtained his J.D. from the University of Wisconsin Law School, *cum laude*, and was elected to the Order of the Coif.

Overview

- Roles, Responsibilities, and Obligations of Bank Board Members
- Categories of Risk
- Director Liability
- Recent Examples

Roles, Responsibilities, and Obligations of Bank Board Members

- Oversee the Affairs of the Bank
- Supervise and Monitor the Bank’s Performance and Operations
- Govern and Guide the Bank’s Business
- Maintain Independence
- Observe Applicable Laws and Regulations
- Ensure that an Effective Risk Governance Program is in Place
- Meet the Community’s Credit Needs
- Safeguard Deposits and Assets

Discharge of Responsibilities and Obligations

- Fiduciary Duties
  - Directors owe fiduciary duties to the Bank in overseeing the Bank's affairs and discharging the Director's obligations.
    - Duty of Care – Exercise ordinary diligence, use reasonable judgment, and honestly oversee the Bank's affairs.
      - This means obtaining sufficient knowledge of material facts and circumstances relating to particular transactions, monitoring performance, gauging risk, planning, and other business decisions.
      - Review and critically examine all information available. Request additional information or reports from Bank officers and employees.
      - Attend and actively participate in board and committee meetings and in the board's overall decision-making process. Ask questions if you don't understand a particular issue.
    - Duty of loyalty and good faith – Discharge your obligations with honesty, integrity, candor, and in the interests of the Bank and its shareholders.
      - Do not act in your own self-interest. Do not obtain personal benefit using information obtained in your role as a director. Actions taken by the director must be independent – based on your own judgment and critical evaluation of the transaction or issue at hand. Do not simply rubber stamp or approve management decisions without evaluating the issue on its merits. All of this should be done free from undue influence from management or other extraneous parties.

Discharge of Responsibilities and Obligations

- Select, Retain, and Evaluate Executive Officers and Management
  - Day-to-day responsibilities are delegated to executive officers
    - As such, the board will want to hire and retain qualified officers and management who can effectively and responsibly manage the Bank and implement and act within the policies and procedures established by the board.
    - This will require critical and independent analysis of the performance of executive officers and key management. Performance and compensation of executive officers and key management should be reviewed at least annually.
    - Criteria to consider in evaluating performance and determining compensation:
      - Bank performance and financials
      - Record of compliance with laws and regulations
      - Audit and examination results and response/resolution to negative findings or comments
      - Compliance with board directives, including policies and procedures developed by the board
      - Quality, accuracy, and timeliness of materials, presentations, reports, recommendations

Discharge of Responsibilities and Obligations

- Oversee the Performance and Affairs of the Bank
  - **Board and Committee Meetings.** Regularly attend and participate in these meetings. Review materials in advance. Request appropriate information for review and consideration by the board/committee.
  - **Establish Clear Written Policies and Procedures.** These policies will likely include:
    - Lending/Loan
    - Investments
    - Asset/Liability Management
    - Conflicts of Interest
    - ALLL
    - IT/Cybersecurity
    - Emergency, Disaster Recovery and Continuity of Operations
    - Environmental, Social, Governance
  - **Understand Bank's Condition.** Understand bank's performance relative to peers. Monitor compliance with policies. Analyze exceptions from board policies and procedures and make sure that such exceptions were warranted.
  - **Audit, Supervisory, Examination Communications.** Review communications, reports, and findings from auditors and regulators. Identify and pay attention to problem areas, negative findings, negative comments, suggestions for improvement. Make sure that identified items and deficiencies are addressed and timely responses are provided.
  - **Independence.** Directors can rely on information, reports, and materials provided by management, employees, or outside parties, but these must be thoroughly examined and considered independently and using the director's reasonable and best judgment. If you disagree with an action, provide your opinion and make sure that your position is reflected in the minutes.

Categories of Risk

- Credit Risk
- Liquidity Risk
- Market Risk
- Operational Risk
- Reputational Risk
- Legal/Compliance Risk

Credit Risk

- Credit risk is the potential that a borrower or counterparty will default or fail to perform on an agreement or obligation.
- Most obvious example is the risk related to loans that are extended by the Bank.
- Having a clear written loan policy approved by the Board can help manage this risk – the policy should discuss matters related to extensions of credit, loan/credit risk review functions, allowance for loan and lease losses (ALLL), workout/troubled loans, and charge-offs.
- Provide objective criteria for evaluating and making credit decisions.
- Where can loans be made (geographically)?
- What are acceptable types of loans and collateral (products)?
- Information on loans to insiders (Regulation O).
- Loan concentrations (by type, to a single borrower or group of borrowers, or industry).
- Loan review criteria, what should be reported to the Board, review of loan policy by the Board.

Liquidity Risk

- Risk related to the Bank's ability to meet its obligations as they come due.
- Some sources of liquidity: (a) attract short and long-term deposits; (b) increase short and long-term borrowings; (c) sell assets (securities, loan portfolios, etc.); or (d) capital (debt or equity).
- Ways to manage liquidity risk: (a) accurately assessing current and future need for funds and making sure that there are sufficient funds to meet those needs; (b) provide an adequate liquidity cushion to meet unexpected changes in the need for funds (like an unforeseen outflow of customer deposits); and (c) finding a balance between the costs of certain sources of liquidity against providing adequate liquidity to account for unforeseen adverse circumstances.
- Liquidity risk can also be due to failure to adjust to changes in market conditions that affect the ability to quickly liquidate an asset with minimal loss.
- Liquidity risk can be tied to exposures from the other risks discussed here (*e.g.*, failure to mitigate credit risk could lead to decrease in cash flow/increase in default related expenses.)
- Importance of matching the nature (short-term or long-term) of cash inflows (investments/assets) vs. outflows.
- Effective oversight by Board and management – making sure that information and reports provided to Board are comprehensive and contains sufficient details to monitor liquidity.
- Develop policies, strategies, and procedures for management and mitigation of liquidity risks.
- Measurement and monitoring systems. Internal controls and internal audit process to determine liquidity and liquidity management process.

Market Risk

- Risk to Bank's conditions from movements in market prices, such as interest rate, commodity prices, equity prices, or exchange rates.
- Interest rate risk is likely the recognizable market related risk.
- Repricing risk is related to the Bank's assets and liabilities being repriced at different times for different amounts.
- Other types of interest rate risk: yield curve risk; basis risk; options risk; or price risk.
- Board should establish and review interest rate risk policies, procedures, and risk tolerances. Understand and be appropriately informed of the Bank's interest rate risk exposure, how new initiatives/products could be impacted by interest rate risk, and the adequacy of the Bank's current risk management measuring, monitoring, and reporting system.
- Establish internal controls which include an independent review or audit.
- Cryptocurrencies and similar emerging technologies.

Operational Risk

- Risk related to internal operational processes, procedures, systems, or people failing or being inadequate.
- Touches on pretty much every aspect of banking: employees, controls, processes, IT, vendor management, facilities, security, and compliance with policies, procedures, processes, and systems that have been put into place.
- Many emerging risks would fall into this category – the role and use of Artificial Intelligence, cybersecurity, social media/marketing, environmental risks, and risks related to social issues.
- Operational risk may depend on the sufficiency of items already discussed – quality of management/employees; implementation and enforcement of clear, written policies, procedures, and controls; obtaining timely and accurate information from management; actively engaging and participating in board and committee meetings; and asking questions, raising issues, or voting/dissenting on issues based on independent analysis and judgment.

Reputational Risk

- Risk of negative publicity relating to the Bank's business practices, employees, clients, or operations, which could cause significantly impact customer/client engagement, incoming revenue, or increased expenses (legal/litigation or marketing)
- Reputational risk could be related to nearly any other aspect of risk discussed.
- Examples: (a) poor customer service – with social media and review sites, word can spread quickly; (b) operational deficiencies – cyberattacks, security breaches, employee wrongdoing and malfeasance (*e.g.*, opening unsolicited accounts, embezzlement, or fraud); (c) credit/lending policies – failing to service the community's credit needs, actual or perceived discrimination, unsound underwriting leading to high number of defaults and foreclosures/enforcement actions, CRA results; (d) social issues – failing to take a stance on the social issue of the day or taking a perceived unpopular stance.
- Effectively managing other risks and issues discussed could help manage and minimize reputational risks.

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Legal/Compliance Risk

- Legal Risks relate to possible lawsuits, claims, damages, sanctions, or adverse judgments against the Bank that could negatively affect or interrupt the operations or financial condition of the Bank.
- Compliance Risks are risks of sanctions, fines, penalties, enforcement actions, or other losses relating to the Bank's failure to comply with applicable laws, regulations, rules, supervisory requirements, or directives from supervisory institutions.
- Regulations of note for new Directors:
  - Regulation O – Limitations on loans to insiders, including directors.
    - Combine credit extended to insiders with immediate family and businesses affiliated with insider.
    - Limit on loans to a single insider and an aggregate limit on loans to all insiders.
    - Payment of overdrafts may be prohibited, unless a part of an extension of credit with interest.
    - Insider's endorsement or guaranty may be considered extension of credit.
  - Bank Secrecy Act/Anti-Money Laundering – Know your customer; Large currency transactions and suspicious activity reports – making sure that Bank's are not used for laundering or hiding illicit funds.
    - Must have written BSA/AML compliance program, must be approved by Board.
    - Customer Identification Program – identifying/know your customer.
    - Suspicious Activity Reports – report transactions inconsistent with customer or no identifiable business purpose; SARs filed for marijuana related businesses; Board must be notified of SARs.
    - Customer due diligence program – get information necessary to serve customers and identify suspicious activities.

Legal/Compliance Risk

- Regulation P – Privacy notice.
  - Notify customers of its policy on sharing customer information.
  - Opportunity to "opt out" when information is shared with non-affiliated third parties.
- Equal Credit Opportunity (ECOA) – Prohibition from discriminating against applicants on prohibited basis.
  - Policies in place to prohibit discrimination.
  - Notice of action taken sent to applicants in certain circumstances.
  - HMDA reporting
  - New 1071 Small Business information and demographic reporting
- Regulation H – Flood Insurance.
  - Cannot make, increase, renew, or extend loan on improved property located in special flood hazard area unless required flood insurance is obtained for entire term of the loan.
  - Borrower/property owner must be informed if loan is secured by special flood hazard area.
  - Failure to comply my lead to civil money penalties and enforcement action.
- Truth In Lending – Uniform disclosure of certain credit terms.
  - Disclosure of loan costs (APR, finance charges, etc.).
  - Inaccurate disclosure of required terms can result in civil liability and/or reimbursements to customers.
- Real Estate Settlement Procedures – Certain disclosures and info to be provided on 1-4 family residential property loans
  - Good faith estimates of loan closing costs and other information

Director Liability

- Violation of Laws or Regulations
- Breach of Fiduciary Duties
  - Negligence (reasonably prudent person standard) to gross negligence (recklessness/wild indifference)
  - Examples of findings of negligence:
    - Failure to maintain reasonable supervision over Bank and its affairs.
    - Failure to hold meetings as required by bylaws, obtaining info re financial condition of Bank, or examination of books and records of Bank.
    - Failure to heed warnings of mismanagement or wrongdoing by officers or employees and take appropriate action.
    - Failing to adopt generally expected policies or procedures.
    - Ceding control of Bank to officers/employees without appropriate supervision.
    - Assenting to loans exceeding applicable statutory limitations.
    - Misrepresentations in a Report of Condition.
- Acts in excess of powers
- Fraud
- Conversion of assets
- Banks and directors can obtain some liability protection: (a) indemnification agreements; and/or (b) director and officer (D&O) liability insurance

Recent Example - SVB

- April 2023 – Federal Reserve Board issued a 118-page Report of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank ("Report").
- The Report identified that SVB "failed because of a textbook case of mismanagement by the bank. . . . Its board of directors failed to oversee senior leadership and hold them accountable."
- SVB tripled in size from 2019 and 2021, based primarily on deposit inflows during rapid venture capital and technology sector growth. SVB customer base was concentrated in VC-backed tech and life science companies. Uninsured deposits were invested in longer-term securities.
- SVB's failure "can be linked directly to its governance, liquidity, and interest rate risk-management deficiencies."
- Governance issues - Board focused on short-run profits at the expense of effective risk management. Comp packages of management were tied to short-term earnings and equity returns without regard to risk-management and metrics. Management did not provide the Board with adequate information about these risks and did not subsequently hold management accountable.
- Liquidity - SVB failed its own internal liquidity stress tests. Less conservative stress test assumptions were used to potentially mask some liquidity risks. SVB relied on uninsured deposit base, but when depositor faith was lost, SVB was not able to meet the requests for withdrawal, "in part because of the maturity transformation inherent in its business activities." SVB's did not adequately prepare to access contingent funding sources and was not able to stave off the deposit withdrawals ($40B in one day).
- Interest rate/market – Interest rate risk policy lacked specifics on scenarios to run, assumptions, how to conduct a sensitivity analysis or model back-testing requirements. SVB had a mismatch between the repricing of liabilities and assets. SVB based its position on protecting net interest income against falling rates but not rising ones. SVB removed hedges protecting against interest rate increases in order to protect profitability. "Importantly, there was no evidence that management made the full board aware that [SVB] . . . was breaching limits for years."

Helpful Resources

Helpful Companion Resources:

- Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank: https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf; https://www.federalreserve.gov/publications/2023-April-SVB-Evolution-of-Silicon-Valley-Bank.htm
- FDIC Commercial Bank Examination Manual: https://www.federalreserve.gov/publications/files/cbem.pdf
- OCC Director's Book: Role of Directors: https://www.occ.gov/publications-and-resources/publications/banker-education/files/pub-directors-book.pdf
- OCC Director's Reference Guide to Board Reports and Information: https://www.occ.gov/publications-and-resources/publications/banker-education/files/pub-directors-reference-guide.pdf
- FDIC Pocket Guide for Directors: https://www.fdic.gov/regulations/resources/director/pocket/index.html
- Federal Reserve Bank of Kansas City: Basics for Bank Directors: https://www.kansascityfed.org/Banking/documents/9393/BFBD20.pdf

Thank you.

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