Who's Minding the Bank?

GOVERNANCE PRACTICES AT TENTH DISTRICT INSTITUTIONS

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Probably at no other time in recent history has there been so much attention paid to how companies run their businesses. Well-publicized abuses at publicly traded corporations have prompted lawmakers to craft legislation to improve corporate accountability.

What about accountability at banks? One need not look hard to find instances of banks brought down by corporate malfeasance—often the result of poor management or a lack of internal controls. The results can be disastrous: In 2002, the chief executive of an Oakwood, Ohio, bank confessed to embezzling more than $40 million, rendering the institution insolvent. He later told regulators that he had received online orders for certificates of deposit sold on the bank website and had diverted the funds to gambling operations he partly owned.

"A combination of poor internal controls and a lax board opened the door for this individual," said Esther George, senior vice president in charge of banking supervision at the Federal Reserve Bank of Kansas City.

"That is why we're always interested in governance at banks and open to ways to improve it," George said.

Like other corporations, banks must comply with newly mandated governance requirements if their stocks are publicly traded or if they are subject to certain provisions of banking law. However, only about 13 percent of U.S. bank holding companies fall into those categories.

Even banks that are not compelled by law to change their governance practices may want to review their processes to ensure a profitable and safe operation, as well as to avoid litigation. Earlier this year, shareholders of Allfirst Financial Inc. filed a civil suit, contending that higher-ups of the Baltimore bank should have known about fraud conducted by a currency trader.

Federal banking agencies such as the Federal Deposit Insurance Corporation, Comptroller of the Currency, and the Federal Reserve System, as well as state banking authorities are concerned with such issues as capital adequacy, market risk management, and internal audit and its outsourcing. They also see good governance as the foundation for a soundly run bank.

"Bank supervisors have always recognized good governance as an important determinant of bank safety and soundness, and our examiners review governance practices at banks and bank holding companies we supervise," George said.

"More generally, policy guidance issued by the federal banking agencies stresses the role of the board of directors and senior management, two important factors in the governance process, in addressing the supervisory matters covered in the guidance. It doesn't matter if the bank is publicly traded, large, or small; governance practices enter into our management assessment."

Smaller institutions are the norm for Tenth District banks. The median-size bank at year-end 2003 had total assets of $61 million. Many of these banks are closely held, family-owned, and owner-managed. Their governance structure tends to be less formal and less structured than that at larger, publicly traded institutions.

"That doesn't mean that governance is any less important," George said. "It couldn't be any further from the truth. Over the years, we've seen cases where poor governance contributed to bank failure and cost the FDIC insurance fund millions of dollars."

Indeed, the Oakwood bank, small by most standards with assets of $73 million, has cost the FDIC's insurance fund $64.8 million at last accounting.

Finding out about governance practices was largely why the Reserve Bank's bank supervision area surveyed Tenth District community banks—banks with total assets under $1 billion. A seven-part survey asked bankers for their views on many matters, including governance at their banks. The Federal Reserve Bank of Kansas City has published bankers' responses and a summary article on governance practices at Tenth District community banks at http://www.kansascityfed.org/Publicat/FIP/Fipmain.htm#2004.

"I think people will find the survey results interesting," George said. "Little is known about governance practices at community banks outside the supervisory community. The information we've gathered gives an insider's look at how community banks organize themselves to run their business."

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Checks and balances

Most people associate governance with a corporation's board of directors. Governance, however, includes many participants internal and external to a corporation, each with a role in the governance process. Certainly, the board, as overseer and protector of stakeholder interests, is an important internal player. However, other important players include senior management, which has responsibility for running the business on a daily basis, and shareholders who are owners of the business and on whose behalf it is run. A less frequently mentioned player is internal audit, responsible for ensuring that the business is run in keeping with management dictates and reports information accurately.

Beyond these internal players, there is a wide array of governance players outside the corporation. Included among the external actors are government and regulatory agencies, auditing firms, securities exchanges, rating agencies, stock analysts, and others. In general, these players establish the legal framework in which the corporation operates, police compliance with this framework, independently evaluate and offer opinions on the corporation's financial reporting, and monitor and analyze financial performance.

Together, the governance players form a system of checks and balances. Among this system's many purposes is to protect the interests of stakeholders in the corporation, including shareholders, employees, and customers. For banks, an important stakeholder is the FDIC and its deposit insurance fund. The FDIC wants to ensure that banks, whose depositors it protects, don't expose the insurance fund to excessive risk.

Certain basic assumptions are implicit in the governance process. Among these are that participants act independently of one another, that they act ethically, that they have the necessary skills to perform their duties, and that they are active in meeting their responsibilities.

"Many times these assumptions aren't met,"

Governance Scorecard—Tenth District Banks

SOURCE: *Survey of Community Banks in the Tenth Federal Reserve District*, Federal Reserve Bank of Kansas City, February 2004

GOVERNANCE PRACTICE	ASSETS UNDER $150 MILLION		ASSETS OVER $150 MILLION	
	FAMILY-OWNED	NON-FAMILY OWNED	FAMILY-OWNED	NON-FAMILY OWNED
Moderate board size with frequent enough board meetings to conduct bank's business	VERY GOOD	VERY GOOD	VERY GOOD	VERY GOOD
Board make-up—majority of board made up of outside directors	FAIR	GOOD	FAIR	VERY GOOD
Built board skill set by stressing business expertise as a major director recruiting factor	POOR	FAIR	POOR	FAIR
Board/committee structure included audit, compensation, and nominating committees made up of outside directors	FAIR	GOOD	GOOD	VERY GOOD
Outside directors* make up majority of audit committee to separate management from assessment of management	FAIR	GOOD	FAIR	VERY GOOD
CEO/outside directors* had ownership in the bank to better align their interests with shareholders	FAIR/POOR	POOR/POOR	FAIR/POOR	POOR/POOR
The bank had a written succession plan to ensure orderly management transition	FAIR	FAIR	FAIR	POOR
The bank adopted a written code of ethics to guide director, officer, and employee behavior	FAIR	FAIR	GOOD	GOOD
The bank performed director assessments to judge the contribution of board members and to identify needed additions to the board	FAIR	POOR	FAIR	FAIR
Directors attended training to increase banking knowledge and strengthen oversight skills	FAIR	GOOD	GOOD	GOOD

* Outside directors are directors who do not also serve as officers or management officials of the bank or own more than five percent of its stock

George said. “Our examiners find instances where a chief executive officer dominates the affairs of a bank or board members are so closely tied to the CEO that there is no meaningful board oversight. It is a one-man show.”

Some boards are ineffective for other reasons, noted George.

“A Federal Reserve staff member attended a meeting with senior FDIC and state banking department officials where the board was told the bank would fail without a capital injection,” she said. “One of the bank’s directors fell asleep during this important meeting, making us wonder about how active this director was in the bank’s oversight.”

Poor management has figured prominently in the fate of failed banks. In an accounting by the FDIC, only one bank since 1997 failed due to economic conditions. Poor management was blamed in 95 percent of cases.

“Where poor management is present, lack of internal controls and fraud have often followed,” George said.

The accounting by FDIC bears this out: Of 28 cases where fraud has been alleged at failed banks, poor management has been blamed in all cases but one.

Over the years, pension funds, consultants, academics, and others have pushed for measures they consider important in achieving effective corporate governance. The aim of many of their proposals is to enforce the basic assumptions behind the governance process.

So what is the state of governance at Tenth District banks? Have Tenth District community banks seen value in what experts propose? Even when they are not required to do so, have they adopted any strong governance recommendations?

Survey results

The 2004 Survey of Community Banks in the Tenth Federal Reserve District attempted to answer these questions by providing a glimpse of governance practices at these institutions. Governance topics addressed in the survey focused on those often stressed by proponents of good governance. The survey asked about board size, composition, committee structure, and meeting frequency. It asked about outside director leadership; director compensation, assessments, and education; management succession planning; and a host of other governance matters.

To help discern patterns in governance, the survey data were segmented into four groups based on ownership and bank asset size. Family-owned banks were separated from non-family-owned banks. Within these ownership groups, banks were divided between small banks, those with assets less than $150 million, and large banks, those with assets greater than $150 million. Summary data for the four bank groups were used to create a scorecard or profile of governance practices at each. The scores assigned were “poor,” “fair,” “good,” or “very good” based on the proportion of banks within each group engaging in a particular practice (See the scorecard on page 24).

In general, the scorecard shows that Tenth District community banks engage in many practices advocated by strong governance proponents. Further, it shows that larger organizations

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Governance Improvements

Developing formal strategic plans and management succession plans

This includes involving the board of directors in strategic planning for the bank. It also includes developing a written management succession plan for the bank and periodically reviewing that plan for its appropriateness. Any succession plan developed should include establishing a process for finding replacement management in an emergency, identifying the experience and traits the board wants in a successor, and ensuring that needed experience and traits are developed within the bank's management team.

Performing self-assessments of board performance and member contributions

The contributions of individual board members, the board as a whole, and board committees to the bank's oversight should be evaluated at least annually. The evaluation should be used to judge board effectiveness and to determine if additional experience or skills are needed. A sample assessment form that can serve as a starting point for a bank's own assessment form is at http://www.kansascityfed.org/bs&s/confer/2004RegUpdate/SampleDirectorSelfAssessment.doc.

Adopting a formal ethics policy and/or codes of conduct

The bank should develop a "no-nonsense" code of ethics and ensure employees are trained on the board's expectations regarding adherence to the code. After that, the board should enforce the code rigidly from its own members and the CEO down to the lowest level employee.

Providing formal training for the directorate

The bank should provide its directors with formal training to help improve oversight. If directors aren't knowledgeable on banking matters, the effectiveness of the board is diminished and the contribution of the board to bank management is lessened. Today, there are a good number of low-cost training programs for directors available from trade associations, banking supervisors, and others. One such resource is Insights for Bank Directors, a free online director training program available at www.stlouisfed.org/col/director. This course provides information that directors, particularly outside directors, will find useful in evaluating their banks' condition and financial performance and aid their understanding of controlling and monitoring credit, liquidity, and market risks, basic portfolio risks that all banks face.

Establishing an audit committee and/or audit-like function in the bank

The bank should consider establishing an audit committee and specifying its responsibilities in a charter. Even if the bank is too small to have a full-time internal auditor, it should designate an employee to be responsible for reviewing internal controls throughout the bank. This person should report to the audit committee, not the president, cashier, or CFO. If financial statements aren't audited, the bank may want consider a periodic review of internal controls by a qualified, independent expert.

are more likely to have adopted recommended governance principles than smaller banks. Finally, non-family-owned organizations, regardless of size, proportionately engage in more of the recommended practices than do family-owned organizations.

"The results from the survey on community bank governance practices are for the most part positive," George said. "One important 'take-away' from the survey is the key role family ownership plays in the governance process. The governance structure at family-owned banks tends to be less formal. Although survey information doesn't tell us why this is so, anecdotal information from examiners and studies done by others indicate that many important management decisions in family-owned businesses—such as who will serve as CEO or who will serve on the board—are made at the family level rather than the corporate level."

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Despite the positive governance report card for Tenth District community banks, there is room for improvement.

"Many of the governance suggestions we would make cost little to implement and can yield a much stronger governance process," George said. "In some instances, they can prevent a tragic event like the unexpected loss of a key employee causing costly harm to a bank, help create a positive environment in which a bank's internal controls operate, or provide directors with the skills necessary to make meaningful contributions to a bank's management."

Towards higher marks

Good governance is key to a strong management process. Where management processes are strong, banking problems are kept to a minimum, and, when problems do occur, they are caught quickly and corrected before they become costly to fix.

Overall, the governance report card for Tenth District community banks gives them high marks, with many banks adopting practices suggested by proponents of strong governance. With respect to groups of banks, larger and non-family-owned banks tend to do better in adopting these practices than do smaller and family-owned banks.

Despite this positive report card, Tenth District banks can take a few low-cost actions to strengthen their governance. These include developing formal strategic and management succession plans, periodically assessing board and individual director performance, adopting and enforcing a formal code of ethics, providing the directorate with training to enhance banking knowledge, and instituting some form of audit program for evaluating internal controls. These low-cost additions will strengthen an already strong governance and help contribute to a stronger management process.

The Oakwood bank failure has been a painful and costly lesson in what can happen when poor management is not checked. In that case, the surrounding community paid dearly and many were left questioning the trust they had placed in the institution. One bank shareholder summed it up well: "I feel somebody should have known."

That is what good governance is all about. T

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.