INTRODUCTION....2
MANAGEMENT/DIRECTORS....2
Selection and Qualifications of Directors....2
Powers, Duties and Responsibilities of Directors....3
Governing the Manner in Which All Business of the Bank is Conducted....3
Strategic Planning....3
Selecting and Retaining Competent Management....4
Personnel Administration....4
Observance of Applicable Laws....4
Avoiding Self-Serving Practices....5
Paying Dividends....5
Appropriate Internal Control System and Adequate Auditing Program....5
Management Information System (MIS)....5
Supervision by Directors....5
Legal Liabilities of Directors....6
FEDERAL BANKING LAWS AND REGULATIONS PRIMARILY PERTAINING TO BANK DIRECTORS....7
Section 18(k) of the Federal Deposit Insurance Act (FDI Act) - Authority to Regulate or Prohibit Certain Forms of Benefits to Institution Affiliated Parties....7
Part 359 of the FDIC Rules and Regulations - Golden Parachutes and Indemnification Payments....7
Section 39(c) of the FDI Act - Compensation Standards....7
Section 32 of the FDI Act - Agency Disapproval of Directors and Senior Executive Officers of Insured Depository Institutions or Depository Institution Holding Companies....8
Section 19 of the FDI Act - Penalty for Unauthorized Participation by Convicted Individual....8
Section 22(g) and 22(h) of the Federal Reserve Act - Loans to Executive Officers of Banks and Extensions of Credit to Executive Officers, Directors and Principal Shareholders of Member Banks....8
The Federal Reserve Board's Regulation O – Loans to Executive Officers, Directors and Principal Shareholders of Member Banks....8
Section 337.3 of the FDIC Rules and Regulations – Limits on Extensions of Credit to Executive Officers, Directors and Principal Shareholders of Insured Nonmember Banks....8
Part 348 of the FDIC Rules and Regulations - Management Official Interlocks....9
Section 7(j) of the FDI Act and the Change in Bank Control Act of 1978....9
Section 737 of the Gramm-Leach-Bliley Act – Bank Officers and Directors as Officers and Directors of Public Utilities....9
Section 8 of the FDI Act....9
OTHER ISSUES....9
Indebtedness of Directors, Officers and Their Interests....9
Conflicts of Interest....10
Nonbanking Activities Conducted on....11
Directors of Banks with Dominant Management Officials....11
Report of Examination (ROE) Treatment....13
Advisory Directors....13
Restrictions on Golden Parachute Payments and Indemnification Payments....14
Golden Parachute Payments....14
Indemnification Payments....14
Issues....14
Excessive Compensation....15
Gaining Access to Bank Records and Employees....16
Bank Owned Life Insurance (BOLI)....16
MODEL RISK MANAGMENT....16
Overview....16
Model Development, Implementation, and Use....17
Model Validation....17
Governance, Policies, and Controls....17
Examination Review....17
EVALUATION OF MANAGEMENT....18
RATING THE MANAGEMENT FACTOR....19
Uniform Financial Institutions Rating System....19
Ratings....19

the regulation when aggregated with the amount of all other extensions of credit or lines of credit to that person. This approval must be granted by a majority of the bank's directors and the interested part(y)(ies) must abstain from participating directly or indirectly in the voting.

Any FDIC-supervised institution that violates—or any officer, director, employee, agent or other person participating in the conduct of the affairs of a FDIC-supervised institution— who violates any provision of Section 22(g) or 22(h) of the Federal Reserve Act may be subject to a CMP. In determining the amount of the penalty, the FDIC takes into account the financial resources and good faith of the bank or person charged, gravity of the violation, history if any of previous violations, and such other matters as justice may require. Examiners are reminded violations of Regulation O must be evaluated in accordance with the 13 factors specified in the Interagency Policy Regarding the Assessment of Civil Money Penalties by the Federal Financial Institutions Regulatory Agencies.

Part 348 of the FDIC Rules and Regulations - Management Official Interlocks

The Depository Institution Management Interlocks Act (DIMIA) is codified at 12 U.S.C. 3201 *et seq.* and its general purpose is to foster competition. The DIMIA prohibits a management official of one depository institution or depository holding company from also serving in a similar function in another depository institution or depository holding company if the two organizations are not affiliated and are located in the same area or if the two organizations are not affiliated and are very large, as defined in the regulation.

A number of exceptions allowing interlocking relationships for certain organizations and their affiliates are detailed in Part 348 of the FDIC Rules and Regulations. In addition, Section 303.249 of the FDIC Rules and Regulations provides a procedure to seek the approval of the FDIC to establish a management interlock. Under Section 8(e) of the FDI Act, the FDIC may serve written notice of intention to remove a director or officer from office whenever, in its opinion, such director or officer of an insured bank has violated the management interlock regulation.

Section 7(j) of the FDI Act and the Change in Bank Control Act of 1978

Section 7(j) of the FDI Act prohibits any person, acting directly or indirectly or through or in concert with one or more other persons, from acquiring control of any insured depository institution through a purchase, assignment, transfer, pledge, or other disposition of voting stock of the insured bank unless the appropriate Federal banking agency has been given 60-days prior written notice of the proposed acquisition. An acquisition may be made prior to the expiration of the disapproval period if the agency issues written notice of its intent not to disapprove the action. The term "insured depository institution" includes any bank holding company or any other company which has control of any insured bank. The term "control" is defined as the power, directly or indirectly, to direct the management or policies of an insured bank or to vote 25% or more of any class of voting securities of an insured bank. Willful violations of this statute are subject to civil money penalties of up to $1 million per day. This statute gives the FDIC important supervisory powers to prevent or minimize the adverse consequences that almost invariably occur when incompetent or dishonest individuals obtain positions of authority and influence in banks.

Section 737 of the Gramm-Leach-Bliley Act – Bank Officers and Directors as Officers and Directors of Public Utilities

This section of the Gramm-Leach-Bliley Act amends the Federal Power Act to preclude persons from serving both as an officer or director of a public utility and a bank except in certain circumstances. Dual service is permissible when the individual does not participate in any deliberations involved in choosing a bank to underwrite or market the securities of the utility, when the bank is chosen by competitive procedures, or when the issuance of securities by the public utility have been approved by all appropriate regulatory agencies.

Section 8 of the FDI Act

Among other things, Section 8 of the FDI Act provides the Federal banking agencies with the authority to take action to remove from office or prohibit an IAP from any further participation in the conduct of the affairs of any depository institution. Specifically, Section 8(e) and Section 8(g) are utilized in such proceedings. Actions taken under this authority represent serious charges with significant potential consequences. Therefore, outstanding guidelines should be closely followed during the examination process. For additional guidance, refer to Section 8 the FDI Act and the Formal Administrative Actions section of this Manual.

←

OTHER ISSUES

Indebtedness of Directors, Officers and Their Interests

The position of director or officer gives no license to special credit advantages or increased borrowing privileges. Loans

to directors, officers and their interests must be made on substantially the same terms as those prevailing at the time for comparable transactions with regular bank customers. Therefore, management loans should be evaluated on their own merits. Their business operations will, in many instances, necessitate bank loans, and these ordinarily will be among a bank's better assets. Since directors usually maintain a deposit relationship with their bank, this carries with it an obligation to meet their reasonable and prudent credit requirements.

On the other hand, there have been many instances where improper loans to officers, directors, and their interests resulted in serious losses. Unfortunately, when the soundness of a management loan becomes questionable, an embarrassing situation usually results. That is, management loans frequently may not be subject to the same frank discussion accorded other loans. Bank directors may assent to such loans, despite knowledge that they are unwarranted, rather than oppose a personal or business friend or associate. Moreover, directors who serve on the board in order to increase their opportunities for obtaining bank credit are reluctant to object to credit extensions to their colleagues. Problems that occur with management loans have received considerable legislative attention and laws have been passed to curb abuses associated with the position of director or officer (*e.g.*, Sections 22(g) and (h) of the Federal Reserve Act). However, while steps have been taken to reduce the potential for problems in this area, a review of the board's policies and actual practices regarding insider loans remains an important part of the examination process.

Conflicts of Interest

Examiners should be especially alert to any insider involvement in real estate projects, loans or other business activities that pose or could pose a conflict of interest with a director's fiduciary duties of care and loyalty to the bank. On occasion, loans are advanced to business associates involved in apparently unrelated projects where an insider nevertheless benefits. The involvement of bank insiders in these projects is sometimes not apparent because ownership is held in the form of "business trusts" or other entities without disclosure of the identity or personal guarantees of the principals. In order to help uncover these types of situations, examiners should routinely inquire of senior management, through incorporation in the "first day" letter or request, whether any of the following situations exist:

- Loans or other transactions existing at the bank in which an officer, director or principal stockholder (or immediate family member of each) of the bank holds a beneficial interest.
- Loans or other transactions in which an officer, director or principal stockholder (or immediate family member of each) of another depository institution holds a beneficial interest.
- Loans or other transactions at any other depository institution in which a bank officer, director, or principal stockholder (or immediate family member of each) holds a beneficial interest, either direct or indirect.
- Loans or other transactions in which an officer, director or principal stockholder (or immediate family member of each) has no direct interest but which involve parties with whom an insider has other partnership or business associations.
- Loans extended personally by officers, directors or principal stockholders (or immediate family member of each) to parties who are also borrowers from the bank or loans extended personally by any borrowing customers to an officer, director or principal stockholder of the bank.

If any of this information is not readily available and of reasonably recent compilation, management should be requested to survey their officers, directors and principal stockholders, as necessary, to obtain it.

Examiners are also reminded to inquire into bank policies and procedures designed to bring conflicts of interest to the attention of the board of directors when they are asked to approve loans or other transactions in which an officer, director, or principal stockholder may be involved. Where such policies and procedures are lacking or insufficient to reveal insider involvement before action is taken by the board, examiners should strongly encourage the board to remedy the deficiency. The board should also be encouraged to act specifically on any loan or other transaction in which insiders or their associates may be involved, either directly or indirectly, or because of business associations outside the loan or transaction in question. Moreover, examiners should determine whether the results of board deliberations on any matter involving a potential conflict of interest are noted clearly in the minutes.

Examiners are also reminded to carefully scrutinize any loan or other transaction in which an officer, director or principal stockholder is involved. Such loans or other transactions should be sound in every respect and be in full compliance with applicable laws and regulations and the bank's own policies. Any deficiencies in credit quality or other aspects of the transaction should receive critical comment not only from an asset quality perspective but from a management perspective as well. More specifically, if a director has a personal financial interest in a loan or other transaction subject to adverse classification, the board should be urged to require that director to strengthen the credit sufficiently to remove the adverse classification within a reasonable time frame or resign from the board. In the event a principal stockholder or an officer who is not a

director is involved in an adversely classified loan or other transaction, the board should be urged to assume special oversight over the loan or activity, either directly or through a committee of outside directors, with a view towards limiting any further exposure and moving aggressively to secure or collect any exposed balances as the circumstances may permit. These types of situations not only tend to compromise the credit standards of the lending institution and increase the risk of eventual losses, but that they can also lead to violations of civil and criminal laws.

Nonbanking Activities Conducted on Bank Premises

Many banks conduct nonbanking activities on bank premises by selling insurance (*e.g.*, credit, life, accident, and health) in conjunction with loan transactions of the bank. When these nontraditional banking activities take the form of establishment of a new department or subsidiary of the bank, the benefit and profit is directly realized by the bank and its shareholders. However, when these activities are conducted on bank premises for the benefit of others, a bank may be deprived of corporate opportunity and profit. The FDIC has long taken the position that when nonbanking activities are conducted on bank premises either by bank personnel or others and when the benefit and profit do not flow directly to the bank, certain disclosures, approvals, and reimbursements must be made.

In all cases, it is important for the bank's directors and shareholders to be fully informed regarding the nonbanking activity conducted on bank premises. The operation is typically be approved by the bank's shareholders, and expenses incurred by the bank in connection with these operations formally approved by the board of directors annually. A well run bank ensures that it is adequately compensated for any expenses it incurs in furnishing personnel, equipment, space, etc. to this activity. It is recommended that bank management disclose completely to its bonding company any such nonbanking activity conducted on its premises. Management would also be well advised to obtain acknowledgement from the bonding company that such activities do not impair coverage under the fidelity bond. Finally, the conduct of nonbanking activity must be in conformance with applicable State statutes and regulations. For additional discussion, refer to the Interagency Statement on Retail Sales of Nondeposit Investment Products.[2]

Situations where the bank is being deprived of corporate opportunity through the diversion of opportunity or profit, or inadequately compensated for the utilization of its resources should be discussed with bank management and commented upon in the Risk Management Assessment and the Examination Conclusions and Comments pages, if appropriate. Additionally, the absence of disclosure and approval to the bank's directors, shareholders, and bonding company should be discussed with management and covered in the aforementioned schedule(s). Finally, in those instances where the examiner believes, based on known facts, that a violation of applicable statutes or regulations has occurred, or where there is material or substantial evidence that a criminal violation has been committed, the matter should be handled in accordance with guidelines prescribed in other sections of this Manual.

Directors of Banks with Dominant Management Officials

Examiners should carefully consider the risks associated with institutions controlled by an official that has material influence over virtually all decisions involving the bank's policies and operations. A dominant official can be an individual, family, shareholder, or group of persons with close business dealings or otherwise acting together regardless of whether the individual or any other members of the family or group have an executive officer title or receive compensation from the institution.

The definition of dominant official, as provided in this section, is not intended to capture individuals who merely occupy multiple positions, particularly in small institutions, if they do not also exert material influence over virtually all decisions involving the bank's policies and operations. Nevertheless, in such situations additional transaction testing to confirm the adequacy of segregation of duties and internal controls may be necessary.

Examiners should not automatically view the presence of a dominant official negatively or as a supervisory concern. For example, in a small bank with limited staff, a dominant official may emerge because no one else at the bank has the skills or experience to operate the bank. The presence of a dominant official does however present two potential challenges for boards of directors: incapacitation or loss of the dominant official and difficulties in resolving mismanagement, should it occur.

Incapacitation or loss of the dominant official may deprive the bank of competent management presenting key person risk. Key person risk results when an institution is dependent upon a single, yet highly qualified official that is core to the operation of the institution. For example, the loss or incapacitation of the key person may deprive the

[2] See Interagency Statement on Retail Sales of Nondeposit Investment Products (Feb. 15, 1994) and Joint Interpretations of The Interagency Statement on Retail Sales of Nondeposit Investment Products (Sep, 12, 1995).

not limited to, a review of the audit committee minutes or a review of auditor notifications;[3]

- An adequate written code of conduct, ethics, and conflict of interest policies have been established;
- A need exists for the bank's board to perform and report on an annual conflicts of interest and ethics review;
- A need exists for a bank to engage outside consultants to conduct an external loan review; and
- A proper segregation of the internal loan review process is established.

Report of Examination (ROE) Treatment

If a dominant official is identified during an examination, examiners should describe related risks in the ROE. ROE comments should identify the dominant official, describe the official's material influence and effect on the bank, describe the level of board independence and oversight, and describe the effectiveness of any mitigating controls. If no concerns are identified, the comments should be included in the Confidential-Supervisory Section. If concerns attributed to a dominant official are identified, supervisory recommendations should be scheduled on the Examination Conclusions and Comments or Risk Management Assessment pages, as appropriate, according to ROE instructions. Concerns attributed to a dominant official, including non-compatible duties, pursuit of high-risk business strategies, ineffective board oversight, or lack of other adequate mitigating controls should be raised on the Matters Requiring Board Attention (MRBA) report page. Supervisory recommendations, including those raised on the MRBA page, should specify clear corrective actions that mitigate risk. Additionally, when a dominant official is identified, the Dominant Officer/Policymaker line item of the Summary Analysis of the Examination Report (SAER) should be answered "Yes."

Examiners should consider how identified dominant official related weaknesses might affect the institution when assigning component and composite ratings. Concerns or deficiencies should not be excluded from the ROE or disregarded when assigning ratings simply because the bank's current financial condition is satisfactory or does not reflect deterioration. Forward-looking supervisory practices require that examiners consider how current practices may affect the future condition of the bank. Additionally, the extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority must be considered when assigning the Management rating. And finally, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution.

Enhanced supervision to address supervisory concerns related to dominant management or ownership include recommending director education to assist board members in performing their fiduciary responsibilities and engaging outside directors during the examination and other supervisory processes. Directors' fiduciary duties, include changing management composition, or seeking change in board composition, if a dominant official's influence hinders a director's oversight, independence, or influence.

When warranted, supervisory concerns should be addressed with informal or formal corrective programs. When concerns are particularly elevated or prior supervisory actions do not effect timely corrective actions, consideration should be given, after consultation with the Regional Office, to recommending changes to board composition or management to reduce a dominant official's impact on material decisions. Enforcement action provisions should be tailored to, and specifically address, the risks identified by specifying what actions the institution should take to mitigate the risk. For instance, a provision requiring the board to obtain a management study should also require the study to provide recommendations for specific actions that the institution should take to implement appropriate controls to mitigate the risk associated with the dominant official. Case managers should also record and retain information regarding the basis for key supervisory decisions and actions in a memo to the file, including instances where supervisory actions are considered or recommended but not ultimately taken.

Application review and processing should include an assessment of whether a dominant influence is present, mitigating factors are adequate, and related prior supervisory actions have been effective. If mitigating factors are not adequate or related supervisory actions did not have the intended effect, case managers should reflect that in the Summary of Investigation and consider whether changes to the application or appropriate conditions should be sought prior to approving an application.

Advisory Directors

Some banks establish a position of honorary director (or similar title) for various reasons for persons who do not want to relinquish their position but are no longer able to effectively fulfill the demanding duties of director, such as due to illness. Generally, the honorary director attends board meetings as desired and offers advice on a limited

[3] If the bank recently changed external auditors, examiners should assess the board and audit committee's rationale and review committee minutes and "change-in-auditor" notifications for possible opinion shopping and any other safety and soundness issues.

participation basis, but has no formal voice or vote in proceedings, nor the responsibilities or liabilities of the office, except where there may be a continuing connection with a previous breach of duty as an official director.

Restrictions on Golden Parachute Payments and Indemnification Payments

Golden Parachute Payments

- Part 359[4] of the FDIC Rules and Regulations limits and/or prohibits, in certain circumstances, insured depository institutions, their subsidiaries, and their affiliated depository institution holding companies from agreeing to make or making golden parachute payments when the entity making the payment is "troubled," as defined in Section 303.101 of the FDIC Rules and Regulations.
- The rule does not restrict the payment of golden parachutes by healthy institutions, except that depository institution holding companies (including healthy ones) are prohibited from making golden parachute payments to IAPs of troubled subsidiary banks and savings associations.
- Several exceptions to the prohibition are included in the regulation; some are required by statute, others have been added by the FDIC. These exceptions are as follows:

  - Bona-fide deferred compensation plans;
  - Nondiscriminatory severance payment plans (for personnel reductions in force);
  - Qualified pension or retirement plans;
  - Payments pursuant to employee welfare benefit plans;
  - Payments made by reason of termination caused by death or disability; and
  - Payments required by State statute or foreign law.

  The final three listed exceptions require the approval of both the appropriate Federal banking agency and the FDIC:

  - A troubled institution hiring new management;
  - Severance payment in the event of an unassisted change in control; and
  - Any others on a case-by-case basis with the regulators' approval.

Indemnification Payments

- With regard to indemnification payments, Part 359 limits the circumstances under which an insured depository institution, its subsidiary, or its affiliated depository institution holding company may indemnify IAPs for expenses incurred in administrative or civil enforcement actions brought by bank regulators. The circumstances where indemnification may be permitted are as follows:

  1. The institution's board of directors determines in writing that these four criteria are satisfied:

     - The IAP acted in good faith and in a manner believed to be in the best interests of the institution;
     - The payment will not materially adversely affect the safety and soundness of the institution;
     - The payment is limited to expenses incurred in an administrative proceeding or civil action instituted by a Federal financial institution's regulator; and
     - The IAP agrees to reimburse the institution if he/she is found to have violated a law, regulation, or other fiduciary duty.

  2. An insurance policy or fidelity bond may pay restitution and the reasonable cost of defending an administrative proceeding or civil action. It may not pay a penalty or judgement.

- Under no circumstances may an institution or an insurance policy of the institution indemnify an IAP for any judgment or civil money penalty imposed in an action where the IAP is assessed a civil money penalty, is removed from office or prohibited from participating in the affairs of the institution, or is required to cease and desist from or take any affirmative action pursuant to Section 8(b) of the FDI Act. However, partial indemnification is allowed for charges that are found in the IAP's favor as explained below under "Issues."

Issues

Generally speaking, the essence of Part 359 lies in its definitions of terms such as: golden parachute payment, bona fide deferred compensation plan, and prohibited indemnification payment, as well as certain significant exceptions to the general prohibitions.

[4] Part 359 implements Section 18(k) of the FDI Act, 12 U.S.C. 1828(k).

The following are additional discussions on several issues encompassed in the regulation.

- With regard to indemnification payments, the majority of administrative or civil enforcement cases end in a settlement and no indemnification payment will be permitted unless charges are dropped. The parties concerned will have to factor in this cost of no indemnification in their decisions to settle or not.

  However, there are situations when an individual has been charged with several significant items of misconduct, etc., and then during the process a settlement is reached where only some of the infractions are admitted. The rule permits partial indemnification by reasonable payment of legal or professional expenses in those cases if there has been a formal and final adjudication or finding in connection with a settlement that the IAP has not violated banking laws or regulations or engaged in unsafe or unsound banking practices or breaches of fiduciary duty. There is a special case-by-case exception to allocate costs to the sets of charges with indemnification permitted for those that are dropped.

  Regardless of findings or adjudication conclusions, partial indemnification is not permitted in cases where an IAP is removed from office and/or prohibited from participating in the affairs of the institution.

  It is recognized that in many cases the appropriate amount of any partial indemnification will be difficult to ascertain with certainty. Although no prior regulatory consent is required, the regulators, obviously, are part of the settlement process. The process provides the opportunity for the regulators to give "non-objections" at the time of settlement, prior to the indemnification being made. As part of the settlement process, the bank should be required to provide from the attorney or expert seeking fees a statement containing a description of specifically attributable expenses. Concern should focus on the reasonableness of the allocations.

- If a golden parachute is prohibited to an individual leaving the institution, it is prohibited forever, even if the institution returns to health (after the individual has left the institution). There are ample exceptions and procedures for an individual who is leaving a troubled institution to avoid the prohibition if that individual has not contributed significantly to the demise of the institution. If an individual does not qualify for one of these exceptions, that individual should not benefit due to the institution reversing its course and returning to health after that individual has left the institution.

- Troubled institutions cannot apply for an exception to offer "white knight" parachutes to their current officers to not leave the institution. Rather such provisions are intended to entice new management to join the institution by compensating for the uncertainty of joining a troubled institution. It is considered illogical for the FDIC to provide an exception to permit a troubled institution to offer a buyout to current management to get them to stay. The regulation does not prohibit an institution from offering golden parachutes to their current officers. It only prohibits the payment of a non-permissible golden parachute if the individual leaves while the institution is troubled. On the contrary, it is believed to be of greater incentive that the only way the current officers' golden parachutes will be of value is if they stay and work to return the institution to health.

- Approval is required for a severance payment in the event of an unassisted change in control. A maximum payment of 12 months' salary is permitted under this exception. Any requests for payments in excess of 12 months' salary would have to be considered for approval under the general case-by-case exception.

  The change-in-control exception is provided in recognition of the need for current management to be motivated to seek out acquirers. This exception is believed appropriate for cases where the IAP may not clearly demonstrate that all the factors for the general exception are evident, yet an acquisition of the troubled institution has been arranged and the acquirer is willing to make the otherwise prohibited golden parachute payment. On the other hand, if after consideration of the factors for the general case-by-case exception, the appropriate Federal banking agency and/or the FDIC determines it inappropriate to make the severance payment, an exception should not be approved.

Excessive Compensation

Section III of Part 364, Appendix A, prohibits the payment of excessive compensation, as well as compensation that could lead to material financial loss to an institution, as an unsafe and unsound practice. Furthermore, Section II of Part 364, Appendix A, urges institutions to maintain safeguards that prevent excessive compensation or compensation that could subject the institution to material financial loss. Excessive compensation is defined as when amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder. The following items should be considered when determining whether compensation is excessive:

- The combined value of all cash and noncash benefits provided to an individual;
- The compensation history of the individual and other individuals with comparable expertise;
- The financial condition of the institution;
- Compensation practices at comparable institutions, based on such factors as asset size, location, and the complexity of the loan portfolio or other assets;
- For post-employment benefits, the projected total cost and benefit to the institution;
- Any connection between the individual and any instance of fraud or insider abuse occurring at the institution; and
- Any other factors determined to be relevant.

The FDIC does not seek to dictate specific salary levels or ranges for directors, officers, or employees. In fact, Section 39 of the FDI Act prohibits establishing guidelines that set a specific level or range of compensation for bank insiders. The criteria listed above are designed to be qualitative rather than quantitative in order to grant an institution's directors reasonable discretion when structuring a compensation program.

Examiners should review the information used by the board to establish the compensation structure of the institution. The information should adequately explain the rationale for the system in place and should enable the board to consider the above items that determine whether compensation is excessive.

Gaining Access to Bank Records and Employees

Section 10(b)(6) of the FDI Act provides authority for examiners to make a thorough examination of any insured depository institution and requires them to complete a full and detailed report of the institution's condition. In most instances, the executive officers of insured depository institutions cooperate with the requests of examiners. However, there are rare occasions when executive officers are extremely uncooperative, or refuse to provide access to bank records and employees that are essential to the evaluation of the condition of the institution. In such cases, this pattern of behavior by executive officers may be indicative of serious problems in the bank, including fraud, mismanagement, or insolvency. The Regional Office should be consulted when executive officers restrict access to bank records or employees.

Bank Owned Life Insurance (BOLI)

A number of banks use BOLI as a means of protecting against the loss of key employees or hedging employee compensation and benefit plans. However, the purchase of life insurance is subject to supervisory considerations and life insurance holdings must be consistent with safe and sound banking practices. Examiners are to assess whether bankers complete a thorough analysis before purchasing BOLI. Associated risks, minimum standards for pre-purchase analysis and basic guidelines are detailed in the Other Assets and Liabilities section of this Manual.

MODEL RISK MANAGMENT

Some banks routinely use models for a broad range of activities, including underwriting credits; valuing exposures, instruments, and positions; measuring risk; managing and safeguarding client assets; determining capital and reserve adequacy; and many others. The use of models can improve business decisions, but can also introduce risk, such as potential adverse consequences (including financial loss) of decisions based on models that are incorrect or misused. To ensure safe and sound operations, it is important that, like any other risk, a bank's board and management identify, measure, monitor, and control model risk.

The Supervisory Guidance on Model Risk Management (MRM Guidance) describes the key aspects of effective model risk management. While this manual section provides an overview of model risk management principles, examiners should refer to the MRM Guidance for a more thorough discussion of model risk management.

Appendix A to Part 364 has long-established standards for safety and soundness for banks in the areas of internal controls and information systems; internal audit systems; loan documentation; credit underwriting; interest rate exposure; asset quality; earnings; and compensation, fees, and benefits. To the extent that models are used in these major operating areas of the bank, whether the model was developed and operated internally or through a third party, examiners are to assess model risk management practices for consistency with safety and soundness standards.

Overview

The term *model* refers to a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates. A model also includes quantitative approaches whose inputs are partially or wholly qualitative or based on expert judgement, provided that the output is quantitative in nature.

It is important for model risk management practices to be commensurate with the bank's risk exposures, as well as the complexity and extent of its model use.

An effective model risk management framework includes:

- Disciplined and knowledgeable model development processes that are well documented and conceptually sound, with controls to ensure proper implementation and processes to ensure correct and appropriate use;
- Effective validation processes; and
- Strong governance, policies, and controls.

Tools used for simple mathematical calculations are generally not considered models, but should nonetheless be subject to a reasonable control process.

Model Development, Implementation, and Use

Disciplined and knowledgeable development and implementation processes that are consistent with the model's intended use and with bank policy are critical to appropriately managing model risk. There are many important aspects to model development and implementation, including:

- A clear statement of purpose to ensure development is aligned with intended use;
- Design, theory, and logic that are well documented and supported;
- Rigorous assessment and documentation of data quality and relevance;
- Documented testing during model development to determine whether the model is performing as intended; and
- Controls and testing for model implementation and systems integration.

Model use provides additional opportunity to test whether a model is functioning effectively and to assess its performance over time as conditions and model applications change. Also, an understanding of model uncertainty and inaccuracy and a demonstration that the bank is accounting for them appropriately are important outcomes of effective model development, implementation, and use.

Model Validation

Model validation is the set of processes and activities intended to verify that models are performing as expected, in line with their design objectives and business uses. Effective validation helps ensure that models are sound. It also identifies potential limitations and assumptions, and assesses their possible impact. Independence, competence, knowledge, skills, expertise, incentives, influence, and authorities of staff conducting validation are important elements of model validation.

Key elements of comprehensive validation include: evaluation of conceptual soundness, ongoing monitoring, and outcomes analysis.

- Evaluation of conceptual soundness includes assessing the quality of the model design and construction, a review of documentation supporting the methods used and variables selected for the model, sensitivity analysis (where appropriate), and evaluating qualitative information and judgment.
- Ongoing monitoring includes designing a program of ongoing testing and evaluation of model performance to confirm that the model is appropriately implemented and is being used and is performing as intended, which may include process verification and benchmarking.
- Outcomes analysis, including backtesting, includes a comparison of model outputs to corresponding actual outcomes, with the precise nature of comparisons depending on the objectives of a model.

Governance, Policies, and Controls

Developing and maintaining strong governance, policies, and controls over the model risk management framework is fundamentally important to its effectiveness. Even if model development, implementation, use, and validation are satisfactory, a weak governance function will reduce the effectiveness of overall model risk management. A strong governance framework provides explicit support and structure to risk management functions through policies defining relevant risk management activities, procedures that implement those policies, allocation of resources, and mechanisms for evaluating whether policies and procedures are being carried out as specified. Notably, the extent and sophistication of a bank's governance function is expected to align with the extent and sophistication of model usage.

Examination Review

Examination planning contact with bank management, as well as interim contacts, provides examination staff with opportunities to discuss the extent of model use and determine whether there are any material changes since the prior examination. If management indicates new model use or material changes since the prior examination, examiners should consider asking some additional questions to assist in exam scoping and to appropriately tailor the request list. For example, ask management:

- Where model risk management is addressed in policies and whether there are any procedures, standards or monitoring practices the bank may have that address model risk management practices.
- Whether the bank maintains a model inventory. While banks are not required to maintain a model inventory, identifying models used across the bank can be an important practice to assist in model risk management. For banks with minimal model use, model risk, and model complexity, the inventory may

be an informal list. To the extent a bank maintains an inventory, it will be useful in the exam planning process in developing the scope of the model risk review.
- Whether the bank has model documentation or validation reports for models used.
- Whether model risk management is covered in the audit scope.
- Whether the bank maintains any exception or findings tracking reports.

Based on discussion with management, examiners should consider including relevant documents in the request list. Based on management discussions and the response to the request list, examiners should determine whether a review of the model risk management framework or review of specific models is necessary or warranted. Examiners should tailor the examination review scope based on the bank's risk exposure, activities, complexity and extent of model use. The review should focus on assessing the adequacy of the model risk management framework. To the extent models are used for key operating areas, examiners should consider reviewing the model documentation and validation. This review process can provide examiners with insight not only into the model and its quality but also the adequacy of risk management practices. If examiners determine the risk posed by the bank's model use is not at a level to necessitate a model sample review, examiners should consider reviewing internal risk management standards imbedded in operating policies and discussing vendor model due diligence processes with bank management. Such information can provide examiners with meaningful insight into whether model risk is managed appropriately.

References:
- Appendix A to Part 364 of FDIC Rules and Regulations
- Supervisory Guidance on Model Risk Management (FIL 22-2017)

EVALUATION OF MANAGEMENT

A bank's performance with respect to asset quality and diversification, capital adequacy, earnings performance and trends, liquidity and funds management, and sensitivity to fluctuations in market interest rates is, to a very significant extent, a result of decisions made by the bank's directors and officers. Consequently, findings and conclusions in regard to the other five elements of the CAMELS rating system are often major determinants of the management rating. More specific considerations are detailed in the Basic Examination Concepts and Guidelines section of this Manual. However, while a bank's overall present condition can be an indicator of management's past effectiveness, it should not be the sole factor relied upon in rating management. This is particularly true when there is new management or when the bank's condition has been or could be significantly affected by external factors versus internal decisions.

When significant problems exist in a bank's overall condition, consideration must be given to management's degree of responsibility. However, appropriate recognition should also be given to the extent to which weaknesses are caused by external problems (such as a severely depressed local economy). A distinction should be made between problems caused by bank management and those largely due to outside influences. Management of a bank whose problems are related to the economy would warrant a higher rating than management believed substantially responsible for a bank's problems, provided that prudent planning and policies are in place and management is pursuing realistic resolution of the problems. Management's ability becomes more critical in problem situations, and it is important to note management's policies and acts of omission or commission in addressing problems.

The extent to which mismanagement has contributed to areas of weakness is particularly relevant to the management evaluation. Similarly, positive economic conditions may serve to enhance a bank's condition despite weak or undocumented policies and practices. At a minimum, the assessment of management should include the following considerations:

- Whether or not insider abuse is in evidence;
- Existing management's past record of performance in guiding the bank;
- Whether loan losses and other weaknesses are recognized in a timely manner;
- Past compliance with supervisory agreements, commitments, orders, etc.; and
- Capability of management to develop and implement acceptable plans for problem resolution.

Assessment of new management, especially in a problem situation, is difficult. Performance by individuals at their former employment, if known to the examiner, may be helpful, but the examiner should assess each situation based on its particular circumstances. The management rating should generally be consistent with any recommended supervisory actions. A narrative statement supporting the management rating and reconciling any apparent discrepancies between the assigned rating and any recommended supervisory actions (or lack of recommended actions) should be included on the confidential pages of the examination report.

Examination procedures regarding the evaluation of management are included in the Examination Documentation Modules.

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RATING THE MANAGEMENT FACTOR

Uniform Financial Institutions Rating System

The Federal Deposit Insurance Corporation and the other Federal Financial Institutions Examination Council (FFIEC) member agencies adopted a uniform interagency system for rating the condition and soundness of the nation's financial institutions. The Uniform Financial Institutions Rating System involves an assessment of six critical aspects of an institution's condition and operations. Management and administration is one of those critical dimensions.

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls, taking into consideration the size and sophistication of the institution; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved.

The capability and performance of management and the board of directors is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of oversight and support of all institution activities by the board of directors and management;
- The ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products;
- The adequacies of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities;
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and risk profile;
- 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;
- Compliance with laws and regulations;
- Responsiveness to recommendations from auditors and supervisory authorities;
- Management depth and succession planning;
- The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority;
- Reasonableness of compensation policies and avoidance of self-dealing;
- Demonstrated willingness to serve the legitimate banking needs of the community; and
- The overall performance and risk profile of the institution.

Ratings

A rating of 1 indicates strong performance by management and the board of directors and strong risk management practices relative to the institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's

activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.