SHOULD YOUR BOARD BE APPROVING LOANS?

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June 23, 2011

The Honorable Sheila C. Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429-9990

Dear Chairman Bair:

AABD recently advised bank directors to stop approving loans other than loans subject to Regulation O or involving certain insider conflicts. There are serious risks of potential personal liability that do not justify directors' involvement in the loan approval process unless the FDIC satisfactorily clarifies their appropriate role and corresponding personal liability. We ask that you direct the FDIC to clarify that role as soon as possible. A copy of my Viewpoint American Banker article dated June 14, 2011 is enclosed.

Large banks' boards and director loan committees commonly do not approve loans unless they are subject to Regulation O or internal insider transaction rules. Boards and director loan committees of community banks do commonly approve loans – often reserving their review and approval for the loans with the greatest amount of potential risk, such as large loans and loans that vary in some respect from loan policy.

Based on our review of FDIC complaints against directors of failed banks, we believe that a director's risk of personal liability is heightened by (i) voting for approval of loans; (ii) approving loans where the board or committee has received a board or committee loan package; or (iii) serving on a director loan committee. We are also aware of the FDIC's recent willingness to use its enforcement powers aggressively against directors of failed and open banks for "reckless lending."

A bank director's logical response to these suits and possible enforcement actions would be to do one of the following:

- Resign from the board
- Decline to serve on a director loan committee
- Decline to review or vote for approval of individual loans
- Only approve loans where there is no risk of repayment

Current federal laws, regulations and regulatory guidance do not require a board or board committee to approve any loans other than loans subject to Regulation O. So a board or board committee may choose simply not to be involved in the loan approval process. Directors may meet their fiduciary duties by adopting sound loan policies, procedures and controls, retaining a qualified CEO, relying reasonably on the CEO in assuring that other officers and employees of the Bank are qualified to do the kind of lending in which the Bank engages, monitoring adherence to loan policy and safe and sound lending practices, and taking steps to identify and correct any deficiencies in the lending process. Controls might include independent loan review and internal loan ratings, internal and outside audit of the lending function, and an independent credit function.

An alternative is for the board or board committee to approve only those loans that have no risk of repayment. Loans fully secured by certificates of deposit or by US bonds or notes could be approved, but unsecured loans or loans secured by real estate or other asset that can vary in value would not be.

AABD has advised its members not to approve loans until the FDIC formally clarifies its expectations and requirements for bank directors who want to be involved in the loan approval process.

We urge the FDIC to address the following questions:

- If a board or board committee decides not to be involved in the loan approval process at all (other than as to Regulation O and insider loan approvals under certain circumstances), what other measures, if any, will the FDIC expect the board or board committee to take in addition to the steps described in the first paragraph on page 2 of this letter?
- If a board or board committee relies on a board loan package in considering whether to approve loans, what should that loan package contain and what standards will the FDIC apply in determining whether a director who votes in favor of the loan is legally responsible for any statements or omissions in the board loan package?
- Does a bank director who serves on a director loan committee have a higher risk of being sued by the FDIC or being subject to an administrative action based on reckless lending than a bank director who does not serve on a director loan committee? If not, why is it that most of the complaints filed so far against directors of failed banks highlight that certain directors served on the director loan committee?

Sincerely,

David Baris
Executive Director

Enclosure

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

General Counsel

August 1, 2011

Mr. David Baris
Executive Director
American Association of Bank Directors
National Capital Office
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Washington, D.C. 20037

Dear Mr. Baris:

Thank you for your letter of June 23, 2011, to the Chairman. Your letter has been referred to me for a response.

You state in your letter that the American Association of Bank Directors ("AABD") "recently advised [community] bank directors to stop approving loans other than loans subject to Regulation O or involving certain insider conflicts." The basis of this advice is AABD's opinion, as also stated in your letter, that large banks' boards and loan committees commonly do not approve non-insider loans while boards and loan committees of community banks do approve such loans and that community bank directors' potential liability would be reduced if they were to stop approving non-insider loans. Your letter finally makes the somewhat disturbing statement that the AABD has advised its members not to approve loans until the FDIC clarifies its expectations and requirements.

The FDIC has not altered its expectations or requirements for bank directors and those standards have remained unchanged for many years. In short, bank directors owe duties of care and loyalty in fulfilling their responsibilities. The FDIC has only filed complaints against bank directors who failed to adhere to these long-standing standards. Consequently, there is no basis for your contentions that the standards require clarification or that the FDIC is imposing new requirements on bank directors that put them at risk of liability for appropriately performing their responsibilities. Bank directors are a critical component in the effective and efficient management of insured institutions precisely because they provide experience and community engagement that may not be otherwise found in bank management. We certainly do not believe it to be in the public's interest, or in the interest of the banking industry, for you to urge bank directors to avoid applying their experience and judgment to important credit decisions for the institution.

Directors of community banks typically approve larger non-insider loans on the merits either at the board or loan committee level. Given the relatively smaller size of a community bank compared to a money center bank, community bank directors are better able to supervise their smaller bank's lending function in this manner. Also as a result, members of community bank loan committees that are directors are in a better position to take prompt action to remedy observed weaknesses in their bank's lending function. Of course, a community bank, both as a legal and regulatory matter, may delegate loan approval authority below its loan committee if it so chooses, provided that the bank's board of directors amends the bank's loan policy to so provide. In fact, community banks often do delegate loan approval authority, at least for smaller non-insider loans, below the bank's loan

committee typically to lower level loan officers. If a bank were to do so for all non-insider loans, its loan committee members, whether directors or officers, would no longer have the responsibility to approve non-insider loans on the merits. While this may not be a best practice from the standpoint of good corporate governance for the reasons noted, it is not legally prohibited.

If authority is delegated to lower level officers in the bank's organization, the board of directors nevertheless would retain its nondelegable duty to supervise the bank's lending function. Directors cannot delegate their ultimate responsibility to supervise the core functions of the bank. Directors of financial institutions, large or small, are responsible for establishing the strategic direction of the bank, including managing risks and supervising management to ensure that strategic goals are met. This requires bank directors to undertake diligent and ongoing review of information concerning the bank's operations and performance, including – specifically with respect to the loan approval function – information and data on credit and other risks, loan concentrations, incentive compensation to make loans, and compliance with loan policies, statutes, and regulations, among other things.

If, however, a bank's board has delegated authority to approve non-insider loans to a loan committee, the loan committee members cannot abdicate their responsibility and instead must review loan files and either approve or refuse extensions of credit in accordance with applicable loan policies and safe and sound underwriting standards. If the committee members fail to do so, they risk legal liability that is very well-established by law. If, as is typically the case, the loan committee relies on loan packages to approve loans, the packages must be sufficiently detailed to enable the committee members to make informed and sound business judgments on the merits of the loans that they are approving or rejecting.

The final point in your letter is that over the past year the FDIC has filed several complaints against community bank directors (and officers in some cases) for breaching their duties as members of the failed bank's loan committee. In these cases, the loan committee members had been delegated the authority to approve the loss loans at issue by their boards of directors, but they breached their duties of care, and in some cases their duties of loyalty, to the bank when they approved loans that violated the bank's loan policy and underwriting standards, among other things, and in some instances that were abusive insider transactions.

I am confident that community bank directors will keep these well-established corporate governance and legal banking principles firmly in mind as they reflect on the AABD's recent advice. Thank you again for your June 23 letter to the Chairman. If you have any questions regarding anything in this letter, please feel free to contact me or Richard J. Osterman, Jr., Deputy General Counsel, at (202) 898-3706.

Sincerely,

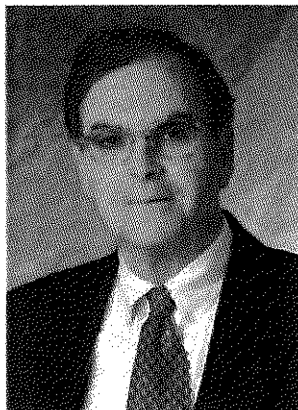
Michael Krimminger
General Counsel

AMERICAN BANKER®
THE FINANCIAL SERVICES DAILY

Tuesday, June 14, 2011

VIEWPOINT

Approving Loans Is a Risky Role for Bank Directors



By David Baris

Recent FDIC lawsuits against directors of failed banks assert that they are personally liable for voting to approve individual loans that went bad if the loans had deficiencies at the time of approval. This places bank directors in the shoes of loan and credit officers, a role for which they are both unsuited and unqualified. It may be time for bank directors to stop approving loans and instead to delegate all noninsider loan approvals to bank officers and officer loan committees.

It is commonplace for board members of community banks to vote on approvals of a variety of loans, unlike board members of large banks, who usually only vote to approve insider loans subject to Regulation O. What compounds the problem is that board members often consider approval of only those loans that entail more potential risk — the largest loans, insider loans, and those loans that vary from one or more of the requirements of the loan policy. Smaller loans within policy guidelines are normally approved under the authority of an individual loan officer or officers' loan committee.

A review by the American Association of Bank Directors of recent cases filed by the FDIC against directors of failed banks suggests that the FDIC believes that directors who voted in favor of a loan as members of the board of directors or its loan committee are as legally responsible as the officers who underwrote and recommended approval of the loan. Any director who serves on the director loan committee is at heightened risk of personal liability. AABD expects that the FDIC will also be actively using its enforcement powers (e.g., civil money penalties and prohibitions from participating in banking) against directors of both failed and open banks who the FDIC believes engaged in reckless lending. This is a departure from the historic practice of using enforcement powers against outside bank directors primarily where there has been insider abuse, intentional misconduct or criminal acts or where there have been violations of consent orders or formal agreements.

FDIC seems to expect boards and board loan committees to micromanage the loan approval process; that is, once the board or board committee receives a board package on an individual loan, it has the responsibility to identify any potential weaknesses or flaws in the board package, and if it approves a loan that in the judgment of the FDIC should not have been approved, the board members may be liable for having recklessly voted in favor of such a loan.

No matter that bank directors are typically not from banking backgrounds and lack training or experience as loan or credit officers. If there is a perceived flaw in the loan that the FDIC believes the board member who voted for the loan should have known about, and the loan was approved by the board and funded and losses ensue, the board member is at risk for personal damages.

In the early 1990s, the Resolution Trust Corp. also sued directors of failed savings institutions for approving loans that later went bad. At that time, AABD recommended that bank boards of directors consider not approving loans. AABD pointed out that the responsibility of the board was not to approve individual loans, but to approve safe and sound policies, procedures and controls to govern the loan approval process; set parameters on risk; hire and retain a competent CEO, and other officers that it reasonably believed, in reliance on the CEO, were qualified; monitor adherence to the loan policy and safe and sound lending; and direct corrective action of problems as they arise.

AABD hasn't changed its mind. There is nothing in federal laws, regulations and regulatory guidance that require bank boards of directors or board committees to approve noninsider loans. So when a board takes it upon itself to approve loans other than those subject to Regulation O, it is doing more than is required. But in doing more than is required, board members are

also taking on more personal liability risk.

The intention of many board members in reviewing and acting on an individual loan is not to repeat or second guess the work of the loan or credit officer, but rather to apply their business judgment. Bank directors may have insight into the local economy and its direction, the trends in local real estate values, information about a borrower that is not fully reflected on the borrower's financial statement; and business instincts that they have developed over many years being in the business of business. They will consider not just the loan package but other factors in evaluating the pros and cons of any individual loan. No one factor may be the determining element in the decision and some will be considered more relevant or important than others. In fact, there really is no way of knowing after the fact why a board or board committee approved a loan. It is by its nature a collegial decision made based on the collective act of all of the board members who attended the meeting.

Most bank directors will not be very useful in undertaking technical reviews of loan packages, and if they did, many would not nearly be as competent as those the bank has retained to do that job. In the past, banking agencies have discouraged bank directors to micromanage their institutions. That was good advice and still is. If bank directors were to micromanage, we fear that many good loans would not be made, thereby further exacerbating the current constraints on credit availability.

The dilemma for community bank directors is to choose between minimizing their personal liability and the useful function that board and board committee reviews of individual loans can serve. Community bank directors may have insights into the local economy and local borrowers that the loan or credit officer may not have, and business experience and savvy that can help decide close calls. Banks whose boards don't participate in the review and approval of individual loans will miss that insight.

On balance, AABD believes that boards and their committees should get out of the business of approving loans other than insider loans until the FDIC satisfactorily clarifies its expectations as to their appropriate role in approving individual loans. AABD has asked the FDIC to clarify its position in a manner that would provide protection to bank directors so that they may approve loans without taking undue risk of personal liability.

David Baris is the executive director of American Association of Bank Directors and a partner in the law firm BuckleySandler.

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