To even the casual observer it would be hard not to notice the growing concern in regulatory circles for unburdening community banks of many strictures more appropriately designed for the largest institutions. From the regulators’ point of view, this trend towards tailoring of rules must come with the assurance that bank directors understand and pursue best practices in governing their institutions. To that end, the FDIC has published a Special Corporate Governance Edition (the “Special Edition”) of Supervisory Insights, billed as “a refresher on the FDIC’s guidance related to corporate governance and fiduciary responsibilities.”

Despite its initial disclaimer that it is “neither supervisory guidance nor required reading for any banker,” the Special Edition offers valuable insight into the supervisory priorities of the FDIC, which, as history demonstrates, are typically shared by its sister banking agencies. Fundamentally, it is a commentary on the Pocket Guide for Bank Directors, published in 1988 and still a standard primer for bank directors.

The Special Edition is addressed to “community banks,” which are defined not by asset size but, rather, as “insured depository institutions whose business models
reflect a focus on traditional lending and deposit-gathering activities within a fairly limited geography.” For these banks the FDIC considers corporate governance to be the foundation of safe and sound operations. Good corporate governance is nothing less than adherence to common-sense principles that frame sound objectives, policies and risk limits and ensure close coordination with bank management. Particularly highlighted are the duty of loyalty, by which directors administer bank affairs with candor, personal honesty and integrity, and the duty of care, by which they act as prudent and diligent business persons in conducting bank affairs.

The FDIC makes a special point of recognizing that diligent directors are treated as its partners in effective supervision. Examiners count on a bank’s board to promote a “risk management culture” (i.e., the system of organizational goals, objectives, policies, controls, values and behaviors influencing risk decisions) that includes an “ethical culture” (i.e., holding the interests of customers, investors, the community, and other stakeholders above short-term profits).

A large part of the Special Edition is devoted to updated observations on corporate governance practices that relate to various sections of the *Pocket Guide*. Among the general principles covered are:

- Maintaining independence
- Selecting and retaining competent management
- Establishing long- and short-term business objectives
- Supervising management
- Keeping informed
- Meeting community credit needs
- Avoiding preferential insider transactions

A number of topics are accompanied by illustrations and source references designed to improve a director’s understanding of how principles are put into practice.

Without qualification, the FDIC cites the quality of management and the manner in which bank directors and officers govern a bank’s affairs as the paramount factors in the successful operation of a bank. On the other hand, the FDIC cites ineffective leadership and board oversight as a common root cause of a bank’s problems.

Examiners assess a bank’s corporate governance framework by measuring the performance of the board and senior management, the effectiveness of risk management processes, and compliance with applicable laws and regulations, incorporating their findings in the Management component of the CAMELS rating. Especially instructive for directors is the list of elements factoring into the Management component review:

- Oversight by the board of directors and senior management
- Skills and competence of directors, officers, and staff
• Strategic planning, policies, processes, and controls, taking into consideration the size and sophistication of the institution

• Audit program and internal control environment

• Risk monitoring and management information systems

• Ability to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products

• Compliance with laws and regulations

• Responsiveness to recommendations from auditors and supervisory authorities

• Management depth and succession

• Effect of dominant management influence

• Reasonableness of compensation policies and avoidance of self-dealing

• Willingness to serve the legitimate banking needs of the community

While these elements are not explicitly prioritized, it is interesting to note that the list is followed immediately and without parallel by a section outlining strategic planning considerations. This may carry a subtle message that boards should pay particular attention to formulating assumptions and goals, understanding that they will be rigorously judged by how well they meet the targets they set for themselves. It also is a timely reminder that self-reflection is a cornerstone attribute of a diligent board and management team.

The Special Edition saves the most valuable instruction for last. However they choose to conduct their community banking business, directors should be on constant alert for conditions under which the FDIC expects a higher level of board oversight. These include:

• A CAMELS composite or component rating of 3, 4 or 5, the existence of an enforcement action, or both

• Elevated asset or funding concentrations

• Complex or highly specialized products or activities

• High levels of historical or planned growth

• Rapidly shifting balance sheet structure

• Low or shrinking levels of liquid assets

• Plans to change the business model or enter into significant new lines of business

• Deviations from bank policy or prudent banking practice, violations of laws and regulations, or heightened examiner or auditor criticism
Poor operating results
Low capital levels or poor access to new capital
Operational problems in BSA/AML, information technology, and cybersecurity
Deterioration in local economies or in business line fundamentals
Low Community Reinvestment Act or consumer compliance ratings, or high levels of consumer complaints

In its most basic terms, the Special Edition embodies the convergence of two governing principles. Common sense should be the watchword of every director and it should guide every board action, be it planning, oversight or communication with regulators. Of equal importance, as the FDIC emphasizes in its concluding section, every director should seek a meaningful level of involvement in the examination and supervision process.

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