BALANCING ACT:
WALKING THE FINE LINE BETWEEN CHALLENGE AND OPPORTUNITY

SEPTEMBER 11-13 • FRENCH LICK RESORT
2016 INDIANA BANKERS ASSOCIATION ANNUAL CONVENTION AND TRADE SHOW
THE BOARD AND LOAN COMMITTEE’S ROLE IN LOAN UNDERWRITING: LESSONS LEARNED FROM THE CRISIS

SEPTEMBER 13, 2016

BY: VINCE VAN NEVEL
MANAGING DIRECTOR
A director or officer of an insured depository institution may be held personally liable for monetary damages in any civil action by [FDIC as receiver].

For gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence).

- Section 210 (k)
Gross negligence and breach of fiduciary duty against directors and officers of the failed banks

Generally those on the DLC, not full board

Some attempts to sue officer-directors only and claim ordinary negligence

FDIC claims officers have lower liability threshold of ordinary negligence
Sec. 1. (a) A director shall, based on facts then known to the director, discharge the duties as a director, including the director's duties as a member of a committee:

1) in good faith;
2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
3) in a manner the director reasonably believes to be in the best interests of the corporation.
Sec. 1. (b) In discharging the director's duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

1) one or more officers or employees of the corporation;
2) legal counsel, public accountants, or other persons; or
3) a committee of the board of directors of which the director is not a member.

...when the director reasonably believes these parties to be reliable and competent in the matters presented.
Sec. 1. (e) A director is **not liable** for any action taken as a director, or any failure to take any action, regardless of the nature of the alleged breach of duty, including alleged breaches of the duty of care, the duty of loyalty, and the duty of good faith, **unless**:

1) the director has breached or failed to perform the duties of the director's office in compliance with this section; **and**

2) the breach or failure to perform constitutes willful misconduct or recklessness.
Sec. 1. (f) Therefore, the general assembly intends:

1) to reaffirm that this section allows directors the full discretion to weigh the factors enumerated in subsection (d) as they deem appropriate; and

2) to protect both directors and the validity of corporate action taken by them in the good faith exercise of their business judgment after reasonable investigation.
The business judgment rule appears to protect directors and officers when the alleged negligence concerns only the wisdom of their judgment, but...

...may not protect when those decisions are shown to have been made without proper deliberation and reasonable investigation of the facts needed to make the decision.
The Georgia Supreme Court wrote:

“... statutory reference to ordinary ‘diligence, care and skill’ is most reasonably understood to refer to the care required with respect to the process by which a decision is made, most notably the diligence due to ascertain the relevant facts.”

- FDIC v. Loudermilk, 761 S.E. 2nd at 341-42
PBS has seen a wide variety of loan approval and administration processes that work well in the context of community banks.

Community banks have an added advantage of knowing their customers and markets well.
Indiana commercial and savings banks hold about 65% of TA in RE loans representing about 75% of gross loans. Let’s look at regulatory requirements for establishing “processes” in underwriting and approving real estate loans.
FDIC Improvement Act 1992

12 CFR 32 - RE Lending and Appraisal Standards (OCC)

12 CFR 365 - RE Lending Standards; 12 CFR 323 - Appraisal Standards (FDIC)

12 CFR 208.50 and 225.61 - RE Lending and Appraisal Standards (FRB)
B.1. Real estate lending policies adopted pursuant to this section shall be:

- Consistent with safe and sound banking practices;
- Appropriate to the size of the institution and the nature and scope of its operations; and
- Reviewed and approved by the bank's board of directors at least annually.
B.2. The lending policies shall establish:

• Loan portfolio diversification standards;

• Prudent underwriting standards, including LTV limits, that are clear and measurable;

• Loan administration procedures for the real estate portfolio; and

• Documentation, approval, and reporting requirements to monitor compliance with the bank's real estate lending policies.
C. Monitoring conditions. Each member bank shall monitor conditions in the real estate market in its lending area to ensure that its real estate lending policies continue to be appropriate for current market conditions.

D. Interagency guidelines. The real estate lending policies adopted pursuant to this section should reflect consideration of the Interagency Guidelines for Real Estate Lending Policies (contained in Appendix C of this part) established by the Federal bank and thrift supervisory agencies.
# Common Allegations in FDIC-R Complaints

<table>
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<th>Lack of adequate underwriting practices in approving loans:</th>
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<td>Failure to follow policies and/or properly approve exceptions</td>
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<td>No or outdated financial information on hand at approval or renewal</td>
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<td>Inadequate or outdated DTI or DSCR ratios and weakness not mitigated</td>
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<td>Lack of adequate collateral valuations</td>
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<td>High LTVs</td>
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<td>No or lacking construction inspection process</td>
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<td>Common Allegations in FDIC-R Complaints</td>
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<td><strong>Lack of proper internal controls in the lending function:</strong></td>
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<td>No separation of duties between credit analysis and approval</td>
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<td>If credit officer existed, reported to Chief Lender</td>
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<tr>
<td>No independence/separation of duties in appraisal order and review process</td>
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<td>Most complaints alleged some form of lack of independence</td>
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Common Allegations in FDIC-R Complaints

Significant concentrations of credit in ADC and CRE categories:

Well above peer and regulatory guidelines

Weak monitoring of concentrations

Cited continued CRE lending in the face of national downturn
Common Allegations in FDIC-R Complaints

Excessive growth strategies:

- CRE was profitable line of business
- High demand in certain markets
- Directors failed to follow economic conditions sufficiently
- Lack of backroom infrastructure/expertise
- Claimed Board should have known of downturn as early as 2006!
Common Allegations in FDIC-R Complaints

Directors ignored or failed to address regulatory/audit warnings:

1. FDIC stretched here claiming any report comment was a “warning”
2. Often bank still rated 1 or 2 in AQ and Composite at time of comments
3. Comments not carried forward to Matters Requiring Attention by Examiner
4. FDIC-R claimed “warnings put Board on notice” of unsafe/unsound policies
5. FDIC-R used lack of response to “warnings” as evidence of gross negligence/recklessness

(Note: Regulators recently issued new clarifications on MRBA’s)
Examination Report

- Examiners very well trained (FDIC/State joint training)
- Don’t be lulled into a sense of complacency by regulatory examination results
- FDIC as receiver and their law firms use the exams against you
- Ditto on audits and loan review reports of findings
The FDIC expects Boards to provide a clear governance framework that incorporates sound:

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<th>Objectives</th>
<th>Policies</th>
<th>Risk Limits</th>
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Equally important, the Board should monitor the extent to which officers and employees comply with this framework.
The Board’s role in lending begins with policy. Without a clearly written policy it will be difficult for the Board to properly monitor the loan portfolio. It is expected that Board members have reviewed the loan policy and have a satisfactory comfort level with it.
• If Board members do not feel comfortable with the policy, they should endeavor to change it.
• Reviewed and approved on at least an annual basis.
• FDIC’s Manual of Examination Policies, “...the board of directors at every bank has the legal responsibility to formulate lending policies and to supervise their implementation...”
Directors must attend and participate in Board and assigned committee meetings regularly to fulfill their responsibilities.

This is critical to sound corporate governance.
Approving Individual Credits

Director Review Required by Policy

This procedure should be used judiciously, only for loans that are of such interest to the Board as to require its specific knowledge of their terms and conditions.

- Larger borrowers
- Out-of-policy loans
- Special attention loans
Approving Loans

Presenting loans requiring Board approval

• Board should receive a summary of the relevant credit information in advance.
• The actual credit file (or a synopsis), should be available for the Board’s review.
• The loan should be presented with an oral synopsis by the loan officer most familiar with the credit.
• Summary loan presentations should be maintained with the minutes in the form of Board reports.
Role of the Directors’ Loan Committee

*In addition to approving individual loans...*

- Reviews past-due, non-accrual, re-negotiated and problem loans on a thorough basis.
- Receives the reports of the loan review department.
- Keeps the Board continuously well-advised on activity in and the condition of the loan portfolio.
- May be responsible, along with the audit committee, for monitoring and following up on deficiencies pointed out by auditors or examiners.
Portfolio Composition

• The Board should have a broader perspective on the composition or components of the portfolio as a whole.

• The Board should be aware of any regulatory guidance and/or periodic warnings on the risk in concentrations in certain loan types.

• There is significant guidance issued on concentrations in CRE loans, on oil and gas (energy) and agricultural loan concentrations.

• Downturns in a particular industry or sector will also impact ancillary businesses serving that industry.
Independent Monitoring Reports

Monitoring reports can be both from internal and external sources, and must be independent.

Internal reports include watch lists, nonaccrual reports, ALLL analysis and exception reports.

External reports may include loan reviews, audits, and independent targeted reviews prepared by third party vendors.

These reports provide objective analysis of lending activity, policy compliance and credit quality issues that allow the Board to monitor management’s performance.
Vital Role in Lending

Steps in fulfilling duties in credit area:

- Policies
- Committee
  - Attend
  - Participate
- Ask questions and seek explanations
- Monitor compliance with policy, quality and regulatory requirements

- Exercise independent judgment
  - Each director contributes an important perspective to the Board
  - Exercise of objective judgment is critical the Board’s effectiveness

Be loyal to the bank’s interests!
Regulators’ Version of Lesson Learned

One important lesson we learned from the financial crisis is that poor planning can harm institutions, their communities, and the financial system as a whole.

Many failures were traced to management engaging in a new or expanded business line without adequate planning, controls and understanding of the risks related to the new activity.

- FDIC Supervisory Insights Summer 2015.

This Special Corporate Governance Edition for community banks offers commentary on the FDIC’s classic Pocket Guide for Directors and other guidance related to corporate governance and strategic planning.

- April 2016
Who are the regulators holding accountable?

“The quality of management is probably the single most important element in the successful operation of a bank.”

“Management includes both the board of directors and executive management.”

- DSC Risk Management Manual of Examination Policies
Board Independence

“All those opposed, signify by saying, ‘I quit.’”
Takeaways From Lessons Learned
Review Existing Loan Policies

To determine:

- They comply with regulatory guidance
- They sufficiently set forth and reflect the Board’s risk appetite
- They are detailed enough to hold management accountable
- They have provisions on a process to identify and approve exceptions
Who is responsible for enforcing loan policy compliance?

What control points exist to identify, capture and report on exceptions?

Exceptions are reported to the Board, by officer, loan type, branch, etc.

Aggregate levels of exceptions in the portfolio are reported and reviewed.
Monthly Board Reports Should Include:

- Concentrations of credit
- Periodic evaluation of market and national economic trends
- Portfolio level trends and metrics
- Stress testing results
- The Board should question adverse trends or levels
Proactively Support the Existence of Your Process

- Loan presentations are comprehensive and support the approval of the transaction.
- Loan approval presentations reflect the existence of current information.
- Presentations discuss factors mitigating risk of approving loans with critical exceptions.
Proactively Support the Existence of Your Process

- Board and Committee level minutes reflect reasonable deliberative discussion.
- Loan files should be complete and neatly organized.
- Files should lead examiners to your conclusions; a void lets them make their own.
Review All Audit, Loan Review and Examination Reports

Respond in writing to all criticisms and recommendations.

Document your consideration of recommendations and reason not adopted.

Verify corrective actions have been taken on all criticisms/recommendations.

Avoid repeat recommendations and violations.
Connect your Strategic Planning Strategies to Risk Management Process

- Explain growth plans and ensure actual performance within Stated goals.
- If pursuing riskier loans or markets, explain reasons and mitigating factors.
- Loan strategies should be supported by front and back office expertise.
- Board minutes should document its deliberation of and comfort with strategies.
- Can state these directly in the strategic plan and/or ERM reports.
Questions & Answers
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