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Fed Exam Finds Some Board Reports Lacking

How adequate is your bank's information security board reporting? According to the Federal Reserve Bank of Richmond, this is one area of a bank's information technology operations that is often found lacking during safety and soundness examinations.

In its Jan. 28 issue of *Supervision News Flash,* the Bank reports that its examiners frequently find a bank's reporting is either not comprehensive or not occurring annually, as it should be.

"While the initial development and implementation of the risk assessment usually requires the most significant time and effort, the risk assessment process should be an ongoing and dynamic part of your information security program," the newsletter states. "As a critical component, your board should approve written information security policies, and the written report to your board describing the overall status and effectiveness of the information security program must be presented *at least annually*."

The newsletter reminds banks that the risk assessment itself begins with gathering data about the information and information systems that need to be protected, including the components used to access, store, transmit, protect and eventually dispose of the information. The relative importance of each system should then be analyzed, along with potential threats and vulnerabilities and controls to mitigate those threats. Finally, the risk assessment should assign risk ratings to information and systems based on the likelihood of an event occurring and the impact it would have on the bank.

The annual report to the board or board committee, as required under interagency guidelines on safeguarding customer information, should review the bank's information security risk assessment and include information on the bank's risk management and control decisions; service provider arrangements; results of testing; security breaches or violations and management's responses; and recommendations for changes in the information security program.

Taking a Closer Look at Board Best Practices

Whether from large or small banks, highly effective boards share a number of similarities and best practices.

These common traits, according to Bryan Cave LLP attorneys Jim McAlpin and Walt Moeling, begin with the basics. Directors are qualified and foster strong participation at meetings. They also demonstrate leadership through such things as periodic self-evaluations and rotating committee chairmanships.

McAlpin and Moeling underscore that a bank's board is expected to actively:

- Engage with management in developing the company's strategic vision and plan.
- Understand the company's business.
- Monitor management's execution of the business plan.
- Adopt policies designed to ensure compliance with laws and regulations.
- Act with due care without conflict of interest.
- Monitor enterprise risk.

Some of the other best practice recommendations include:

Fostering a meaningful agenda. "Board packages should be delivered well in advance of each meeting in order to provide the directors with adequate time to prepare," McAlpin said. "Committee chairs should be prepared to give concise but informative reports at the meeting." He added that the board should focus on committee reports and meaningful information on bank performance in order to support its oversight role.

Making the committees work is the foundation of the board's oversight role. The attorneys said that, for example, almost all of the recent FDIC lawsuits "assert a lack of adequate attention and focus by directors, and particularly by loan committees." They noted that a strong committee system helps build real expertise on the board and supports management.

Meeting in executive session. McAlpin and Moeling emphasized that executive sessions create an environment that promotes "conversations" of real issues and concerns. They explained that "the most effective boards of directors move these conversations from informal meetings, such as in the parking lot of the bank to the board room by means of executive sessions." The chair or lead director also has an obligation to advise management of any serious concerns expressed in the executive session.

Use directors in the examination process. The board's role in examinations is crucial. "Involve the board or key members from the first meeting to the exit meeting," the speakers advised, and "allow the board to hear issues identified by regulators first hand" and proffer evidence that the board is engaged.

Make use of special-purpose board meetings. McAlpin advised the board to have at least one meeting a year focusing on the bank's strategy. Included or in addition, the board should schedule a "Buy, Sell or Hold" discussion "since management needs to know the direction of the board on this fundamental issue in order to effectively run the bank and position it for the future." Another special purpose meeting should be planned to address director liability and discuss D&O policy and indemnification.

Directors Highly Concerned With Willetts Appeal

Bank directors and officers are universally concerned about the potential for personal liability in the business decisions they make, an issue at stake in the case of *FDIC v. Willetts* currently on appeal in federal courts.

According to an ABA survey, almost two-thirds of respondents said they were "very concerned" and another third said they were "somewhat concerned." Eighty-four percent said that that changes to personal liability would make them less willing to serve as a director or officer in the future.

The FDIC is appealing a federal judge's ruling rejecting its legal case against the directors and officers of Cooperative Bank, a failed North Carolina community bank. The bank failed as a result of bad loans made in the run-up to the 2008 financial crisis, and the case is part of the FDIC's litigation intended to recover losses to the Deposit Insurance Fund.

Relying on North Carolina's business judg-

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ment rule—a longstanding legal principle that protects directors and officers from personal liability for decisions made in good faith and according to a rational process—the trial judge in *FDIC v. Willetts* dismissed the agency's claims against the defendants. The FDIC challenged the business judgment rule, arguing that the current standard for allowing personal liability claims, "gross negligence," should be replaced with an "ordinary negligence" standard.

ABA's survey showed that lawsuits from regulators over business decisions would affect willingness to serve as a bank director or officer for 92 percent of respondents—the leading cause for worry. For banks, these concerns have affected director and officer recruitment more than retention. One in five said they have had difficulty retaining directors over these concerns, while 40 percent said a candidate had declined a director or officer role at their bank for these reasons.

In a friend-of-the-court brief filed in the case in February, ABA and the state bankers associations argued that both federal and North Carolina legal precedents protect the business judgment rule, with numerous courts finding the rule necessary for attracting and retaining qualified directors and officers. They also pointed out that the FDIC's approach would increase unproductive litigation and, for bank customers, limit credit availability.

According to the survey, three quarters of directors and officers projected that if the business judgment rule is changed, loan administration and evaluation costs will go up because boards have to devote greater scrutiny to credit decisions. The result: less credit for underserved markets, according to 76 percent, and less credit for borrowers with no credit history, according to 80 percent of the responses.

Meeting the Challenges of Operational Risk Oversight

Among other industry risk management and regulatory frameworks, the Basel Committee states that operational risk is "the risk of a change in value caused by the fact that actual losses, incurred for inadequate or failed internal processes, people and systems, or from external events (including legal risk), differ from the expected losses."

So write Grant Thornton authors Graham Tasman, Mark Springer and Jose Molina in an article on the firm's website that examines operational risk in the banking industry and how to address it. "Even the most well-thought-out systems can be affected by internal and external events that can significantly increase operational risk," the authors point out. "Further, an increase in operational risk that is not properly managed typically implies operating environments prone to underperformance, either because of frequent reworks, fragmented workflows, manual activities and repetitive reconciliations or ineffective

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controls. These factors add unnecessary costs to doing business and inhibit profitability."

As new regulatory requirements continue to shape the industry, banks face both uncertainty and added operational complexity. Given this environment, operational risk management has become even more critical to a robust and customized enterprise-risk management framework. It is essential for banks to understand which elements of their business will be affected by the regulations. Banks must also take the next step and address operational issues by identifying root risk factors and mitigating negative impacts on profitability.

The authors provide several tips for achieving an effective operational transformation that reflects current regulatory demands and may further address business imperatives.

Make an executive mandate. "The importance of cross-functional operational leadership — especially for compliance, risk management, operations and IT—cannot be overstated," the authors said. Change management is critical. However, this function often lacks the resource accountability and authority to ensure tasks and responsibilities are executed as planned.

Additionally, strong governance and control at the top are essential to ensure that both long-term and day-to-day goals are met.

Understand the data. Poor data management can tack an additional 8 percent to 10 percent onto existing operating costs. Getting a handle on data is critical, but difficult when dealing with an array of application architectures, database structures, integration platforms and system owners all embedded in a complex IT network.

Establish a monitoring mechanism. Improve monitoring and reporting processes, for example, by optimizing operational risk dashboards by level and function. Implement automated tools that can assist in maintaining an effective, less-manual risk-monitoring process.

Improve risk data aggregation capabilities and overall risk reporting. Assess and address shared-services and partnership alternatives to improve overall business performance.

Create a process for third-party assessment of the operating effectiveness of the risk-mitigating controls. Implementing a robust operational risk program is often a reactionary process, in response to enhanced regulatory requirements. "If done strategically (taking into consideration enterprise-wide needs), operational risk programs can bring the added benefit of improving transformation cost management initiatives—a boon for institutions that must do more with less in today's highly competitive environment," the authors said.

The bottom line: "Sound operational risk management capabilities are key to the continued success of all organizations. For optimal effect, programs should be embedded in the institution's overall strategic plan, mandated from the top down and supported by a robust change management initiative with adequate funding, as investment in technology and data management solutions may be necessary."