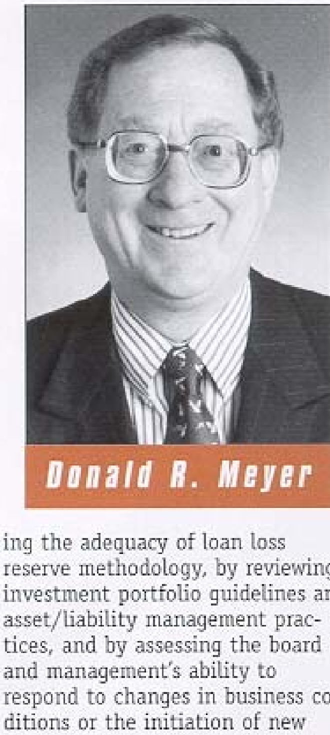
California's Commissioner of Financial Institutions answers the question:

What do examiners expect from boards of directors?

In this exclusive interview with Western Banking, *California's Commissioner of Financial Institutions, Donald R. Meyer, spells out in considerable detail the roles and responsibilities of bank directors in 10 critical management areas, as seen through the eyes of his department's examiners.*



Donald R. Meyer

1. Audit function, internal controls

We expect all banks to adopt an adequate audit program. The audit program should be in written form, be approved by the bank's audit committee or board of directors, be reviewed on a regular basis and be revised when necessary. The audit function should be independent of management, and audit findings should be reported directly to the bank's board of directors or directors' audit committee consisting of outside directors.

The board of directors is also responsible for adopting, implementing and policing a system of internal controls. Internal controls are designed to safeguard assets, to ensure accuracy and reliability of data, to ensure compliance with bank policies and applicable laws and regulations, and to promote management efficiency. Our examiners ascertain that adequate controls are in place, that policies have been developed and implemented and that both are operating effectively.

2. Management oversight, relationship between board and management

It is a primary duty of a board of directors to select and appoint executive officers who are qualified to administer the bank's affairs effectively and soundly.

The board is charged with the responsibility of supervising the bank's affairs, but the responsibility for the day-to-day operation of the bank rests with executive management. Supervision by directors does not mean that the board performs management tasks, but rather it means insisting that the board's policies are being implemented and adhered to by management.

Examiners will review policies and procedures to see that there is a system to bring matters of a significant nature to the attention of the board of directors. Minutes of board meetings are also reviewed to determine director attendance and interaction and should therefore be sufficient in detail to document that the directors' fiduciary responsibilities have been carried out in a reasonable manner.

3. Risk assessment and management

Board oversight is vital to effective risk management and the board of directors should adopt policies that establish guidelines for management and periodically review management's performance. While the board and management may obtain professional advice to supplement their understanding of risks, their responsibilities cannot be transferred to another party.

Examiners will assess management's ability to manage, monitor and control risks by reviewing lending policies, credit underwriting and the loan review process, by analyzing the adequacy of loan loss reserve methodology, by reviewing investment portfolio guidelines and asset/liability management practices, and by assessing the board and management's ability to respond to changes in business conditions or the initiation of new activities and products.

4. Regulatory compliance

It is expected that banks comply with all laws and regulations applicable to them. As a result, a high priority is assigned to the detection and prompt correction of violations of laws and regulations.

It is expected that policies and procedures be developed, implemented and effectively communicated to ensure that officers and employees are sufficiently familiar with applicable laws and regulations and that the directors monitor for compliance and effect timely corrective measures.

5. The examination process

We encourage full communication between examiners, management and boards of directors. We transmit an examination report to each institution and expect boards of directors to thoroughly review, discuss and respond to the report's findings and recommendations and document this review in the minutes of board meetings.

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6. Safety and soundness

Sound management practices are demonstrated by active oversight by the board, 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. An evaluation of these areas is made to make a determination of a bank's condition.

We expect that each bank will have effective risk management policies and will operate in a safe and sound manner. Should deficiencies be identified in the examination process, we expect that prompt corrective action will be taken to effectively remedy any deficiencies noted.

7. Bank performance

The board's policies should have established mechanisms for providing the board the information needed to monitor the bank's performance. The board has a responsibility to see that the bank is generating an adequate return to shareholders, while protecting the interests of depositors and creditors.

While directors are not expected to be financial analysts, they should know enough to be able to discern poor operating performance. Management reports should be designed to be sufficient for the board to fulfill its responsibility to evaluate bank performance, both against established targets as well as past and peer group performance.

8. Strategic planning

Innovation and increased competition have produced an environment characterized by uncertainty. Sound strategic planning is a must in dealing with this uncertainty and rapid change. Strategic planning is an ongoing process from which an institution's mission and objectives are developed. A strategic plan should be a road map of the vision of the board of directors. It should set reasonable and measurable goals and assign responsibility for attainment of these goals. The planning process is as important as the plan itself, and, as such, both should be periodically reviewed.

Our expectations are that the assumptions used in the planning process are reasonable and that our review does not identify any perceived deficiencies in the plan or planning process. Absence of a satisfactory planning process or glaring weakness in the plan itself will be considered in the overall evaluation of the board and management.

9. Directors' qualifications/ stock ownership

Directors are expected to be successful businesspersons or professionals who bring experience and skills that contribute to the board's composite wisdom. They should have their own ideas and the willingness to express them. No director should be unduly influenced by another director or by bank management.

Each director should be familiar with the local community and the bank's trade area. Each should be able to bring quality business to the bank.

Each director should have high personal integrity and be capable of recognizing and avoiding conflicts of interest.

While the amount may vary widely, directors are generally expected to have a vested interest in the bank. The director should have funds invested into the bank to ensure that he or she has a strong personal interest in the bank's success.

10. Business development

Directors should take an active interest in the bank's affairs by promoting the bank through business and personal contacts. They should also watch for opportunities for the bank to gain new business. Ideally, the bank's board of directors should be a significant source of business for the bank. As such, directors are expected to refer potential customers to bank management, who will perform the requisite underwriting or account analysis to determine whether the referred customer is one the bank desires. The involved director should not attempt to pressure the officer into making a hasty or unwise decision.

Many directors are also important customers to the bank, but they should take appropriate precautions in structuring their business and personal ties to avoid even the appearance of a conflict of interest.

Donald R. Meyer was appointed Commissioner of Financial Institutions of the State of California by Governor Gray Davis last April. He was an attorney at Graham & James in San Francisco from 1971-76; vice president, general counsel and assistant corporate secretary of California First Bank from 1976-78; senior vice president, general counsel and assistant corporate secretary of Union Bank from 1978-96; executive vice president, general counsel and corporate secretary of UnionBanCal Corp. from April 1996 to July 1998; and served as counsel in the San Francisco law firm of McCutchen, Doyle, Brown & Enersen from July 1998 to November 1998.

Meyer has been active in the California Bankers Association (CBA) by serving on its Legal Affairs and Federal Government Relations committees, and received CBA's Almon B. McCallum Award for outstanding service to the banking industry in 1989. He has served as the California state vice president for the American Bankers Association (ABA) and he was a member of the ABA Government Relations Council for many years.

Commissioner Meyer gratefully acknowledges the contribution of Craig Carlson in the preparation of this article.