

**THE EDUCATION OF A BANK DIRECTOR**  
**A REPORT OF THE AMERICAN ASSOCIATION OF BANK DIRECTORS**

**BY**

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**Introduction**

As an outside bank director, you probably have never worked for a bank or been trained to be a banker. Yet you are legally obligated to supervise both the bank and bankers who know a lot more than you will ever know about managing a bank.

What is it that you need to learn to meet your responsibilities, and how do you learn it?

Let's face it. You will never know as much as your CEO or Chief Lender about managing the bank. But don't worry.

The education you need is different from the education needed by your CEO, CFO or loan officer. You don't need to know how to make a loan as much as how to review the loan review reports you receive from independent third parties. You don't need to know how to manage assets and liabilities as much as how to oversee the implementation of the asset/liability management policy. You don't need to know how to audit a bank but you will need to know how to ask tough questions of management and the auditors, and read a bank balance sheet, income statement, and cash flow statement.

You can learn on your own. But it is also very helpful to obtain the education you need from others to perform your responsibilities.

Where is this education available and how do you find it? This report will provide you some tips.

**Who needs education?**

It is true that to serve effectively as a director of corporations that are not highly regulated by the government, no special education is normally needed. You need to have a basic understanding of fiduciary duties, some business sense or experience, and an honest character. However, following the Enron scandal, the New York Stock Exchange began to require directors of companies whose stock is listed on the NYSE to participate in educational programs.

Serving effectively on a bank board requires more. There is a lot more at stake; a bank takes the public's money as deposits insured by a government agency, the FDIC. Banks are essential ingredients to a healthy and functioning economy. As such, banks are highly regulated and their board members have certain heightened responsibilities. To meet these responsibilities, bank directors need to know more about the workings of a bank and its regulator or regulators.

What kind of education does a bank director need? That depends on the nature of a bank director's job.

### **What is the job of a bank director?**

There are two fundamental components to a bank director's "job": decision-making and oversight functions.

Examples of the decision-making function are hiring, evaluating, and setting compensation of the CEO; acquiring another bank or business, or being acquired; approving the offering of a new product or entering into a new geographic market; and approving written policies and procedures. Many community bank boards or board committees approve individual loans.

Examples of oversight functions include reviewing financial statements, board reports, and financial ratios at monthly board meetings and evaluating the CEO's and Board's performance. It also entails addressing and correcting weaknesses as they are uncovered through the board's oversight functions.

### **What skills does a bank director need to fulfill each function?**

The decision-making function of a bank director requires that the Board members exercise care that they believe is reasonably required under the facts and circumstances. What they need to know and how they make decisions will depend on the importance of the decision. What they need to know on whether to sell the bank would be a great deal more than what they need to know before deciding whether to declare the annual cash dividend. Do board members need to be merger experts to decide whether to sell the bank? No, but they need to understand enough about the presentations made to them by management and independent experts to reach an informed judgment. And they need to be sure that the information presented is sufficient for them to reach an informed decision.

To fulfill their oversight function, board members need to be able to determine that the information that they are receiving about the bank is adequate for them to understand the financial condition and trends of the bank, and to comprehend what they are reading. The information base needs to be sufficient for the board members to be able to identify "red flags" early enough in order to take effective corrective action.

## **Does it matter whether you are a director of Bank of America or a director of Community Bank of No Name?**

Yes, it matters. It's a lot harder to be a director of a community bank (or even a regional bank) than a director of a large money-center bank. A money-center bank has the resources to assure that the board is well-insulated from making mistakes and not making any decisions that it is not required to make under law.

In the mid-1990's, following the rash of lawsuits filed by the RTC and, to a lesser extent, the FDIC, against directors of failed institutions over certain loans approved by boards of directors of mostly community banks or savings institutions, I called the General Counsel of a large money center bank to find out what kinds of loans the Board or its Loan Committee approved. The response was only those that the law requires the Board to approve – loans to insiders subject to Regulation O. The response also included a comment that the bank wasn't about to put its board in jeopardy of approving loans that later turned bad.

In contrast, directors of most community banks are very much involved in the underwriting of loans through their loan committee, executive committee, or board of directors. This role in the loan underwriting process carries an increased responsibility that needs to be addressed by boards of community banks.

Do boards or board committees get out of that responsibility by not approving loans, or do they take reasonable steps to minimize personal liability for their directors by adhering to practices and controls and documentation that will support the defense of their approvals some years after the loan approvals were made ?

A loan underwriting function performed by board members changes the nature of the education and information they need to be effective directors.

### **What is AABD's Core Course?**

In 1994, AABD established the Institute for Bank Director Education in order to devote resources to developing a core curriculum for outside bank directors and fostering bank director education throughout the United States. At the time, there was little attention paid by other banking trade groups to the educational and informational needs of outside bank directors.

We recognized from the start that the education of a bank director requires an entirely different orientation from the education of a CEO, CFO, CLO, and branch manager.

We developed a "core course" which we would cover the basic knowledge that a bank director would need to meet his or her fiduciary responsibilities.

We circulated a draft core course to each of the state banking commissioners and each of the federal banking agencies for comment. Following comment, we finalized the core course and circulated it to AABD's members and others.

Every few years, we review the core course and make changes to it to fit the changes occurring in the banking industry and the evolving expectations for boards and board committees. We also seek suggestions from state and federal banking agencies and the banking industry.

Those AABD members who complete the core course and complete six hours of supplemental courses receive a **Certificate of Completion**. Those who thereafter complete six hours of supplemental courses annually receive an annual **Certificate of Maintenance**.

AABD works with insurance carriers to seek discounts and/or added coverage on D&O insurance for those banks whose directors participate in the Bank Director Certification Program. AmTrust, a prominent insurance carrier, has agreed to provide up to a 15% premium on D&O insurance for banks whose directors participate in the Bank Director Certification Program.

The following are the components of AABD's Core Course, which is also posted on our website, [www.aabd.org](http://www.aabd.org):

- A. Corporate governance/fiduciary duties
- B. Essential Board reports
- C. Red Flags
- D. Audit, internal controls, and the audit committee
- E. Risk management principles and Enterprise Risk Management
- F. Lending and the Loan Committee
- G. Strategic and capital planning (and capital raising)
- H. new products and control of 3<sup>rd</sup> party vendors
- I. Evaluating the CEO and Board
- J. Director and officer compensation and the Compensation Committee
- K. Essential banking laws and regulations
- L. BSA and consumer compliance laws and regulations
- M. Role in examinations and relationships with banking agency supervisors
- N. Steps to minimize personal liability

The following are some comments on several of these core course components.

To do his or her job effectively, a bank board member needs to understand that he or she is part of a larger whole – a member of a board of five to thirty members, and a member of a committee or committees of several members, and the board in turn is only one part of the bank which also has management, employees, shareholders, customers, regulators, advisors, and members of the public. Part of your responsibility is to figure

out how to use these various constituencies effectively in helping you do your job and not to try to do everything yourselves.

The Board is very much a living organism. A board member may be a genius and hardworking, but if the board is deficient, the board member will not be able to fulfill his or her responsibilities.

How do you know whether your board is working or not working? That's where **corporate governance principles** come into play. They will help you learn whether your board is properly functioning or not.

The **board reports** you receive are only useful if you understand what you are reading. The core course component on board reports and related subjects is designed to assure that you will understand what you read so that you may make reasonable inquiry into the matters raised by such board reports. This component also explores how the board can determine whether it is receiving too much or too little information in the board reports.

**Red flags** arise in both well-performing and under-performing or poorly performing banks. They are tools that board members and senior management can use to identify problems at an early enough stage so that they can be corrected in time. The OCC has published two pamphlets on red flags that are available on its website ([www.occ.treas.gov](http://www.occ.treas.gov)). You do not need to be a director of a national bank to derive much useful information from these pamphlets.

A board member needs to know how to read an **audit report** and management letter, **report of examination**, **compliance report**, and **loan review report**. The **audit function** and the **internal control systems** in the bank need to be understood by not just Audit Committee members, but all board members. At the very least, **Audit Committee** members need to know what questions to ask auditors and management. For example, a couple of catch-all questions can be helpful to ask outside auditors:

- If the outside auditors were solely responsible for preparation of the company's financial statements, would they have been prepared in any way different than the manner selected by management? The audit committee should inquire as to both material and nonmaterial differences. If the auditor would have done anything differently than management, an explanation should be made of management's argument and the auditor's response.
- Is the company following the same internal audit procedures that would be followed if the auditor were in a position to set the internal audit procedures? If not, what are the differences and why?
- Has the company adopted the same internal control measures that would be adopted if the auditor were in a position to set internal controls? If not, what are those differences and why?

## **How do you learn the personal qualities of being a good bank director?**

You don't. You either have them or you don't. If you have them, you probably have had them since childhood. They are the personal qualities of honesty, integrity, independence of thought and action, reputation, and success in your own endeavors. AABD hasn't yet figured out how to teach these personal qualities.

## **How does a bank board member go about learning what is covered by the core course?**

You can be on your own and seek out educational opportunities, or you can be part of the entire board effort. It's better to be part of the overall effort. AABD strongly urges each bank board to institutionalize the bank director education effort so that all members will participate in meaningful educational opportunities through the support of the bank.

### **A New board orientation program**

How many of you have been through a board orientation when you joined the board? If your bank does not have a formal orientation program for new directors, AABD urges that it establish one. AABD staff can conduct the orientation program for your bank or can instruct bank officers on they can offer the program.

### **B. On the job**

On the job training is doable. That's how many bank directors have learned what they need to know. AABD believes that you can learn a great deal from on the job training, but you probably will not learn all that you need to know on a timely basis just from on the job training.

### **C. Formalized programs on and off premises**

Some bank trade groups have excellent programs designed for outside bank directors, some of which cover core course components and others cover supplemental courses. Take advantage of them. On its website, AABD lists the programs it has reviewed and believes will be worthwhile.

AABD offers in-bank programs run by instructors selected by AABD, including a one-day (a very long day) or two half-day program that cover all of the Core Course components.

As mentioned previously, AABD offers a certification program for bank directors that helps organize and motivate directors to participate in the core course exclusively offered by AABD and supplemental courses leading to a certificate of completion and certificate of maintenance.

#### **D. Internet**

The St. Louis and Kansas City Federal Reserve Banks offer an internet interactive program for bank directors on asset/liability management. See [www.stlouisfed.org/col/director/agenda.htm](http://www.stlouisfed.org/col/director/agenda.htm). Other resources are available via the internet. AABD provides information in its website ([www.aabd.org](http://www.aabd.org)) tailored for bank directors.

#### **E. Reading list**

AABD posts reading lists designed for bank directors on its website.

#### **F. Bank management**

Bank management can and should play a very supportive role in providing training for bank directors. The Board or board committee can periodically make some time available during regularly scheduled board or committee meetings for bank management to make presentations on subjects that the board wishes to address in the core course curriculum. Even fifteen minutes every other month can contribute to the Board members' knowledge.

#### **G. Auditors, attorneys, and vendors**

The Bank's external and internal auditors, attorneys, and vendors (those who perform tasks such as loan review and consumer compliance) should be willing to assist board members in furthering their education as a bank director.

#### **Getting the answers**

If you can't find an answer to your questions about educational and training opportunities, please call AABD. Our hotline is (202) 463-4888. Or email us at [info@aabd.org](mailto:info@aabd.org). We would be pleased to help.

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