WHY YOUR BOARD SHOULD STOP APPROVING INDIVIDUAL LOANS

BRYAN CAVE LEIGHTON PAISNER LLP

As we continue into the new era of banking, our clients are looking for ways to enhance efficiency and effectiveness at all levels of their organizations. This line of thinking has led to the revolution of the bank branch and the adoption of many new technologies aimed at serving customers and automating processes. Perhaps most importantly, however, banks have begun to focus on optimizing their governance structures and practices, particularly at the board level.

As we discuss this topic with our clients, the conversation quickly turns to the role and function of the bank's director loan or credit committee, which we refer to herein as the "Loan Committee." We continue to believe that Loan Committees should move away from the practice of making decisions on individual credit decisions absent a specific legal requirement, and here we set forth the position that this change should be made in order to enhance Board effectiveness, not just to avoid potential liability.

ENSURING BOARD EFFECTIVENESS

Whenever we advise clients with regard to governance, our fundamental approach is to determine whether a given course of action helps or hinders the Board's ability to carry out its core functions. Of course, defining the core functions of a Board can be a difficult task. Fortunately, the staff of the Board of Governors of the Federal Reserve System recently outlined its view of the core functions of a bank Board. We agree with the Federal Reserve's outline of these functions as set forth in its proposed guidance regarding Board Effectiveness applicable to large banks. These functions are

- set clear, aligned, and consistent direction;
- actively manage information flow and board discussions;
- hold senior management accountable;
- support the independence and stature of independent risk management and internal audit; and
- maintain a capable board composition and governance structure.

In carrying out the final core function of evaluating a bank's governance structure, a board should evaluate whether the practice of making individual credit decisions supports its pursuit of the first four functions. We believe that it does not, as described below.

Considering individual credit decisions hinders the committee's ability to set overall direction for the credit function.

We have observed time and time again that Loan Committee discussions are most apt to dive "into the weeds" and stay there. In most Loan Committee meetings, the presenting officer directs the committee's attention to an individual credit package and discusses the merits and challenges related to the proposal. Committee members then typically ask detailed questions about the particular financial metrics, borrower, or the intended project, assuming that any discussion occurs at all prior to taking a vote.

While it may sometimes be healthy to quiz officers on their understanding of a credit package, focusing on this level of detail deprives the Loan Committee of the ability to focus on setting direction for the bank's overall loan portfolio. In fact, in many of the discussions of individual credits, detailed questions about the individual loan package distract from the questions that really should be asked such as "What is the market able to absorb with regard to this project?" and "What is our overall exposure to this segment of our market?"

In setting direction for the credit function of the bank, the Loan Committee should look at overall market trends, concentrations in the bank's loan portfolio, and any emerging opportunities on

which the bank should focus. To the extent that discussing individual credits takes the committee's focus away from these issues, the practice should be reevaluated.

The pressure for responsiveness frequently creates an inadequate information flow for making decisions.

As its second core function, the Federal Reserve suggests that Boards are charged with managing information flow and their meetings, and the same can be said for Board committees. We often see Loan Committees caught in a catch-22 with regard to information flow, and it is driven by the practice of considering individual credits.

Most banks pride themselves on their responsiveness to loan requests. For community banks, personal service and responsiveness are the key areas of branding focus. If the Loan Committee is required to grant prior approval for each loan request prior to an approval being communicated to the borrower, the Loan Committee must be equally responsive. The desire to move with speed typically creates an information flow that does not support proper governance.

We see this issue unfold in one of two ways. First, bank officers may want to give directors time to consider the credit materials and may submit incomplete draft credit packages with material information omitted, then ask the committee to approve the loan subject to the final information being gathered. Assuming the committee is willing to grant an approval subject to material information being gathered and with authority delegated to officers to gather and evaluate the missing information, one must ask what the committee has really accomplished if meaningful parts of the underwriting continue to be left to officers. Would it not be better to delegate the gathering and evaluation of all of the detailed information to officers, subject of course to the bank's loan policy?

Alternatively, we see Loan Committees left with very little time to read and evaluate long and detailed credit packages before a decision is needed. This situation is even more troubling. Making decisions with inadequate time to prepare and consider the underlying information provides tremendous risk of making poor decisions. In addition, the practice may not satisfy the director's legal duty of care if he or she does not have time to read the materials.

The practice of considering individual credit decisions harms the Loan Committee's objectivity in evaluating management.

We once discussed the prospect of changing a Loan Committee's credit approval practices with a bank president, and his response was, "If I am on the hook for these loans, I want all of them to be on it with me." This statement was made in jest, but it holds a disturbing truth for Loan Committees that approve individual credit decisions. Once the Loan Committee approves a loan, it jointly owns the moral accountability (if not legal) for the loan with management. As a result, the Loan Committee will have a more difficult time making an objective evaluation of the performance of the originating and underwriting professionals responsible for the loan.

We believe that the Loan Committee can perform a more effective arm's length evaluation of the bank's credit officers when it is not involved in individual credit decisions. By co-signing on credit decisions, individuals will inevitably rationalize poor decisions and fail to give due credit for good ones. Objectivity is key in management evaluations, and removing itself from individual credit decisions will help foster the Loan Committee's objectivity.

By removing a focus on individual credits, the Loan Committee can focus on credit risk appetite.

When the Federal Reserve describes independent risk management, we immediately think of the establishment of appropriate credit risk appetite, which is a natural function for the Loan Committee. Being in the risk business, each bank has to make a choice as to where it wants to sit on the risk curve. For some, it is worth taking more credit risk than their peers in order to pursue earnings and growth goals. For others, a more conservative approach to

credit risk is desired, even if it means risking earnings because the bank is unwilling to make loans that its competitors offer.

No matter the approach that a bank takes, it is choosing to take some level of risk. The role of the Board and its committees is to set a risk tolerance and then monitor the management of that risk. We do not believe it is reasonable to expect a Loan Committee to perform that very important function while at the same time attempting to co-underwrite individual loans. To the contrary, making decisions on individual loans prevents the Loan Committee from focusing on the overall loan portfolio and monitoring risks that may be emerging in it. We believe a focus on setting appropriate credit risk appetite in lieu of individual credits enhances the performance of the Loan Committee.

THE CHALLENGES

Notwithstanding these benefits derived from moving away from making decisions on individual credits, many directors and banks are hesitant to do so. Below are some frequently asked questions about making the change and our responses.

Aren't we required to approve individual loans?

In the past, the laws of many states required directors to approve all loans, while laws in other states limited board approvals for those loans that exceeded a certain percentage of the bank's capital. However, with many states having revisited their state banking codes over the past generation, nearly all of these requirements have been eliminated. For example, North Carolina's 2012 re-write of its banking code eliminated a requirement that directors of a North Carolina state bank approve all of the bank's loans.

While directors should be careful to confirm that their state has eliminated broader loan approval requirements, federal law now only requires board approval of insider loans subject to Regulation O.

Why are some boards still approving individual loans if there is no legal requirement to do so?

Among those banks continuing to approve loans, we believe inertia may be the chief reason for the continuation of this practice - "we've always done it that way." In other banks, directors may believe that it is their job to approve the bank's largest loans or those that deviate from the bank's loan policy, as they constitute the biggest risk to the capital of the bank. At the same time, why should those who have the least banking experience and credit training be making decisions on the riskiest credits? And are weekly or bi-weekly meetings to approve individual credits the best use of the time and talents of directors or an effective way to add value to the bank's credit function?

In the worst case, we have seen some boards continue to participate in individual credit decisions because the board has different risk preferences from management or because it has lost confidence in the management team altogether. In these circumstances, if the board feels that it "knows better" than its management, it would often be better served to find new management it trusts than to approve individual loans on its own.

What will the regulators think?

The bank's regulators of course want to ensure that the bank has sound risk management practices, and the Loan Committee performs a key function in that process. We believe that regulators are now seeing that the Loan Committee's function in risk management is best performed when it stays "out of the weeds" of individual credits. As evidenced by the Federal Reserve's recent proposed guidance, we see a shift in regulatory mindset in favor of directors focusing on higher level issues. While we acknowledge that some degree of examiner discussion and education may be necessary as banks change their practices, we are not aware of any pushback from regulators related to this more streamlined approach to credit approvals.

Won't I lose the market knowledge that I gain from seeing credit activity at the individual credit level?

This question raises an important distinction – we are not suggesting that directors no longer be made aware of the individual loans being made by the bank. Instead, we are suggesting removing Loan Committee approval as a prerequisite to the bank's approving a loan. Consistent with their function of managing information flow, directors should continue to receive all information that they desire with the necessary level of detail to allow the Loan Committee to perform at its best.

I have specialized knowledge related to certain loans. Won't the bank be worse off if I cannot offer it?

In many cases, Loan Committee members have specialized knowledge, be it at the industry level or with regard to the character of individual borrowers. In these cases, it may be helpful for loan officers to consult with these directors prior to extending an approval. We suggest that these special circumstances be discussed by the Board and, if appropriate, that officers be directed to consult with appropriate directors prior to extending credit. Offering this input still falls well short of the formal prior approval process that the bank likely has today in terms of distracting the Loan Committee from its core functions.

ADDED BENEFITS

While we believe the primary benefits of moving away from the prior approval of individual credits are primarily related to enhancing the effectiveness of the Loan Committee, those are not the only benefits. First, the bank's responsiveness to borrowers should improve if decisions are made by full-time officers who are in the bank every day.

Second, we believe that moving away from approval of individual credits reduces litigation risks for directors. In claims by the FDIC as receiver for failed banks, the FDIC frequently focused on individual loans approved by the Loan Committee. In depositions, the FDIC frequently focused on details in the credit package, including inconsistencies and parts of the credit package that were left blank. These claims were not limited to failed banks. In some shareholder derivative actions, the board's role in approving individual loans came under fire.

While the Loan Committee will continue to perform many important functions, its decisions will be more focused on high level strategic matters. Assuming proper information and deliberation, those decisions are more difficult to criticize, even with the benefit of hindsight. For example, a considered strategy of pursuing commercial real estate lending based upon current market information is more difficult to criticize than an individual loan that goes bad. Individual credit decisions are always susceptible to criticism with the benefit of hindsight.

CONCLUSIONS

As we have discussed above, the Board and its Loan Committee has a significant role in the bank's credit and risk management policies, but this role typically should not include approval of individual loans. Instead, keeping the Board focused on monitoring management's compliance with the bank's loan policies, procedures, and overall credit strategy is a far better use of directors' time than it is to act as a rubber stamp on individual loans. We have found that taking a more strategic approach to the credit function puts the board in a better position to use and relay its unique talents and perspective to management and streamlines board discussions to facilitate the discussion of other risks and opportunities presented to the bank. Together, eliminating board approvals of individual loans can prove to be addition by subtraction, and better position the bank and the board to better manage the institution into the future.

IF YOU HAVE ANY QUESTIONS PLEASE CONTACT

Ken Achenbach
+1 404 572 6808
ken.achenbach@bclplaw.com

Barry Hester
+1 404 572 6711
barry.hester@bclplaw.com

Rob Klingler
+1 404 572 6810
robert.klingler@bclplaw.com

Beth Lanier
+1 404 572 4571
beth.lanier@bclplaw.com

Jim McAlpin
+1 404 572 6630
james.mcalpin@bclplaw.com