An Assessment of the Corporate Governance Practices of Fifth Federal Reserve District Banking Institutions

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Introduction

An effective corporate governance framework is essential to a banking organization's overall safety and soundness. To that end, traditional examination activities have always sought to ensure that boards of directors have established effective corporate governance frameworks for their organizations. While traditional examination activities have been sufficient to assess management oversight, recent high profile failures in corporate governance and the subsequent passage of the Sarbanes Oxley Act of 2002 (SOX) prompted the Fifth Federal Reserve District's Department of Banking Supervision and Regulation (Department) to collect and assess the range of corporate governance practices currently existing at District institutions. Based on this data, we have identified sound practices as well as areas where institutions could improve governance practices. To assist in this effort, existing examination procedures were enhanced through the development of a corporate governance module. The module was subsequently utilized in all examinations of state member banks in addition to most of the largest bank/financial holding companies. The findings discussed in this paper are the results of the reviews conducted in 2003.

Scope

Any review of corporate governance processes and practices must first begin with a comprehensive definition of governance itself. Only through the development of a definition of corporate governance that banking organizations' governance processes and practices can be fully evaluated.

After an extensive review of recent research and literature, the Department developed the following definition of corporate governance:

> *"Corporate governance is the framework by which a company's board of directors and senior management establishes and pursues objectives while providing effective separation of ownership and control. It includes the establishment and maintenance of independent validation mechanisms within the organization that ensure the reliability of the system of controls used by the board of directors to monitor compliance with the adopted strategies and risk tolerance."*

With this definition in hand, along with the revised corporate governance module, we began to assess governance processes and practices at the District's community, regional, and large-complex banking organizations (LCBOs). This assessment focused on four general topic areas: structure effectiveness, board supervision adequacy, management effectiveness, and adequacy of control functions. A three tiered rating system (i.e. "strong", "adequate", and "weak") was used to summarize the results of the review.

The review of structure effectiveness targeted the organizational structure through a top down review of legal entities, individuals, and policies. More specifically, it focused on how clearly roles, responsibilities and lines of authority, as well as communication channels, were reflected in the legal structure of the institution. In addition, we considered the quality of the ethics policy and the code of employee conduct established by the board to guide the actions of management and employees on behalf of the institution.

To assess the adequacy of board supervision, we focused on eleven elements that demonstrate the ability of board members to understand and oversee the activities of the organization. Board charters were reviewed to understand the legal requirements that were established for the board by the shareholders. The assessment of board committees focused on how committees were structured, the quality of minutes and most importantly, the quality, frequency, and timeliness of information flows to the full board. Given their importance, additional attention was focused on the activities of the audit and governance committees. The evaluation of board supervision adequacy also targeted board members and their qualifications, the reasonableness of compensation practices, the quality and accuracy of board minutes and MIS reporting, and the adequacy and frequency of training and self assessments. Finally, the assessment focused on board member attendance and the use of executive sessions by outside directors.

Evaluation of management effectiveness centered on management committee charters and activities, and line of business metrics. In particular, our review of this area focused on the qualifications of committee members, the scope of committee activities, and the flow of information to the board. Line of business management, through self assessments and other MIS, can provide useful information to the board of directors regarding risk profile and valuable insight for setting strategy. Thus, for institutions managed by line of business, which were typically the more complex institutions, the quality of self-assessments was evaluated.

As control functions provide an independent assessment of the quality of internal controls and risk levels, their effectiveness and relationship with the board is an important component of corporate governance. In this context, our evaluation of the adequacy of control functions focused on the efficacy of the internal audit, external audit, credit review, and compliance.

During 2003, corporate governance processes and practices were evaluated at thirty-seven Fifth District banking organizations. To minimize regulatory burden, the reviews were included in the ongoing supervision programs of the district's two LCBO's and embedded within commercial examinations of five large regional organizations and twenty-one community banks. In addition, nine community banks were evaluated off-site by reviewing examination reports and work papers. In analyzing the results of these reviews, institutions were segregated by complexity[1], in addition to being analyzed as a whole.

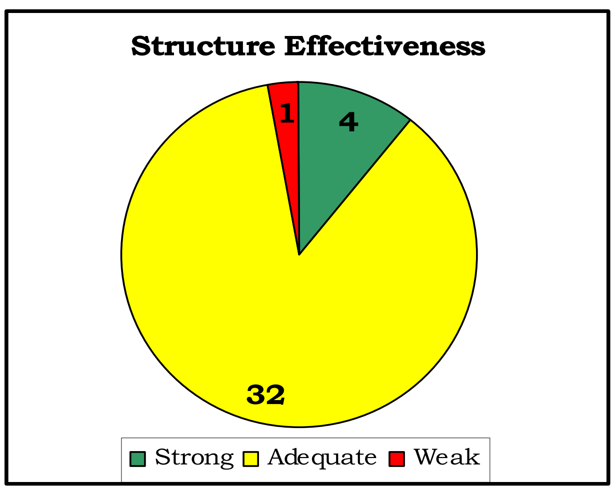
[1] **Less Complex Organizations** are defined as organizations that (i) do not have any, or only a small number of minor affiliates and/or subsidiaries; (ii) have one location or a small number of branches in a diminutive geographic area; (iii) have no, or very little, optionality in the investment portfolio; (iv) have no or very little counterparty risk exposure; (v) and does not have, and is not required to have, an internal audit function. **More Complex Organizations** are defined as organizations that (i) have affiliates and/or subsidiaries; (ii) have a network of branches, affiliates, or subsidiaries in multiple geographic locations; (iii) have optionality in the investment portfolio; (iv) have counterparty risk exposure, (v) and have, or are required to have, an internal audit function.

Findings

Although room for enhancement exists in several areas, the vast majority of institutions were considered to have satisfactory governance practices in place. This includes board and management structures that are designed to promote clear lines of responsibility, provide for the appropriate escalation of information and key issues, and ensure the proper level of supervision by the board. Furthermore, established control functions assist the directorate in monitoring the level of risk taking. In addition, and not surprisingly, the findings also indicate that the range of practices, varied among institutions depending on their size and complexity, particularly with regard to control functions.

Structure Effectiveness

In general, most of the organizations that were reviewed had effective ***board structures*** and exhibited at least adequate practices. Moreover, the review indicated that all organizations had well defined lines of reporting and responsibility that facilitated effective communication between senior management and the board of directors.

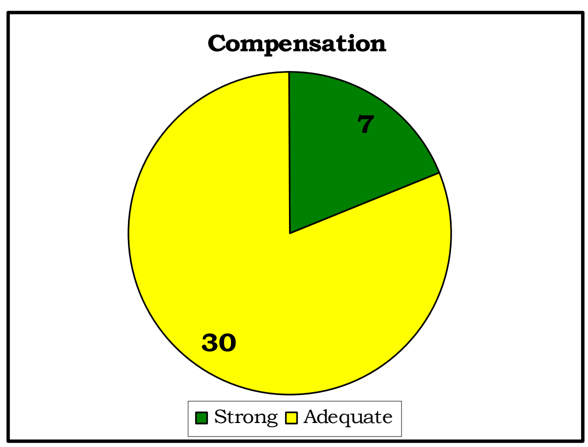


In addition, the directorates had approved conduct and ethics policies to guide their organizations.

Adequacy of Board Supervision

As mentioned previously, the adequacy of board supervision was addressed through the evaluation of the eleven key elements deemed necessary for effective oversight. Most organizations exhibited at least adequate practices in all eleven elements. Of note, all institutions had at least adequate director compensation practices and board membership, or director qualifications. However, ***weak practices*** were evident in the areas of board self assessments, director education, and corporate governance committees.

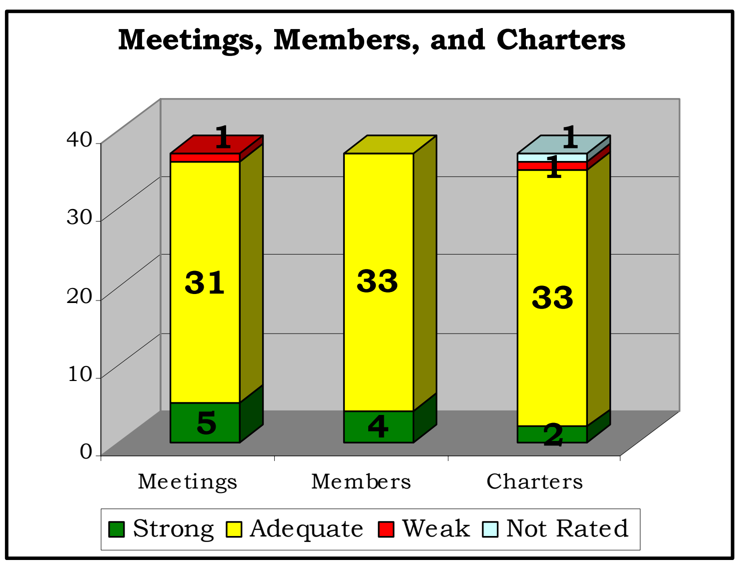
In terms of ***director compensation***, which had the greatest number of organizations rated "strong", practices ranged from the payment of no compensation to combinations of cash, stock, and deferred payments. Instances where no remuneration was provided were only found at de novo institutions, while combinations of cash, stock, and deferred payments were generally found at more complex organizations. There appears to be an emerging trend towards stock and deferred payment practices at less complex organizations. These types of



performance-based ***sound practices*** were primary drivers where "strong" ratings were assigned.

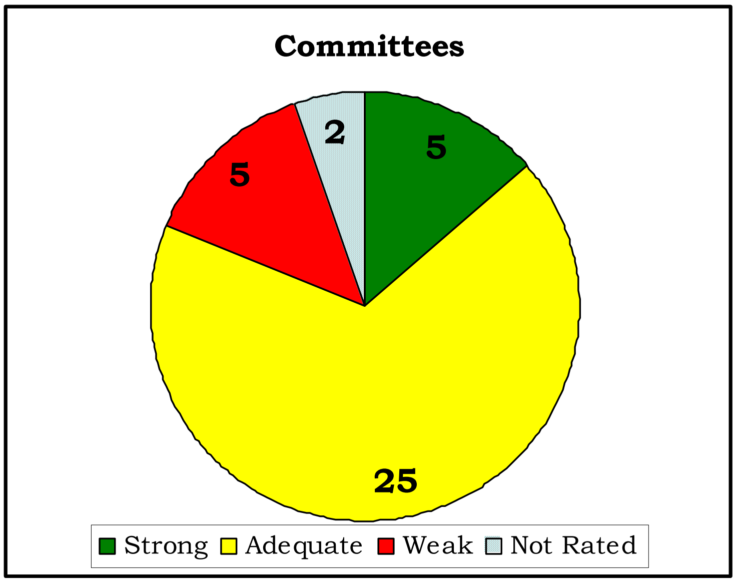
For the most part, ***board meetings*** were well attended and only one organization was assigned a weak rating due to excessive absences. Practices at most organizations were considered at least adequate if the board met monthly and good directorate participation and attendance were evident. ***Sound practices*** were observed at organizations where outside directors held executive sessions (without management present) on a regular basis.

Board members were found to be fully qualified individuals with broad backgrounds and diverse experiences. In more complex organizations, board members were either industry leaders or, in some instances, prominent public figures. In less complex organizations, board members were mostly local business and community leaders. A ***sound practice*** was cited at one less complex organization for having the roles of chairman and vice-chairman filled by outside directors.



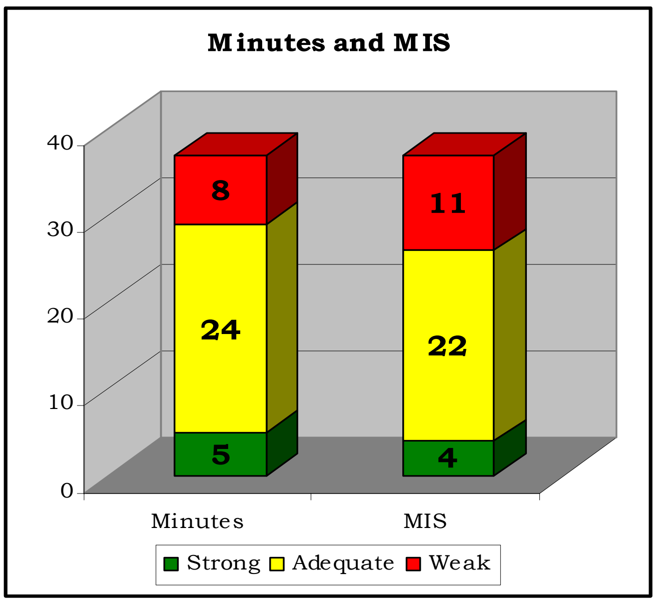
Most ***board charters*** addressed the number, terms, and qualifications of directors, the director election process, and the types of board committees required. ***Sound practices*** were noted where charters included provisions for staggered terms as well as specific corporate governance guidelines outlining desired characteristics for board membership. Only one less-complex organization was rated weak due to discrepancies between the board charter and actual practice. In addition, one less-complex organization was not rated because its board charter was not available for review.

While some organizations exhibited weak practices with respect to ***board committees***, most weak assessments occurred at less-complex organizations where committees (1) did not have charters, (2) lacked detailed committee minutes, or (3) failed to provide sufficient information to the board. However, one more-complex organization was also considered to have weak practices for similar types of deficiencies. In contrast, organizations demonstrating ***sound practices*** had detailed committee charters that clearly specified



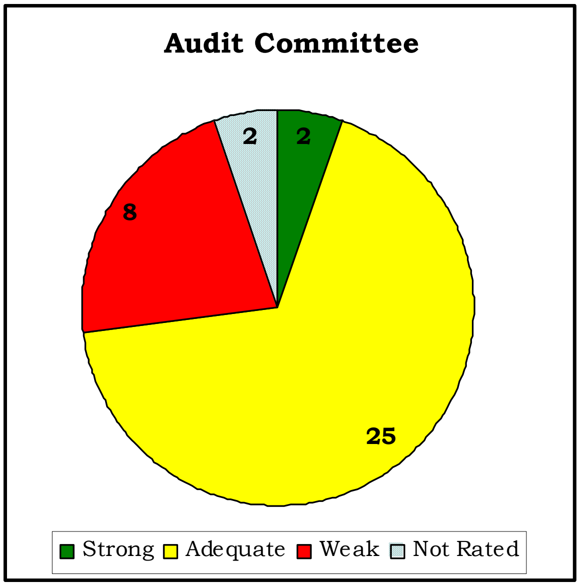
authorities granted and also provided detailed, accurate, and timely information to the board. Two institutions that were reviewed off-site were not rated due to limited information.

The review of ***board minutes*** revealed a wide range of practices with regard to the documentation of the board's activities. For organizations exhibiting ***sound practices***, minutes were detailed and included discussions of major risk areas, policy exceptions, budgets, and strategic plans. For organizations exhibiting ***weak practices***, minutes were generally in summary form and did not clearly identify board members and their comments. In addition, there were only limited discussions of major risk areas, policy exceptions, budgets, and strategic plans. For the most part, weak practices were observed at less-complex organizations.



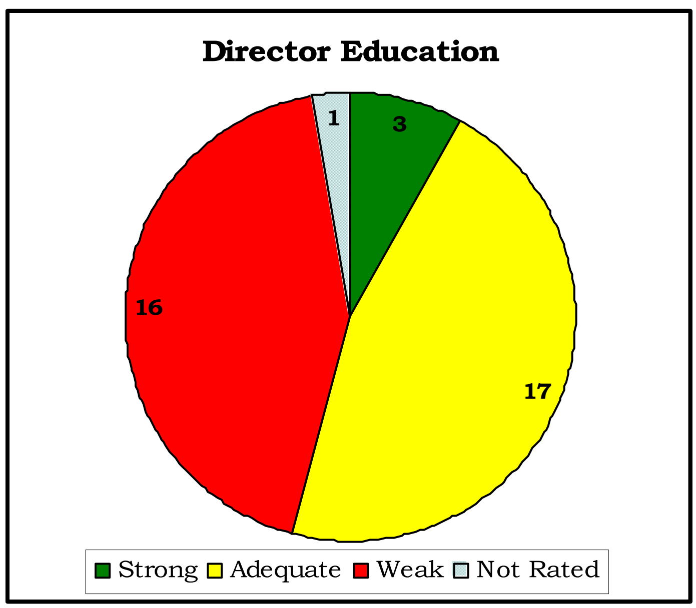
MIS provided to board members was generally sufficient to effectively evaluate risk. MIS reports that were highlighted as ***sound practices*** were detailed, accurate, and timely and covered a variety of topics including profitability, credit quality, capital, liquidity, market risk, compensation, and the budget, and explicitly addressed exceptions to policy and established risk tolerances. In addition and where appropriate, comparisons were made between actual performance and strategic plans. ***Weak MIS*** insufficiently covered major risks and was not provided in a timely manner. In several cases, it was noted that board packages were received at the meetings and not provided well enough in advance to allow for an effective preparation. This was generally noted at less-complex organizations.

The range of practices with regard to ***audit committees*** varied significantly. Organizations subject to SOX were generally found to be in compliance with the provisions of the Act. Those organizations subject to SOX and not in full compliance as of the date of their corporate governance reviews were in process of addressing issues regarding the upcoming SOX requirements for communications with external audit firms, financial expert designations, and whistler blower programs.



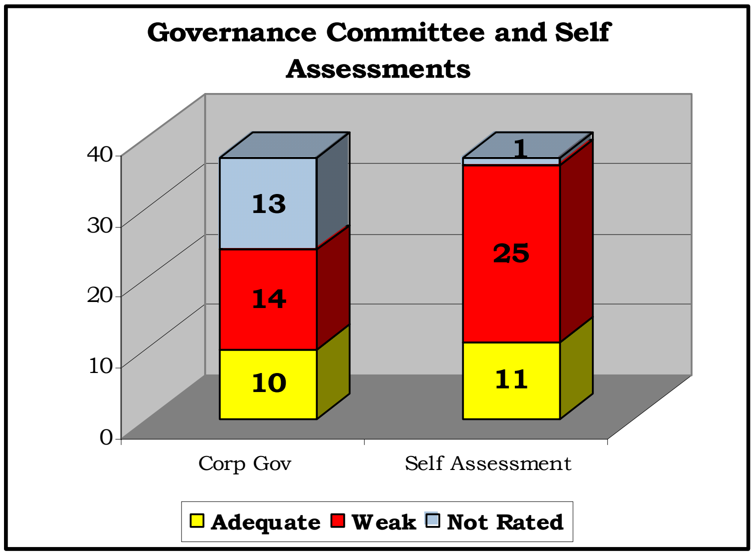
Interestingly, all institutions that demonstrated ***sound practices*** for this topic were subject to SOX and had independent and financially literate members that pre-approved audit and non-audit services. In addition, these audit committees had fully addressed upcoming SOX requirements. Organizations with ***weak audit committees*** were mostly less-complex and either did not have audit committees or lacked the appropriate oversight of the audit function. Weak ratings were not assigned to organizations lacking audit committees, provided that the responsibilities of that committee were executed by the full board.

Director education was noted as one area where the industry appears to have room for improvement as practices were considered weak at nearly half of all organizations reviewed. Directors at many less-complex organizations were provided no training at all. Surprisingly, training at several more–complex institutions was also weak as it was informal and only administered during orientation. Moreover, in some instances training was entirely absent. Director education should be ongoing for all organizations regardless of size or complexity. In addition, ***sound practices*** in director education should include the use of both internal and external training resources to enhance director's knowledge and skills. A ***sound practice*** noted in some less-complex



organizations is the use of Director Colleges sponsored by State and Federal regulatory agencies.

Many organizations have not established ***corporate governance committees*** or completed ***self assessments***. In the absence of governance committees, oversight matters are usually handled by the full board and this is considered an acceptable practice as long as the board clearly fulfills its oversight responsibilities.

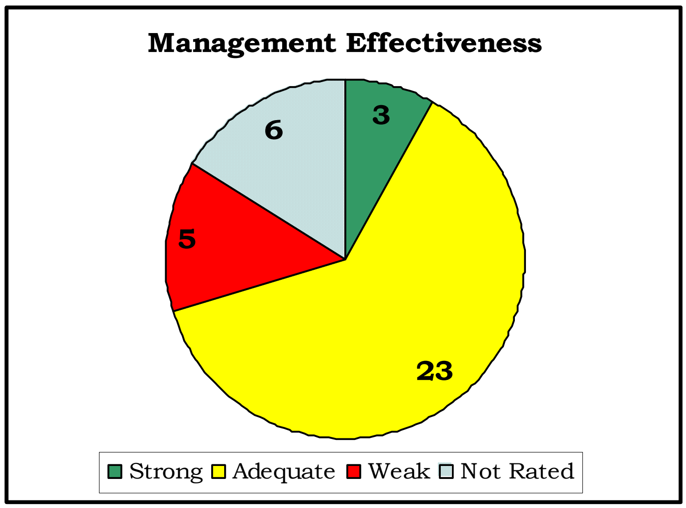


Nevertheless, whether fulfilled by a separate committee or the full board, oversight practices in this area should, ***at a minimum***, include (1) an assessment of board performance; (2) a review of director qualifications; (3) the identification of prospective members; and (4) the review of director and senior management compensation.

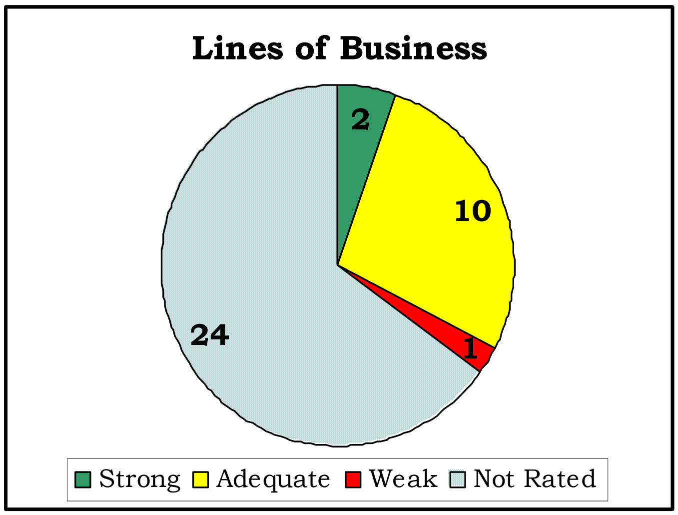
Whether governance of the organization is administered by a corporate governance committee or the full board, the completion of a ***self assessment*** or a third party assessment is considered an essential oversight practice. Regardless, the majority of organizations have not completed assessments of any type. Self assessments should include an evaluation of whether the board and its committees are functioning effectively and if director knowledge and skills are appropriate for the risk profile of the organization.

Management Effectiveness

The evaluation of ***management effectiveness*** revealed that the clear majority of organizations had management committee structures that provided for sufficient oversight of operations and risks. In most cases, these structures allowed for effective communication between the board and senior management. Organizations that evidenced ***sound practices*** in this area had management committees that (1) had charters that clearly outlined responsibilities; (2) met on a monthly basis; (3) documented their discussions; and (4) provided detailed information to the board. In contrast, in organizations where management practices were considered ***weak***, committees met only as needed and provided limited or no information to the board for review. Organizations "not rated" in this area were less complex and did not have management committees.



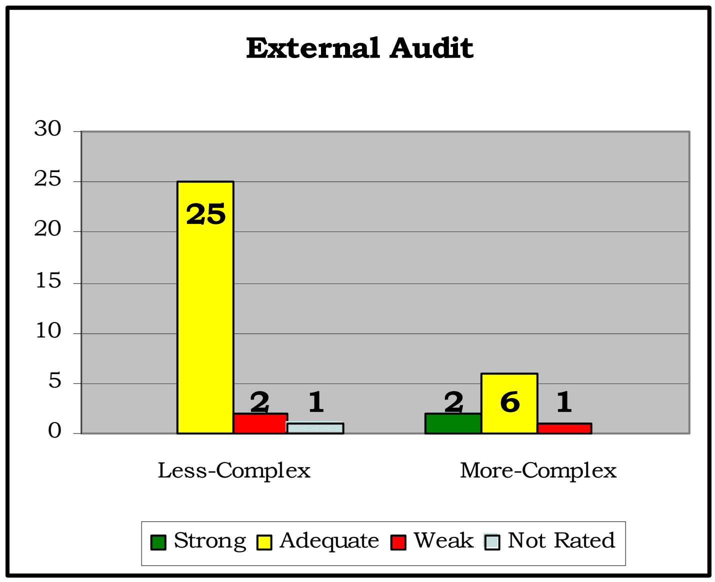
While more-complex organizations typically manage by ***business line***, less-complex organizations typically manage the entity as a whole. Accordingly, the clear majority of less-complex organizations were not rated. As a ***sound practice***, organizations that are managed by business lines should have business line managers perform self assessments so that the board can determine progress towards performance, and risk goals and objectives. In addition, these assessments should also track whether recommendations to implement change have occurred and they should be reviewed by audit or an independent party.



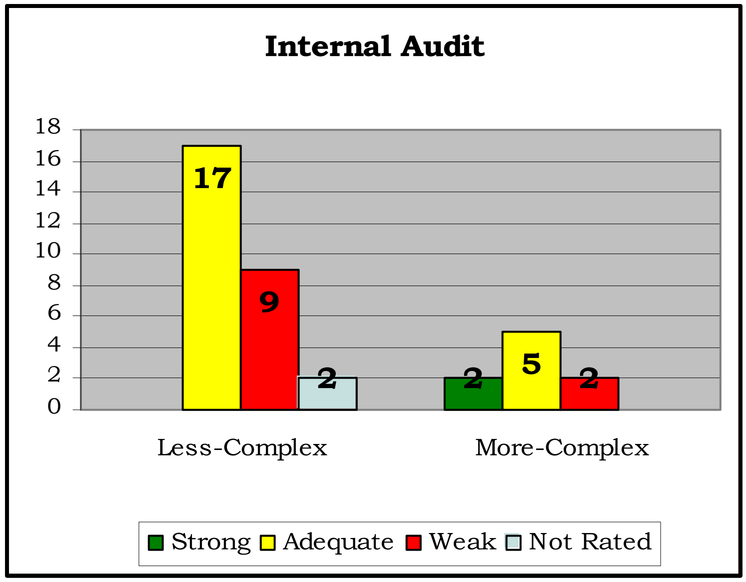
Adequacy of Control Functions

The adequacy of control functions was assessed through an evaluation of four key elements deemed necessary to assist the board in monitoring the organization's overall control structure. Those four elements are external audit, internal audit, credit review and compliance. Control functions are vital to an organization's overall safety and soundness as they are responsible for developing and providing independent assessments of operational controls over the institution's activities. Through these functions, the board receives assurances that the state of operations are as management reports, and thus they function as a necessary check and balance on senior management decisions and actions.

In general, ***external audit*** was found to be adequate regardless of the size or complexity of the organization. For organizations subject to SOX, external audit ***should provide financial review only and not services related to internal audit or any other area prohibited by SOX Section 201.*** In addition, ***sound practices*** suggest that communications from external auditors be directed to the board or a committee of the board and ***not*** to management and include discussions of areas reviewed, ratings assigned, and recommendations offered. While less complex organizations are generally not subject to SOX, they could improve practices by adopting some of the Act's requirements. In particular, external audit ***should always*** report its findings directly to the board or a committee thereof.

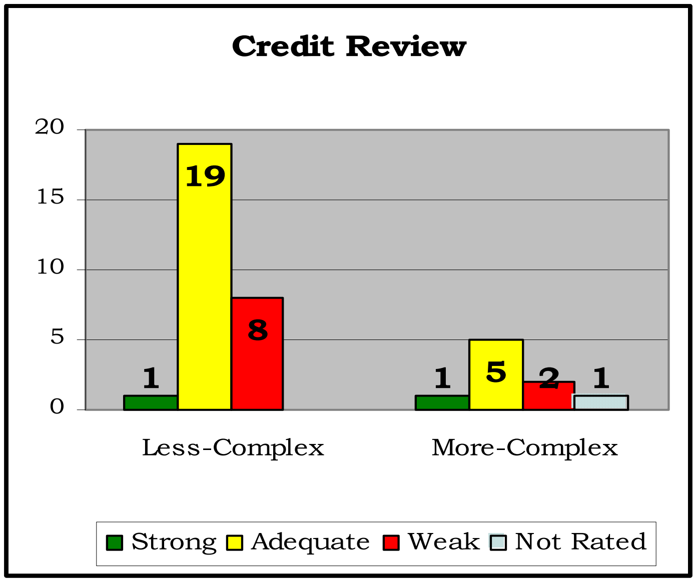


Internal audit was considered adequate at most organizations. However, there were deficiencies noted, particularly at less-complex organizations. Whether outsourced or in-house, internal audit staff at some less-complex organizations lacked the full range of qualifications and knowledge necessary to administer the function effectively. In some instances audit schedules were not met and audit reports lacked the necessary detail to support conclusions. Internal audit **weaknesses** at more-complex organizations included (1) inadequate coverage of risk areas; (2) poor information flows to the audit committee; and (3) staff levels that were not commensurate with the level of growth.

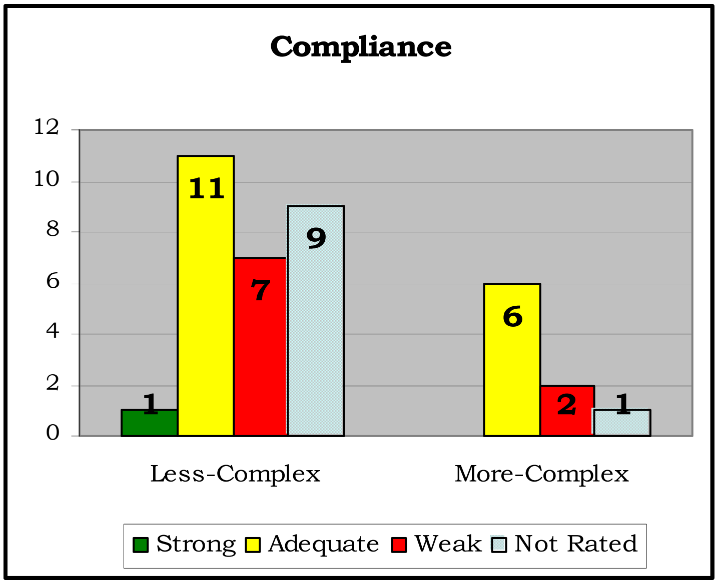


Organizations exhibiting ***sound practices*** had independent, influential, and respected internal audit functions. In addition, these organizations also had audit committee chairmen that were responsible for the annual appraisal of the internal audit function and had internal audit functions that used business line assessments to develop their annual audit plans.

Credit review functions were found to be sufficient to identify, measure, monitor, and control credit risk at most organizations. ***Sound practices*** in this area include (1) the development of policies that clearly define responsibilities and procedures; and (2) provide ongoing assessment of credit quality, credit administration, and adherence to policies to senior management and the board. Less-complex organizations not meeting expectations did not have independent review functions or current policies. All organizations should have credit review functions or other practices that provide independent evaluation of credit risk processes and validate risk profiles that are presented to the board.



For the most part, ***compliance*** functions adequately covered regulatory and legal requirements for their organizations. Nevertheless, at less-complex organizations, ***weaknesses*** were noted where policies did not adequately address laws and regulations and where staff levels were insufficient to fully cover operations (see illustration on page 21). In some instances, these weaknesses resulted in violations of law (i.e., Regulation H (BSA) and Regulation O). Interestingly, a small number of more-complex organizations evidenced weak compliance practices because of the lack of audit coverage.



Sound practices for compliance include having experienced and knowledgeable personnel, issues aggregated and reported to appropriate board committees, and personnel perform follow up on issues after corrective action has been implemented. This component was not rated at organizations where available information was limited.

Conclusion

Overall corporate governance processes and practices in the Fifth Federal Reserve District were found to be adequate. Corporate structures were well documented, clearly defined, and found to promote effective communication between senior management and the board. In addition, despite some weaknesses with regard to director education, board self assessments, and corporate governance committees, governance practices were sufficient to allow directors to fulfill their responsibilities. While control functions have been established to assist board members in monitoring the level of risk taking, weaknesses were noted in internal audit, credit review, and compliance. Notwithstanding the above noted weaknesses, there were also numerous "sound" practices observed in virtually all elements of the governance process. As a result of this review, we believe that existing corporate governance processes and practices are generally sufficient to help promote safety and soundness in banking institutions in the Fifth Federal Reserve District.

Appendix A

Corporate Governance / Risk Management Assessment

Organization: _ ___________ Date: __________ Total Assets:________
City: ___________________ State: ____________ RSSD: ______
Preparer: ________________ Reviewed: ___________________________

Definition

"Corporate governance is the framework by which a company's board of directors and senior management establishes and pursues objectives while providing effective separation of ownership and control. It includes the establishment and maintenance of independent validation mechanisms within the organization that ensure the reliability of the system of controls used by the board of directors to monitor compliance with the adopted strategies and risk tolerance."

Ratings

Strong - For all, or a significant majority of the characteristics reviewed for each element, the institution performed at the highest standards possible, and no characteristics were rated weak.

Adequate - The institution generally met expectations for each element but could have anywhere from one to a few instances where individual characteristics did not meet expectations. These shortfall(s) could be easily addressed in the normal course of business and would not be significant enough to adversely affect any supervisory ratings.

Weak - The institution had one or more characteristics where there were serious shortfalls in meeting minimum expectations. These shortfall(s) would require significant efforts to correct and could negatively affect an institution's supervisory rating.

Objectives

- Detail and assess corporate governance practices and risk management structures within Fifth District organizations.
- Identify best practices and negative outliers across the district from information obtained from reviews.

Work Program

I.		**Structure Effectiveness**	
	A.	Document the Organizational Structure and discuss any weaknesses.	
		1. Review the legal entities that make up the organization and document the structure.	
		2. Review the decision-making process and identify the individuals involved. Also, include those individuals involved in risk management and policy implementation.	
	B.	Document whether the institution's common stock is publicly-traded or the	

		institution is required to file SEC reports through the following: ***(Note: Institutions registered with the SEC (publicly traded or file reports with the SEC, i.e. 10K, 10KSB) or have 500 shareholders or more are subject to Sarbanes-Oxley requirements.)***	
		1. Is the entity a SEC registrant?	
		2. List stock exchange and ticker symbol.	
		3. Does the organization have more than 500 shareholders? (If available, please list number of shareholders.)	
	C.	Identify external audit firm and the scope of their engagement, and internal audit staff.	
	D.	Identify any outsourced arrangement as well as the firm used by the organization. (i.e., IT Audit, Model Validation.)	
	E.	Obtain and review the entity's key corporate governance documents.	
	F.	Assign rating to this area. (Strong, Adequate, Weak)	

II.		**Directorate Structure and Administration**	
	A.	Directorate Membership	
		1. Note the number of directors required by the organization's charter/bylaws, compared to actual number of directors.	
		2. Note the number of inside and outside directors.	
		3. Determine the qualifications for directors as outlined in the organization's charter/bylaws. Note the range and level of experience on the Board. (Name, age, years with organization, occupation)	
		4. Note required retirement age, if any.	
		5. What are the terms for elected directors?	
		6. Describe the nomination process.	
		7. Are there requirements for the chairman to be internal or external and what is the role for lead outside director, if required?	
		8. Does the board have any director that serves on more than five boards and are they effective in deciding the affairs of this	

		institution?	
		9. Examiner comments.	
		10. Assign rating to this area. (Strong, Adequate, Weak)	
	B.	Directorate Compensation	
		1. Detail the amounts and types of compensation for the directorate.	
		2. Are the amounts paid considered reasonable?	
		3. Determine schedule of payments.	
		4. Examiner comments.	
		5. Assign rating to this area. (Strong, Adequate, Weak)	
	C.	Directorate Education	
		1. Describe the board's training program, if any, and determine its adequacy. (Note frequency and areas for which training is provided)	
		2. Who conducts the training (i.e., CFO, consultant, banking schools) and who attended?	
		3. Examiner comments.	
		4. Assign rating to this area. (Strong, Adequate, Weak)	
	D.	Directorate Assessment	
		1. Does the directorate perform self-assessments?	
		2. Does the directorate engage an external firm to conduct an assessment?	
		3. At a minimum, is the content of the assessment linked to the board's charter and responsibilities?	
		4. Comment on the outcome of the assessment (especially the degree to which recommendations have been addressed.)	
		5. Examiner comments.	
		6. Assign rating to this area. (Strong, Adequate, Weak)	

III.		**Directorate Function and Supervision**	
	A.	Board Meetings	
		1. Determine the meeting schedule.	
		2. Comment on any excessive absences.	
		3. Do the outside directors convene an executive session (meetings without	

		inside directors present)? • What is the frequency of such meetings? • What is the purpose for these sessions?	
		4. Examiner comments.	
		5. Assign rating to this area. (Strong, Adequate, Weak)	
	B.	Board Agenda and Minutes	
		1. Obtain several sample agendas and the corresponding minutes.	
		2. What level of board participation is reflected in the minutes and does one figure dominate the process?	
		3. Do the agenda and minutes detail the board's review of the strategic plan and is it clear what is presented and discussed during these sessions?	
		4. Do the agenda and minutes detail the discussions surrounding the approval of the budget?	
		5. What is the timing of the information packets provided to the directorate prior to their meetings?	
		6. Examiner comments.	
		7. Assign rating to this area. (Strong, Adequate, Weak)	
	C.	Board Level Risk Reporting	
		1. Review several board packages to ensure information provided to board members is adequate (detailed vs. summary). Does the board package cover all major risk areas? Is it of sufficient depth and quality to accurately depict the existing risks?	
		2. For each of the areas below, list the reports provided for the directors' review and the frequency with which they are provided. • Asset quality. • ALCO/Liquidity. • Earnings. • Capital. • Compensation/Management. • Operations, legal and compliance. • Exception reporting, if not already included in the other areas.	

		• Other (describe).	
		3. Are reports in line with the strategic plan and objectives?	
		4. Is reporting consistent with the organization's budget?	
		5. In general, how are policy and performance exceptions reported to and addressed by the board?	
		6. Examiner comments.	
		7. Assign rating to this area. (Strong, Adequate, Weak)	
	D.	Board Committees **For each committee:**	
		1. List and discuss its primary function and meeting frequency.	
		2. How are committee memberships and the qualifications of committee members determined?	
		3. What are the requirements for rotating committee membership?	
		4. Are the chairs for each committee independent?	
		5. Review a sampling of the meeting agendas and minutes.	
		6. Review at a minimum, the packages for each committee including key MIS reports. Does the information adequately support the committee in fulfilling its responsibilities?	
		7. Examiner comments.	
		8. Assign rating to **each committee**. (Strong, Adequate, Weak)	
		Additional Section for the Audit Committee (including interaction with the external audit firm)	
		1. Does the committee include only outside independent[1] directors?	
		2. Does the committee have a "financial expert[2]"? Who is it? (SOX, Section 407)	
		3. Do minutes indicate that the external auditor discussed critical accounting policies and practices with the directorate?	
		4. Do minutes indicate that the external auditor discussed	

[1] See attached definition of "independence" under Sarbanes-Oxley
[2] See attached definition of "financial expert" from Sarbanes-Oxley

		alternative treatments within GAAP for policies and procedures with the audit committee?	
		5. Do minutes indicate the review and approval of audit plan and subsequent revisions to the audit plan?	
		6. Do minutes indicate the review of internal/external audit results and management responses?	
		7. Was the audit committee provided all written communications between the external audit firm and management?	
		8. Do minutes indicate that management and internal audit brought significant items to the committee's attention?	
		9. Does the audit committee review and approve the annual 10-K?	
		10. Does the audit committee review and approve the process for compliance with FDICIA 112?	
		11. Does the committee have procedures in place to resolve complaints about accounting, internal controls or auditing issues?	
		12. Does the committee have the resources to carry out its function? (The audit committee should have funds available to hire external audit firm(s) for audit and non-audit work as well as legal counsel to carry out it's duties.)	
		13. What is the process and the frequency with which the audit committee reports its activities to the full board?	
		14. Examiner comments.	
		15. Assign rating to this area. (Strong, Adequate, Weak)	
	E.	Corporate Governance	
		1. Who is responsible for corporate governance oversight? (i.e. committee, full board)	
		2. At a minimum, does the full board or committee address the assessment of board performance, the review of director qualifications, the	

		identification of prospective board members and the review of directorate and senior management compensation?	
		3. How does the organization review compliance with Sarbanes-Oxley and applicable stock exchange guidelines?	
		4. How often are governance matters, such as those items outlined in question 2 discussed? Are these matters captured in board and or committee minutes?	
		5. Examiner comments.	
		6. Assign rating to this area. (Strong, Adequate, Weak)	

IV. Management Effectiveness			
	A.	Management Committees	
		1. For each senior management committee, list and discuss the primary function.	
		2. Review each committee's charter and determine authorities granted.	
		3. How is committee membership determined? Are there specific qualifications for each committee?	
		4. How are disclosures for public documents reviewed?	
		5. List the meeting frequency of each committee.	
		6. Review a sample of meeting agendas and minutes.	
		7. Review at a minimum, one sample package for each committee including key MIS reports. Does the information adequately support the committee in fulfilling its responsibilities?	
		8. Examiner comments.	
		9. Assign rating to this area. (Strong, Adequate, Weak)	
	B.	Lines of Business	
		1. Review the policies, procedures and responsibilities for each reportable line of business to the board.	
		2. Review and document the reporting lines for each line of business.	
		3. How does management hold lines of business accountable for operating	

		results?	
		4. Is the line of business covered by an internal audit or external audit review?	
		5. Has each line of business established internal control procedures? Has internal audit or external audit reviewed this line of business?	
		6. Did management address internal audit/external audit findings?	
		7. How often are lines of business operations/results presented to the board? Does the board receive information relative to the risk levels in each line of business on a routine basis?	
		8. Do the lines of business perform self-assessments? (These assessments should focus on, but not be limited to, structure, policies and procedures, internal controls and risk levels.)	
		9. How are the results used?	
		10. Does an independent party review the results?	
		11. Does the board review the results?	
		12. Examiner comments.	
		13. Assign rating to this area. (Strong, Adequate, Weak)	

V. Adequacy of Control Functions			
	A.	Internal Audit	
		1. Review the department's charter or outsource agreement and determine authorities granted.	
		2. What are the reporting lines for the internal audit department or the outsourced function?	
		3. Are findings and recommendations from the internal audit department or outsourced function accepted and acted on by management and the board?	
		4. What are the qualifications of the internal audit department staff or outsourced function?	
		5. Has the internal audit staff or the outsourced function reviewed board reports for accuracy?	
		6. Has the internal audit staff or outsourced function reviewed the	

		line-of-business self-assessments?	
		7. Review internal audit's reporting to the full board and/or audit committee	
		8. Review annual audit plan.	
		8a. How is the plan developed? What is the process for setting priorities and assigning risk levels?	
		8b. Does it incorporate the major risk areas of the organization?	
		8c. Is the scope and coverage by the internal audit department or outsourced function adequate?	
		8d. Is the function on target to meet the plan?	
		8e. Is there adequate staffing to fulfill responsibilities?	
		9. What is the end product issued for each review?	
		10. Were internal control conclusions addressed through the appropriate channels?	
		11. Did the internal audit department or outsourced function review and assign a risk level to areas of the organization?	
		12. Examiner comments.	
		13. Assign rating to this area. (Strong, Adequate, Weak)	
	B	External Audit	
		1. What is the process for hiring external auditors for the annual financial audit? Did the full board or audit committee approve the scope?	
		2. What was the process for determining the scope of the external audit?	
		3. What is the process for approving additional services outside the annual financial audit? (Note the services provided by the firm auditing the financial statements.) Did the full board or audit committee approve the scope?	
		4. Were services provided by the external audit firm reviewed for compliance with the Sarbanes-Oxley Act[3]?	

[3] See attached list of prohibited services from Sarbanes-Oxley

		5. Review the fee schedule for the external audit and other services provided. Are they in line with peers?	
		6. Is there effective communication between the external auditing firm and the board of directors regarding audit findings?	
		7. Examiner comments.	
		8. Assign rating to this area. (Strong, Adequate, Weak)	
	C.	Credit Review	
		1. Review the policies, procedures and responsibilities for the credit review function.	
		2. Review and document the reporting lines for the credit review function.	
		3. Is there effective communication between the credit review function and the board of directors regarding findings? Are findings and recommendations accepted by management and the board?	
		4. Is the credit review function reviewed by internal or external audit?	
		5. What is the process for determining the scope or coverage for credit review?	
		6. Were internal control deficiencies addressed through the appropriate channels?	
		7. Examiner comments.	
		8. Assign rating to this area. (Strong, Adequate, Weak)	
	D.	Compliance	
		1. Review the policies, procedures and responsibilities for the compliance function (i.e., BSA, Regulation H, Regulation O, and Consumer Regulations).	
		2. Review and document the reporting lines for the compliance function.	
		3. Is there effective communication between the compliance function and the board of directors regarding findings? Are findings and recommendations accepted by management and the board?	
		4. Is the compliance function reviewed	

		by an internal or external audit?	
		5. How is the scope or coverage for the compliance review determined?	
		6. If there were internal control conclusions, were they properly addressed?	
		7. Examiner comments.	
		8. Assign rating to this area. (Strong, Adequate, Weak)	

EXHIBIT A

1. **Independence** "may not accept any consulting, advisory, or other compensatory fee from the company, or be an affiliated person of the company or any of its subsidiaries.
2. **Audit Committee Financial Expert** to mean a person who has the following attributes:
   - an understanding of generally accepted accounting principles and financial statements;
   - an ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
   - experience preparing, auditing analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
   - an understanding of internal controls and procedures for financial reporting; and
   - an understanding of audit committee functions.

   A person can acquire such attributes through any one or more of the following means:
   - education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
   - experience actively supervising a principal financial officer, principal accounting officer, controller, public account, auditor, or person performing similar functions, or experience overseeing and assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements; or
   - other relevant experience.

3. **Non-audit Services** "means any professional services provided to an issuer by a register public accounting firm, other than those provided to an issuer in connection with an audit or a review of the financial statements of an issuer."

   Prohibited Activities S 201 of Sarbanes-Oxley Act:
   - bookkeeping or other services related to accounting records or financial statements;
   - financial information systems design or implementation;
   - appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
   - actuarial services;
   - internal audit outsourcing services;
   - management functions or human resources;
   - broker or dealer, investment advisor, or investment banking services;
   - legal services and expert services unrelated to the audit; and
   - any other service that the board determines, by regulation, is impermissible.

Appendix B

Board Functions and Related MIS

The following functions need to be covered by the board of directors or a separate committee. At a minimum, each function should develop and review MIS reports similar to those listed below.

Function	Available Reports
Corporate Governance	Board Assessment Reports Compliance Reports (SARs) Director Qualifications Employee, Officer and Director Compensation Management Succession Plan Personnel Reports Policies and Procedures Strategic Planning
Audit	Audit Fee Schedules Audit Schedules Audit scope documents Auditor Qualifications Correspondence between Management and Audit Functions Follow-up on Reporting Exceptions Internal and External Audit Reports Internal and External Engagement Letters
Credit	Analysis of ALLL Methodology and Level Charge-offs and Recoveries Commitments Insider and Employee Loans Large Borrowers Large Relationships Loan Approval Exceptions Loan Extensions Loan Funding New Loans Non-performing Assets Overdrafts Participations Past Dues Policy Exceptions Watch List
Finance	Borrowings (FHLB and Other) Branch Analysis Reports Budget Cashflow Statement Funding Requirements Investment Portfolio Analysis (Purchases, Sales and Maturity) Interest Rate Risk Analysis (Modeling Analysis and Validation) Large Depositors Liquidity Reports New Accounts Performance Analysis (Ratio) Policy Exceptions Shareholder Reports Statements of Financial Condition and Income (Comparison to Budget) Tax Calculations