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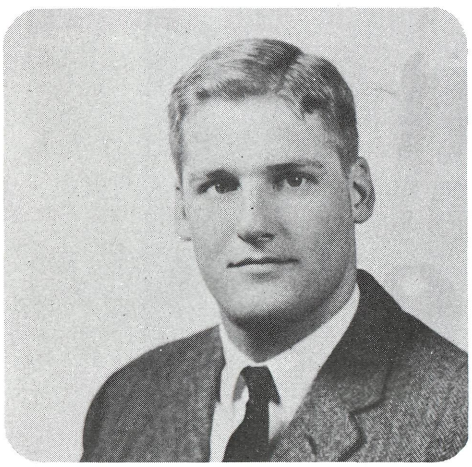

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by Richard S. Bodman

DURING THE PAST TWO YEARS we have witnessed unprecedented growth in the number of banking facilities. In California alone more than 85 organizing groups received charters to enter the banking business. At the same time, existing banks in the state received approval for and opened more than 300 branches. As a result of this increase in the number of banking facilities, the banking system is in need of many additional qualified managers and directors. This article will describe several of the major problems faced by new banks, and will outline a program showing how directors can fulfill their responsibilities by taking a more active part in the supervision of their banks.

The Problems

The organizing group of a new bank is typically comprised of successful local businessmen, public figures and professional men. In most cases, none of the organizers has had significant experience in banking; yet as directors they assume significant responsibility for the operation of the bank. In fact, the responsibility of a bank director is greater than that assumed by directors in any other industry.

In most cases organizers, upon obtaining a charter, attempt to locate an experienced banker to shoulder the full responsibility for operating the bank. Since it is difficult to find an experienced bank president, the man finally chosen often lacks experience in one or more of the major functional areas of banking. Few men can be expected to be fully qualified in all loan areas, in credit and operation, and at the same time have experience in investments and asset management. In addition, it is often economically impractical for a small bank to obtain qualified back-up personnel in each of these areas, because the small bank usually has to pay a premium to win such personnel from larger banks. Consequently, the daily operation of the new small bank, of necessity, falls largely under the control of one man who often does not have all of the experience required.

This centralization of power in one man, though perhaps expedient, can be detrimental to the interests of the public and the stockholders. Segregation of duties and independent verification and review are fundamental features of any program and assure the safekeeping and proper disposition of the bank's resources. Concentrated control over operations by one man is, by definition, contrary to the principles of internal control.

To add to the difficulties of the new bank, management is under pressure to show earnings as soon as possible. In meeting competition for increased deposits and new loans, they may be tempted to incur risks which are out of proportion with the bank's capital resources. A new bank is more likely to yield to the pressure of the corporate treasurer or county official who is shopping for an extra ¼% interest on his deposit. Management is also likely to be less careful in evaluating the credit soundness of potential borrowers. Evidence of new banks taking these extra risks is apparent in California where several of the new banks have offered to waive all or a portion of service charges on small checking accounts of new depositors; where several are paying the maximum legal interest rate on 91 day certificates of deposit; and where some new banks have large problem loans in their portfolios.

The recent closing of the San Francisco National Bank is an example of what can happen ultimately if these conditions exist. Although the actual causes of the Bank's difficulties are not yet fully explained, it is reported that management had paid very high interest rates to attract volatile deposits and had been making high risk loans.

In general the newest banks, with the least capital and the least capacity for sustaining losses, often take the greatest risks. These banks have an overwhelming need for management skill. Since it is not practical for them to pay high salaries to obtain this skill in depth on the staff, management performance should be closely monitored by the Board of Directors. This is the only way the Board can carry out its responsibilities effectively and with a minimum of risk.

The Directors' Responsibility

Directors of new banks should continually ask themselves such questions as "What policies can we establish to assure ourselves that operations will be controlled effectively?" "What steps can we take to assure that the long term interests of the stockholders are being served?" "What can we do to assure ourselves that the public resources are protected?"

One of the first acts of a bank director should be to study and understand the legal responsibilities of his position. He must recognize that since banks are quasi-public institutions, the exposure of a director to liability is greater than that of a director in other industries and as a consequence, active participation is vital. In the case, *Rankin v. Cooper,* 149 Fed. 1010, a summary of principles underlying the directors' responsibilities was made, which should be studied by every new director.

The director should not hesitate to seek help in interpreting the requirements. Other bankers, state commissioners, the Comptroller's Office, examining authorities, Federal Reserve Bank officials, lawyers and accountants all can be helpful in familiarizing board members with the responsibilities of the director. This is not an easy job; it is time consuming, but it is absolutely necessary.

What the Board Can Do to Control Bank Operations

A diligent board of directors can do a great deal to predetermine the future of a bank and to minimize the cost of expansion. The board and its committees can actively participate in setting objectives, planning performance and designing operating systems to report and audit actual performance. While the board should work with internal management in accomplishing these tasks, it is essential that board members employ the best outside professional advice they can obtain to help compensate for their own lack of banking experience. Correspondent bankers, lawyers, certified public accountants and bank investment counselors can apply concentrated knowledge and experience to specific problem areas, whereas internal bank personnel seldom have the time or experience to make detailed analyses.

Short-term Objectives

Although it would be impractical to establish specific long-term objectives for a new bank until a reasonable amount of operating experience has been obtained, the board can and should set in writing a list of sensible short-term objectives to be sought. Some of the following objectives might be included in such a list:

1. The bank will recover initial organization and operating losses and become profitable within two years.
2. After five years the bank will return 12% annually on stockholders' equity.
3. The bank will emphasize service to (A), (B) or (C) sector of the community.
4. The bank will seek to grow at an annual rate not to exceed 50% per year during the first five years.

In connection with these short-term goals, the board should define a series of target ratios to aid in controlling the overall structure of the bank's liabilities and, as a consequence, the risk it bears. Examples of such target ratios include the following:

1. Capital to deposits
2. Capital to total resources
3. Cash and government bonds to capital
4. Loans to deposits
5. Loans to capital
6. Loans to total resources
7. Investments to deposits

The loan and deposit ratios have been refined and computed for a hypothetical bank on Tables I and II (Exhibit I).

The new bank often has on deposit a high proportion of time money from government bodies, savings and loan associations, title companies, and non-local investors. Individual deposits may be large in proportion to total deposits and highly volatile. The board should be fully aware of the circumstances surrounding these deposits and the potential loss of liquidity if one were withdrawn. It is for this reason that the author has made a division between stable and volatile deposits in setting target ratios in Tables I and II. The division can be made quite easily if the board and management review the large accounts with respect to the size of the deposit, the interest paid and the bank's overall relationship with the depositors.

Having set overall target ratios, the board should establish maximum limits for the size of individual loans of each variety. In addition, the board should establish maximum balances for time deposits on account and time certificates of deposit in order to lessen the effect of losing any one deposit and to provide adequate protection for the individual depositor. The board as a group should also determine the maximum interest to be paid for each type of deposit.

In setting limits and establishing ratios, directors should bear in mind that the limit of the law is not a measure of sound business practice. The limits should be estab-

Exhibit I

Table I
Loan Rates

	Total dollars	% of total loans	% of total resources	Percent of Deposits: Stable	Volatile	Total
Commercial loans	3.9 mil	60	33	53	150	39
Installment loans	1.5 mil	23	13	20	58	15
Real estate loans	1.0 mil	15	8	13	38	10
Other loans	.1 mil	2	1	1	4	1
Total	6.5 mil	100	55	87	250	65

Table II
Deposit Ratios*

	% of total	Deposits: Total	Volatile	Stable	% stable to total deposit
Demand deposits	55	5.5 mil	.8	4.7	85
Savings deposits	30	3.0 mil	.4	2.6	87
Time certificates	8	.8 mil	.8	0	0
Public deposits	6	.6 mil	.6	0	0
Other	1	.1 mil	—	.1	100
Total	100	10. mil	2.6 mil	7.4 mil	74

*The amounts and percentages in the above table are not suggested ratios; they were included only as an aid to understanding the computation of the ratios.

lished in proportion to the risk bearing capacity of the individual bank.

Establish a Profit Plan

Once the board has determined its short-term objectives, target ratios, and limits for relationships with individual customers, it should request that annual profit plans be prepared by management. The purpose of this plan is to put one-year goals in tangible and more detailed, written form so that the board can later use comparisons of actual with planned performance as a tool in evaluating the effectiveness of management.

During the early years of a bank, the profit plan need not be too sophisticated. The necessary items would include planned balances for all balance sheet accounts, and budgeted expense accounts on a monthly basis. Management must participate in the creation of the plan. The board cannot expect them to carry out a plan which was constructed without their approval.

To plan changes in deposits, the board and management should prepare a list of all prospective depositors and make an estimate of the amount that could be obtained from each. Then, after specific assignments to seek these deposits have been made to board members and managers, it will be much easier to arrive at a realistic estimate of new deposits to be booked. Major accounts currently with the bank should be analyzed in the same fashion to make allowance for changes in the amount of these.

Requirements for Reporting System

Since the primary method of evaluation and review by board members involves analysis of the monthly reports prepared by management, the information in the reports must be pertinent for control purposes. The most meaningful approach is to design the reporting system so that actual results of operation are compared with planned performance. The reports should highlight areas where actual performance varies from planned so that the board can concentrate on them.

Sample reports of balance sheet items for the XYZ National Bank are shown in Exhibit II.

Note that these reports show actual and variance amounts by account at the end of each month. Planned balances could be included if the board felt it would make the statements easier to understand. In addition to focusing attention on variances, the reports also show trends by reporting each month on the same page. Thus, changes over time can be noted. Important overall ratios are shown on this report to help simplify the analysis of the statements.

The board should review similarly constructed monthly reports on "Deposit and Capital Position" and "Opera-

EXHIBIT A

1964	LOANS						INVESTMENTS		LEASES		CASH & DUE FROM BANKS		BANKING HOUSE & EQUPMENT OTHER		TOTAL ASSETS		1964
	COMMERCIAL		INSTALLMENT		MORTGAGE												
	ACTUAL	VAR.	ACTUAL	VAR.	ACTUAL	VAR.	ACTUAL	VAR.	ACTUAL	VAR.	ACTUAL	VAR.	ACTUAL	VAR.	ACTUAL	VAR.	
JAN.																	JAN.
FEB.																	FEB.
MAR.																	MAR.
APRIL																	APRIL
MAY																	MAY
JUNE																	JUNE
JULY																	JULY
AUG.																	AUG.
SEPT.																	SEPT.
OCT.																	OCT.
NOV.																	NOV.
DEC.																	DEC.

1964	LIQUID RATIO	LOANS TO TOT./A	MORT. TO TIME & CAPITAL	LEASES TO CAPITAL	EARN/A TO TOT./A	EXCESS RESERVES	LOANS MADE						1964
							COMMERCIAL		INSTALLMENT		MORTGAGE		
							AMT.	YIELD	AMT.	YIELD	AMT.	YIELD	
PLAN													PLAN
JAN.													JAN.
FEB.													FEB.
MAR.													MAR.
APRIL													APRIL
MAY													MAY
JUNE													JUNE
JULY													JULY
AUG.													AUG.
SEPT.													SEPT
OCT.													OCT.
NOV.													NOV.
DEC.													DEC.

EXHIBIT B

	DEMAND DEPOSITS								TOTAL DEPOSITS		OTHER LIABILITIES		CAPITAL	RATIOS			1964
	COMMERCIAL		PUBLIC		SAVINGS		TCD's & OTHER							RCT. ON CAPITAL	CAP.TO TOT.DEP	CAP. TO RISK ASSETS	
1964	ACTUAL	VAR.	ACTUAL	VAR.	ACTUAL	VAR.	ACTUAL	VAR.	ACTUAL	VAR.	ACTUAL	VAR.					PLAN
JAN.																	JAN.
FEB.																	FEB.
MAR.																	MAR.
APRIL																	APRIL
MAY																	MAY
JUNE																	JUNE
JULY																	JULY
AUG.																	AUG.
SEPT.																	SEPT.
OCT.																	OCT.
NOV.																	NOV.
DEC.																	DEC.

	DEMAND DEPOSITS				TIME DEPOSITS						
	COMMERCIAL		PUBLIC		SAVINGS			TCD's AND OTHER			
1964	NEW ACCOUNTS	TOTAL ACCOUNTS	NEW ACCOUNTS	TOTAL ACCOUNTS	NEW ACCOUNTS	TOTAL ACCOUNTS	EFFECTIVE RATE	NEW ITEMS	TOTAL ITEMS	EFFECTIVE RATE	1964
JAN.											JAN.
FEB.											FEB.
MAR.											MAR.
APRIL											APRIL
MAY											MAY
JUNE											JUNE
JULY											JULY
AUG.											AUG.
SEPT.											SEPT.
OCT.											OCT.
NOV.											NOV.
DEC.											DEC.

tions". For the small bank this latter report should contain a breakdown of all significant income and expense items by natural classification. The balances should be compared with planned amount in the same manner as is shown in Exhibit II. A year-to-date balance should also be shown against plan for income and expense accounts.

A highlights report should also be prepared which would show the present position and current operating results in summary on one page. Even in a very small bank this report is necessary because it allows each board member to briefly familiarize himself with overall results before making a detailed review of other statements.

Included with these reports should be detailed schedules of the following items:

Losses and chargeoffs
Resources and non-recurring profits
Loans granted and paid off
Securities purchased and sold
Outstanding loan commitments
Applications for new loans
Delinquent or otherwise questionable loans
Overdrafts
Significant new deposit accounts opened and old accounts closed
Other special items

Duties of the Board Committees

Three committees of the board — the loan committee, the investments committee, and the examination committee — have much of the burden of setting up the plans, supervising and reviewing daily operations.

The loan committee (which should contain at least two non-management members) in a small bank should perform two functions:

1. The committee should be the ultimate point of authorization for all loans in excess of management's lending limit; this limit having been previously set by the committee.
2. The committee is responsible for approving all new and renewed loans made during the month between meetings.

In order to prevent the loan committee from making only a perfunctory review of smaller loans, the directors should insist that one of their non-officer members review the discount register directly and present the controls to the board. To assure that the review of loans for approval is adequate, the loan committee should establish a checklist of all points to be covered in review.

The investment committee is responsible for approving all securities investments of the bank. In the case of a new bank, a non-management member of this committee should review and approve all investments in securities before the investment is made. If management is skilled in investment decisions, they should be given more latitude in making investment decisions which would be subject to subsequent review by the committee as a whole.

The directors and management of many new banks have been relying on correspondents to make investment decisions and to execute securities transactions. Although this is an acceptable approach, it should be noted that management of correspondent banks make investment decisions based on their own corporate objectives which may not be applicable to a new bank.

The examination committee is charged with the responsibility of assuring the board that their established policies concerning the following areas are being carried out:

1. Division of duties
2. Vacations of officers and employees
3. Authority of officers to buy and sell securities and make loans
4. Scope and frequency of internal audit procedures
5. Directors' examination and outside audits

Since the members of the examination committee seldom have the time or experience to perform the audit and review the procedures necessary, much of the work must be delegated. In a small bank, however, it is not economical to employ permanent internal auditors and it is difficult for a part-time internal auditor who has other duties in the bank to be independent. The best way to resolve this problem is to employ independent public accountants to perform the annual directors' examination on behalf of the examining committee. Thus, the board pays for audit capacity only when used.

In conclusion, we have seen that management of new banks is often tempted to take extra risks to show early earnings and to grow fast. In addition, there is seldom sufficient management depth to plan and control effectively the overall operation of the bank. As a result, the board of directors must take measures to maintain control over management and operation in order to limit their own risk and to protect the interests of stockholders and customers.

The consequences of failing to control bank operations can be severe. The board of directors cannot afford that risk.