Module: Management
Section: Overall Assessment
EM-510

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Introduction

Management is probably the most important element in an institution's operations. All areas of operations, including assets, capital, earnings, liquidity, and compliance, are affected by management actions. As such, management must have a thorough and complete understanding of the interrelationships between these areas and how their decisions will affect the soundness of the institution. Management must also be cognizant of the institution's external environment and how factors outside the institution will affect operations. Even with adequate knowledge of the institution's operating environment, management must still exercise considerable judgment and carefully weigh the costs, benefits, risks, and rewards of decisions.

The adequacy of management can be determined by assessing several different factors. The processes, systems, and functions established by management are factors to be considered in this evaluation. The management processes, systems, and functions, which are discussed in the remaining sections of the Management module, include: business planning, policies and procedures, internal controls, human resources, and standards of conduct. However, management processes alone do not guarantee the success of an institution. Examiners also need to consider the extent to which management has fulfilled its duties and responsibilities, the qualifications of management, and management's performance in generating adequate results in credit and financial operations, and complying with laws and regulations. This section addresses these factors as additional items to be considered in the overall evaluation of management.

Examination Objectives

Assess the overall adequacy of management. Specifically:

Determine if management's processes and systems are sufficient to ensure safe and sound operations and compliance with laws and regulations.

Determine management's adherence to safe and sound business practices and compliance with laws, regulations, and enforcement actions.

Determine if management adequately understands and fulfills its duties and responsibilities.

Determine if the qualifications and experience of management are sufficient to ensure safety and soundness and compliance with laws and regulations.

Assess the impact of management strengths and weaknesses on the past, present, and projected condition and performance of the institution.

Management Duties and Responsibilities

While the board of directors and executive officers collectively constitute the managing body of the institution, it is important to recognize the differences between the duties and responsibilities of directors and those of executive officers. This is particularly important in evaluating the various processes and systems established to direct and control operations. For instance, understanding that policy is established by the board and implemented by executive management allows examiners to better determine accountability for deficiencies cited. A description of the key duties and responsibilities of each party is set forth below.

<u>Board of Directors</u>

The ultimate responsibility for the conduct of the institution's affairs lies with the board of directors. The board of directors determines the strategic direction for the institution, formulates policies, provides supervision, and promotes the institution's welfare. Directors are placed in positions of trust by the institution's stockholders.

The board of directors is also responsible for the adoption of the institution's bylaws. Bylaws provide a general description of how the institution will conduct business and are approved by the institution's voting shareholders. FCA Regulations outline specific areas to be addressed in bylaws. Some of the areas required to be addressed include director election and conduct of meetings, issuance and retirement of capital, and the method of distribution of earnings. Additional information on requirements for specific bylaws can be found in the Finance and Compliance modules of this manual. However, bylaws should comply with FCA Regulations, and any changes since the previous examination should be reviewed to determine the impact on the institution.

The board delegates the day-to-day conduct of the institution's business to its officers and employees. However, too broad a delegation is considered an abdication of its management functions. Conversely, too excessive an involvement precludes the board from holding executive management accountable for the day-to-day operations. The board remains responsible for ensuring that the institution operates within prescribed policies, in compliance with laws and regulations, and in a safe and sound manner. The directorate must safeguard the stockholders' interests through lawful, informed, and efficient administration of the institution. Directors should have sufficient time available to fulfill their responsibilities, and be free of financial difficulties which may tarnish the institution. The legal responsibilities of directors are addressed in the Standards of Conduct section of this module.

One of the most important responsibilities of the board is selecting a chief executive officer (CEO) for the institution. Directors must exercise due care to ensure the CEO selected has sufficient qualifications, experience, and integrity to effectively manage the institution. In this regard, the board's policies should address the CEO selection process, as well as the board's plans for management succession.

Once a CEO is appointed, the board must ensure the CEO's duties and responsibilities are clearly defined. Standards of performance and measurable key result areas should also be established. A job description and performance plan that includes these elements helps ensure the CEO understands the board's performance expectations and is accountable for fulfilling those expectations.

The board should also maintain a formal process to evaluate the CEO on a periodic basis. If performance expectations are not being met, it is the responsibility of the board to address the situation immediately. Failure to act expeditiously may represent a serious breach of its responsibilities.

Effective boards have their duties and responsibilities defined in written job descriptions for the board chairman and board members. Effective boards will also maintain an adequate record of their actions through well-documented board minutes. Board minutes should evidence regularity in attendance, and active and informed participation by board members. Board minutes which show participation by only one or a few board members may be indicative of an ineffective directorate controlled by one or a few dominant board members.

A well organized board will examine the demands that will be placed upon it and identify areas that could be handled by committees. Matters that require detailed review or analysis might be better addressed in this manner. All committees should have clear written statements of their missions, authorities, responsibilities, and duration. Standing committees address continuing areas of responsibility, such as a loan committee or an audit committee, while ad hoc committees may be set up to handle special projects. Committees should report regularly to the full board. The board may rely on information provided to it by committees, but the full board retains responsibility for all decisions. If such decisions are based on the recommendation of a committee, the board must assure itself that the committee has done its work responsibly and that its recommendations are reasonable.

Executive Officers

Executive officers are responsible for implementing the board's plans, policies, and objectives in day-to-day operations. This is accomplished, in part, by establishing systems, processes, and specific internal control procedures that ensure entity objectives are met. Executive officers are also responsible for implementing any corrective actions specified by the board of directors.

In addition to implementing direction received from the board, it is executive management's responsibility to ensure directors are fully informed about activities and potential operational or financial problems. This advisory role is critical to the success of the board since it is removed from the day-to-day operations of the institution and accurate, complete, and timely information is necessary for sound decision-making.

As with directors, executive officers may delegate certain activities. However, executive officers remain accountable for the actions of subordinates. As such, executive officers should have an adequate performance evaluation process in place to ensure delegated activities are performed effectively. This process, as well as others related to the management of human resources, is discussed in detail in the Human Resources section of this module.

Management Qualifications

An experienced and qualified management team is necessary to manage the complex operations of a financial institution. Furthermore, the board of directors and executive officers of financial institutions are held to a higher standard than those of other corporations because they put the funds of others at risk through their lending activities. Examiners should review the qualifications, experience, and past performance of both the board of directors and executive officers as part of their overall assessment of management. This will help identify areas of risk important in the examiners' assessment of management's overall skills.

Board of Directors

The board's effectiveness will depend in part on how well its members know the business they are directing and the principles of business in general. Directors can acquire this knowledge through their experiences on the board and previous business experience in farming, agribusiness, and other financial institutions. In general, the tenure and past performance of the board, along with its members' diverse and collective business experience and background, are good indicators of the board's qualifications.

When first elected, if board members do not have the experience or knowledge desirable to effectively supervise operations, they must diligently seek to understand the operations of the institution in order to execute their duties faithfully. Serving on committees is one opportunity directors have to develop more specialized knowledge and skills. However, it is wise to rotate committee responsibilities to allow directors to broaden their knowledge and understanding of the institution's operations. Rotation of committee responsibilities also provides a good internal control.

Equally important is the composition of the board. Some Farm Credit System (System) institution boards are broadened by members representing a cross section of agricultural endeavors. The election of outside directors provides an excellent opportunity to bring additional expertise, as well as other kinds of knowledge and skills, to the board. Important new perspectives and objectivity can be provided by these individuals. As such, the institution's process of nominating candidates for the board of directors is very important in ensuring nominees meet basic legal and bylaw requirements and should include a careful analysis of a candidate's qualifications, capabilities, and business experience.

Executive Officers

The CEO and other executive officers must have the expertise necessary to assist the board in managing the institution. Integrity, education, technical competence, and sound credit, financial, and management experience should be key considerations in the selection of executive officers. Management should also understand the cooperative philosophy and principles upon which the institution is based.

Effective executive officers must also demonstrate the leadership qualities necessary to coordinate and organize resources and guide personnel toward the institution's objectives. An effective executive management team does not allow short-term problems to affect long-term objectives, under ordinary circumstances. In this regard, the leadership demonstrated by executive management may be the difference between success and failure during difficult economic times or swings in the farm economy.

Management Performance

An institution's performance with respect to asset quality and portfolio management, capital adequacy, earnings capacity and trends, liquidity, and compliance with laws and regulations is, to a very large extent, a result of decisions made by the institution's directors and officers. Consequently, examiners' findings and conclusions in these areas often are major determinants in evaluating management performance.

While the institution's overall present condition can be an indicator of management's past effectiveness, it should not be the sole factor relied upon in evaluating or rating management. This is particularly true when there is new management or when the institution's condition has been significantly affected by external factors versus internal decisions. For example, positive economic conditions may serve to enhance an institution's condition despite weak or undocumented management systems and processes.

The dynamic environment in which System institutions operate necessitates that examiners appropriately consider the adequacy of systems and processes established to direct and control operations over the long term. This includes consideration of management's willingness and ability to take timely corrective actions once weaknesses are identified. Management's willingness to take corrective action is, in part, demonstrated by its responsiveness to audit, review, and examination recommendations. Effective management teams should welcome recommendations provided by these parties and view them as another business tool for improving the quality of their operations. Examiners encountering management who lack this perspective should consider the effect of such weakness on the prospects for corrective actions and the overall management rating and conclusions.

Examination Procedures

The examination of management is ongoing throughout the examination process and is performed in conjunction with the examination of assets, finance, and compliance. Consequently, considerable coordination between examiners is necessary to achieve examination objectives while minimizing duplication of work.

As part of the management evaluation process, examiners should maintain adequate and ongoing dialogue with management to gain additional insight into the institution's operations and the quality of the management team. Effective communication and meetings with management can often provide examiners with key information needed to fully develop examination findings. While most of the interaction is with executive management, examiners are encouraged to meet with the board chairman or other board members. Appropriate discussions with the board may be necessary to determine if they fully understand their duties and responsibilities. Meetings with the board of directors also can disclose important information regarding the performance of executive management and their working relationship with the board.

Each section of the Management module provides examiners with examination procedures for the area presented. The procedures provided in this section outline the steps necessary to make an overall assessment of management. Consistent with risk-based examination principles, examiners should add, delete, or modify procedures as needed based on the particular circumstances of the institution.

1. Review and summarize the findings disclosed through the examination of business planning, policies and procedures, internal controls, human resources, and standards of conduct.

2. Review and summarize the findings disclosed through the examination of assets, capital, earnings, and liquidity relating to management and management processes and systems.

3. Discuss the condition and performance of the loan portfolio with the examiner(s) assigned the loan

portfolio management evaluation to determine the effectiveness of management's processes and systems in achieving adequate results.

4. Discuss the financial condition and performance of the institution with the examiner(s) assigned the finance evaluation to determine the effectiveness of management's processes and systems in achieving adequate results.

5. Discuss the institution's compliance with laws and regulations with the examiner(s) assigned the compliance evaluation to determine the effectiveness of management's processes and systems in ensuring compliance with laws and regulations.

6. Conclude on the adequacy of management's systems and processes.

7. Review the institution's bylaws to determine the duties, responsibilities, qualifications, and legal requirements of directors.

8. Determine if the board has its duties and responsibilities defined in written job descriptions.

9. Review board and committee meeting minutes to determine the board of directors' participation and involvement in the following areas:

    a. Strategic and operational planning;

    b. Policy formulation;

    c. Monitoring the condition and performance of the institution for all major operational areas;

    d. Monitoring compliance with policies, laws, and regulations; and

    e. Achieving corrective actions and implementing audit, review, and examination recommendations.

10. Review and summarize the results of the current examination and assess the adequacy of corrective actions directed by the board to address audit, review, and previous examination recommendations and to strengthen and improve operations.

11. If applicable, review and assess the actions directed by the board to comply with FCA enforcement actions and determine overall compliance with such actions.

12. Through discussions with examiners responsible for the finance, management, and compliance evaluations and through a review of the institution's bylaws, determine that the bylaws are in compliance with FCA Regulations.

13. Review changes made to the institution's bylaws for compliance with FCA regulations and determine the impact, if any, on the institution.

14. Identify the board responsibilities handled by committees to determine if the board has adequately addressed the areas of operations requiring detailed review and analysis.

15. Determine if the board receives regular reports from standing and ad hoc committees, including recommendations to the full board, which are fully supported and reasonable.

16. Review board meeting minutes and identify directors that do not attend meetings regularly, or fail to participate in an active and informed manner.

17. Identify and summarize significant decisions and/or actions taken by the board of directors which were not adequately documented in board meeting minutes.

18. Examine the loans extended to directors and determine that board members are free of financial difficulties which may embarrass the institution or affect their performance as a director.

19. Review the background, experience, and education of the CEO to determine if the board has selected a qualified and competent CEO with the expertise necessary to assist the board in managing the institution.

20. Review the CEO's job description and determine if management duties and responsibilities are clearly defined.

21. Review the CEO's performance standards and determine if the board established clear standards of performance and measurable key result areas to ensure the CEO fully understands the board's expectations.

22. Compare the CEO's performance standards to the objectives established in the board's business plan and policies for consistency.

23. Identify any duties and responsibilities inappropriately delegated from the board to executive management.

24. Identify key areas of operations or CEO responsibilities not reflected in performance standards which may reduce accountability to the board, such as:

    a. Correction of previously identified weaknesses;

    b. Compliance with laws and regulations;

    c. Compliance with board policies; and

    d. Reporting to the board of directors.

25. Identify any instances where the CEO or executive management inappropriately dominate or infringe upon the duties and responsibilities of the board. In addition, identify instances where the board's involvement is excessive.

26. Review the board's process for evaluating the CEO's performance and determine if it is documented, conducted on a periodic basis, and results in a reasonable assessment of CEO performance.

27. Determine if the board addresses problems with CEO performance in a prompt and direct manner.

28. Review the board's succession policy and determine if it addresses the position of CEO and other key management positions.

29. Conclude on the board's fulfillment and understanding of its duties and responsibilities and the effect, if any, on the overall effectiveness of the board.

30. Assess the qualifications of the board of directors by considering the following factors:

    a. Background, experience, and tenure of board members;

    b. Areas of expertise offered by outside directors; and

    c. Diversification and composition of the board.

31. Review the institution's process for nominating candidates for the board of directors and determine if it includes a careful analysis of a candidate's qualifications, capabilities, and business experience.

32. Conclude on the qualifications of the board of directors and the prospects for maintaining or strengthening this component of management.

33. Obtain the institution's organizational chart and identify the key executive officers and their responsibilities.

34. Review the background, experience, and education of key executive officers to determine if the executive officers have the expertise necessary to assist the board in managing the institution.

35. Compare the results of operations to the standards, objectives, and direction established by the board to determine if the CEO and executive management are adequately implementing the board's direction.

36. Review the information reported to the board of directors and determine if executive management is keeping the board adequately informed about activities and potential operational or financial problems.

37. Conclude on the CEO's and executive management's performance in capably managing the institution and meeting the board's expectations.

38. Assess the impact of strengths and weaknesses in management on the condition and performance of the institution. Draw tentative conclusions, giving consideration to cause, effect, materiality, and results of other related examination work.

39. Discuss tentative conclusions and examination findings with examiners responsible for the assets, finance, and compliance evaluations.

40. Discuss items of concern, scope of work performed, and conclusions with the examiner-in-charge and with the appropriate institution manager. Obtain a response regarding the cause(s) of deficiencies or weaknesses and anticipated corrective actions.

41. Prepare a leadsheet or other summary document to provide workpaper support for the work performed and the conclusions reached.