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VIEWPOINT

Approving Loans Is a Risky Role for Bank Directors

By David Baris

Recent FDIC lawsuits against directors of failed banks assert that they are personally liable for voting to approve individual loans that went bad if the loans had deficiencies at the time of approval. This places bank directors in the shoes of loan and credit officers, a role for which they are both unsuited and unqualified. It may be time for bank directors to stop approving loans and instead to delegate all noninsider loan approvals to bank officers and officer loan committees.

It is commonplace for board members of community banks to vote on approvals of a variety of loans, unlike board members of large banks, who usually only vote to approve insider loans subject to Regulation O. What compounds the problem is that board members often consider approval of only those loans that entail more potential risk — the largest loans, insider loans, and those loans that vary from one or more of the requirements of the loan policy. Smaller loans within policy guidelines are normally approved under the authority of an individual loan officer or officers' loan committee.

A review by the American Association of Bank Directors of recent cases filed by the FDIC against directors of failed banks suggests that the FDIC believes that directors who voted in favor of a loan as members of the board of directors or its loan committee are as legally responsible as the officers who underwrote and recommended approval of the loan. Any director who serves on the director loan committee is at heightened risk of personal liability. AABD expects that the FDIC will also be actively using its enforcement powers (e.g., civil money penalties and prohibitions from participating in banking) against directors of both failed and open banks who the FDIC believes engaged in reckless lending. This is a departure from the historic practice of using enforcement powers against outside bank directors primarily where there has been insider abuse, intentional misconduct or criminal acts or where there have been violations of consent orders or formal agreements.

FDIC seems to expect boards and board loan committees to micromanage the loan approval process; that is, once the board or board committee receives a board package on an individual loan, it has the responsibility to identify any potential weaknesses or flaws in the board package, and if it approves a loan that in the judgment of the FDIC should not have been approved, the board members may be liable for having recklessly voted in favor of such a loan.

No matter that bank directors are typically not from banking backgrounds and lack training or experience as loan or credit officers. If there is a perceived flaw in the loan that the FDIC believes the board member who voted for the loan should have known about, and the loan was approved by the board and funded and losses ensue, the board member is at risk for personal damages.

In the early 1990s, the Resolution Trust Corp. also sued directors of failed savings institutions for approving loans that later went bad. At that time, AABD recommended that bank boards of directors consider not approving loans. AABD pointed out that the responsibility of the board was not to approve individual loans, but to approve safe and sound policies, procedures and controls to govern the loan approval process; set parameters on risk; hire and retain a competent CEO, and other officers that it reasonably believed, in reliance on the CEO, were qualified; monitor adherence to the loan policy and safe and sound lending; and direct corrective action of problems as they arise.

AABD hasn't changed its mind. There is nothing in federal laws, regulations and regulatory guidance that require bank boards of directors or board committees to approve noninsider loans. So when a board takes it upon itself to approve loans other than those subject to Regulation O, it is doing more than is required. But in doing more than is required, board members are also taking on more personal liability risk.

The intention of many board members in reviewing and acting on an individual loan is not to repeat or second guess the work of the loan or credit officer, but rather to apply their business judgment. Bank directors may have insight into the local economy and its direction, the trends in local real estate values, information about a borrower that is not fully reflected on the borrower's financial statement; and business instincts that they have developed over many years being in the business of business. They will consider not just the loan package but other factors in evaluating the pros and cons of any individual loan. No one factor may be the determining element in the decision and some will be considered more relevant or important than others. In fact, there really is no way of knowing after the fact why a board or board committee approved a loan. It is by its nature a collegial decision made based on the collective act of all of the board members who attended the meeting.

Most bank directors will not be very useful in undertaking technical reviews of loan packages, and if they did, many would not nearly be as competent as those the bank has retained to do that job. In the past, banking agencies have discouraged bank directors to micromanage their institutions. That was good advice and still is. If bank directors were to micromanage, we fear that many good loans would not be made, thereby further exacerbating the current constraints on credit availability.

The dilemma for community bank directors is to choose between minimizing their personal liability and the useful function that board and board committee reviews of individual loans can serve. Community bank directors may have insights into the local economy and local borrowers that the loan or credit officer may not have, and business experience and savvy that can help decide close calls. Banks whose boards don't participate in the review and approval of individual loans will miss that insight.

On balance, AABD believes that boards and their committees should get out of the business of approving loans other than insider loans until the FDIC satisfactorily clarifies its expectations as to their appropriate role in approving individual loans. AABD has asked the FDIC to clarify its position in a manner that would provide protection to bank directors so that they may approve loans without taking undue risk of personal liability.

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