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BEST PRACTICES OF BANK BOARDS

Jim McAlpin recently wrote a series of articles for BankDirector.com regarding best practices of Bank Boards of Directors. We thought you would be interested in Jim's discussion of these best practices.

I frequently speak to groups of bank CEOs and directors at state and national conferences and one of my favorite topics is "best practices for bank boards." The audience reaction always confirms my belief that bank boards of directors all face the same fundamental challenges, regardless of the size or geographic location of the bank and the shareholder base which they serve. Boards of directors are groups of people, and every group of people develops its own set of shared expectations and priorities. It can be helpful from time to time for a bank board to reflect on its approach to self governance and decision making.

As bank boards look for ways to strengthen their institutions, they should not overlook the opportunity to strengthen themselves as a group. Over the past several decades my partners and I have attended hundreds of bank board meetings, for institutions ranging in size from under $100 million in assets to well over $10 billion. Regardless of the size of the entity, we have noticed a number of common characteristics and practices of the most effective boards of directors.

Best Practice No. 1 -- Select Good Board Members

Some of the most challenging and distracting issues a board can face are those related to its own members. These issues typically arise in connection with conflicts of interest between board members and the banks they serve, or when board members experience financial stress. They can also arise when there are personality clashes in the boardroom, or when one or more board members seek to dominate the conversation. The best time to avoid such issues is during the selection process for new directors. Compromise and wishful thinking in the selection of directors will almost always dilute the effectiveness of the board as a whole. Key characteristics of good directors include:

- Independence - being free of conflicts.
- Time to devote to the job, including time to gain a knowledge of the industry, to prepare for board meetings, and to participate in committees.
- Attention - being fully engaged and proactive as a board member.

- Courage - having a willingness to deal with tough issues.

- Curiosity - possessing an intellectual curiosity about the bank, the financial services industry and the trends impacting both.

A group of good, solid and dependable board members is, in my experience, preferable to a big-hitter, all-star line-up of directors. A board is most effective when it acts as a group, with a culture in which all members can voice their opinions, and in which probing, and sometimes difficult questions can be asked. Dominant personalities and board cultures in which constructive debate never occurs have contributed to the demise of many banks in the current downturn. Careful selection of new board members, keeping in mind the strengths and weaknesses of the other members of the board, is well worth the time and effort involved.

Best Practice No. 2 -- Adopt a Meaningful Agenda

Take the time to review, revise and update your board agenda. I'm aware of several banks that are using the same approach to board meetings and the same agenda as 30 years ago. The absence of any objection from board members may only mean that they are drifting off to sleep during the half-hour-long financial presentation. Board members greatly appreciate a shift to a more efficient and effective agenda, with a focus on committee reports and presentation of only meaningful information about the condition and operations of the bank. This can free up substantial time for the board to focus on the overall direction and progress of the bank.

Most directors only visit the bank once or twice a month, which makes a full understanding of the bank's plans and status very difficult. There needs to be an educational element in board meetings. Most directors have an ongoing need, and desire, for growth and development in their understanding of the banking industry. With such education, directors can become more effective in their recognition and understanding of the risks to be monitored, as well as the factors that most influence a bank's strength and performance.

Board packages should be delivered well in advance of each meeting in order to provide the directors with adequate time to prepare. Committee chairs should be prepared to give concise but informative reports at the meeting. Financial and operational presentations by management should focus on telling the board members what time it is, not how the watch was built. This approach can result in more interesting and informative board meetings and will likely result in greater interaction and contribution by the board members.

Best Practice No. 3 -- Provide the Board with Information, Not Data

Change the monthly financial report to something meaningful. Most boards need to know only about 20 – 30 key data points and ratios and how those numbers compare to budget, peer banks, and prior year results to have a good handle on the condition of the bank. By contrast, the typical financial report at a bank board meeting is encompassed in a 25 – 30 page document that blurs into a very detailed, and often meaningless, recitation of data that is difficult to follow.

Providing meaningful information in an understandable format is essential for the board members to identify and manage risk. Less is often more in effective board presentations.

Best Practice No. 4 – Encourage Board Participation

No board should be burdened with a Devil's Advocate who has to speak in opposition to everything, but there should be an atmosphere in the board room which allows for dissenting views and occasional "no" votes. Far too many meaningful questions go unasked in the board room. Board members need to feel empowered to ask challenging questions, and also to say that they don't understand a proposal or a presentation.

In my experience, "why?" can be a very powerful question. A sense of momentum and inevitability can develop during the discussion of a proposal in a board room, particularly when the discussion is dominated by one or more directors who are persuasive or who feel strongly about a position.

I know several bank boards that greatly benefited from a few independent thinking directors in the years running up to the current economic downturn. Those directors had the insight and the courage to question generally held beliefs in a boom real estate market. More importantly, the culture of the boards on which they served allowed for real discussion of concerns expressed by directors.

Best Practice No. 5 – Make the Committees Work

The best functioning bank boards almost always have an active and involved committee system. There is effective leadership of their committees, and the committee members take the time to read and analyze management reports and related materials in advance of meetings. If you ever need to provide motivation for committee members to be more focused and attentive in their efforts, give them a copy of one of the complaints filed in litigation by the FDIC against directors of a failed institution. Almost all of the FDIC lawsuits assert a lack of adequate attention and focus by directors, and particularly by loan committees.

Directors should not become micro-managers, but management of the bank should feel that board members are holding them to a certain level of performance and accountability. "Noses in and fingers out" is a good maxim for directors to follow, whether in the committee setting or on the board as a whole.

A strong committee system also helps build real expertise on the board, which can help support management. Future board leaders can be identified through their work on committees. We recommend that committee chair positions, particularly among the two or three most active committees of the board, be rotated every few years. This allows for broader exposure of directors to leadership positions, and can heighten their overall understanding of the bank's business. It also brings a fresh perspective and approach to the committees. Leadership ability and the commitment of time and energy should be the main criteria for selecting committee chairs.

Best Practice No. 6 -- Meet in Executive Session

It is not uncommon for the most passionate and meaningful discussion among board members to occur in the parking lot of the bank following a board meeting. Much more time is spent in these parking lot sessions discussing a possible sale of the bank and the compensation and performance of the bank CEO than ever takes place in the board room. The most effective boards of directors move these conversations to the board room by means of executive sessions. Whether monthly or quarterly, the independent (i.e., non-management) directors meet in executive session and set their own agenda for those meetings.

I have found that CEOs who welcome and facilitate such executive sessions never regret doing so. Executive sessions provide a structured forum for the independent directors to meet as a group and speak freely regarding matters of interest and concern to them. Many positive ideas and discussions can result from these sessions. If the CEO is also chairman of the board, a "lead director" can chair the executive sessions. A best practice is for the chairman or lead director to meet with the CEO following an executive session and report on the substance of the matters discussed.

Best Practice No. 7 – Make Use of a Nominating Committee and Director Assessments

No director has a "right" to sit on a board. Members of the most effective boards of directors have an active desire to serve the bank, which is evidenced by a high level of engagement, preparation and participation. There should be a transition from the typical practice of automatically re-nominating existing board members to a process of conducting annual director assessments coupled with a nominating committee for director elections.

The CEO should not be involved with either director assessments or the nominating committee – these are board functions and should be managed by the board under the direction of the chairman or the lead director. Annual director assessments could initially be done by means of self-assessments, coupled with a one on one meeting between each director and the chairman. These one on one meetings can serve as the basis for discussion of the director's enthusiasm for and participation in the activities of the board.

The process of implementing an active nominating committee and annual director evaluation process is also about risk management going forward. In these times of continued economic uncertainty and increased regulatory scrutiny it is important that banks have active and engaged directors.

Best Practice No. 8 – Actively Participate in the Examination Process

Members of the board should be involved in the regulatory examination process. The regulators really do want and expect the board to be involved in and understand the issues which the regulators believe may be facing the bank. Involvement of the entire board or key members of the board from the first management meeting with the examiners to the exit meeting is tangible evidence that the board is actively engaged in oversight of the bank. It can also be beneficial for members of the board to hear the concerns of the regulators directly, and to observe management's interaction with the examiners.

I recently attended an exit meeting with bank management following conclusion of an exam. Several of the bank's directors were present because they wanted to get a preview of the exam findings on asset quality. During the exit meeting the lead examiner raised concern about a risk management issue of potentially significant magnitude. The issue clearly took the bank's CEO by surprise, but the presence at the meeting of the board's chairman had a calming effect. The chairman looked across the table at the lead examiner and said in a convincing tone, "We will fix this immediately." The issue was then quickly resolved, and the final examination report commented favorably on that action. The end result may well have been the same without the presence of board members at the exit meeting, but I believe their presence was very helpful and reflected well on the bank.

Best Practice No. 9 – Develop Real Board Leadership

Every board should periodically evaluate whether it has effective leadership. Just as no director has a "right" to sit on a board, which gives rise to the need for director assessments and evaluations, leadership positions are also not tenured. To be effective a leader must be engaged, prepared for meetings, willing to take on difficult issues, and, in my view, willing to lead by example. Burn-out and growing complacency can be expected in all leadership roles. The ability and willingness to recognize and address these issues when they arise, and not delay action over time, is in the best interests of a board and the bank and shareholder base which it serves.

If the CEO is also chairman of the board, is that arrangement working for the board? A test for whether such an arrangement is working is for the non-management independent directors to consider whether the board is truly making its own decisions. If not, then reconsider the existing leadership structure and, at a minimum, appoint a Lead Director to bring more balance to the board's decision making process and better ensure a flow of important information to the board.

Also, consider rotating committee leadership on a regular basis, particularly among the most important committees such as audit, ALCO and loan committee. Fresh leadership perspective can be an effective risk management tool.

Best Practice No. 10 – Make use of Special Purpose Board Meetings

Have at least two meetings a year dedicated to focusing on the bank's strategy and why it works (or should work) and its strengths and challenges. Include in one such meeting a discussion of "Buy, Sell or Hold," since management needs to know the direction of the board on this fundamental issue in order to effectively run the bank and position it for the future.

Consider scheduling a special meeting to address any questions or concerns that directors may have but won't express in a regular board meeting. For example, in this time of increased regulatory burden and more aggressive regulatory enforcement, many directors are interested in knowing what their personal liability exposure is and what protections exist, whether they ask or not. Directors are also very interested these days in hearing a more complete description of the impact of Dodd-Frank and the scope of authority and impact of the CFPB.

Finally, consider setting aside most or all of a board meeting to have the directors hear directly from the key senior staff of the bank. This can be helpful in the directors gaining confidence in the bank's overall management team, and it can also be a source of insight into the strength of the institution. Good banking is fundamentally about good people, and in-person communication is the best way for the board to take the measure of the bank's people.

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I hope this discussion of "best practices" has been helpful and we would be happy to discuss them further with your board.