THE HABITS OF HIGHLY EFFECTIVE BOARDS

These eight characteristics and habits that should form the foundation from high performance boards are:

1. Create a Culture of Inclusion;
2. Uphold Basic Fiduciary Principles;
3. Cultivate a Healthy Relationship with the CEO;
4. Select an Effective Board Chair;
5. Establish Strong Corporate Governance Committees;
6. Delegate Appropriate Decision Making Authority to the Committees;
7. Consider Strategic Risk Factors; and
8. Focus on Accountability.

In the banking world, there are calls for increasing accountability, greater transparency, trust and independence, as well as a boldness that only comes from a smarter and more focus level of engagement by boards and true collaboration with management. Getting governance right calls for boards to regularly review these matters as they adapt to changing expectations. Most bank boards are made up of successful leaders, usually from outside of the banking industry, who need to respect the culture of their bank, and at the same time, they must recognize that the pace of change requires a new level of fiduciary engagement in an environment of consistent challenges. Boards must move to strategic governance, which means primarily forming a far more robust partnership with management, as well as all of the partners that affect their banking enterprise.

We all know that a board's role is not to be responsible for daily oversight, but to provide guidance to the CEO and other members of management. We also know that management teams often seek to limit board involvement in the strategic challenges confronting their bank. This is what we've normally referred to as the mushroom principle (keeping board members in the dark, feeding them manure and cutting their heads off when they express themselves). The stakes for the banking industry are too high. Boards which hold ultimate authority should expect to be full partners with all parties that matter with regard to their enterprise. The truth is that management teams cannot succeed in a vacuum, and visionary leadership requires the support of, as well as a sense of partnership between the board and the CEO with the participation of the partners, such as staff, customers, community shareholders and regulators. Balance is necessary with all of these partners to meet the bank's goals.

Most directors would do well to recognize that they must collaborate with and support management in order for the bank to achieve its mission and succeed. For its part, management also needs to depend on board support and recognize that we are in a moment (one that is unlikely to change anytime soon) when board members will express their thoughts and expectations. This new standard of board engagement is reflected through broader awareness, curiosity, imagination and input, which allows board to meet the realities of an ever changing banking industry. Boards will be better positioned to consider an assessed risk, and they will come to understand that their most important value during these times of change may be as a story teller of the bank's mission, vision and goals.

Create a Culture of Inclusion

Highly effective boards have a culture of engagement built upon commitment to inquiry, knowing that it is better to ask the hard questions within the structure of board meetings than to publicly critique board decisions after the fact.

Strategic governance works best when boards understand the business of the banking enterprise and the stakes involved. This requires a commitment to what matters most - the priorities of the business model in an environment of increased regulation, increasing uncertainty and demands for higher performance from all partners.

A culture of inclusion allows for active debate and discussion among board members. Inclusion requires full transparency.

Uphold Basic Fiduciary Principles

The duties of care, loyalty and obedience are the essentials of board responsibility. Board members should be aware of what each principle requires of them as individual directors, as well as part of the board as a whole.

These duties call upon boards to recognize that they hold ultimate authority and should act both independently and prudently in making policy decisions to meet their responsibilities. Boards should enforce a process of principled discipline when one of their members presumes a level of personal authority when fiduciary authority does not extend the responsibility of acting as a team.

Cultivate a Healthy Relationship with the CEO

The most important decision that a board ever makes is the selection of the bank's leader. Exceptional banks that we have profiled in this *Newsletter* have solid working relationships between the board and the CEO. There is consistency, continuity and an understanding of expectations.

Strategic governance is about the board being a thought partner with the CEO. Successful bank leaders are those who meaningfully strive to evolve their board, so that it is in the best position to offer full support, help frame bold decisions and then advocate on bank's behalf with all of its partners.

Select a Strong Board Chair

Board chairs are selected for a variety of reasons: stature; trust; leadership skills; ownership; length of service; and influence, among others. But, a high performing board requires a leader who can support and facilitate a model of strategic governance, develop an essential and candid relationship with the CEO, have the respect of his and her board colleagues, understand and respect the banking culture and ensure that the full board is focused on the issues that matter.

This month we'll focus on the four remaining characteristics and habits:

- Establish Strong Corporate Governance Committees;
- Delegate Appropriate Decision Making Authority to the Committees;
- Consider Strategic Risk Factors; and
- Focus on Accountability.

Establish Strong Corporate Governance Committees

In today's banking environment board committee structures require an active governance committee that oversees effective board governance, whether it is a small community bank or major bank.

We believe that boards should delegate oversight of board effectiveness to a governance committee. For smaller community banks this is not a committee of the entire board. Whether it's an ethics, personnel or nominating committee, an audit committee or one of the responsibilities of the executive committee, it should be a smaller working committee that is capable of looking hard at board performance and the overall board structure and developing a culture of accountability.

The board must monitor their overall performance and take seriously the behavior and ethics of their members. High performing boards ensure that policies about director responsibilities, ethical behavior and conflicts of interest are current and enforced. This also includes overstepping bounds with regard to individual director insertion in management.

Boards that can influence board appointments (mostly smaller community banks) should focus on breadths of expertise and commitment among the people being considered to serve on the board. They should carefully and intentionally build a board profile with a mix of skills and expertise, developing future board leadership from among respected and knowledgeable board members, which can make a significant difference in a board's ability to achieve a higher level of performance.

The boards of community banks are not country clubs but are business endeavors focused in on the welfare of the organization and doing the right work. Boards should be sure that their makeup addresses the full breadth of expertise necessary to contribute to the strategic issues confronting the bank. This includes men and women on boards who understand the business of the banking enterprise. On an annual basis, boards, specifically a governance committee, should look at the job description and responsibilities of directors, as well as the qualifications to become a director of a banking institution. It isn't who you know, but what you can do for the bank going forward!

Delegate Appropriate Decision-Making Authority to the Committees

Not all of the work can be done by the board as a whole. Boards that engage in strategic governance allocate a span of policy making authorities to standing committees, enabling the full board to focus on more strategic issues. For highly effective boards, much of the work is done in the committee level. Boards should trust that the committees will do important work and have the capabilities to present actions, decisions and recommendations that are fully vetted.

Committee meetings that are repetitive and committees with overly restrictive authority invite limited engagement and interest. Rather than structure committee meetings merely to receive staff reports, management and committee chairs should work together to frame strategic agenda discussion topics for each of the committees.

We have some banks that utilize executive committees to do much of the work of the board; however, it should be noted that substituting executive committee meetings for full board meetings as a form of process, while perhaps facilitating decision making, often sends signals that lead to limited interest and engagement among board members. It is less likely to lead to the level of performance and collaboration that is essential for today's expectations for board accountability.

Consider Strategic Risk Factors

Effective risk management has been the major focus of the regulatory agencies over the last decade and will be on a going forward basis. Effective boards should look at the key challenges through the prism of risk. Enterprise risk management ("ERM"), a common business practice used by many board members in their day jobs, facilitates a smart model of decision makings for boards. The process of assessing risk factors and making policy decisions based upon them allows boards to ask questions and make choices in collaboration with management and in line with the level of risk tolerance that the bank might have concerning the specific initiative.

This can include anything from investing in change in the business model by accepting the upside of a bold initiative, to mitigating threats or avoiding some initiatives that might run to high a risk to the business model. Often smaller community banks don't fully understand all of the areas of risk that impact the banking franchise. At the same time, if a board's focus is solely on risk, how can they achieve an effective return on investment? Banking is an area of risk. The risks of 5, 10 or 15 years are nothing like the risks that are identified today in an ever changing and quickly developing world.

Risk management should be a topic during strategic planning, setting the business model and direction for the bank. It should also be a topic of discussion at each meeting of the audit committee, as well as meetings of the board of directors, to determine whether the risk management levels should be modified, or have there been any additional risks that impact the institution? Effective risk management, discussion between board members and managements and an understanding of management's view points, since they're the ones responsible for implementing the business plans, are critical in achieving a highly effective board.

<u>Focus on Accountability</u>

Highly effective boards recognize that they are accountable for their bank's most fundamental principles: an acceptable return on investment for shareholders, a safe and sound banking institution, an effective business partner for depositors, customers and borrowers, an effective working environment for employees and a good neighbor.

Part of the importance of an effective strategic plan is to develop a balance, where all of the partners are taken care of. Our long time experience is that if all of the interests of the partners are addressed to some degree, then the bank will be successful. How well boards of directors of banking institutions meet their own responsibilities to be accountable will significantly influence how shareholders, regulators, customers, as well as staff and community, look at the bank and the board of directors. We live in a world where boards and their individual members must be fully aware of the stakes associated with being accountable and demonstrate a strong commitment to protecting the adherent principles that define their work. We all know this increase in accountability makes it difficult to recruit new board members.

CREATING AN EFFECTIVE BOARD AGENDA AND MAKING IT WORK

Regular meetings of a board of directors should last anywhere from one hour to two hours, and we have long stated that directors need to be prepared and committed, both mentally and physically to the board meeting process. We recognize that the time of the directors is valuable; therefore, the meetings should be structured in a manner to move through the items quickly, but allow for appropriate discussion so that board action is taken after informed discussion. Board meetings are not social events -- the meetings are business.

Based upon our experience we believe that there are nine items that should be on a board agenda. Those are:

- Minutes
- Financials
- Loan Reports
- Corporate Matters
- Policies/Procedures
- Risk Assessment
- Strategic Discussion
- Education
- Executive Session

Our thoughts on each of these items and a suggested time line, assuming normal matters, are as follows:

Minutes – (less than five minutes – actually should be one minute)

The first item on the agenda should be minutes of the board and all committees. The board packet should contain the minutes from the last meeting of the board and all of the committees of the board, inclusive of loan committee, ALCO, audit, compensation and any ad hoc committees (such as BSA/AML) that have been established by a board of directors. The minutes should be complete and reflect a thorough discussion on the items discussed by the respective committees. We have long stated, “If a plan is not written, it is either a dream, a vision or a nightmare.” If the minutes don’t reflect the discussions and the decisions of the committees, then they do not exist. Therefore, the minutes must be accurate and all the minutes should be reviewed and approved by the board.

Financials – (10 to 15 minutes)

The amount and type of financial information disseminated to a board is a matter of choice; however, we strongly believe that a Chief Executive Officer or Chief Financial Officer should provide a detailed narrative to the board on the financial performance as compared to the business plan. The analysis should include: ratio trend analysis; return on average assets; return on average equity; efficiency ratios; net interest margins; loan growth; deposit growth; deposit mix; non-interest income; and non-interest expense. This narrative should be two to three pages long and should summarize for the board the variations of the monthly financial statements as compared to the business plan.

Included in board materials should be the detailed balance sheet as well as income statements, both on a month-end basis as well as on an average for the month. There should also be financial information on net interest margins, interest rate risk, asset/liability sensitivity, and a breakdown of non-interest expense. There should also be a comparison to budget and discussion of variances.

We have long believed that a board should not get bogged down in reviewing the previous month's financial statements unless there is an unusual event that occurred during the month, and the focus should be based on where the bank stands in comparison to the business plan, and what the plans of management are with regard to any adjustments in the balance sheet or the income statement necessary to achieve plan. Also, if there are individual questions – often best to send to management before the meeting, so they can be prepared to discuss and provide additional information prior to or at the meeting rather than a follow up.

Loan Reports – (10 to 15 minutes)

The loan report materials should focus on: the pipeline report; the loan status report; problem loans and delinquency reports inclusive of issue tracking reports on problem or delinquent credits; concentrations, not only identified with commercial real estate but also identified with other loan categories; and loan loss reserves. We suspect going forward that there will be updates related to CECL progress. Included in the loan reports should be a report from the Chief Lending Officer with regard to how bank is tracking pursuant to plan and any specific issues identified with the loan portfolio.

Corporate Matters – (10 Minutes)

This section of the agenda should deal with: shareholder related matters; stock price; shareholder communications; marketing; IT and cybersecurity; regulatory related issues; normal corporate items; internal or external audits; and litigation. The focus of this section has to do with if there is anything that could have an impact on the overall corporate structure, regulatory matters or shareholder matters.

Policies/Procedures – (less than 10 minutes)

The board is required to annually review and approve policies and procedures for the bank. It is normal that this not be a lump sum approval, but provided in installments so that the board has the ability to review the policies and procedures and to understand them before approval. Therefore, it is better that three or four policies are presented to the board on a monthly basis rather than 36 policies presented during one month a year. We have long recommended that policies and procedures be placed in electronic format where they can be disseminated to the board for review rather than in bulk fashion as part of a board agenda/board packet.

Risk Assessment - (10 minutes)

The board is responsible for evaluating risk assessment involving existing products and services, as well as new ventures. This has been expanded also to BSA/AML/OFAC matters and also IT and Cybersecurity related matters. It should be a normal course of business for risk assessments to be prepared by management and distributed to the board of directors for review. This would include vendor risk assessments and product and service risk assessments, taking into consideration the risk factors that have been identified by the regulatory agencies.

Strategic – (10 to 20 minutes – can be longer)

At least ten minutes of each board meeting should be focused on the forward looking thoughts of strategic planning. Where is the organization headed? What new products and services are being evaluated? What geographic expansion should be considered? What potential acquisitions could be of interest to the bank? What is the potential exit strategy for bank? What are the issues facing the board concerning management succession and overall management talent? What are the issues with regard to board-related matters, inclusive of board succession and board expansion? Each of these are strategic discussions that should be regularly covered at board meetings. These topics should not be deferred solely to the strategic planning meeting. By setting aside part of the agenda for strategic discussion, the board is asked to open their minds as to future thoughts and the direction of the bank.

Education – (5 to 10 minutes)

Every board meeting should have some form of education, whether it is a five minute presentation or a 30 minute presentation, on something involving the bank and of interest to the board. With the continual focus on corporate governance and all of the regulations and statutes involving banks, it makes sense for a board to have training sessions where they talk about various subjects such as BSA/AML, CRA, fair lending, privacy, internal audits and IT cybersecurity. This is an opportunity for directors who have attended outside seminars or sessions to report back to the board their findings. Sharing and obtaining knowledge is critical for board to effectively perform its function. If directors attended an outside conference, we recommend that they submit a short memo on the topics and ideas that were presented that should be discussed with a board.

Executive Session – (at least 10 minutes)

Every board meeting should have an executive session where inside directors and members of management are excused and outside directors have an opportunity to discuss the banking franchise. This should be something that is set on the agenda. Most of these executive sessions are short in duration, giving the outside directors an opportunity to discuss the performance of management, the direction of the banking franchise and their particular concerns with other outside directors. An executive session is healthy for the banking franchise and is something that the regulatory agencies suggest strongly. However, we strongly suggest that the Chairman of the Board or the lead outside director be in a position to brief the inside directors as to what occurred. We all know that anxiety can occur if inside directors are excluded from a meeting and they don't know the general topics of discussion. Most often executive sessions are positive experiences; however, this is the opportunity in which outside directors can express their concerns to other directors.

The desire of all board meetings is to move them along quickly, to provide the information necessary to make informed decisions, to provide accurate information as to the current status and the future direction of the bank and to provide a mechanism for healthy dialogue among directors. We firmly believe that directors should receive their board packets at least three days prior to the board meeting so that they have an opportunity to review and thoroughly understand the board packet. We encourage board members who have questions concerning the financial or loan reports to feel comfortable in contacting either the Chief Financial Officer or the Chief Lending Officer in addition to the Chief Executive Officer prior to the meeting so that they can move the discussions along quickly. Board members should not come to the meetings unprepared and read and open the board packet for the first time. We have recommended to several boards that if a director comes to the meeting unprepared, they should receive no more than 50% of their director fee, since by not being prepared and not having reviewed the materials, they are not in a position to fully perform their director function.

ESSENTIALS OF A GOOD DIRECTOR

1. **Connection with Other Directors**. Know and be able to communicate and relate personally with five other independent bank directors from different banks.

2. **Understand Duties and Responsibilities.** Be knowledgeable and understand the duties and responsibilities identified with the fiduciary obligations of independent bank directorship.

3. **Understand Bank's Culture.** Be knowledgeable of the bank's organizational characteristics, general corporate culture, and the general style of management in implementing and carrying out bank policies and board decisions and actions.

4. **Stay Informed and In The Know**. Be informed, on a continuing basis, of the financial condition and operating situation of the bank.

5. **Be Present and Prepared**. Be prompt in board meeting attendance; be prepared, attentive and constructively participate in board of directors' dialogues and decision-making processes.

6. **Be Constructive and Part Of the Team**. Be a team player, and promote director harmony, cohesion, and constructive interplay and dialogue between and among the directors.

7. **Be Discrete and Maintain Confidentiality**. Be prudent, discrete and maintain the confidentiality of board of directors' decisions and deliberations.

8. **Understand and Report Conflicts**. Be mindful of and promptly disclose any potential conflict of interest.

9. **Maintain Bank's Integrity**. Avoid self-interest promotions and endeavors that may harm or damage the bank's reputation, image, good standing and integrity.

10. **Complete The Work**. Be diligent in carrying out specific assignments for the board of directors and the bank.

11. **Respectful and Responsive**. Be considerate and supportive of the authorities, responsibilities, and discretion of bank officers in carrying out their official assignments. Be responsive of management requests for assistance in carrying out official assignments and board of directors' directives.

12. **Understand and Protect Shareholders Rights**. Be prudent and mindful of shareholders' rights, expectations, and demand for full accounting of director stewardship.

13. **Have A Meaningful Share Ownership.** Invest in Bank ownership and demonstrate an alignment with shareholders.

14. **Advocate and Business Develop For Bank.** Be an advocate and promoter of bank within community and cultivate business customers.