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Bank Director's Educational Program for Members of the Board

A Director's Guide to Corporate Governance 101

WHITE PAPER

BRYAN CAVE

Walter G. Moeling IV co-chairs Bryan Cave LLP's Financial Institutions Practice Group. The Financial Institutions Practice Group represents hundreds of community banks throughout the United States.

Jonathan Hightower is an attorney in the Financial Institutions Group of Bryan Cave LLP. His experience includes representation of both banks and bank directors on a wide range of issues.

Executive Summary

The day when the board's focus was limited to approving loans and marketing the bank in the community is long past. Today's boards face a wide array of complex tasks, and, accordingly, the composition, structure and organization of the board must all be geared to facilitate the board's performing its duties and functioning properly. This process today is lumped under the heading of "corporate governance."

The concept of functioning properly, of course, is in the mind of the beholder, but it clearly includes the board's performing its primary duties of enhancing shareholder value, selecting, compensating and overseeing management and implementing risk management policies.

Boards of publicly traded banks are now fairly well acclimated to the issues comprising corporate governance, and bank regulators are now bringing many of these issues into the community bank board rooms. The regulatory exam almost always includes as its foundation an assessment of the strength of the board, whose oversight is considered critical to the proper functioning of a healthy bank. As a result, it is important for community bank directors to understand corporate governance principles, which fall under three broad categories.

• *Board Assessment*—Is the board properly structured to provide optimal oversight to the bank?
• *Director Independence*—Is the board able to effectively review management recommendations and make its own independent decisions regarding the bank's strategy?
• *Management Review and Compensation*—Does the bank have the right management team, and are those individuals compensated in a way that incentivizes them to implement the bank's strategy?

Board Assessment

A review of hundreds of regulatory memorandums of understanding (MOUs) and consent orders has produced a clear starting point: Virtually every formal action begins with the requirement that the board increase its involvement and conduct an assessment of the performance and composition of management. The board's assessment function, however, begins with the directors themselves. This self-assessment by the board is a logical starting point to ensure top board performance.

Based on our experience, implementing a board assessment process is a very sensitive undertaking, and understanding how other banks have overcome the initial reluctance to start one can be very helpful. While directors are naturally uneasy about assessing board colleagues (and also about being assessed), a good process is largely based on objective standards. For most community bank boards, a good starting point is to ask each director to complete a self-evaluation form (see bottom of this article), which will form the basis for a meeting with the appropriate board committee. In addition to the self-assessment items, the meeting should also be used to uncover any ongoing concerns or issues the director may have with the board or bank. For a more thorough discussion, see the DirectorCorps article entitled: "Board and Individual Director Evaluations."

Once implemented, bank boards with effective assessment programs almost invariably reflect improved board performance. The assessment areas are logical:

• Is the size of our board appropriate?
• Do we have directors with experience and expertise required to add value to the board's oversight of the bank, keeping in mind that representation of large shareholders of the bank and community involvement are only a part of the board's function?
• Do we have members who have the knowledge and skills to perform our required duties?
• Should we have age requirements?
• Do we have a process to implement annual member review or reassessment?
• Do we have appropriate attendance requirements?
• Are all of our members fully committed to the time and involvement that is now being required of directors?
• Very importantly, are our outside directors truly independent and not otherwise obligated or tied to management?

No director has a "right" to sit on a board (a principle often forgotten), and there should be a transition from the typical automatic re-nomination of the existing board members to a more robust assessment model that addresses the questions above. The burden of initiating this transition, however, should begin and be implemented by the board itself, not by management. The selection of appropriate director nominees is a board issue, and the directors themselves are best positioned to address the needs of the board. This observation leads to the next logical issue: board independence.

Board Independence

There are many different ways to objectively define or measure board independence, but in reality, the issue is subjective, not objective: Does the board make its own decisions? A board that is functioning properly should neither rubber stamp management's recommendations, nor should it operate in remote vacuum. Management's recommendations obviously deserve great deference. By the same token, the board is obligated to reach its own conclusions. There should be a logical balance between management input and director independent review.

There are several indicators that a board is exercising appropriate independence. Does the board meet in executive session? Does the board have an independent chairman, or if the board decides the CEO should be the chairman, does the board have a lead director whose job is to act as a structured link between the outside directors and management?

To review regulatory and public stock exchange definitions of independence, see the DirectorCorps article on "Director Independence." A director is typically not independent if he or she receives compensation above certain thresholds as a vendor or provider of professional services to the company, or if the director owns more than 10 percent of the company's stock, or if the director is or has served recently as an employee.

However, too often, the independence of individual directors is the sole focus when assessing whether the board has appropriate independence. While the independence of the individual directors is obviously essential to their objective performance, the collective independence of the board should be the focus in reviewing independence. The outside directors of a board with appropriate independence should function as a unit to review management recommendations and ensure that the bank's overall strategy is being implemented. Directors on a board that is functioning properly can not only reach independent conclusions but also discuss those conclusions in a structured environment that leads to appropriate implementation. The board's ability to function in this manner is critical to addressing the next corporate governance issue: management review and compensation.

Management Review and Compensation

There is no board function more critical than reviewing, evaluating and compensating management. The independence and objectivity of the directors help make this process beyond reproach. While the views and input of the CEO are essential, over and over we see that bank performance is greatly enhanced where there is an arm's length, objective assessment by the board of executive management. Where this process is functioning properly, problems and concerns come to the table sooner and are typically more easily resolved. Both shareholders and regulators expect the board to diligently exercise this role, yet all too often, boards abdicate this essential duty in practice. The process of evaluating and compensating management should never be adversarial, but it should be objective. By ensuring that the board has the right directors (through regular board assessment) and that the board is collectively independent, the function of management review and compensation should come naturally.

Implementing "Functioning Properly"

In recent years, oversight of basic corporate governance functions has become vested in many banks in a corporate governance committee, but there are many variations. Some banks place the corporate governance function in a nominating or compensation committee, and some boards use the audit committee. What is most important, however, is that there be a committee of outside directors, with specifically delegated authority and responsibility to perform these roles. The committee so designated should be given authority by the full board to adopt a charter, engage advisers as needed, set the parameters of its jurisdiction, and determine the criteria for committee membership, subject to full board approval. The committee should not be a substitute executive committee or audit committee. Instead, its role is more internally oriented—determining if the bank's board is functioning properly. If it is, the bank, its shareholders and regulators will all be well served.

DIRECTOR SELF ASSESSMENT

The purpose of the director self-assessment process is to:

Review what is expected of members of the board of directors and assess how well these expectations are being met, recognizing that each director has different strengths and interests;

Provide the chairman of the board and the [____________] Committee with a means of assessing the direction and overall performance of the board.

SELF ASSESSMENT FACTORS:	**PERFORMANCE RATING (1-5, with 5 being highest)**
* Attends meetings on a regular basis	____________
* Willingly assumes additional responsibilities	____________
* Exhibits high degree of preparation for scheduled meetings	____________
* Actively promotes the bank's products and services throughout the community and seeks new leads and business markets	____________
* Contributes to the community through civic and business organizations	____________
* Demonstrates sound knowledge of the bank's internal policies, procedures and controls designed to ensure compliance with statutes, regulations, and good banking and business practices	____________
* Offers multiple perspectives, expertise, and experience through active participation on various internal committees	____________
* Generates ideas to improve profitability and shareholder value	____________
* Maintains an ownership interest in the bank	____________