Community Banks Directors Guide

A series of articles specifically tailored for Community Bank Directors on board membership, governance and risk management.

Article Two

The PERFECT© Model for Community Bank Board Governance

Authored by:

John "Jay" Gallo, Partner

David E. Brown, Partner

RMPI CONSULTING, LLC

Risk Management & Process Improvement Specialists

60 State Street | Suite 700 | Boston, MA 02109
T 617 973 5742 F 617 963 7119

3001 North Rocky Point Drive East | Suite 200 | Tampa, FL 33607
T 813 367 3510 F 813 982 3310

I www.rmpiconsulting.com

About the Community Bank Directors Guide:

The Community Bank Directors Guide is a series of leadership articles specifically tailored for Community Bank directors. Topics include board membership, governance and risk management. In each article we discuss issues such as the role of the director, what relevant questions directors should be asking management or how directors can improve their performance as leadership figures.

Article Two

The PERFECT© Model for Community Bank Board Governance

A great Community Bank board of directors does not occur by happenstance. Attracting superior talent and maintaining an exceptional team in today's competitive and legally challenging banking environment requires strong leadership and a well-develop strategy for obtaining and developing outstanding directors.

Over the past five years RMPI Consulting, LLC has spent a considerable amount of time with the management and directors of Community Banks on assignments ranging from growth strategy to enterprise risk management to board governance.

In our board and management assessment projects, we typically conclude with individual interviews of each director to identify what works and doesn't work at their bank. We pose the open-ended question, "If you were trying to build a great board for a new bank, what critical elements would you include in your plan?"

This question usually opens a floodgate of opinions and ideas. Comments fall into two main categories: better governance and director development. The common underpinning to all responses, however, is an articulation by interviewees of the often-ineffectual framework that their boards use to address these concerns. Directors pine for a proper, supportive model of governance.

To help with this inquiry, RMPI developed a diagnostic framework for listening to directors concerns, conducting research and due diligence and linking issues to the structural components that we identified as the root causes of board inefficiencies. Our conclusions have resulted in the development of RMPI's "PERFECT© Model for Community Bank Board Governance."

This PERFECT© Model is the outcome of over 100 interviews with Community Bank directors and executives about what inspires a good board and supports valuable directors. Additionally, we conducted extensive outside research and had multiple discussions with several different regulators about effective governance.

Our research focused not only on governance elements – like organizational infrastructure – but also on the personal attributes, such as individual skills and talents, that are the essential building blocks for a cohesive, well run, top performing board that can fulfill its fiduciary responsibility to shareholders.

The seven elements of good board and director management are as follows:

People –Banks need a Board with a core group of individuals who know how banking institutions operate. As banking has become more competitive, financial institutions have become more sophisticated in the products and services they offer. This has led to new balance sheet and enterprise risks that require a board to be more knowledgeable than ever before. Layer-on increasing and ever changing compliance requirements, and it becomes crucial to have directors who truly understand how a bank operates. Additionally, it is difficult to offer wise counsel to the CEO when directors do not have a nuanced understanding of the risks and rewards of strategic options. Having directors who understand from experience the concepts of risk management enables a board to act from a knowledgeable position.

Expectations about director tenure, committee rotation and retirement should be clear and written into bylaws or charters. To develop a mature set of directors who can each participate in a meaningful way, directors need to rotate across committees and leadership roles. Additionally, age-band concentrations can cause difficult transitional problems for boards. Since boards live in perpetuity, there needs to be an appropriate distribution of directors across age groups. There should be a minimum age for directors – we want a certain amount of like experience – and a retirement age so that new minds can continually replenish the team with new perspectives.

Reporting needs to be clear, focused and graphical. Directors and managers should look for two types of executive-level reports to drive discussion, analysis and decision-making. Historical Reports should be used to manage long-term performance trends. They should show bank performance against goals and peer group. Relational Reports should be used for critical decision-making; these reports, showing how two or more elements relate (for example, advertising dollars spent versus new loan production by market area), help directors and CEOs focus on the cause and effect of investment and strategy. In the end, if you don't use the information presented to make a decision or affirm a strategy, ask yourself why you're looking at it. With so much data flooding the boardroom, reporting needs to be distilled and presented in ways that allow directors to understand risk options and the impact of key decisions.

Formal criteria needs to exist around new director selection: skills, geography, cultural fit, etc. Banks should develop a skills matrix based on the strategy and risk appetite of the institution. This skills matrix should ensure the directorship is balanced across multiple areas of expertise, education and experience. As directors retire, the skills matrix should be used to identify weaknesses or gaps in the board so the

new director search committee can take these into account when seeking new board members.

Enterprise-wide strategy needs to be clearly articulated and tailored to each institution. If your strategic plan looks like everyone else's, then directors are not helping management define the unique value proposition that brings in customers and keeps the bank growing profitably. The bank's strategic plan should state how the institution intends to make money, how it is different from its competitors and what risks it is willing (or not willing) to take. Value is maximized when management sets strategy and objectives to strike an optimal balance between growth return goals and related risks, and it efficiently and effectively deploys resources in pursuit of its written objectives.

Confidential mechanisms should exist for feedback so directors can share goals and concerns related to board governance and team performance. Directors need a vehicle for getting confidential performance feedback from their colleagues. If done correctly, "360 degree" evaluations can provide a convenient, non-threatening way for individual directors to assess their performance and develop personal training programs to fill perceived weaknesses. Confidential, multi-source surveys are also helpful for raising sensitive issues and topics that need to be discussed but are difficult to introduce. Chair-driven, periodic self-examinations enable directors to maintain accountability in their personal contribution and provide a non-aggressive mechanism for furthering board discussions.

Training and education are vital to the successful development of a mature approach to risk management. Initial training should be built around what a director will see and read on a monthly basis. Once newcomers are familiar with the bylaws, charters, monthly reports and the elements of CAMELS, they will then have context for further training. Once committee assignments are made, each individual director should conduct focused training in their particular area of responsibility. Over the long term, there should be a mix of education guiding directors either individually or in small groups. Training programs differ from education because one teaches "how" whereas the other teaches you "why." Competent directors and well-functioning boards need to cover both. Everyone needs to know how an ALLL can be affected by concentration risk, and additionally, it's extremely helpful for a few individuals to understand why diversification strategies reduce risk and actually improve long-term, risk-adjusted returns.

Conclusion

Directors do not come together as a great board serendipitously. To develop a superior team, directors and management need to display strong leadership and follow a clearly defined, written plan. If a board has directors who have been in the same roles for an extended period, there may be some reluctance to change. A collaborative chairman and supportive CEO will need to help all directors see the benefits of governance modifications.

It is important, however, that any changes do not appear to put a particular director at a disadvantage. Saving face is a vital social concept that needs to be included in any decision by the group. An explicit statement to every participant may be needed so all directors understand that the improvement plan is not designed to weed out individuals but is instead focused on turning weaknesses into strengths. Once certain directors understand that governance revisions and new training programs are designed to help them and not push them out the door, then the collective group may more easily adopt changes.

The best time to improve board governance, therefore, is when the bank appears to be doing well and executing smartly against its strategy and when all directors feel they are valued members of the boardroom team.

###

About the Authors

Jay Gallo and David Brown are both partners at RMPI Consulting, LLC, where they specialize in business strategy and enterprise risk consulting services for Community Banks.

Experience the RMPI Difference

With offices in Boston and Tampa, RMPI Consulting provides risk management services to Community Banks across the credit life cycle. The company helps clients with interim, outsourced staffing, and its thought leadership has defined industry "best practices" on a broad range of risk management services.

Recognizing there is no "one size fits all" solution for every Community Bank, RMPI works with each client to develop an appropriate, custom solution to solve their specific problem at a reasonable cost.

For more information, please call us or visit rmpiconsulting.com