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ARTICLES

BANK GOVERNANCE: AN INDEPENDENT DIRECTOR'S PERSPECTIVE

JOHN D. "JAY" CORNET*

In 1995 and 1996, I was privileged to work with a local group of business people to found a community bank. The process turned into a rather arduous task, but through the work of a fine board and exceptional management, in the end it worked out extremely well. One day during the organizational process, I met with an examiner from one of the regulatory agencies. I asked what training was available for new boards and how board members, most of whom had limited banking experience, prepared themselves to effectively govern a bank. His response stunned me. He said, "Oh, you'll figure it out."

A couple of years later I visited with a bank CEO. During our conversation, I asked him what one word best described what he wanted his board to be. He looked cautiously around his office, leaned towards me and in hushed tones said, "GONE!" While said in jest (I think), his comment, along with my earlier experience with the bank regulator, really drove home the nature of governance in banking. For me, these experiences accentuated the need for a thorough exam of governance practices in banking.

Over the years, my experience as a bank officer, bank consultant, bank director, and board chairman, has provided me with a unique perspective on the concept of bank governance and

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the relationship between the board and management. I have been struck by the passive application of effective governance principles in banking. There are probably numerous reasons for current bank governance practices, and since they have helped me in formulating my view of bank governance today, several warrant mentioning.

I. CURRENT BANK GOVERNANCE PRACTICES

Banking is one of the most heavily regulated industries in America. Most of these regulations are "operational" in nature, dealing with practices and procedures. Banks, depending on their charter, are audited by multiple state and federal agencies as well as by internal and external auditors. This oversight provides boards with a sense of security that anything that needs to be resolved will be accomplished with little need for their own active involvement. Thus, receiving reports from management at board meetings with little questioning seems appropriate.

Despite significant bank regulations, few regulations directly address governance issues. However, regulations addressing director relationships with banks, such as "Reg. O,"[1] are understood and followed. Several good publications that offer guidelines for directors, such as the FDIC Pocket Guide for Directors and the Federal Reserve Board's Basics for Bank Directors, are underutilized.[2] Directors are ultimately held responsible for the safety and soundness of their bank, yet they receive very little regulatory and banking education.

Overall, there is very little emphasis on director "banking" education.[3] Directors are successful people in their own fields.

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1. Loans to Executive Officers, Directors, and Principle Shareholders of Member Banks (Regulation O), 12 C.F.R. § 215 (2002).

2. FDIC Pocket Guide for Directors, *at* http://www.fdic.gov/regulations/-resources/directors/index.html (last visited Feb. 5, 2003); Forest E. Myers, BASICS FOR BANK DIRECTORS (3rd ed. 2001), *available at* http://www.kc.frb.org/BS&S/Publicat/PDF/dirbasics.pdf (last visited Feb. 15, 2003).

3. Efforts in North Carolina to meet director educational needs include the North Carolina Bank Directors' College, sponsored by the North Carolina Office of Commissioner of Banks and the Center for Banking and Finance at the University of North Carolina School of Law, and the North Carolina Banker's Association's Director's Assembly. Other suggestions for meeting educational needs consist of

They are knowledgeable, insightful, and experienced people. Many are entrepreneurial in nature and are used to individual decision-making without a high level of external oversight. The assumption seems to be that these skilled individuals do not need education into the business of banking. I believe that there are three distinct educational goals for directors: (1) education in the business of banking; (2) education regarding their duties and responsibilities in governing a bank; and (3) education regarding the goals, objectives, and culture of their specific bank.

In addition to director education, the relationship between boards and management is also significant. This relationship, as CEO comments indicate, ranges from: "I've got the board in the dark and I'm keeping them there;" "They're a necessary evil;" "They try to micro-manage the bank;" "I provide them with what they need to know;" "They can develop business for the bank;" "They are a good resource;" "My board provides me with good support and direction," to "My board is an integral part of our bank team and we work well together for the good of the bank and our shareholders." The question is – why the disparity?

First, I recently read that an FDIC study found less than half of all banks had a Directors Code of Ethics. While this study is a few years old, until lately that number was probably still true. Even fewer banks have adopted a written Governance Plan. Additionally, very few bank boards have written performance criteria for directors, and director and board performance evaluations are virtually nonexistent. Without a Code of Ethics, Governance Plan, and performance criteria and evaluations, there is no direction for proper governance practices, or an accepted understanding of directors' responsibilities and the appropriate working relationship between management and board. The lack of these basic components of governance leads to the disparity in CEO opinions on the integration of the board into a sound working relationship with management.

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planning in-house retreats, providing director education at board meetings by asking bank personnel to explain specific bank operations, and taking advantage of programs specifically directed to bank directors, such as those sponsored by the American Association of Bank Directors and the National Association of Corporate Directors, as well as consultants, attorneys, and accountants.

Most banks in America are community banks. Of the 9,415 FDIC insured institutions, 89% have under $500 million in assets and 81% have less than $300 million in assets.[4] Most community banks are of a manageable size and their directors feel comfortable that they know the bank's market, business and personnel.[5]

I believe that America's banks are run by talented, dedicated, and ethical managers and staff, with boards of directors who truly care about their communities and the important, fundamental service they provide to their communities and customers. Directors trust their management – and they should.

Given these observations, I believe a studied approach to understanding and implementing effective governance in banks is appropriate.

II. UNDERSTANDING AND IMPLEMENTING EFFECTIVE BANK GOVERNANCE

For many banks, governance is defined by the delineation of roles: *the board's role is to govern and management's role is to manage*. While this is an important separation of duties, I believe a better working definition of governance is: *A partnership of the independent members of the board and the CEO to control and direct the making and administration of bank policy*; in other words, "independent oversight." This is simple to state, but much more difficult to implement.

Accomplishing effective governance requires careful planning, development, and implementation by the board chairman and the CEO, along with the participation of an engaged, active, and knowledgeable board.

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4. *See* FDIC, Statistics on Banking, *at* http://www.fdic.gov/bank/statistical/statistics/0209/allstru.html (Sept. 30, 2002) (last visited Feb. 15, 2003) (listing statistics on the number and total assets of FDIC-insured depository institutions).

5. I have often heard others describe a "community bank" as one under $1 billion in assets. I personally define a community bank as one under $500 million in assets. Only 5.8% of banks are over $1 billion in assets. *Id.* It is interesting to note that the top 1.3% of banks, those over $10 billion in assets, hold 68% of total assets. *Id.*

Since the last banking crisis in the 1980's, the industry has been doing very nicely. Then along came the "Crisis in America's Business" of 2002, followed by the Sarbanes-Oxley Act, then SEC regulations and stock exchange listing rules. This will soon be followed by other agency regulations and bank regulations.

Much has been and will continue to be, written, discussed and presented on the details, meaning, and consequences of this legislation, rules, and regulations. It will certainly provide legal counsel many hours of study and interpretation and provide wonderful opportunities for advice to bank clients. Although I am not qualified to offer any type of legal interpretation, what does interest me, as a board member and chairman, are the practical implications and impact of this legislation on a bank's management and board.

I began working with banks and boards on governance issues prior to this "crisis." For the most part, I have not changed my approach a great deal as a result of the crisis or its legislative and regulatory aftermath. The overall effect of the Sarbanes-Oxley Act and related regulation on bank boards, management and shareholders has reinforced the essential nature of governance and is, I believe, quite positive.

III. BANK GOVERNANCE: SEVERAL POINTS OF IMPACT

Currently, there is a heightened awareness of the importance of effective bank governance. This fact alone establishes the need for bank CEOs to carefully examine their working relationship with the board and the board's role in bank governance. Those managers who tend toward the "leave them in the dark" end of the spectrum of board interaction will need to change.

A fundamental statement addresses the issue of board structure: *the independence of directors is fact.* Given the importance of director "independence," a structure where the board is comprised of independent directors and where board officers, chairman and vice-chairman, are also independent directors, is preferred. Since "management oversight" is a fundamental role of the board, it is difficult for the Chairman to be

a member of management. I realize that it is the practice of some banks for the CEO to serve as chairman. Where this is the practice, I believe it is essential that the board have a "strong," independent vice-chairman who serves in the capacity of chairman when actions of the board require an executive session, an evaluation of the CEO and management, or an action of the independent directors as stipulated under regulation. While I personally believe that the board chairman and vice-chairman need to be independent directors, I also believe that the CEO must be a member of the board. It is also acceptable for other members of management, such as the CFO or a senior credit officer, to be members of the board, as long as the majority of board members are independent.

The selection of candidates for the board is the responsibility of the independent directors. This does not preclude the CEO or management from suggesting candidates, but clearly the process must be in the hands of the independent directors. The independent chairman or board members must contact potential directors, interview them, and recommend persons for positions on the board. Following the election of a new board member by the shareholders, the chairman and training staff of the bank should conduct a thorough orientation for the new director.

It is proposed in the New York Stock Exchange listing rules that independent director "executive sessions" be required on a periodic basis.[6] To avoid these meetings becoming "gripe" sessions or phantom board meetings, it is important they are carefully planned, have a defined purpose, and are effectively run by the meeting's chair. These meetings should be termed "independent director meetings." They are not board meetings, nor are they board committee meetings. These meetings are an

6. *See* NYSE, Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors August 1, 2002, *at* http://www.nyse.com/pdfs/corp_gov_pro_b.pdf (last visited Feb. 15, 2003) (principal text of rule filing submitted to the SEC on August 16, 2002 by the NYSE); *see also* NYSE, NYSE Approves Measures to Strengthen Corporate Accountability, *at* http://www.nyse.com/content/articles/NT0056F8D4.html (discussing the NYSE Board of Directors' approval of proposals that would require a higher standard of corporate governance) (last visited Feb. 15, 2003).

excellent opportunity for director continuing education programs, economic and market review, and open discussion among the independent directors. The meeting's chairman should bring any issues raised at the meeting to the bank board meeting when appropriate.

Although I firmly believe that the board's role is to govern and management's to manage, with the change in rules for audit committees, directors are now involved in areas previously left to management. The audit committee, which must be composed of independent directors, is responsible for hiring, compensating, and managing external and internal auditors.[7] Directors must be certain that their limited management role with respect to auditing does not carry over into other areas that remain the responsibility of management. CEO's and CFO's need to relinquish control of these audit relationships and support the role of the independent audit committee. This is a significant change for all involved.

While these new regulations under the Sarbanes-Oxley Act are applicable only to publicly traded institutions, through the application of best practices, litigation and customer pressure, the practical effect will be to apply these principles to virtually all banks. These new regulations should not be a burden for bankers because bankers are adept at implementing and comfortable working within regulation. Bank counsel should advise boards of the changes in corporate and personal liability based on new regulations. Counsel should also meet and work *directly* with boards to assure implementation of required policies and procedures to comply with regulations.

IV. A SEVEN STEP PLAN FOR EFFECTIVE BANK GOVERNANCE

The time is right for banks to take a hard look at their governance practices and to implement a program of effective governance. The new regulations arising in the aftermath of the "Crisis in America's Business" and the legislative response in the Sarbanes-Oxley Act should be seen as an opportunity to improve the board's effectiveness and to establish the highest standards of

7. 15 U.S.C.A. § 78j-1(m)(2)-(3) (2002).

bank governance. To accomplish this, I would suggest a seven-step plan for effective bank governance. This plan can be developed and implemented by the CEO and independent chairman or with the aid of legal counsel or a consultant.

First, assess the current state of governance. Before beginning to develop a plan, find out where you are. Conduct objective interviews with board members and management to determine their understanding of governance and their expectations of each other. These interviews should be detailed and cover a broad range of subjects such as board duties, bank knowledge, education, expectations, management, working relationships, and measurement. From this information, direction and recommendations can be determined.

Second, based on the assessment and resulting recommendations, prepare a written bank governance plan. The bank governance plan is a written statement covering how the bank will be governed, and the board's duty to shareholders, management, and itself. The plan should state the qualifications, standards, and expectations for directors. It should present the summary of board committee charters. It should address issues of governance such as election of directors, compensation, term of office, retirement age, continuing education, meeting schedules, attendance requirements, meeting procedures, succession plans, and code of ethics.

Third, develop a governance policies and procedures manual. This document should provide board members with all the information needed to understand the duties a member must undertake to accomplish his or her role in effective governance. It should cover every issue affecting a board member, such as the governance policy, pertinent federal and state regulations, the board orientation program, the board structure, committee charters, a summary of policies adopted by the board and dates when each is to be reviewed and approved, duties and expectations, the strategic plan and planning guide, board policies and procedures, the compensation plan, educational documentation, and bank operations information.

Fourth, implement the governance plan through the policies and procedures manual. With a governance plan in hand and a

written policies and procedure manual, make certain to follow them. These should not be documents that look good sitting on the shelf, but rather they should be understood and used. It is a good idea to introduce and implement these during a board retreat where everyone can focus on the material. When implementing a new governance plan, it is important to present the findings of the assessment to the board and link policies to the recommendations identified by the board and management.

Fifth, communicate your governance plan. Let your shareholders know you have a governance plan. Share this information with potential investors and market makers. Be certain that senior management and staff know that the board has a plan for effective governance of the bank. Communication of the plan can help to instill confidence in all constituencies of the bank.

Sixth, evaluate board and CEO governance effectiveness. Board performance should be evaluated at least annually. At a minimum, the board as a whole should be evaluated on its performance relative to the governance plan. A more comprehensive evaluation plan provides for the board to evaluate itself as a whole, for each board member to individually evaluate other members, and for each director to evaluate the CEO. The CEO's evaluation should be done anonymously and can be included as a part of the CEO's compensation review.

Seventh, review and revise the governance plan. The governance plan and policies should be reviewed annually. This can be done in conjunction with the annual review of the bank's strategic plan. Any time there is a change in the bank's structure, the plan should be revised to reflect that change. The governance plan is a "living" document that is integral to proper bank governance. Polices should be reviewed to make certain they still properly reflect the board's governance philosophy. Each board member and the CEO should objectively and critically ask whether board decisions are made in accordance with these policies. Board members should evaluate how they met their responsibilities to themselves, other board members, management and shareholders. Based on this evaluation, adjustments should be made to the governance plan and policies and procedures manual.

V. CONCLUSION

Bank governance does not just happen. It requires effort on the part of the board and senior management. It requires dedication to the task of governing. An effective, actively pursued governance plan will provide valuable benefits for the bank. It will help all board members to be more effective and will build the partnerships within the board and between the board and management that are necessary to meet the shareholders' demands for effective governance of the bank.