Corporate Governance: Where Do Tenth District Community Banks Stand?

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INTRODUCTION

Corporate governance practices have been debated for more than 50 years, spawning numerous reform proposals aimed at improving the system of checks and balances built into the corporate model to protect shareholders' interest against possible management abuse. Highly visible troubles at publicly traded companies have led to the passage of recently enacted laws that add more rigor and formality to the governance process by, among other things, improving independence among governance participants and codifying the responsibilities of certain of those participants. Most of these reform proposals and new laws are aimed at protecting investors in publicly traded firms.

Relatively few Tenth District community banks, however, are publicly traded or are subject to new laws that would require them to change their corporate governance practices. Indeed, many are small in asset size, family-owned, closely held, and owner-managed. Given these characteristics, the governance process at community banks tends to be less formal and structured than that required for publicly traded companies. What then has been the impact of corporate governance reform on community banks? Have community banks perceived benefits from the practices recommended by proponents of a more formal governance process? Although not required to do so, have community banks adopted any of the practices required of publicly traded companies?

This paper uses information gathered from the Federal Reserve Bank of Kansas City's 2004 Tenth District Community Bank Survey (Community Bank Survey or Survey) to answer these questions.[1] The analysis that follows is divided into two sections. The first section briefly includes background information and definitions that provide the basis for the governance areas covered by the Community Bank Survey. The second section summarizes survey findings for these governance areas and offers some conclusions on governance practices at community banks drawn from survey data.

BACKGROUND

Corporate Governance Defined

Like many other terms of art, there is no one generally accepted definition for corporate governance. Some are quite lengthy, while others are abbreviated. The definition used here is:

> "Governance involves many players, each with specific assigned responsibilities to ensure that the [risk management] system as a whole is sufficient to support the business strategy and ensure the effectiveness of the systems of internal control."[2]

Governance Players and Their Roles

Governance includes many participants internal and external to the corporation. Included among the internal players are officers, significant shareholders, and directors (a listing of internal players and their governance roles and responsibilities can be found at Appendix A). External influences on governance include auditing firms, regulatory agencies, securities exchanges, rating agencies, and others (a listing of these players can be found at Appendix B).[3] Together, these participants form a system of checks and balances. Among this system's many purposes are to control the principal-agent problem inherent in the corporate business form and protect shareholder interests; to provide, monitor, and evaluate the corporation's daily management; to plan for its future; to ensure its fair and accurate financial reporting; and to make sure it complies with laws and regulations.[4] Whether the corporation is a large automotive manufacturer, a hotelier, or a small community bank, these basic governance objectives are the same.

Implicit in the governance process are the assumptions that its participants act independently of one another, that they act ethically, that they have the necessary skill sets to perform their duties, and that they are active in meeting their responsibilities. Indeed, the intent of many "best practices" set forth by good governance proponents is to make operational these implied assumptions. It is these best practices that underlie the 26 governance questions included in the Community Bank Survey. These questions focused on:

- Board size and composition
- Board committee structure
- Board membership and recruitment
- Director compensation and ownership
- Senior management team succession
- Other governance matters

Each governance topic is discussed in turn, starting with a brief description of why proponents advocate certain practices as a way to achieve more effective governance. This introduction is followed by a review of Community Bank Survey governance data pertaining to the practices. Because ownership structure and size can influence the governance process, survey data are disaggregated by family and non-family ownership and within these ownership categories, smaller and larger banks.[5]

2004 COMMUNITY BANK SURVEY RESULTS[6]

Board Size and Composition

Board size. National or state banking laws set the minimum and maximum number of directors that can sit on a bank's board. For banks in most Tenth District states, the minimum is three, and the maximum is 25 board members.[7] Within this range, it is left to the discretion of individual banks to determine an appropriate board size.

Although many factors may enter into a bank's decision regarding appropriate board size, two important ones are its size/operational complexity and the maximum number of directors the organizers believe can support effective decision-making. Large size and operational complexity may place a greater workload on directors. Size and complexity may also require greater diversity of experience among the directorate in order to explore fully issues associated with business decisions. Each of these may make a larger board necessary. Offsetting this need for a larger board is the ability to reach consensus. Too large a board may be unwieldy, making it difficult to come to agreement and take decisive action. Proponents of good governance tend to focus on this last factor, recommending smaller rather than larger boards.

Table 1 reports board size information for those responding to the Community Bank Survey. Data suggest that boards at community banks tend to be relatively small and near the lower end of what banking laws allow. The data also show that board size stayed relatively constant at a majority of banks during the last five years, with the exception of larger, non-family-owned banks. Additionally, when board size changed, the overall tendency was for boards to shrink (the proportion of banks reporting a decrease in board size exceeded those reporting an increase over the last five years) at all banks except large, non-family-owned banks where the proportion of banks reporting an increase in board size equaled that reporting a decrease.

Board composition. Outside directors bring diversity of knowledge, skills, and experience to the board table, which is invaluable in advising management and making business decisions. Because they are not active in daily operations, they are also unbiased judges of the management of those operations. In light of the important role

Table 1

Community Bank Board Size and Composition

		Assets< $150M		Assets>$150M	
	All Responses	**Family**	**Non-Family**	**Family**	**Non-Family**
Median board size	**7**	**7**	**7**	**9**	**11**
Percent of banks reporting **no change** in board size over the last five years.	61.37	65.53	57.89	54.76	37.50
Percent of banks reporting **increase** in board size over the last five years.	16.20	15.53	14.03	16.67	31.25
Percent of banks reporting **decreased** board size over the last five years.	22.43	18.93	28.07	28.57	31.25
Median number of outside directors.	3	2	4	4	7
Percent of boards with outside directors a majority.	**42.24**	**30.76**	**67.24**	**47.22**	**85.71**
Percent of banks reporting **no change** in number of outside directors over the last five years.	65.92	71.78	60.71	57.50	31.25
Percent of banks reporting **increase** in number of outside directors over the last five years.	13.69	12.87	12.50	10.00	37.50
Percent of banks reporting **decrease** in number of outside directors over the last five years.	20.38	15.34	26.79	32.50	31.25

Source: Survey of Community Banks in the Tenth Federal Reserve District

outside directors play in the governance process, proponents of good governance advocate that outside directors constitute the majority on corporate boards.

Community Bank Survey data (see Table 1) indicate that outside directors constitute the majority at less than half of Tenth District banks. This is largely due to the limited role played by outside directors at family-owned banks, especially at smaller family-owned banks. Outside directors play a larger board role at non-family-owned banks, especially larger non-family-owned banks. Approximately 86 percent of these banks reported outside director majorities on their boards.

Table data also show the waning influence of outside directors over the last five years. This decline occurred despite emphasis by governance reformers on a greater role for outside directors. With the exception of large, non-family-owned banks, more banks reported a decline in outside directors than did those reporting an increase. Large family-owned banks, on net, reported the greatest outside director decline.

Board Committee Structure

Banking organizations use an extensive committee structure to manage their risk exposures and govern their operations. It is common for bank boards to use their loan, asset-liability management (ALM), and investments committees to monitor and manage their credit, liquidity, and market risk exposures. Many banks also have executive, audit, nominating, compensation, and operations risk committees to help monitor and govern operations.

In general, there is no regulatory or legal guidance that dictates committee structure or composition for banking organizations. The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), however, requires that all publicly traded companies have audit, compensation, and nominating committees comprised solely of outside directors. The Sarbanes-Oxley requirements pertain to publicly traded banking organizations and, by supervisory policy, to organizations that meet conditions set out in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). While Sarbanes-Oxley is not applicable to non-publicly traded banks, and FDICIA requirements do not apply to smaller banks, proponents of good governance believe there are positive benefits associated with having these committees and that outside directors should at least constitute the majority on these committees.[8]

Appendix C summarizes Community Bank Survey data relating to committee structure and composition. The data show that nearly all community banks have board committees that oversee management of credit, liquidity, and market risk—loan, ALM, and investment committees. Inside directors (chief executive officer (CEO) and other bank officers) tend to be well represented on these committees while outside directors are not, especially at family-owned banks. The data also show the dominant role played by the CEO at community banks. Ninety percent or more of respondents said their CEOs served on these three committees. Outside directors, on the other hand, constituted a majority of committee members at fewer banks and were less likely to serve as committee chairs. Once again, this tended to be more typical for family-owned banks than non-family-owned banks.

The story is somewhat different for the audit, nominating, and compensation committees. Outside directors have greater representation, more often constitute a majority, and more frequently serve as committee chairs than they do on the loan, ALM, and investment committees. Yet, there is a significant minority of community banks where inside directors dominate these committees. Furthermore, the data show that outside directors seem to play a smaller role on these three committees at family-owned banks. Not as many family-owned banks reported outside directors on these committees, fewer outside directors chaired the committees, and CEO and other bank officers were slightly more prevalent as committee members.

Committee Rotation and Assignments

Besides recommendations on board committee structure, advocates of good governance support periodic rotation of committee assignments to help reduce complacency, to re-energize committee oversight, and to minimize the existence of comfort levels and relationships that may reduce the quality of oversight. To promote diversity in decision-making, backers of good governance practices recommend that directors, through their votes on candidates put forward by the nominating committee, determine committee assignments.

Table 2 data indicate that only 25 percent of Community Bank Survey respondents periodically rotate committee assignments. This practice occurs less frequently at small family-owned banks and more often at non-family-owned and larger banks.

Board chairs, CEOs, and directors all seem to play a role in determining committee assignments. In general, directors play the largest role in deciding committee assignments, followed by CEOs and then board chairs. This pattern holds for all but large family-owned banks, where board chairs play the largest assignment role.

Table 2

Committee Rotation and Assignments

		Assets<$150 M		Assets>$150 M	
	All Respondents	Family	Non-Family	Family	Non-Family
Periodic committee rotation—percent yes	25.00	17.09	33.33	45.00	43.75
Individual(s) who determine committee membership (percent)					
Board chairman	28.16	27.09	24.56	39.02	26.67*
CEO	29.75	28.57	35.09	31.71	20.00*
Directors	36.39	37.44	38.60	26.83	40.00*
Other	5.69	6.89	1.75*	2.44*	13.33*

*Fewer than 10 observations.

Source: Survey of Community Banks in the Tenth Federal Reserve District

Board Membership and Recruitment

Advocates of good governance recommend that board members be selected for their relevant business and industry skills. They believe that the nominating committee should track and monitor these skills, using the organization's changing need for skills and experience as the criteria for recommending new board members.[9] Another common corporate governance recommendation is to recruit board members with specialized skills, such as accounting expertise, even when the organization is not a publicly traded company.[10]

Community Bank Survey information (Table 3) indicates that a principal reason for asking someone to become a director depends upon ownership structure. Ownership interest is the principal reason

Table 3

Reasons Why Individuals Are Asked to Join Community Bank Boards

Reasons	All Respondents	Small Family-Owned	Large Family-Owned	Small Non-Family-Owned	Large Non-Family-Owned
Business expertise	1	2	1	3	1
Ownership interest	2	1	3	1	3
Community leader	3	3	2	2	2
Family member	4	4	4	6	6
Background	5	5	5	4	5
Important customer	6	6	6	5	4

Source: Survey of Community Banks in the Tenth Federal Reserve District

for board service at small banks, while business expertise is the main reason at large banks. Being a community leader was an important reason at all banks. Not too surprisingly, being a family member was cited more often as a reason for board service at family-owned banks than at non-family-owned banks, but it did not rank as high as business expertise and community leadership.

Director Compensation and Ownership

Supporters of good governance recommend that a significant part of director compensation take the form of long-term equity. The intent of this recommendation is to align directors' interests with those of the corporation's shareholders, providing directors with incentives similar to shareholders in guiding their decisions.

Community Bank Survey data (Table 4) shows that about 16 percent of Tenth District community banks pay compensation beyond a standard director retainer. This added compensation (e.g., performance bonus) primarily takes the form of cash payments and other remuneration (e.g., insurance). This is generally true for both family and non-family-owned banks, with the exception of a few larger family-owned banks that offer stock. Given the nature of the ownership in these community banks (i.e., family members) reinvestment in the long-term growth of the banking organization seems to receive greater emphasis than distributions of earnings.

At first, the predominance of cash payments over stock may seem contrary to what proponents recommend as a way to align director interests with those of shareholders. However, at community banks, a significant portion of directors have 25 percent or more of their personal assets devoted to ownership in the banks they oversee. The exception to this is at larger, non-family-owned banks where directors typically own far less.

In addition to recommendations for significant stock ownership by directors, governance advocates recommend an ownership stake for the CEO. Community Bank Survey information in Table 5

Table 4

Director Compensation and Bank Ownership

		Assets<$150M		Assets>$150M	
	All Respondents	**Family**	**Non-Family**	**Family**	**Non-Family**
Annual director pay for board service					
Minimum	0	0	0	$2,400	$1,200
Median	$3,600	$3,000	$4,025	$6,000	$4,800
Average	$4,362	$3,617	$4,763	$6,859	$5,988
Maximum	$22,000	$22,000	$14,400	$14,000	$12,000
Directors paid regardless of meeting attendance—percent yes	43.39	45.46	40.00	45.95	25.00
Pay additional compensation—percent yes	16.10	14.01	22.41	14.29	25.00
Form of additional compensation					
Common stock—percent that pay	1.52	0	0	12.50	0
Cash—percent that pay	81.82	86.84	85.71	62.50	66.67
Other—percent that pay	16.67	13.16	14.29	25.00	33.33
Percent of directors with 25 percent or more of their personal assets invested in bank					
Outside directors	10.41	9.85	13.92	11.33	2.86
Inside directors	51.16	51.26	58.03	52.51	21.43

Source: Survey of Community Banks in the Tenth Federal Reserve District

Table 5

Community Bank Survey—President/CEO Bank Ownership

		Assets<$150M		Assets>$150M	
	All Respondents	Family	Non-Family	Family	Non-Family
Average ownership	24.06	28.81	11.05	24.42	10.83
Median ownership	8.00	11.94	5.16	8.00	1.55

Source: Survey of Community Banks in the Tenth Federal Reserve District

indicates that CEOs, on average, own or control about 25 percent of the outstanding stock in their banks or parent bank holding companies. Driving this number is the large ownership stake CEOs have in family-owned banks. Average ownership by CEOs at non-family-owned banks is less than half of that at family-owned banks.

Senior Management Team Succession

Management succession and planning for the orderly replacement of senior management team members is an important matter and recommended as a good governance practice.[11] Despite this, only 36 percent of Tenth District community banks have written plans in place, even though 20 percent of CEOs are over the age of 60 and an almost equal number indicate plans to retire within the next five years (see Appendix D). A greater proportion of family-owned bank respondents reported they have plans in place than did non-family-owned banks.

Management succession takes on added importance because of the gradual aging of senior management teams at many District banks. These officials have many years of experience, making it crucial that their banks prepare for any future management needs.

Appendix D contains Community Bank Survey summary age and retirement plan information for senior management and board members. Of particular note is the number of CEOs and outside directors that have retirement plans within the next five years or are 60 years or older (making them potential retirement candidates within the next five years). At a minimum, almost one in five banks could lose their CEO through retirement. They could lose more than half of their outside directors if those directors decide 65 is time to retire from board service.

The loss of these particular management officials could be problematic for some community banks. Table 6 data indicate that few organizations foresee problems filling vacant staff positions. However, a higher proportion, more than a quarter, of Survey respondents see filling official and outside director positions being a problem during the next five years. This was especially true for family-owned banks.

Other Governance Matters—Code of Ethics, Director Assessments, Director Mandatory Retirement, Directors' Training

Code of Ethics

The "tone at the top" is established by the character of board members and senior management. A positive tone is critical in establishing a proper control environment in which a company's internal control system must work and

Table 6

Percent of Respondents Indicating Some Problem Obtaining Needed Staff and Outside Directors During the Next Five Years

		Assets<$150M		Assets>$150M	
	All Responses	Family	Non-Family	Family	Non-Family
Staff	9.59	9.17	6.90	11.9	18.75
Official staff	26.09	27.67	20.69	23.81	31.25
Outside directors	24.45	25.49	18.97	31.71	12.50

Source: Survey of Community Banks in the Tenth Federal Reserve District

is an important component of its governance process. Consequently, many promoters of good governance recommend companies adopt a code of ethics that establishes appropriate ethical values and prohibits activities that create actual or the appearance of conflicts of interest.[12] They recommend the code of conduct be prominently displayed throughout the organization and on its web site. They suggest establishing procedures to ensure that all employees, including officers and directors, understand and abide by the code of conduct. They also recommend that an ethics officer be appointed and a board committee be established to oversee ethics issues and code of conduct compliance and to document any waivers from the code.

Community Bank Survey data (see Table 7) indicate that about two-thirds of Tenth District community banks have established a code of conduct. The percentage for family banks, regardless of size, was somewhat lower than that for non-family banks.

Table 7

Code of Ethics, Director Assessment, Mandatory Retirement, Training

		Assets<$150M		Assets>$150M	
	All Respondents	Family	Non-Family	Family	Non-Family
Adopted code of ethics —percent yes	65.62	60.59	62.72	87.18	87.50
Director assessment performed —percent yes	28.30	27.05	25.00	35.90	37.50
Mandatory director retirement age —percent yes	7.74	3.38	11.86	19.51	18.75
Director training in 2003 —percent yes	49.53	40.98	62.71	69.23	62.50

Source: Survey of Community Banks in the Tenth Federal Reserve District

Director Assessments and Mandatory Retirement

Director assessments serve many purposes.[13] For instance, they can serve as valuable input to a bank's nominating committee determination of a director's effectiveness or fitness for nomination to another board term. Because of this, many proponents believe director assessments have an important place in good governance.[14] Table 7 data show that director assessments were done by 25 to 37 percent of Tenth District community banks and that there was little difference in the director assessment percentage between family- and non-family-owned banks. However, larger banks, family- and non-family-owned, were more likely to perform such assessments than smaller banks.

Another area that proponents believe is important for maintaining an active and effective board is a mandatory retirement age for directors. Many banks are responding to this governance recommendation. One bank survey showed that 51 percent of respondents had a director mandatory retirement age, up by 40 percent from a year-earlier survey; the average maximum retirement age was 71.[15] Community Bank Survey data indicate that only 8 percent of Tenth District community banks have a mandatory retirement age for directors, and smaller banks were less likely to have adopted a mandatory retirement age than larger banks.

Director Education

Knowledgeable directors are a valuable source of information, advice, and management counsel for a corporation, making director education another area stressed by good governance backers. With widely publicized troubles at publicly traded companies and increased scrutiny given to board performance, this area of governance receives more attention than in the past. In this regard, nearly 50 percent of banks reported their directors participated in some form of training during 2003. At non-family-owned banks, this percentage was over 60 percent. Regardless of size and ownership, District community banks relied most heavily on trade associations and banking supervisors as a director training resource (for a selected list of

Table 8

Director Training Resources Used by Community Banks

		Assets<$150M		Assets>$150M	
	All Respondents	Family	Non-Family	Family	Non-Family
Bank supervisor	34.58	36.09	28.81	36.11	41.67
Trade association	33.75	34.59	30.51	36.11	33.33
Consultant	13.33	12.78	20.34	8.33	0.00
Academic institution	3.33	3.01	5.08	2.78	0.00
Governmental body	3.33	3.01	3.39	5.56	0.00
Other	11.67	10.53	11.86	11.11	25.00

Source: Survey of Community Banks in the Tenth Federal Reserve District

training materials for bank directors see Box). Consultants were used less frequently by both bank ownership groups, with smaller non-family-owned banks tending to use them more.

Tenth District Corporate Governance at a Glance

Table 9 presents a summary picture or a governance scorecard for Tenth District community banks based on previously discussed practices. Recommended governance practices are listed in the left-most column of the table. The four bank groups used throughout the analysis are listed across the top of the table. The check marks under each column indicate the proportion of Community Bank Survey respondents reporting a practice. One check mark means that 1 to 25 percent of the banks in the group reported the governance practice. Two check marks indicate that 26 to 50 percent of banks in the group reported the practice, and so on.

In general, the table data show that Tenth District banks overall engage in many recommended governance practices. However, comparisons among groups show that governance practices tend to be stronger at larger and non-family-owned banks and weaker at smaller family-owned banks. The relative weakness at these banks, however, may be mitigated by other factors. For instance, the principal-agent problems that many governance proposals seek to address are not as big an issue at small or family-owned banks where owners are active in daily management. In such situations, the corporation may be managed more like a sole proprietorship or partnership.

Despite this positive report card for community bank governance practices, one area that deserves more attention is succession planning. This is especially important in light of survey results which show management teams aging at many community banks. Too often, it is simply assumed that an ownership group or family member will fill management vacancies. However, there may be no one in the group or family trained to take over and successfully manage the bank. Consequently, bank ownership may face difficult challenges in its search for management replacements. In this regard, prospective management replacements may see limited advancement or ownership opportunities where only a few individuals or family members own and fill important management positions in the bank. The perceived lack of opportunities is exacerbated if the community which the bank serves is slow-growing or in a state of decline.

CONCLUSION

Governance creates a system of checks and balances to protect corporate stakeholders. Implicit in the governance process are the

Table 9

Tenth District Community Bank Corporate Governance at a Glance

Governance Practice	Under $150M in Assets		Over $150M in Assets	
	Family	Non-Family	Family	Non-Family
Has majority of independent directors.	√√	√√√	√√	√√√√
Business expertise is major recruiting criteria.	√	√√	√	√√
Outside directors have equity ownership that represents 25 percent or more of their personal assets.	√	√	√	√
Inside directors have equity ownership that represents 25 percent or more of their personal assets.	√√√	√√√	√√√	√
Board paid for attendance.	√√√	√√√	√√√	√√√
Had directors participate in training in 2003.	√√	√√√	√√√	√√√
Performed director assessments.	√√	√	√√	√√
Has mandatory director retirement.	√	√	√	√
Has equity ownership by CEO.	√√	√	√√	√
Has written succession plan.	√√	√√	√√	√
Has a code of ethics.	√√√	√√√	√√√√	√√√√
Has a loan committee.	√√√√	√√√√	√√√√	√√√√
Has an ALM committee.	√√√√	√√√√	√√√√	√√√√
Has an investment committee.	√√√√	√√√√	√√√√	√√√√
Has an operations risk committee.	√√√	√√√	√√√	**
Has an audit committee.	√√√√	√√√√	√√√√	√√√√
CEO does <u>not</u> serve on audit committee.	√√	√√	√√	√√
Outside directors are a majority of the audit committee.	√√	√√√	√√	√√√√
Has a nominating committee.	√√	√√√	√√	**
CEO does <u>not</u> serve on nominating committee.	√	√	**	**
Outside directors are a majority of the nominating committee.	√√	√√√	**	**
Has a compensation committee.	√√√	√√√√	√√√√	**
CEO does <u>not</u> serve on compensation committee.	√	√	√	**
Outside directors are a majority of the compensation committee.	√√	√√√√	√√√	**

√ =1-25 percent

√√ =26-50 percent

√√√ =51-75 percent

√√√√=76-100 percent

** =population very small

Source: Survey of Community Banks in the Tenth Federal Reserve District

assumptions that the participants in the process act independently of one another, that they will act ethically, that they have the necessary skill sets to perform their duties, and that they are active in meeting their responsibilities. Practices advocated by proponents of strong governance ensure greater adherence to these principles in order to address problems inherent in the corporate model.

The recommended practices are aimed primarily at protecting stakeholders in publicly traded companies. Few Tenth District community banks, however, are publicly traded. Further, a good number are small in asset size and family-owned. Often, owners manage the bank, reducing problems that many governance recommendations are intended to alleviate and lessening the value community banks may see in implementing them.

This paper used Community Bank Survey data to assess governance at Tenth District community banks to see the extent to which these banks have adopted recommended "good governance" practices. Several broad conclusions from this data are:

- Larger and more complex organizations are more likely to have adopted recommended governance principles.
- Non-family-owned organizations, regardless of size, proportionately engage in more of the recommended practices than do family-owned organizations.
- Overall, community banks have adopted many principles advocated by strong governance proponents.

Appendix A

Roles and Responsibilities for Major Internal Players in a Corporation's Governance Process

Players	Relationship	Roles/Responsibilities
Investors (shareholders)	Outsiders and insiders	• Provide equity funding for the organization's activities with the expectation of earning a return on their investment; generally geographically dispersed and owning only small amounts of stock. • Institutional investors who control more significant blocks of stock often have corporate governance policies and influence corporate policies through moral suasion or proxy initiatives.
Board of directors	Outsiders and insiders	• Elected by shareholders to oversee management's performance on shareholders' behalf. • Engages competent management with integrity to direct the activities of the organization. • Establishes strategic direction and ethical tone for the organization.
Board committees	Outsiders	
• Audit		• Audit committee oversees engagement and services of the external auditor, internal auditor, and financial reporting and disclosure.
• Compensation		• Compensation committee oversees selection, compensation, and evaluation of the CEO and senior officers as well as planning for management succession.
• Nominating		• Nominating committee oversees selection and nomination of committee members, new board members, and review of corporate governance issues; plans for the succession of the CEO.
Chairman of the board	Outsider	• Responsible for the information flow to the board, meeting agendas, meeting schedules, and chairing the executive meetings of the independent non-management directors.
Chief executive officer	Insider	• Responsible for ensuring the organization operates in a safe, sound, and ethical manner. • Monitors senior management's performance and compliance with standards established by the board of directors.
Senior management	Insiders	• Responsible for operating the corporation on a day-to-day basis within the strategic objectives of the board of directors. • Identify, develop, and implement the organization's strategic plans and budget and manage operational risks.
Line management	Insiders	• Determine the level of risk acceptable in individual business processes. • Assure themselves that the combination of earnings, capital and internal controls is sufficient to compensate for risk exposure.
Internal auditors	Independent insiders	• Monitor and provide periodic reports to the audit committee on the existence and effectiveness of the corporation's internal control structure.

Appendix B

External Players and Their Roles in the Governance Process

Third-Party Players	Roles/Responsibilities
Creditors	• Monitor cash flow, liquidity, and accounting information for corporate borrowings. • Default covenants in loans can entitle lenders to director positions, compel involuntary bankruptcy or foreclosure, or bring about management and/or governance changes by moral suasion.
Listing agencies	• Subject to SEC approval, NYSE, NASDAQ, and AMEX establish listing requirements with which publicly traded organizations must comply. These requirements may include specified board committees, board meeting frequency, board member independence conditions and expertise, and other factors relating to corporate governance.

Government and regulators	• Establish the legal framework within which corporations operate and police compliance with this framework. Important policing bodies include:
	    • Securities Exchange Commission (public companies).
	    • Federal Deposit Insurance Corporation (insured institutions and state non-member banks).
	    • Office of the Comptroller of the Currency (national banks).
	    • Federal Reserve System (bank holding companies and state member banks).
	    • State bank departments (state chartered banks).
	    • Federal Home Loan Bank (bank membership and member loans).
	    • State insurance departments (insurance activities conducted by banks or bank holding companies).
	    • Housing and Urban Development (bank lending activities and guarantor programs).
	    • Small Business Administration (banks whose loans are guaranteed or that have a preferred lender relationship).
	    • Federal Trade Commission (financial institutions making consumer loans).
	    • Department of Justice (corporations subject to civil or criminal law).
	    • Department of Labor (corporations subject to labor laws).
	    • Internal Revenue Service (corporations subject to tax law and record keeping).
	    • State departments of revenue (corporations subject to tax law).
	
	The above agencies are the major regulators who may supervise or have laws and regulations pertaining to a bank's internal controls, accounting and reporting, safety and soundness, or governance practices.

,	
External auditors	• Independently evaluate and render an opinion on the fairness of the presentation of management's financial statements. • Independently evaluate and render opinions on management's assertions on the existence and effectiveness of management's internal controls over financial reporting. • Evaluate adoption and implementation of Generally Accepted Accounting Principles.
Stock analysts	• Monitor and analyze the organization's management and performance metrics in the context of the company's performance trends, its competitors, its industry, and the economy as a whole.
Rating agencies	• Monitor and analyze an organization's management and performance metrics to assess the quality of the company's earnings and its ability to service debt.

Appendix C

Board Committee Structure and Composition

All Survey Banks

Committee	Have Committee —Percent Yes	CEO Serves on Committtee —Percent Yes	Other Officers Serve on Committee —Percent Yes	Outside Directors Serve on Committee —Percent Yes	Outside Directors Constitute a Majority of Committee —Percent Yes	Outside Director Chairs Committee —Percent Yes
Loan	98.55	100.00	96.64	62.66	19.63	8.96
ALM	97.23	99.18	95.87	39.41	13.16	9.73
Investment	91.78	97.45	92.19	42.14	14.97	12.41
Audit	91.42	59.09	67.63	76.79	52.47	52.53
Nominating	45.05	89.47	54.55	78.79	58.06	53.33
Compensation	73.13	93.62	51.11	75.58	61.18	45.23
Operations risk	66.67	90.41	97.26	29.31	9.43	9.62

Family-Owned Banks with Assets Less Than $150 Million

Committee	Have Committee —Percent Yes	CEO Serves on Committtee —Percent Yes	Other Officers Serve on Committee —Percent Yes	Outside Directors Serve on Committee —Percent Yes	Outside Directors Constitute a Majority of Committee —Percent Yes	Outside Director Chairs Committee —Percent Yes
Loan	98.31	100.00	97.69	60.00	15.44	6.87
ALM	97.47	99.35	96.03	36.89	11.21	8.11
Investment	94.25	98.44	92.06	41.18	11.58	10.87
Audit	87.60	56.25	71.43	70.79	49.41	45.78
Nominating	41.07	90.48	61.11	76.47	46.67	35.71
Compensation	62.82	97.92	53.33	65.00	47.50	34.21
Operations risk	64.87	88.89	95.65	30.56	6.06	3.13

Non-Family-Owned Banks with Assets Less Than $150 Million

Committee	Have Committee —Percent Yes	CEO Serves on Committtee —Percent Yes	Other Officers Serve on Committee —Percent Yes	Outside Directors Serve on Committee —Percent Yes	Outside Directors Constitute a Majority of Committee —Percent Yes	Outside Director Chairs Committee —Percent Yes
Loan	98.00	100.00	89.58	80.00	33.33	14.63
ALM	95.83	100.00	91.30	56.10	23.68	21.05
Investment	90.24	94.60	86.11	53.13	30.00	26.67
Audit	95.62	63.41	69.05	78.05	53.85	52.63
Nominating	50.00	88.89	37.50	87.50	62.50	75.00
Compensation	87.10	84.00	45.83	92.00	79.17	58.33
Operations risk	61.11	90.91	100.00	22.22	12.50	25.00

Appendix C (Continued)

Family-Owned Banks with Assets Greater Than $150 Million

Committee	Have Committee —Percent Yes	CEO Serves on Committtee —Percent Yes	Other Officers Serve on Committee —Percent Yes	Outside Directors Serve on Committee —Percent Yes	Outside Directors Constitute a Majority of Committee —Percent Yes	Outside Director Chairs Committee —Percent Yes
Loan	100.00	100.00	100.00	48.39	17.24	10.71
ALM	97.06	100.00	100.00	35.71	8.00	4.00
Investment	77.78	100.00	100.00	42.86	16.67	0.00
Audit	97.00	70.00	64.52	92.86	40.00	70.37
Nominating	46.15	**	**	**	**	**
Compensation	88.89	93.33	53.33	80.00	66.67	56.25
Operations risk	68.75	90.91	100.00	**	**	**

Non-Family-Owned Banks with Assets Greater Than $150 Million

Committee	Have Committee —Percent Yes	CEO Serves on Committtee —Percent Yes	Other Officers Serve on Committee —Percent Yes	Outside Directors Serve on Committee —Percent Yes	Outside Directors Constitute a Majority of Committee —Percent Yes	Outside Director Chairs Committee —Percent Yes
Loan	100.00	100.00	100.00	66.67	25.00	8.33
ALM	100.00	92.31	100.00	16.67	9.09	0.00
Investment	100.00	100.00	100.00	42.86	16.67	0.00
Audit	100.00	33.33	33.33	80.00	80.00	60.00
Nominating	75.00*	**	**	**	**	**
Compensation	85.71*	100.00*	50.00*	66.67*	66.67*	33.33*
Operations risk	100.00*	100.00*	100.00*	40.00*	20.00*	20.00*

Source: Survey of Community Banks in the Tenth Federal Reserve District

*Fewer than 10 observations.

**Too few observations to be meaningful.

Appendix D

Management Succession and Senior Management Team Characteristics: Age, Experience, and Retirement Possibilities

		Assets<$150M		Assets>$150M	
	All Responses	Family-Owned	Non-Family-Owned	Family-Owned	Non-Family-Owned
Management Succession Plans					
Percent of banks with written plans	36.39	38.31	31.03	39.02	25.00
Senior Management Team					
Chief Executive Officer					
Average years in position	16.60	16.86	13.75	15.88	26.06
Average age	54.16	54.72	52.42	53.36	55.46
Percent 60 years or older	19.61	20.50	12.28	25.64	20.00
Percent planning to retire within five years	18.99	22.77	15.52	5.00	18.75
Chief Financial Officer					
Average years in position	14.53	16.81	11.88	10.48	15.23
Average age	49.16	49.67	49.03	47.03	50.85
Percent 60 years or older	12.07	16.13	10.53	6.67	0.00
Percent planning to retire within five years	10.93	12.24	10.26	6.25	14.29
Chief Lending Officer					
Average years in position	11.71	13.05	9.12	11.74	6.80
Average age	50.03	50.58	50.13	48.46	48.27
Percent 60 years or older	9.01	8.97	8.51	10.81	6.67
Percent planning to retire within five years	10.94	11.26	16.00	2.56	12.00
Chief Operating Officer					
Average years in position	15.21	16.79	12.45	12.14	14.27
Average age	49.05	49.30	50.02	47.08	47.36
Percent 60 years or older	12.04	13.37	13.46	8.33	0.00
Percent planning to retire within five years	16.43	17.88	18.52	10.53	6.67
Director—Inside					
Average years of experience	15.89	16.77	11.63	16.73	11.93
Average age	55.31	55.64	53.84	54.91	55.00
Median age	55.00	55.00	53.00	54.00	55.00
Maximum age	95.00	95.00	93.00	84.00	70.00
Percent 60 years or older	32.91	34.04	23.31	36.43	32.50
Director—Outside					
Average years of experience	13.35	14.30	11.76	13.97	11.69
Average age	60.30	59.71	60.07	62.42	60.98
Median age	60.00	60.00	60.00	63.00	60.50
Maximum age	97.00	97.00	87.00	93.00	91.00
Percent 60 years or older	52.61	50.98	51.43	59.72	53.54

Source: Survey of Community Banks in the Tenth Federal Reserve District

Box
Director Resources

The banking agencies and industry trade associations offer a variety of reference materials and periodic programs that directors may find useful in meeting their responsibilities. A sampling of these is listed below.

- ***Insights for Bank Directors (Insights)***
  Insights is the Federal Reserve's online course for community bank directors (*http://www.stlouisfed.org/col/director*).

  Insights is designed primarily for new directors (although more seasoned directors may find it a useful refresher), providing them with tools and reference materials they can use to be more effective in their management oversight. Done in the context of a board meeting for a hypothetical bank, the course covers basic bank financial analysis and reviews the sources, monitoring and control of credit, liquidity, and market risk, basic portfolio risks common to all banks. Exercises and short self-quizzes help amplify points and let directors apply what they have learned in the course, not only for the case bank but also their own bank. Ultimately, the goal of the course is to provide directors with enough information to help them spot evolving problems and encourage them to ask questions about matters they see occurring at their banks.

- ***Banking Supervisor Web Sites***

  Federal and state banking agencies maintain web sites that contain information directors many find useful in their oversight. Included among these are:
  - Federal Reserve System (*http://www.federalreserve.gov/*);
  - Federal Deposit Insurance Corporation (*http://www.fdic.gov/*);
  - Office of the Comptroller of the Currency (*http://www.occ.treas.gov/*);
  - Federal Financial Institutions Examination Council (*http://www.ffiec.gov/default.htm*); and
  - Conference of State Bank Supervisors (*http://www.csbs.org/*).

- ***Bank Director Online University (University)***
  The University is the Independent Community Bankers Association's online course for bank directors. The site is located at: *http://www.icba.org/tools/index.cfm?ItemNumber=1347*

ENDNOTES

1 This survey was mailed to approximately 1,300 Tenth District community banks in February 2004. Approximately 27 percent or 341 banks returned their surveys.

2 Remarks by Governor Susan Schmidt Bies, "Corporate Governance and Risk Management," at the *Annual Symposium on Derivatives and Risk Management*, Fordham University Stern School of Law, New York, N.Y., October 8, 2002.

3 The influence these players exert on the governance process, especially that of government, cannot be underestimated in heavily regulated industries such as banking. For example, banking laws and regulations place limits on board size, restrict lending to insiders (executive offices, directors, and principal shareholders) and affiliates, control operating locations, limit dividend payout, limit amounts loaned to a single borrower, require detailed financial reporting and attestation on the adequacy of internal controls to ensure accurate financial reports, etc.

4 In the typical corporation, stockholders often rely on hired managers to run the business on a daily basis. However, this structure can lead to potential problems and conflicts of interest: Hired managers may attempt to serve their own interests rather than those of stockholders. Without the same financial incentives stockholders have to maximize the firm's value, hired managers may be less willing to take appropriate risks, may not give their full effort, may enhance their own return by spending on amenities (nice offices, etc.), or may pursue personal prestige or power. This is commonly referred to as the principal-agent problem.

5 In smaller, closely held, and family-owned community banks, the separate role played by governance players tends to blur. Many times owners are also managers, reducing principal-agent problems. Consequently, owners may feel that implementation of many governance recommendations is unneeded.

6 A note of caution is in order regarding the data reported in the tables that follow for organizations with year-end 2003 assets greater than $150 million. This information came from only 58 banks. Consequently, survey information for larger banks may represent governance practices at a small number of larger community banks.

7 Board size range for national banks is between five and 25 directors, see Section 31, the Banking Act of 1933, (12 U.S.C.71a).

8 The audit committee is generally charged with oversight of the organization's internal controls and audit function. These responsibilities require a high degree of objectivity to ensure that conflicts of interest and potential for fraudulent acts are minimized. The compensation committee is generally responsible for ensuring that executive compensation is fair and appropriate, but not excessive in light of executive compensation at peer organizations. A high degree of independence for these committee members helps ensure that executive and shareholder interests are appropriately balanced. The nominating committee is charged with recruiting and evaluating directors who will proactively serve the best interests of the organization. Having outside board members serve on these committees can help the organization eliminate any appearance that business decisions are not in the interest of all shareholders.

9 *Principles of Corporate Governance*, The Business Roundtable, May 2002.

10 Michael T. Harris, "Fish or Cut Bait: Luring Directors to Corporate Boards Has Become a Daunting Task—One That Requires Ingenuity and Time," *The Chief Executive*, May 2002, pp. 1-2.

11 As part of the management succession process, the CEO is typically expected to develop the senior management team so that one team member could assume the CEO position. The compensation or governance committee reviews potential candidates to assess their ability to assume the CEO position if needed. In the event that the organization must look externally, the board may organize a search committee comprised of the chairman of the compensation committee and a few other qualified board members. Most search committees seek the assistance of an outside consultant to help design a proposed compensation package and to assist in the evaluation of potential candidates.

12 "Findings and Recommendations: Part 2 Corporate Governance," the Conference Board Commission on Public Trust and Private Enterprise, January 9, 2003, pp. 1-29.

13 Assessments can give individual board members an opportunity to reflect on their individual and corporate responsibilities, identify different perceptions and opinions among board members, point to questions that need board attention, serve as a springboard for board improvements, increase the level of board teamwork, provide an opportunity for clarifying mutual board and staff expectations, demonstrate to the staff and others that accountability is a serious organizational value, and provide credibility with stakeholders. Taken from *Director Self-Assessments*, Timothy Palmersheim, Federal Reserve Bank of Chicago.

14 One example of an assessment form can be found as an attachment to the presentation *Achieving Long-Term Success* at *http://www.kansascityfed.org/bs&s/confer/2004RegUpdate/2004RegUpdatematerials.htm*.

15 Kimberly S. Crowe and Deborah Scally, "2003 Bank Director Annual Compensation Survey," *Bank Director Magazine*, 4th quarter 2003.