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## **EVALUATING THE BOARD'S PERFORMANCE** The How and Why of Evaluating Your Own Work as Directors

**WHITE PAPER**





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**Executive Summary**

**I**n times of financial distress, bank directors face an avalanche of scrutiny about their own performance from shareholders and regulators. One way to address those concerns (or head off problems in the first place) is to conduct an independent review of the effectiveness of the board and its individual members. Armed with such an assessment, the board might be able to address its own weaknesses, improve its effectiveness and handle problems that have arisen. This article gives an overview of the board assessment process: How it works, what it entails and what to expect.

One in 10 insured financial institutions are on the Federal Deposit Insurance Corp.'s list of "problem" institutions.

More than 1,000 commercial banks, savings banks, savings institutions and bank holding companies are operating under a formal regulatory enforcement action, generally identified as a written agreement, cease and desist order or consent order. Hundreds more have been issued memoranda of understanding (MOU), informal actions that are often precursors to potentially more severe sanctions.

While the language of each order differs in emphasis, depending on the nature of the bank's deficiencies, most include language that says exactly what the board must do:

*"... the Board shall increase its participation in the affairs of the Bank, assuming full responsibility for the approval of sound policies and objectives and for supervision of all the Bank's activities, consistent with the role and expertise commonly expected for directors of banks of comparable size..."*

The above was taken directly from a consent order issued to a \$350 million-asset commercial bank, and the order further compelled directors to review no less than nine monthly reports, document their reviews and approvals, and include in monthly minutes "names of any dissenting directors."

In another instance, a \$400 million-asset commercial bank was issued an order to:

*"cease and desist from... operating with a board of directors which has failed to provide adequate supervision over and direction to the management of the Bank to prevent unsafe and unsound banking practices..."*

The above-referenced order, which ultimately became a public document, appeared on the front page of the local newspaper. The financial fallout and personal embarrassment were substantial. The bank eventually failed.

### Directors in the Crosshairs

As most of the enforcement actions confirm, regulators view the supervision of directors as equally important to executive management's role in the functioning of the institution. This is reflected in the equal weight regulators give the board and top executives in the management component of the CAMELS rating, the score regulators give an institution for financial strength. Bank directors are held more accountable today by regulators for the performance of financial institutions than at any time in recent memory. More frequently, reports of examination are compelling directors to assess their oversight and effectiveness in supervising key bank functions, especially loan and credit administration.

FDIC lawsuits against directors and officers to recover losses to the deposit insurance fund are increasing in frequency. For the crisis so far through 2010, the FDIC authorized lawsuits against 109 directors and officers to recover \$2.5 billion in losses. For the first nine months of 2011, 185 new defendants were added to the FDIC's list of authorized targets, in an attempt to recover more than \$4.7 billion in losses.

Since the onset of the financial crisis in 2008, 300 of the nearly 400 reported financial institution failures involved community banks. Community bank directors, for healthy and distressed institutions, are bearing the brunt of increased examiner scrutiny and criticism. Given the contentiousness and high levels of personal liability inherent in the current regulatory climate, board self-assessments are more essential than ever.

### What is Being Measured?

The assessment process, no matter how many individual criteria are used, evaluates fundamental attributes that apply to all banks, regardless of size, market, institutional complexity or other characteristics.

- **Decision-making:** All boards confront difficult, complicated and sometimes uncomfortable issues that entail exhaustive deliberation but require prompt decisions. The temptation to "kick the can further down the road" or delegate decision-making authority

is often irresistible. Removing a CEO or fellow director, declining a loan request from a longtime customer, laying off employees, acquiring another company, or selling the company are difficult and emotional decisions. The strength, effectiveness and confidence of a board can be measured by its decision-making prowess when it involves tough, controversial and strategic matters.

- **Communications:** Among the most vital responsibilities of a board is to ensure management is fully aware of and understands its expectations with regard to the company's direction, culture and financial performance. Directors can fulfill this important duty through periodic planning meetings or via other venues specifically designed for establishing or reaffirming strategic objectives. The board should not involve itself in day-to-day decision making. However, it should serve as management's most trusted and valued sounding board for all major decisions.
- **Leadership:** The board assessment process measures leadership. Today's banking environment is more heavily influenced by regulatory, political and social forces that make guiding a company extremely challenging. Bank directors are being held to standards of conduct and accountability that are unprecedented in scope. The "measure" of leadership is the board's ability to use its strengths, experience, expertise and creativity to ensure the bank's success in financial and non-financial endeavors.

### Individual versus Collective Performance

Among the most important attributes of any directorship is its collegiality. This is especially applicable to community banks where directors are often lifelong friends as well as business associates. Directors in such environments are more likely to share common interests, perspectives and knowledge of community and customer banking needs.

While director collegiality may be a board's greatest strength, it can sometimes be the most sig-

nificant impediment to effecting essential changes to board composition and decision making. At times, close-knit directors can be overly deferential to a singular judgment or recommendation pertaining to a customer's loan request or to a key issue.

The bonds of friendship can also dissuade directors from objectively evaluating efforts of their peers. Where criticism or corrective measures aimed at individual directors are warranted, personal relationships may inhibit communication of vital information to resolve the situation. Replacing a director who has served a long and productive tenure is difficult, even under the best of circumstances, when it involves personal relationships. Sanctions involving disciplinary actions affecting a director should be addressed in board or committee charter documents where governance issues are described.

### Assessment Criteria

Board and director effectiveness can be evaluated from a number of perspectives. Individually, directors have a fundamental obligation to attend meetings—both of the full board and of committees—and to actively participate in meeting discussions and deliberations. Especially in a community bank setting, directors should be residents in or near to markets served by the bank, or be sufficiently knowledgeable of local market conditions and businesses. Director involvement and leadership in local community civic and charitable endeavors is also advantageous for the bank.

Although director participation, professional demeanor and collegiality are essential attributes for a smoothly functioning board, it is also essential to assess collective performance standards that are often indicative of board effectiveness. The following are key assessment criteria from which a board's effectiveness can be gauged:

- **Monthly board information packet:** The effectiveness of the board, first and foremost, is dependent upon receiving information about the bank that is complete, accurate, insightful and readable. Meeting minutes should not only reflect board decisions, but should convey the essence of director

deliberations, including disagreements, pertaining to key matters and decisions. In addition, board packets should include a full complement of financial reports and explanatory text that enable directors to quickly analyze and understand the bank's financial condition and trends. Board reports prepared by managers of key operating areas should enable directors to assess priorities across the broad spectrum of bank activities. It is a director responsibility to request and receive all the information he or she needs to make informed judgments and decisions.

- **Director expertise:** The increasing complexity of the banking industry requires a wider range of specialized expertise within the directorship to enable thoughtful and insightful decision-making. A diversity of professional backgrounds encompassing law, accounting, corporate leadership, small business management and finance, among others, equips a board to address a broad cross section of bank challenges.
- **Supervision of the lending process:** The area of greatest risk generally requires the most scrutiny. Directors are necessarily involved with reviewing many interrelated functions, including evaluation of loan requests; monitoring adherence to loan policies and procedures; reviewing loans, delinquencies and the adequacy of the allowance for loan and lease losses (ALLL); monitoring the bank's compliance with Reg. O's rules regarding insider loans and relationships; setting legal (and internal) lending limits; establishing lending authorities; assessing loan impairment; and setting appraisal policies and procedures. A board that earns high grades for effective supervision of lending functions will likely grade out highly in other assessment areas.
- **Regulatory relationships:** The regulator/bank director relationship is dynamic, ranging from contentious to courteous, depending upon the condition of and circumstances

in the bank. For many directors, each examination provides an endorsement or indictment of their oversight and leadership. Directors can take examination findings personally—especially “matters requiring attention” and CAMELS composite ratings, the scores regulators give for financial performance. The degree to which directors (and management) maintain professional interaction with regulators and are responsive to their directives is essential in assessing director and board competence and performance.

### Other Assessment Criteria

The above criteria are not exhaustive; nor should they be the sole basis for evaluating the collective performance and effectiveness of the directorship. A scorecard for the board might also encompass assessments of:

- the quality and frequency of the CEO performance appraisal process
- executive management compensation practices
- effectiveness of board committees
- short- and long-range planning regimens
- enterprise-wide risk management systems and oversight
- shareholder relations

### Grading Scales

Assessing boards of directors involves evaluating a multitude of functions and processes that often are standardized from bank to bank. However, each bank possesses unique characteristics, traditions and “institutional” personalities that may need to be reflected in selecting evaluation criteria and in assigning grades. Grading scales vary, depending on the company handling the board evaluation. Some use numeric grades—generally a five point range—while others use qualitative measures, such as “excellent,” “fair,” or “poor.” The measurement scale should enable directors to discern meaningful differences in each of the assessment criteria.

### In Conclusion

There are no absolutes in the assessment criteria or evaluation process. However, an annual appraisal of board performance can provide directors with an effective gauge of their collective performance. Equally vital, the assessment process enables directors to identify and refocus on priorities and issues that substantially impact the bank. Given the turbulent and rapidly evolving banking environment, this may be an assessment’s most important attribute.