

Balancing Risk & Return at Independent Banks

STRATEGIC INTELLIGENCE FOR DIRECTORS AND SENIOR MANAGEMENT



A Publication of Kei Advisors LLC

SELECTING BANK DIRECTORS
An Art or a Science?

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Arguably, there is no task more important for a community bank's CEO or its Board of Directors than selecting the best candidates to serve as Directors of either the bank or its publicly traded holding company. What should you and your Board look for in new Board members, and how do you go about finding them?

Like most other aspects of corporate governance, there is no "one size fits all" when it comes to describing the ideal Board membership or selection process for any company, including a community bank. However, there are some guidelines that you should keep in mind as you go through the process.

First, you have to decide who is responsible for selecting the candidates. Is it the CEO, a nominating

committee of the Board, or the full Board? Will you permit shareholders to submit recommendations? Institutional shareholders and shareholder activists often advocate for an



independent nominating committee and a mechanism for shareholder involvement. To do otherwise could subject your Board to criticism, and characterize your selection process as designed to entrench the current

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Community banks today face unique challenges and opportunities. In *The Upside*, presented by Kei Advisors, we bring you articles on emerging trends and issues written by recognized experts in individual aspects of this specialized industry. We hope this information will assist you in navigating successfully through these changing times. If you would like us to cover any specific topics in future issues please contact Deborah K. Pawlowski at Kei Advisors 716.843.3908, or by email: dpawlowski@keiadvisors.com. For more insight, you may also contact the authors whose contact information is listed at the end of each article.

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SELECTING BANK DIRECTORS

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Board and management. Also, some firms that advise institutional shareholders on how to vote will recommend voting against the company's nominees if the company does not have a nominating committee. Many companies strike a balance by taking the nomination process out of the CEO's hands, placing it in an independent nominating committee, and either limiting the shareholders' role or eliminating them entirely from the process. Even if your bank is controlled by a holding company, which owns a majority of the publicly traded shares, you can enhance the bank's standing in the investor community by having independent Directors actively involved in the nomination process.

Once you have identified and empowered the person or group responsible for recommending candidates, that person or group needs to know what traits to be looking for in potential candidates. In this regard, the first thing that should be decided is whether you want a majority of your Board members to be "independent" from management, other Board members and the bank. Boards that achieve

this structure are generally viewed in a better light by the investment community than Boards dominated by "insiders."

After you have decided to look for candidates outside the bank, you need to consider what skills you need from them. Does your Board need someone who understands the bank's and its

'Many companies strike a balance by taking the nomination process out of the CEO's hands.'

putting representatives of customers or vendors on your Board. In addition to failing the "independence" test, those relationships can change or terminate and you will be left

with either an unhappy Director or one who has lost interest. You also have to be mindful of the banking regulations on "interested Director" transactions that apply to your bank.

Are there other special skills you need on your Board? For example, you will need individuals with financial and accounting knowledge and experience to satisfy the SEC's and stock exchanges' rules for audit committee members. As regulated entities, your bank and its holding company will need to satisfy the unique Board requirements imposed on them by their respective bank regulators. Other factors to consider in selecting a candidate include: age, background, current position, other board seats, availability, track record, prior employment in the banking industry or with bank regulators, and business and personal reputation. With respect to current position, some companies require a Director to tender his resignation if his title or job changes from what it was when he joined the Board. This gives the

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non-bank subsidiaries' businesses: for example, commercial banking vs. consumer lending; the important role of information technology; the nature of the local communities in which the bank operates; the need to distinguish among the bank's many stakeholders such as its commercial and consumer customers, employees and shareholders? Be careful in

NOVICE OR VETERAN: THE NEW DIRECTOR ASSIGNMENT

What Are Some Questions You Should Ask?

by Bernard M. Brudsky, Esq.
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Congratulations! You have been selected to serve as a Director of an independent bank. Now that you have accepted the position, do you know what your responsibilities are? Here are some suggestions and recommendations that should enable you to get started on the right foot and discharge your new duties more comfortably and confidently.

In the “old days,” becoming a bank Director was like wading into a tranquil pond. However, in today’s post-Enron environment, it can be like jumping into a raging river. As a new Director, you will have to consider the consequences of decisions and Board actions that were made *prior* to your first Board meeting. You will also quickly be confronted with business issues that will require decision making, or at least call for direction and guidance to senior management. And of course there are the new opportunities, ventures and challenges that the bank is eagerly considering.

So prior to your first Board meeting, what do you do to play “catch up” and prepare to participate effectively when you are seated as a Director? Begin by requesting copies of the recent bank examiners’ reports and equally important, the Board’s responses to the examiners’ comments and criticisms. Reading these materials closely will give you a good



general introduction to the performance and operations of the bank. Note whether the examiners made specific requests and whether the Board responded by making commitments to the bank regulators to take remedial action or address certain problems. As a new Director, ascertain the status of this interaction between your bank and its examiners and apprise yourself of whether there has been performance or compliance consistent with any commitments made by the bank. If, at the end of your review, you are left with questions, speak to management. They are obliged to answer, and in most instances, will be pleased that you are demonstrating a level of interest in what they are doing. It will also communicate to them that they can look forward to a collaborative effort in working with you as a

Director, and will be pleased to see how quickly you grasp the bank’s business and operations.

Following on the same path just a bit further, obtain and review the audited financial statements and letters to management. They will tell you the bank’s financial temperature very quickly and help “red flag” any problems or areas of vulnerability. In the same vein, review at least the last twelve months of Board and committee minutes. By reviewing such minutes for at least the past year, you will get a sense of the full range and cycle of issues faced by the Board and thereby develop a “feel” for your institution’s decision making process.

Another important area of inquiry for you not only to identify, but to truly understand, is—what are the major business programs of the bank? How do they operate and what are the risks associated with them? For instance, is the bank involved in sub-prime lending and if it is, are the underwriting guidelines satisfactory? Is the bank a heavy lender to borrowers in a particular industry or line of business and has someone explained the particular risk factors and best practices with lending in that area? Is the bank involved in securitizations, or has it taken a large share of a loan participation? Some perfectly appropriate bank business activities

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‘Does the bank have a strategic plan?’

are by nature complex and require explanation, no matter how intelligent or otherwise educated a Director may be. Strive to understand the business risks associated with the program and become conversant with the fundamentals of the transaction or process. At the completion of this exercise you should be able to discuss the merits of the activity at a Board meeting so that you can meaningfully vote on its continuation or modification as the program’s performance is evaluated.

While you are in the process of collecting the other “required” reading materials, obtain a copy of the bank’s Policies and Procedures Manual. As you leaf through it ask yourself, does this look like it adequately addresses all critical areas of the bank’s operations? For example, is there a

separate section containing underwriting guidelines or one that incorporates the topic

by reference to a separate document? Is there a section that deals with accounting controls, information technology, disaster recovery, etc.? Are there specific policies or procedures for particular kinds of lending situations such as “insider lending?” As a Director, you want to have the assurance that the bank is operated day-to-day in a careful, pre-determined and consistent manner.

Another important area to explore is to find out whether the bank has a written strategic business plan. If it does, you have a very valuable tool to assist you in directing the affairs of the bank. The business plan is a point of departure for a continuing dialogue with your fellow Directors and senior management regarding the course that has been charted for the institution. It naturally focuses inquiry on several critical topics: are the business goals and objectives attainable?; are they appropriate for the institution?; does the bank have adequate resources to execute the plan successfully?; does the bank have the staff and expertise to safely and soundly achieve the objectives? Use the plan as a work in progress, as a focal point, as the point of departure for a reality check.

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MISSION STATEMENT

The Upside: Balancing Risk & Return at Independent Banks is designed for Executive Management and Directors of community banks to provide insight and ideas on best practices, emerging trends and the challenges and opportunities faced by community banks in the evolving strategic environment.

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ARE YOU HAVING AN IDENTITY CRISIS?

How to communicate to multiple stakeholder audiences

by Deborah K. Pawlowski
Kei Advisors LLC, Buffalo, NY

Many complications have developed for community banks with their expansion through acquisitions. There is a dichotomy that occurs in providing the local, personal touch of a community bank and growing into a bank holding company with many subsidiaries.

Two approaches are emerging as the preferred methods for addressing the dichotomy of maintaining community bank friendliness and simultaneously reaching your many stakeholders: corporate branding or subsidiary brand linking. Neither one appears more correct than the other, however, what is critical is understanding who your stakeholders are, the what and why of their information needs and what “product” or message you have to deliver. You will also need to decide on the media, timing and frequency to deliver your message to the various stakeholders while recognizing where there is information overlap.

First, let's define the audiences that are simultaneously being addressed:

- Customers/community members (of several different communities)
- Employees (of the same varied communities)
- Shareholders (who can be both of the above, and can be members of the financial community)

What are the messages that these audiences need to hear?

| MESSAGE | AUDIENCE |
|--|--|
| Consistent, high quality, personal service | Individual customers, business clients, employees |
| Value system | Employees, customers and clients, shareholders/investors |
| Strategy for growth | Shareholders/investors, employees |
| Management capability and operational performance | Shareholders/investors, employees, customers and clients |
| Sustainable competitive advantage, differentiators | Shareholders/investors, employees |
| Markets served | Customers and clients |
| Competition | Shareholders/investors, employees |

The messages have different meanings for each stakeholder because the information provides different benefits for each audience.


The message clearly is *the company* and must be consistent, credible, and constant. But how the message is delivered to the various stakeholders will vary based on the degree of value of the information being provided *for the audience*.

Do you keep the local touch with the names of the acquired banks remaining unchanged in their communities (the brand linking approach)?

Or should you expand the understanding in your growing geographic reach of the high quality service, and warm personal culture that you have purposefully developed throughout your organization and create greater brand value by adopting the parent's name for the acquired local operations (the corporate brand approach)? How do you get recognition from the same audiences of the investment appeal of their local independent bank if they are not even familiar with the parent company (the challenge of brand linking)? How do you avoid diluting the

local bank image (the challenge of the corporate brand approach)?

In future issues we will delve further into the benefit gained by the respective audiences of the required information, the best methods for reaching each audience, addressing the challenge/benefit of overlapping audience members, and the challenge of the typically mutually exclusive audience: the financial community.

In the meantime, if you would like to learn more, you can contact Deborah K. Pawlowski at 716.843.3908, or info@keiadvisors.com. 



SELECTING BANK DIRECTORS

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Board the opportunity to decide if such a change justifies accepting the resignation. Also, with respect to other board seats, more companies are now limiting the number of other boards on which its own Directors can sit for the obvious reason that they want their Directors to have the time to focus on the company's matters.

Having decided who is to recommend and what they are looking for, the next question is—how do they find candidates? The old “tried and true” method of looking to friends, business associates, classmates, customers of the bank and community leaders can yield some quality candidates. But, if one of your goals is gender, racial or ethnic diversification, these methods will have severe limitations. Another method is to employ an executive search firm, such as Korn Ferry, Heidrick & Struggles or Spencer Stuart. However, most companies limit their use of these sources to those situations where they are looking for a high profile candidate or one with a unique background. You should also canvass

the bank's advisers, such as accountants, attorneys and investor relations advisers, for recommendations.


Once the candidates have been

identified they will have to be qualified.

This is often done by the CEO meeting with them to both evaluate them and gauge their interest in serving on the Board.

Companies that want

to avoid the appearance (if not the reality) of the candidates being “hand picked” by management, and therefore beholden to management, will have this role filled by either the nominating committee or a group of nonmanagement Directors. Regardless of who performs this task, the candidates should be presented to the full Board for approval before being sent on to the shareholders for election.


The process of identifying, qualifying and selecting Director candidates is often set forth in the Charter for the Board's nominating committee. If you would like a copy of a form of such a Charter, contact James J. Tanous at 716.843.3905 or jtanous@jaeckle.com. 

‘Once the candidates have been identified they will have to be qualified.’

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Here is one more suggestion, one that strikes a different note. A cautionary note! There is an exposure to personal liability for both officers and Directors of federally insured financial institutions. Find out whether your bank has purchased liability coverage for its Directors and officers; then assess whether the amount of coverage is adequate given the size of the institution and the nature of its business risks. Also determine whether additional layers of coverage are available, and, of equal if not of greater importance, when you read the policy identify any exclusions to coverage. If there are any, promptly consult counsel for an analysis of how the exclusions impact coverage in the event of a claim. You want coverage—not the illusion of coverage. You should also determine if the bank's certificate of incorporation contains a provision protecting Directors from claims arising from good faith mistakes, and if the bank has indemnification agreements with its Directors.

These tips are clearly not meant to be a definitive guide to serving as a Director. However, they should allow you to begin your challenging tasks with greater awareness and confidence, so that you can enjoy the challenge of this position of trust, and the commensurate respect and esteem of the communities served by your bank. If you have any questions you can contact Bernard M. Brodsky at 716.843.3942 or bbrodsky@jaeckle.com. 



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