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Freshening Up the Board Can Position Banks for Long Term

How can a board of directors maintain its relevance at a time of technological innovation and changing customer demographics? Taking a disciplined approach to board refreshment is a giant step in the right direction, according to John Gorman, a partner in the Washington, D.C., law firm Luse Gorman.

Since the enactment of the Sarbanes-Oxley Act of 2002, companies have greatly improved their focus on management succession—but discussions of board succession have taken a back seat, Gorman said. Now, more and more banks are focusing on improving the composition of the board over time to boost their ability to compete in the future.

At issue is whether banks can afford to have what James McAlpin, a partner in the law firm Bryan Cave Leighton Paisner, has called "an ATM board in an iPhone world." He has noted that the typical board of a mid-sized regional or community bank tends to be made up largely of men of similar ages and backgrounds "whose perspectives were shaped during a different era for both business and banking. The concern I have is that continued adherence by banks to such board composition will result in competitive disadvantages."

Gorman noted that external pressure is building for boards to change their composition, pointing to recent California legislation that mandates increases in the number of female directors serving on boards. (See related article on page 4.) While he does not favor a quota-driven approach, Gorman said having a diversity of skill sets and viewpoints can be beneficial to boards, keeping them current and vibrant.

Gorman, who served on the National Association of Corporate Directors' 2016 Blue Ribbon Commission on Building the Strategic-Asset Board, offered some lessons from that report.

"Clean Sheet." Nominating and governance committees may find it helpful to take a "clean-sheet approach" to reimagine their boards, Gorman said. This means asking what the board would look like if it were created from scratch today, and then using these insights to make continuous improvements. The assessment should be conducted at least every two to three years and should inform recruiting and director education.

Evaluations. Boards should conduct annual evaluations at the full-board level, and evaluations of committees and individual directors at least once every two years, using

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FOCUS ON COMMITTEES

Got Culture? How the Audit Committee Can Help

Audit committees have an important role to play in making sure corporate culture is aligned with a company's mission, vision and values, said Cindy Fornelli, executive director of the Center for Audit Quality.

Maintaining an appropriate culture is a shared responsibility of management and directors, and thus culture is very much a "team sport," Fornelli said in an interview. But the audit committee is uniquely positioned to bring internal teams together by connecting the dots

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between internal audit, legal, human resources and compliance, she said.

Corporate culture is closely tied to strategy, risk management and other issues that come before the audit committee—issues that typically have the ability to impact reputation and financial performance, Fornelli noted. In addition, internal audit, which plays an important part in assessing and monitoring corporate culture, often works closely with the audit committee. One of the main duties of internal audit is to root out poor decision-making and make sure that integrity and ethical behavior guide the organization.

The cost of failing to establish and maintain a healthy corporate culture has been in the headlines over the past year. Ethical missteps by large corporations have been a powerful reminder that the tone from the top sometimes gets lost in the middle. Signs that the culture is unhealthy include high turnover, squabbling and tension between departments, a focus on blame and lack of debate.

Audit committees and boards are well advised to think about what culture actually means, Fornelli said. "It can be an elusive term, and it's actually broader than the company's core values or mission statement," she explained. "It is the culmination of shared values, beliefs and assumptions that shape the behavior of an organization. Culture is the unwritten rules that guide decisions that the company makes every day."

Culture means the shared values, beliefs and assumptions that shape the behavior of an organization—the unwritten rules that guide everyday decisions.

"You can have a disruptive culture; you can have a conservative culture," she continued. "There is no correct answer. But the important thing is to be thoughtful about it."

She offered several questions audit committee members should be asking about corporate culture.

Is the CEO sending the right messages to the organization? Audit committees should evaluate the organization to ensure that management's words are matched by actions. Culture can be a unifying force and an organizational asset, but only if the proper tone is set from the top.

What are the bank's zero tolerances? Fraud, sexual harassment and discrimination are usually at the top of the list. "If credible allegations are made in those areas, a company is not going to tolerate that," Fornelli said. The audit committee should evaluate whether the right controls are in place to catch any wrongdoing.

How is the bank coordinating among stakeholders? As Fornelli noted, the audit committee can serve as the hub for communications when negative cultural issues arise. A number of disciplines—internal audit, ethics, compliance, the general counsel and human resources—could be the first to see an issue arise. The audit committee can coordinate to ensure that the others see the warning flags, she said.

Is culture being lived uniformly across the company? Audit committees should be alert to the existence of lower standards for high performers and for differences in the way senior people versus rank-and-file staff members are allowed to behave.

Is good news celebrated? Audit committees shouldn't focus only on what's wrong. One board starts every meeting by asking for an example of a staff member who is living the company's values and culture. "Looking for signs of good culture is just as important as looking for problems," Fornelli said.

DIRECTORS BRIEFING

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Putting Digital Transformation on the Board Agenda

A digital transformation is under way in banking, as ubiquitous mobile devices, emerging blockchain technology and cross-industry convergence redefine the competitive landscape. It's daunting at times to absorb such rapid change, but board member and adviser Christa Steele has this advice for fellow directors: "You don't have to work for Google or be under 30 to understand the digital age. You just have to get educated."

Directors should make their own digital education a boardroom priority if they haven't done so already, Steele said in an interview. "The challenge for boards is to move from discussion to execution. Banks need to figure out how to disrupt their own business model before it gets disrupted for them."

Steele draws on a banking career spanning 20 years and subsequent work in digital innovation. She started as a teller in 1995 and held senior positions at California banks before serving as CEO of a $3.5 billion-asset bank in the San Francisco Bay area. She guided the bank through a 43 percent earnings increase in 2014, doubling the bank's value to guide it through a sale in 2015.

The digital education of the board of directors is key to building and sustaining long-term relationships with clients, employees, and the ever widening generational gap, Steele said. People who have grown up in the age of high technology are digital natives, accustomed to being able to transact business and get access to data on the spot. Paying attention to employees—younger and older—can be particularly instructive in shaping a view of the bank's future, she added.

Digital education of bank boards is key to building and sustaining long-term relationships with clients, employees and the ever-widening generational gap.

"Your own staff is coming into the digital age, if they haven't already. They are asking, 'Do I want to work here? Is this company forward thinking?' There is a real risk of cultural disengagement" if the answer is no, she said.

Steele said surveying employees using a popular and accessible app such as Survey Monkey can be a great way to learn how they are using digital technology in their personal lives. Surveys can reveal what social media and apps employees use, how influenced they are by Facebook advertising, and what opportunities they think the bank is missing when it comes to client education.

The information and insights gleaned from surveys can then be used to determine new ways of engaging with customers of the same generation. The use of customer data to transform, learn, predict, optimize and simulate client experience is the future of financial services, Steele said.

She offered some questions board members can ask as they push to understand the bank's posture on digital technology.

How is the bank's customer profile changing with the advancement of technology and customer education? Some clients may be tech-savvy and want simple-to-use technology services. Others may prefer more traditional services and place a high value on human advice. Still others are interested in innovation while also valuing high-quality service and trust. The bank needs a strategy for engaging with each type of customer.

Does the board agenda include digital disruption as a legitimate threat to the bank's reputation? Many boards are rightfully focused on cybersecurity among normal agenda items. A need for recurring discussion surrounding people, succession, obsolescence and margin erosion from digital disruption needs to be added to the list.

What digital technology services are available through the bank's existing systems, and how is the bank using them? Initiating discussions with core providers is critical. It is not uncommon for a bank to find out that services are available but haven't been turned on, Steele said. "You have to know what your existing vendors can offer you, do a gap analysis against what you need and get educated on what is new and available with a customer centric focus."

What is the bank's game plan? Is there a case for digitizing the front end of the customer experience, and what would that look like? Should the front end be fixed while legacy infrastructure is gradually replaced? Or is a full digital overhaul justified? Boards play a central role in determining whether systems, processes, procedures and policies are still relevant.

California Sets Board Membership Quota for Women

Companies headquartered in California will be required to make room for women on their boards of directors under legislation signed into law by Gov. Jerry Brown on Sept. 30.

The new law, SB-286, mandates that every publicly held corporation in California must have at least one female board member by Dec. 31, 2019. By the end of 2021, there would have to be at least two women on boards that have five independent directors, and at least three women on boards that have six or more independent directors. Companies that violate the requirement would be subject to fines ranging from $100,000 to $300,000.

The development makes California the first state in the nation to mandate a board quota for women. The bill's sponsors argued that more women directors serving on boards of publicly held companies will boost the California economy, improve opportunities for women in the workplace, and protect taxpayers, shareholders and retirees. The legislation cited studies that concluded that publicly held companies perform better when women serve on their boards.

But even as he signed the bill into law, Gov. Jerry Brown acknowledged that its implementation is in doubt. A coalition spearheaded by the California Chamber of Commerce has argued the statute violates the U.S. and California constitutions and civil rights law.

"I don't minimize the potential flaws that indeed may prove fatal to its ultimate implementation," the governor wrote in a letter to the California State Senate and the U.S. Senate Judiciary Committee. But, he added, "it's high time" corporate boards include more women.

At least 377 California companies would have to add female directors to their boards in order to comply with the law by the end of 2021, according to Annalisa Barrett, a University of San Diego business professor who analyzes corporate governance and board of director issues. In all, 66 would have to add three women; 175 would have to add two women; and 136 would have to add one woman, Barrett said.

Barrett noted that her findings, based on a study of public companies headquartered in California that are part of the Russell 3000 Index, are not comprehensive. She pointed out that the Russell 3000 does not include microcap companies—that is, those with market capitalization of less than $300 million. Drawing on her previous research into microcaps, she predicted that the majority of these companies would have to add women as directors.

FRESHENING UP

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qualified independent third parties periodically to encourage candor and neutrality. Board self-evaluations and individual director evaluations shouldn't be used as a crutch to get rid of directors, but as a way of improving board performance overall, Gorman stressed. "In order to do that, you need to know where the perceived weaknesses are," he said.

Tenure, not age. Managing board tenure is an important aspect of boardroom diversity—and, in Gorman's view, may be more valuable than imposing age limits. "For some directors, 75 is the new 55, and it might not make sense for a board to arbitrarily deprive itself of their service and advice," Gorman said. "Instead, we recommend a diversity of tenure rather than age." For example, nominating and governance committees might consider maintaining a composition that includes at least one director with less than five, five to 10, and 10-plus years of service.

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Fed Highlights Trends in Urban and Rural Bank Markets

Community banks have maintained locations in rural markets at roughly the same rate since 1997, even though consolidation has shuttered bank headquarters in many of these markets, Federal Reserve Vice Chairman for Supervision Randal Quarles said at a research conference in St. Louis.

Rural markets have averaged around four community banks (those with under $10 billion in assets) consistently since 1997; in these markets, the average number of larger banks grew from one to 1.4 during this period. Urban markets have seen more consolidation and a shift to larger banks; the average urban area had 18 community banks and eight large banks in 2017, compared with 21 community banks and six large banks in 1997.

Consolidation has cut the number of bank headquarters in rural markets by 45 percent and in cities by 50 percent, Quarles noted. "Consolidation has led to a doubling in the number of banking markets—almost all of which are rural—in which no banks are headquartered," he said. "We hear anecdotally that banks are more attuned to the needs of the communities in which they are headquartered, so the significance of this loss could have an effect on the local markets."

The populations of urban vs. rural banking markets differ significantly in areas including the age distribution of the population, college degrees, homeownership rates, poverty rates and internet access, Quarles said. While the national population has been growing over the past 20 to 30 years, population in many rural areas has declined. Since 2008, most U.S. job growth has occurred in urban areas.

Consolidation has cut the number of bank headquarters in rural markets by 45 percent.

There were 2,973 rural community banks as of 2017, outnumbering their urban counterparts, which totaled 2,482, Quarles noted. But in terms of assets, urban banks held a three-to-one advantage over rural banks. The average urban community bank had assets of $843 million in 2017, while the average rural banks had assets of $270 million.

Charge-off ratios were higher on average at rural banks (0.146 percent for rural banks, versus 0.110 percent for urban banks.) Returns on average assets were also higher at rural banks (0.947 percent for rural banks, versus 0.780 percent for urban banks.)

There is a tendency, Quarles said, to "speak of community banks as though they are all pretty much the same," but reality is more nuanced. He noted that most of the decline in the number of community banks over the past two decades has taken place among those with assets of less than $100 million. The smallest banking organizations also consistently had lower average rates of return on assets than their larger peers, he said.

Banks Face Hurdles in Recruiting Young Talent

Only 19 percent of banks have a strategy in place for recruiting millennials as employees, according to a survey from Crowe.

The millennial generation—born in the 1980s and 1990s—currently makes up the largest generation in the U.S. population, the *2018 Crowe Bank Compensation and Benefits Survey* noted. Slightly more than half of survey participants (51 percent) said retaining younger talent was either very challenging or somewhat challenging. The balance, 49 percent, described retaining younger talent as no more challenging that retaining older employees.

Two-thirds of banks—66 percent—had no particular strategy in place to recruit millennials. Fifteen percent were developing such a strategy.

Compensation, job flexibility and promotion opportunities are the biggest hurdles to recruiting and retaining millennials, the survey found. Tim Reimink, a managing director for Crowe's financial services performance consulting group, said that banks with strategies in place that give millennial candidates clear expectations of their roles and future growth opportunities stand the best chance of long-term success.

The survey draws on data from 420 financial institutions, 85 percent of which had assets less than $1 billion. The largest slice, 29 percent, had assets below $250 million.

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ABA Unveils New Video Training Resource for Bank Directors

Cybersecurity. Blockchain. Payments. The list of issues facing bank directors continues to grow. To respond to community banks' requests for more resources to meet directors' need for continuing education, ABA has created 10 training videos on these and other pressing topics.

The videos, which are available free to members on the ABA website, range from four to seven minutes in length. Access to the videos is also available to non-members for $75 per video or $695 for the set of 10 videos.

Banks using the ABA Learning Management System can generate reports to examiners to show training was completed.

Banks that use the ABA Learning Management System (LMS) can direct their board members to take the training through the LMS. This approach gives banks the capability to generate reports to bank examiners confirming the training has been completed.

The videos can also be incorporated easily into board meetings and training sessions, or accessed via the ABA website for independent learning.

In addition to the three videos on digital trends—cybersecurity, blockchain and payments—the series includes seven videos on board oversight. These topics are: compliance management, compliance controls activities, preparing for the compliance exam, post-compliance exam activities, BSA/AML/OFAC, insiders and Regulation O, and fair lending.

Each video identifies up to four specific takeaways that bank directors can expect to learn. For example, the Reg O video enables viewers to describe the types of insiders who are covered under Reg O, explore the specific activities that are prohibited and permitted under Reg O and explain recordkeeping and reporting requirements and expectations.