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Strategic Governance Planning: What Community Banks Should Know

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INTRODUCTION

- **Strategic Planning** is the process of defining an institution's strategies and making decisions and allocating resources towards the pursuit of these strategies

- An institution's strategic planning process should be overseen by the Board of Directors and should be reflected in a written strategic plan

- The strategic planning process should be consistent with the institution's risk appetite, capital plan and liquidity needs

- An effective governance structure is essential in implementing strategic planning and minimizing strategic risk

STRATEGIC PLANNING PROCESS

- An institution's strategic planning process should address the following questions:

  1. **Where are we now?**

     - Requires an evaluation of the bank's internal and external environment and its strengths, weaknesses, opportunities and threats

  2. **Where do we want to be?**

     - Requires forward-looking consideration of the bank's missions, goals and objectives

STRATEGIC PLANNING PROCESS

- An institution’s strategic planning process should address the following questions:

  3. **How do we get there?**

     - A strategic plan should be designed to achieve the bank’s goals and objectives
     - An effective plan should be tailored to a bank’s internal capabilities and business environment and be based on realistic assumptions

  4. **How do we measure our progress?**

     - Requires regular measurement and reporting on bank objectives and achievements

STRATEGIC PLANNING PROCESS

- Strategic planning should also:
  - Include a review of the bank's organizational structure (including charter)
  - Weigh the impact of significant organizational changes (acquisitions, management changes, etc.)
  - Address strategies to meet unanticipated operational challenges
  - Take into consideration the existing regulatory environment
  - Involve third party advisors

STRATEGIC PLANNING PROCESS

- Effective strategic planning can reduce an institution's strategic risk
- Strategic risk is the risk to a bank's current or projected financial condition resulting from:
  - Adverse business decisions
  - Ineffective implementation of business decisions
  - Inadequate responses to industry or regulatory change

STRATEGIC PLANNING PROCESS

- The absence of appropriate governance in an institution's decision-making process can have significant negative consequences including:

  - Missed business opportunities

  - Financial losses or inadequate capital levels

  - Adverse regulatory treatment (civil money penalties, enforcement actions, etc.)

STRATEGIC PLANNING RESPONSIBILITY

- An institution's Board of Directors is responsible for establishing the bank's strategic focus and goals

- The Board of Directors must ensure that the institution has the following components in place to carry out its strategic plan:

  - Qualified and capable personnel

  - Financial strength and support

  - Technological and operational capabilities

STRATEGIC PLANNING IMPLEMENTATION

- Management is responsible for implementing an institution’s strategic plan and should:

  - Develop policies and processes to guide the execution of the strategic planning process

  - Monitor the implementation of the strategic plan

  - Track outcomes, performance metrics and risk indicators against established targets and limits

STRATEGIC PLANNING CHALLENGES

- Strategic planning – and the management of strategic risk – does not exist in a vacuum

- In the last two years alone, significant national and global events have exasperated strategic planning efforts:

  - COVID-19

  - Social unrest

  - 2020 Presidential election

- Boards have been faced with these unprecedented obstacles while managing strategic oversight

STRATEGIC PLANNING CHALLENGES

- Current strategic planning challenges facing institutions include:
  - Board refreshment and diversity
  - Succession planning
  - Accurate self-assessments of Board of Directors and measurement of progress towards strategic goals
- Each of these challenges can be addressed through effective **corporate governance** measures, which reduce an institution's overall strategic risk

BOARD REFRESHMENT AND DIVERSITY

BOARD REFRESHMENT AND DIVERSITY

- Board composition continues to remain a major challenge for many institutions
- Director age and tenure have become areas of concern regarding continued service on bank boards
- Shareholders and other stakeholders continue to raise concerns regarding Board diversity, composition and refreshment
- Investors have also called for more transparent disclosure regarding the assessment of Board tenure and succession planning for directors

BOARD REFRESHMENT

- In recent years, directors themselves have reported dissatisfaction with peers and have indicated that Board refreshment is needed

- In its 2020 annual survey of corporate directors, PwC reported that:

  - **49%** of directors indicated at least <u>one</u> fellow board member should be replaced

  - **21%** of directors indicated at least <u>two</u> fellow board members should be replaced

Source: PricewaterhouseCoopers 2020 Annual Corporate Directors Survey

BOARD REFRESHMENT

- In addition to concerns from directors, recent survey results show that members of executive management also see the need to address Board refreshment

- In a related survey of C-Suite executives, PwC reported that while 9 in 10 executives say Board members understand corporate strategy:

  - **82%** of executives indicated at least one board member should be replaced

  - Only **37%** of executives indicated that Board members come to meetings fully prepared

Source: PricewaterhouseCoopers, Board Effectiveness: A Survey of the C-Suite (2021)

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BOARD REFRESHMENT

- Challenges to Board refreshment include:
  - A reluctance to have difficult conversations with long-time and/or respected peers
  - An ineffective Board self-assessment process
- To make real change in this area, Boards must have open and honest communication about director expectations and contributions
- The recent pandemic provided a unique opportunity to assess director contributions, adaptability and technological skills/shortcomings

BOARD REFRESHMENT

- To support directors and keep existing Board members engaged and productive, an institution should:
  - Provide the entire Board with ongoing training and educational opportunities
  - Rotate Board committee membership to take full advantage of directors' expertise and talents
  - Provide individualized counsel to key Board members whose performance could be improved upon
  - Conduct feedback and informational meetings following a new director's first year of Board service

BOARD DIVERSITY

- Board diversity also continues to be a key area of focus for directors and corporate stakeholders

- In addition to outside influences, surveyed directors strongly agree that Board diversity has significant benefits:

  - **94%** say diversity brings unique perspectives to the Board room

  - **85%** say diversity improves relationships with investors

  - **83%** say diversity enhances Board performance

  - **72%** say diversity enhances corporate performance

Source: PricewaterhouseCoopers 2020 Annual Corporate Directors Survey

BOARD DIVERSITY

- Recent state laws have been enacted to address Board diversity and diversity reporting:

  - **California** public companies were required to have one woman on their Board of Directors by the end of 2019 and, by the end of 2021, must have between one and three female directors depending on the size of the Boards

    - California public companies also must have a minimum of one director from an “underrepresented community” by the end of 2022, with this number increasing to two or three for companies with larger Board sizes

  - **New York** companies are required to report how may of the directors are female

  - In 2019, a **Pennsylvania** House Resolution was introduced to encourage diversity on Boards by 2021

BOARD DIVERSITY

- For public companies, **proxy advisory firms** have also increased their focus on Board diversity in recent years:

  - ***Institutional Shareholder Services (ISS):*** ISS recommends a vote against or to withhold votes for the chair of the company's nominating committee (and possibly other directors as well) if a company has:

    - No female Board members <u>or</u>
    - No apparent racial or ethnic diversity

  - ***Glass Lewis:*** Glass Lewis recommends a vote against the chair of a company's nominating committee with no female members and may take the same position with respect to other members of the nominating committee

    - Glass Lewis also assess Board diversity based on race and ethnicity

BOARD DIVERSITY

- In addition to ISS and Glass Lewis, other large institutional investors have been actively engaging with public companies on Board diversity matters

  - In January 2021, **State Street Global Advisors** announced that it will vote against a company's nominating committee chair if the company does not disclose the racial and ethnic composition of its board

  - In December 2020, **Vanguard** also issued a new policy setting forth its expectations that public companies will

    - Publish their perspectives on Board diversity

    - Disclose their diversity measures

    - Interview diverse pools of director candidates

BOARD DIVERSITY

- In 2019, the **SEC** also published guidance requiring public companies to:

  - Disclose, to the extent the Board or nominating committee considered any self-identified diversity characteristics of an individual who was under consideration for nomination as a director

  - Identify, provided that the director consents to the disclosure of such characteristics, those characteristics and discuss how they were considered

- The SEC also stated that if a company includes a description of its diversity policies in its public flings, it should also include a discussion of how the company considers the self-identified diversity attributes of a nominee, as well as any other qualifications its diversity policy takes into account, such as diverse work experiences, or socio-economic or demographic characteristics

BOARD DIVERSITY

- In August 2021, **Nasdaq** also issued a final rule – which was approved by the SEC – regarding Board diversity that:

  - Requires larger listed companies to disclose, by the later of August 6, 2022 or the filing of their 2022 proxy statement, statistical information regarding Board diversity

- Companies trading on the Nasdaq Global Select and Nasdaq Global Markets must also have – or explain why they do not have – the following:

  - At least one diverse director by 2023 and

  - At least two diverse directors by 2025

BOARD DIVERSITY

- Companies trading on the Nasdaq Capital Market must also have – or explain why they do not have – two diverse directors by 2026

- For most listed companies:

  - One diverse director must self-identify as female and

  - One diverse director must self-identify as an underrepresented minority and and/or LGBTQ+

- Smaller reporting companies can comply with the rule by appointing two female directors

BOARD DIVERSITY

- In 2015, the **federal banking agencies** issued a final policy statement on diversity that:
  - Provides a framework for assessing an institution’s organizational commitment to diversity, its workplace profile and employment practices, its procurement and business practices and its efforts to promote transparency in its diversity and inclusion
  - Includes a framework for an institution to conduct a self-assessment of its policies and practices and explains how the agencies will use the assessment information voluntarily provided by an institution

BOARD DIVERSITY

- To improve Board diversity, institutions should:

  - Consider individuals with diverse perspectives and backgrounds when evaluating candidates needed to address a missing specific skill set on the Board

  - Assess the institution’s community demographics when appointing a new director to replace a current Board member or to fill a vacancy resulting from an increase in Board size

  - Communicate with local businesses, civic organizations, business schools or other community organizations to expand the Board’s current networking pool

  - Consult with organizations, if need be, that focus on the placement of diverse individuals on Bank boards

SUCCESSION PLANNING

EXECUTIVE SUCCESSION PLANNING

- A change in executive leadership is inevitable for all organizations and can be a very challenging time (goes beyond the CEO)
- Consequently, it is beneficial for institutions to be prepared for a temporary or an eventual permanent change in leadership - either planned or unplanned - to ensure the institution continues to operate without interruption until new leadership is appointed
- One change in leadership may lead to another vacancy elsewhere in the institution
- To prepare for such a change in leadership, an institution should implement a formal policy governing succession planning and continue to review its succession planning readiness

EXECUTIVE SUCCESSION PLANNING

- An effective succession planning policy should:

  - Identify potential employees capable of advancement (or rapid advancement) to positions of higher responsibility than the presently occupy

  - Ensure the systematic and long-term development of individuals to replace key job incumbents as the need arises due to deaths, disability, retirement, scandal and other losses (expected or unexpected)

  - Provide a continuous flow of talented individuals to meet the institution’s management needs

  - Promote discussion of the circumstances under which it is appropriate to look outside the institution (rapid growth, troubled condition, etc.)

EXECUTIVE SUCCESSION PLANNING

- Compensation and benefits reviews are also necessary as part of the succession planning process

- Large gaps in compensation between management positions can be uncomfortable for the Board

- Temporary compensation for interim positions should be considered

- A complete understanding of employment contracts and other compensation arrangements is important for both executives and the Board

EXECUTIVE SUCCESSION PLANNING

- The key executive officers covered by financial institution executive succession plans are the:

  - Chief Executive Officer
  - Chief Financial Officer
  - Chief Operating Officer
  - Chief Lending Officer
  - Chief Retail Officer
  - Chief Risk Officer (larger institutions)

EXECUTIVE SUCCESSION PLANNING

- Obstacles to **addressing** succession planning include:
  - Comfort with the past
  - Management sensitivity
  - Management reluctance
  - More pressing issues for the Board and management

EXECUTIVE SUCCESSION PLANNING

- Obstacles to **addressing** succession planning include:
  - Lack of clarity/focus by the Board and management
  - Fear of internal competition
  - Fear of employee dissatisfaction and turnover

EXECUTIVE SUCCESSION PLANNING

- Obstacles to **implementing** succession planning include:
  - Employees who have "management potential" but are not "management ready"
  - Employees who may be unwilling to assume more responsibility
  - Board overreach
  - Lack of preparedness or Plan B

EXECUTIVE SUCCESSION PLANNING

- Succession planning best practices include:
  - Ensuring that succession planning is a formal Board agenda item at least annually
  - Determining where primary responsibility lies
    - Board of Directors
    - Compensation Committee
    - Nominating/Governance Committee
    - Succession Planning Committee

EXECUTIVE SUCCESSION PLANNING

- Succession planning best practices should also include determining the level of CEO involvement in the process:
  - Evaluating and reporting
  - Counseling
  - Driver of process
  - Involved in capacity as a director

EXECUTIVE SUCCESSION PLANNING

- An effective succession planning policy should:
  - Include a description of skills and expectations (short-term needs vs. long term strategy)
  - Provide for a formal process to review internal candidates
  - Expose internal candidates to the Board of Directors (the interview process) both formally and informally
  - Set forth a process for reviewing outside candidates
  - Be flexible and reassessed as changes occur

EXECUTIVE SUCCESSION PLANNING

- When evaluating candidates eligible to succeed key executive positions, the Board of Directors should consider the following **core competencies** an individual possesses:

  - Contributions to the range of talent, skill and expertise appropriate for management as needs dictate

  - Financial, regulatory and business experience and knowledge of the banking industry

  - Familiarity with the institution's market area and participation in and ties to local businesses and local civic and charitable organizations

  - Personal and professional integrity, honesty and reputation

EXECUTIVE SUCCESSION PLANNING

- When evaluating candidates eligible to succeed key executive positions, the Board of Directors should consider the following **core competencies** an individual possesses:

  - Diverse perspective and background

  - Temperament, charisma and attitude to manage, motivate and attract employees and act as a public face of the institution (i.e., the ability manage managers)

  - Ability to represent the institution’s best interests and devote sufficient time and energy to the performance of his or her duties

  - Interest in moving to a new position (don’t take for granted)

EXECUTIVE SUCCESSION PLANNING

- An annual (or more frequent) review of an institution’s succession planning policy:
  - Reduces the level of apprehension
  - Allows for continuous evaluation of skills as the institution grows or changes
  - Allows for continuous evaluation of the willingness of potential successors
  - Promotes a “healthy” competition for advancement
  - Identifies succession issues created by advancement
    - Departures of those not promoted
    - Vacancies left by those who are promoted

BOARD SUCCESSION PLANNING

- Director succession planning is also a critical strategic governance tool, particularly in light of increased calls for Board refreshment and diversity

- However, in its 2020 annual survey of corporate directors, PwC reported that:

  - **10%** of directors reported that their Board does not have a director succession plan

  - **33%** of directors reported that their Board succession plan is ad hoc

- It is important for directors to have an understanding of – and input on – what the next generation of the Board will look like

Source: PricewaterhouseCoopers 2020 Annual Corporate Directors Survey

BOARD SUCCESSION PLANNING

- The Board of Directors of an institution can implement an effective **director succession plan** by:
  - Making an honest assessment of Board skills and engagement
  - Creating and continuously updating a pipeline of prospective Board members
  - Interviewing potential candidates and not basing appointments on recommendations/references alone
  - Recommending to the full Board candidate(s) for election
  - Re-evaluating new Board members after a director's first term
  - Considering director age/term limits

BOARD AND INSTITUTION SELF-ASSESSMENTS

BOARD SELF-ASSESSMENTS

- Board self-assessments remain a critical tool in improving the Board's overall performance and furthering an institution's strategic objectives

- Boards should regularly (at least annually) undertake some form of self-assessment

- A meaningful self-assessment should evaluate:

  - The Board's effectiveness and functionality

  - Board committee operations

  - Directors' skills and expertise

BOARD SELF-ASSESSMENTS

- Board self-assessments affirm the “tone at the top” and help further an institution’s corporate culture and governance by:

  - Acknowledging the Board holds itself responsible for its performance

  - Emphasizing personal integrity and accountability even at the top of the organizational chart

  - Setting an example for directors’ and managements’ expectations for employee behavior

BOARD SELF-ASSESSMENTS

- Board self-assessments can take a variety of forms, including:
  - Individual written questionnaires
  - Group discussions and assessments
  - Formal interviews with each director
  - Peer evaluations
  - A combination of the above

BOARD SELF-ASSESSMENTS

- Self-assessments should be tailored to an institution’s individual Board dynamics

  - For some Boards, it may be best to provide a self-assessment process that allows for anonymous director feedback

  - For more tech-savvy Boards, online or electronic self-assessment measures may be the preferred method

- In some circumstances, it may be beneficial to work with a third party – such as legal counsel or a Board consultant– to administer self-assessments and provide feedback to directors

BOARD SELF-ASSESSMENTS

- An effective self-assessment should address the following factors:
  - Director qualifications
  - Level of director participation
  - Frequency of Board meetings
  - Quality of Board meetings and discussions (including whether a small group of directors dominates discussions)
  - Quality and timeliness of Board materials

BOARD SELF-ASSESSMENTS

- An effective self-assessment should address the following factors:
  - Comprehensiveness of meeting agendas
  - The Board's relationship with the CEO
  - Effectiveness of strategic and succession planning
  - Quality of executive sessions
  - Effectiveness of Board committees and committee structure

BOARD SELF-ASSESSMENTS

- A critical component of any Board self-assessment is to address items identified to improve performance

- Self-assessments used to be "check the box" exercises but are now taken much more seriously

- In its 2020 annual survey of corporate directors, PwC reported that:

  - **72%** of directors indicated that their Board made changes as a result of their self-assessment process (up from 50%) in 2014

Source: PricewaterhouseCoopers 2020 Annual Corporate Directors Survey

BOARD SELF-ASSESSMENTS

- In response to self-assessment results:

  - **40%** of directors reported that their Board added expertise to the Board

  - **32%** of directors reported that their Board changed committee composition

  - **14%** of directors reported that their Board provided counsel to a director.

  - **12%** of directors reported that their Board did not re-nominate a director

    - However, 49% of surveyed directors indicated that at least one fellow Board member should be replaced

Source: PricewaterhouseCoopers 2020 Annual Corporate Directors Survey

ADDITIONAL ASSESSMENT PRACTICES

- In addition to director self-assessments, an institution’s Board of Directors should also conduct regular assessments of:
  - Executive management and its progress towards the achievement of strategic goals and objectives
  - The bank’s charter (to ensure it remains the best charter to allow the bank to carry out its operations)
  - Industry and regulatory developments
  - Peer best practices

CONCLUSION

CONCLUSION

- Strategic planning remains as important as ever, even with all of the challenges institutions have faced as a result of the COVID-19 pandemic and other external factors

- Effective corporate governance can help institutions reduce strategic and regulatory risk and capitalize on business opportunities

- A forward-looking institution can leverage challenges into changes in Board composition, revamped best practices and restructured priorities to best position the institution for future success

QUESTIONS

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Locations

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