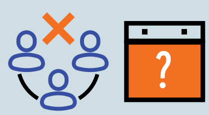
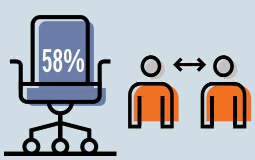
2020 Governance Best Practices Survey

How Bank Boards Manage Their Business

KEY FINDINGS

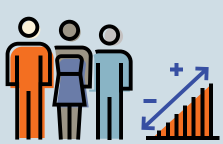
PROCESS
42% lack an executive committee, and those that do tend to meet irregularly.





INDEPENDENCE
58% have an independent chair. Only 55% have a lead director if the CEO is also the chair.

OVERSIGHT
61% say most directors are actively engaged, but 36% say only some are. 34% say only some directors know enough about banking.



COMPOSITION
40% say the performance benefits from greater race, gender or ethnic diversity are overrated, and 8% say it doesn't improve performance at all.

REFRESHMENT
49% do an annual board assessment. Median service is 12 years. Median age for mandatory retirement is 73.

2020 Governance Best Practices Survey

A strong board — and strong governance practices — form the foundation for a high performing bank, and contribute to a safe and sound banking industry. The role of the board is to oversee the senior management team while also representing the interests of the bank's shareholders. The board of directors does not run the enterprise (or at least it shouldn't) but is ultimately accountable for the success or failure of the institution. The thoroughness and level of attention that boards bring to their activities and responsibilities tend to be reflected in the long-term performance of their banks.

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Bank Director was founded almost 30 years ago for the purpose of giving bank chief executive officers and their boards of directors information that would result in better board governance. We are still dedicated to that same proposition, and the 2020 Governance Best Practices Survey is our latest contribution to that effort.

The purpose of the survey, which is sponsored by Bryan Cave Leighton Paisner, is to build clarity around a set of best practices for corporate governance in the banking industry and give directors a sense of how boards at other banks go about their business.

The survey covers a range of issues, and this report has been divided into five modules: process, independence, oversight, composition and refreshment. We conducted the survey in February and March of 2020, gathering the perspectives of 159 independent directors, chairmen and CEOs of U.S. banks under $50 billion in assets.

Of the respondents, 51% are independent directors, 19% hold the title of CEO, 17% are an independent chair or lead director, and 9% are CEOs who also hold the title of chair. The largest number of banks — 43% — have assets between $1 billion to $10 billion, 26% are between $500 million and $1 billion, 23% are less than $500 million and 8% are over $10 billion. Almost half of the banks are privately owned, 37% are publicly owned and 16% have a mutual ownership structure.

Corporate directors in the United States tend to be older, and banking is no exception. Half of the respondents are between the ages of 61 to 70, and another 26% are above 70. Sixteen percent are between ages 51 to 60, and 9% are 50 or younger.

To provide some perspective about the survey results, we interviewed James J. McAlpin Jr., a partner at Bryan Cave and leader of the firm's banking practice group. McAlpin devotes a significant portion of his practice to counseling bank boards on corporate governance issues, and he has spoken frequently on this topic at Bank Director's conferences.

For additional insight, we also interviewed the board chairmen at two banks that in recent years have performed well on Bank Director's Bank Performance Scorecard. Michael L. Kubacki is the independent chairman at Lakeland Financial Corp., a $5.4 billion bank in Warsaw, Indiana. Greg D. Carmichael is the chairman and CEO at Fifth Third Bancorp, a $203 billion regional bank based in Cincinnati, Ohio.

Our hope is that the 2020 Governance Best Practices Survey will foster a broader understanding of corporate governance policies and opinions throughout the banking industry. In the survey, you'll find that there is wide agreement between the participants on some issues, while on others there is a marked lack of consensus. There may never be complete agreement on issues like diversity, performance evaluations, and splitting the CEO and chair roles, to name three that surface in the survey, but it's important to understand where the differences lie.

For those who would like to review the entire survey, the complete results can be found in the research section at BankDirector.com.

PROCESS

Most banks rely on a conventional set of standing board committees, which is to say audit, compensation and corporate governance. Executive committees, which are comprised of a small group of directors and members of senior management including the CEO, appear to be less common, based on the survey results. Forty-two percent of the respondents say they do not have an executive committee, whose function is to make decisions — either in times of emergency or when a pressing issue demands immediate action — when the full board cannot be assembled for a meeting in a timely manner.

This finding doesn't surprise McAlpin. "It really depends on the board and the bank," he says. "I have found executive committees to be useful in certain circumstances, but it's not a widespread practice in the banking industry, except perhaps at larger banks." McAlpin says that most of the work that occurs between regular board meetings takes place in the standing committees.

However, McAlpin says it's not unusual for there to be a de facto executive committee comprised of directors who have a strong relationship with the CEO, especially if that person is also the board chair. "What often happens is you will have one or two directors who serve in more of an informal executive committee capacity," he says. "And there will be conversations which occur between board meetings among that small group about approach and process. I think there are a lot of informal executive committees that exist in the banking industry."

One large bank that doesn't have a formal executive committee is Fifth Third. Instead, the bank has a finance committee comprised of the chairs of its other standing committees that can function as an executive committee when necessary. "If I need a subset of the board to run something by, we use the finance committee," Carmichael says. "We don't have a separate committee that approves certain things that the whole board wouldn't see. We bring all decisions for full board approval."

Three-quarters of respondents say their boards meet monthly, followed by 7% that meet bimonthly and 5% that meet quarterly. The remaining 13% report frequencies that vary considerably. The Lakeland Financial board meets six times a year, which Kubacki believes is sufficient to cover all the necessary bases. "We do enjoy each other's company, but that's not the point," he says. "It's a little less enjoyable for the management team that's making the numbers happen. So we end up with six. We got down to four a few years ago and that was not enough, so six just made sense."

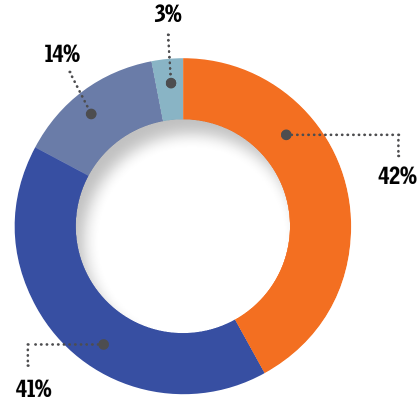
Fifth Third's board meets five times a year, and interspersed between these meetings are various committee meetings. According to Carmichael, this adds up to about 40 meetings a year of the full board and committees.

The length of board meetings also varies considerably. Forty-seven percent indicate that they meet for an average of three to four hours, followed by 40% that meet for one to two hours, 13% that meet for more than five hours – and, incredibly, 1% that meet for less than an hour.

"Two hours is fairly typical," says McAlpin. "One, most of those boards are probably meeting on a monthly basis. And most of what is occurring is informational in nature. There's a loan report, and then there are committee reports. Most of the real work [done] by the board is occurring in the key committee meetings."

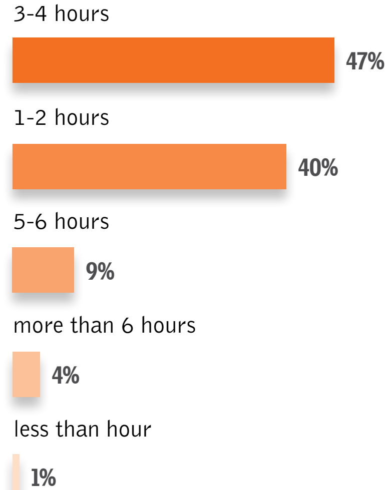
One issue where there is widespread agreement is the distribution of material prior to board meetings. Eighty-five percent say their board material is sent out electronically through a board portal. Six percent still print and mail their materials out beforehand.

If your board has an executive committee, what is its normal routine?

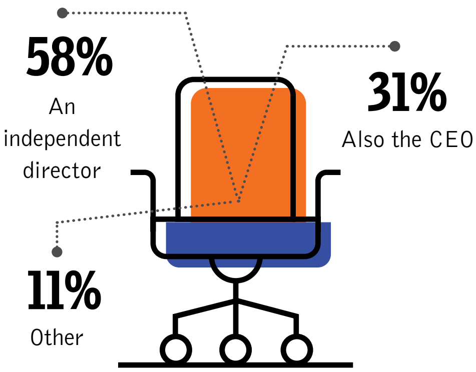


- Our board doesn't have an executive committee
- It meets whenever necessary, including after board meetings
- It meets after every board meeting
- It occasionally meets after board meetings

How long is an average meeting of your full board?

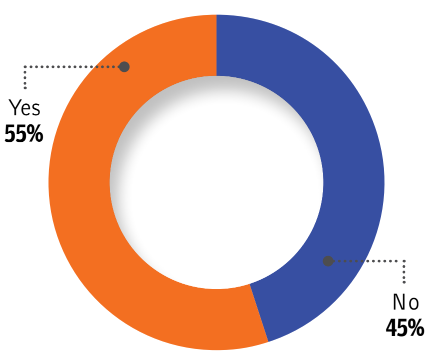


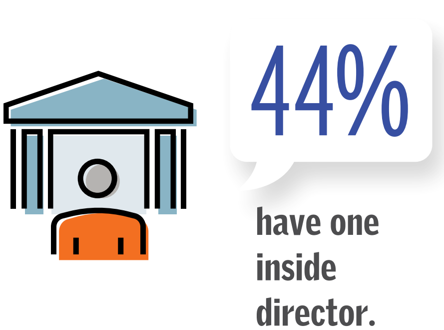
Your board chair is:



If the CEO is also the board chair, does the board have a lead director?

Question only asked of respondents who indicated the chair is also the CEO.





INDEPENDENCE

Independence is a foundational principle of effective corporate governance, and the survey participants fare reasonably well based on their membership characteristics. Forty-four percent have just one inside director on the board, which we can assume is in most instances the CEO. Twenty-seven percent have two inside directors, and 30% have three or more. Boards with a single inside director are more prevalent among banks greater than $1 billion in assets.

An emerging principle of good governance in recent years is to divide the chair and CEO roles between two individuals. But is this a best practice? Many reputable governance advocates would say yes, but McAlpin disagrees.

"I think it can matter in certain situations, but I would not say it's a best practice," he says. When the CEO's performance is in question, having an independent chair can make it easier for the board to resolve the issue, particularly if it decides to dismiss the CEO. "I do think it matters who the individual is," McAlpin says. "In an instance where you have a well-performing and highly respected CEO, it may make the most sense for that person to be chair because they often want to run the board, and it would be difficult to retain him or her otherwise. And that's in the best interests of the bank and the shareholders."

Boards where the CEO and chair titles have been split are most prevalent among smaller banks — particularly those under $500 million in assets, where almost three-quarters have an independent chair.

Carmichael holds both titles at Fifth Third, but that wasn't always the case. When he was appointed CEO in November 2015, the board's independent lead director — Marsha Williams — was elevated to the chair position as part of a planned transition. Carmichael says this was helpful as he moved into his new role. "When you become a new CEO it's like you're drinking from a fire hose," he says. "You're just inundated with a ton of information, and there are things you have to demonstrate and manage that take a lot of time." In January 2018, Carmichael assumed the chair title, and Williams returned to her earlier position as lead director.

Another emerging principle of sound governance is to appoint an independent lead director when the CEO is also the board chair. The lead director serves to represent the interests of the other independent directors and while they do not hold the same authority as the chair, they can be an important counterweight to a strong-minded chair and CEO.

Only 55% of the survey respondents indicate that their board has a lead director when the CEO is also the chair — a practice that the survey finds more prevalent at larger banks.

"I think having a lead director is a best practice, and it should be a director who the independent directors vote on in executive session," McAlpin says.

Carmichael says he has an excellent relationship with Williams, who provides him with a sounding board while also having the ear of the other independent directors. "She's fantastic to work with," he says. "She's very good with the board. She provides a level of independence, and is a buffer for conversations between [me] and the board."

Regardless of how duties have been divided up on the board, it's important that independent directors have a voice in setting the agenda for board meetings, and that they are empowered to surface issues during their deliberations. The survey finds that 96% believe directors can raise issues or concerns even if they don't appear on the agenda.

OVERSIGHT

An important sign of a healthy governance culture is an attitude of mutual respect between management and the board, where each party understands their respective roles. Management's job is to run the bank, while the board's role is to provide oversight. Ninety percent of the survey participants say their board respects the management team's prerogatives but takes its governance responsibilities seriously and tries to strike the right balance. This response is consistent across bank size and ownership structure, and by the respondents' roles on the board.

Another sign of a healthy board culture is transparency: Does management share all relevant information with directors, or do they hold some things back? In this instance, 87% of the respondents are confident that management shares all relevant information in a proactive manner, although 11% say management will answer directors' questions but may withhold certain information unless requested. The issue is slightly more concerning among directors at private (16%) banks than those at public (9%) banks.

A significant number of respondents voice concern about the level of director engagement during board and committee meetings. Sixty-one percent indicate most directors are actively engaged and ask questions during meetings, but 36% say only some directors are actively engaged. The highest level of concern was cited by CEO/chairs and lead directors.

To ensure engagement, Kubacki says that Lakeland Financial tries to appoint a certain kind of director to begin with. "We certainly try to recruit people who are curious, who are successful in their own lives and who are curious about the world as we navigate through it," he explains. Kubacki also draws out specific directors during meetings if he knows they have expertise in an issue being discussed.

McAlpin says it's just as important to judge the quality of a director's engagement as well as how often they speak up. "There are many people who don't speak very often but will speak if they think they need to, and I think those can be very good directors," he says. "You don't want a room full of people who feel they need to make a comment on every agenda item. The concern is for those directors who are not speaking, who are not engaged and not adding value. That needs to be addressed through board evaluations and feedback to those directors."

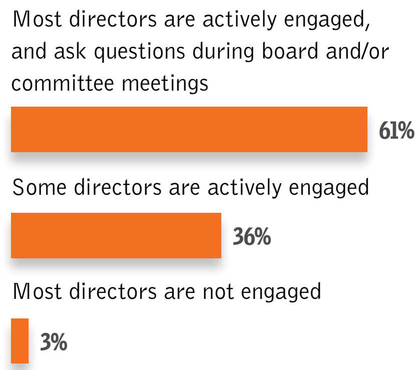
Independent directors who do not have a banking background face the challenge of learning about a complex and highly regulated industry. And 36% of the survey participants say that at least some of their directors do not know enough about banking to provide effective oversight. For McAlpin, knowledge of banking is less important than a thorough understanding of bank finances.

"If I was structuring a board education program for your typical community bank, I would start with financial information," he says. "I think the critical piece of knowledge for a board member is reading the financial statements and knowing the ratios that matter in banking, knowing where the red flags are so they can raise questions."

Kubacki doesn't place a high priority on knowledge of banking either when Lakeland Financial appoints a new director. "That's not why we recruit them," he says. "We don't need them to help us run the bank. We need them to see what we're not seeing from our very focused perspective. Knowledge in banking is not important at all, honestly."

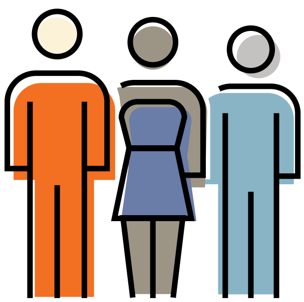
Carmichael might not go that far; he does believe there should be independent directors on the board who have a deep knowledge of banking, which is why Fifth Third has appointed two former bank CEOs and a former bank regulator as directors. But he doesn't expect all Fifth Third directors to have the same level of banking knowledge. "You also want individuals on the board who have other experiences on topics that we discuss."

How would you rate the level of your board's engagement in the governance process?



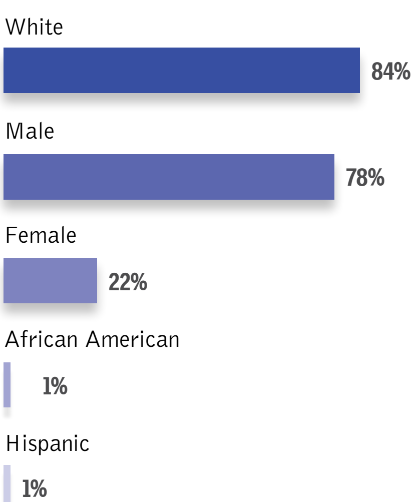
How would you rate your independent directors' knowledge of banking?

Do you believe that greater diversity, defined by race, gender and ethnicity, improves the performance of a corporate board?



- Yes
- Yes to an extent, but the impact is overrated
- No

Which of the following describe your background?



COMPOSITION

Corporate governance in the United States is an activity that is dominated by white males, and the survey finds this to be true among the respondents. Eighty-four percent identify as white, and 78% as male. Indeed, less than one-quarter identify as female; just 1% are Black and 1% are Hispanic.

To address this disparity, public companies — banks included — have been under pressure to increase the diversity of their boards. There is a solid body of academic research that diverse boards make better decisions, resulting in stronger financial performance. When asked to characterize their board's diversity as defined by race, gender or ethnicity, 39% of the survey participants indicate they have several board members who fit that description. Thirty percent have one or two such directors and want to recruit more; 13% have one or two diverse directors and believe that is sufficient for their board.

Not all the respondents buy the argument that greater diversity — again, as defined by race, gender and ethnicity — improves the performance of a corporate board. While more than half believe it does, 40% say the impact is overrated, and 8% do not believe diversity improves performance.

Five of Fifth Third's 15 board members are female, including one who is Black and a former chief information officer. The board's lead director and former chair, Marsha Williams, is also a woman. Carmichael says his board places a high priority on diversity. "It is extremely important, and every board member gets that," he says. "When we recruit [new directors] that is on the forefront of what we're looking for. I'm proud of the diversity we have on the board, [but] I think we can continue to do better. So, you can expect that with the next couple of board positions that I'll have to fill out over time, we'll have a very strong, diverse slate."

Two of Lakeland Financial's board members are women, including one who is Black. Kubacki says his approach to board diversity has changed over time. A few years ago, the board wanted to recruit CEOs of privately held companies because these were the bank's core commercial customers, and it wanted to know what they were thinking. As the bank expanded geographically, the board added directors who understood those new communities. More recently it has worked to break out of the white male stereotype. "We continue to push ourselves to have demographic diversity as well," Kubacki says. "Our judgments about how things work are going to be informed by, again, those people who see life a little differently."

"What I say to boards is to look at your communities," McAlpin says. "Many communities in the United States have undergone fundamental demographic change over the last 15 years." Included in this demographic evolution is an increase in the number of women and minority business owners. "Then look around your board table," he continues. "I think it's really important for the board to reflect the bank's demographic customer base."

Survey participants also express a desire to add certain skill sets or expertise to the board. Sixty-three percent would like to recruit someone with a background in technology; 51% want directors with a background in cybersecurity, and 51% hope to add someone who belongs to the millennial or Generation X cohort, below 55. Other in-demand skill sets or professional experiences include digital commerce (32%), marketing (31%) and risk management (29%).

There is a noticeable trend among the survey participants to appoint younger directors to the board. Sixty percent of the respondents say their board has one or two directors under 55, while one-quarter have several board members in this age range. Only 15% lack this representation.

REFRESHMENT

The composition of the board of directors is an important element in a strong governance culture. Does the board have a collective skill set that supports the bank's strategic plan while also addressing some of the challenges that all banks face, like technology and cybersecurity? Does the board reflect the communities that its bank serves? Are new directors periodically recruited to inject new thinking into board deliberations?

The survey suggests that bank boards are fairly static from a refreshment perspective. Independent directors who responded to the survey have served a median of 12 years on their bank boards. (CEOs were excluded from this question in the survey.) The median tenure for banks under $500 million was even higher at 14 years.

When asked whether their board has a process in place to create new seats for board members, 43% indicate they have a firm mandatory retirement age, 41% say all directors are elected annually, and 15% indicate they have a mandatory retirement age, but with exceptions. For those boards that have mandatory retirement for directors, the median age is 73.

The survey also highlights that a significant number of boards have members with performance issues. Thirty-seven percent of the survey participants say they have one or two underperforming directors who should be replaced, and 5% have several.

Less than half of the respondents say their board performs an annual evaluation of its overall performance, and just 31% perform individual director assessments. Performance evaluations are a sensitive issue for many boards, which fear they will negatively impact board collegiality. McAlpin says that board evaluations are more common at larger banks, and the survey data bears that out. Ninety-one percent of respondents at banks over $10 billion in assets have some type of an annual assessment, compared to just 9% at banks under $500 million in assets. Assessments are also substantially more likely at public (68%) and mutual (70%) compared to privately held banks (26%).

"As a bank grows, its shareholder composition starts to change," McAlpin says. "You get more institutional shareholders, and the proxy advisory companies start tracking the composition of your board and your best practices. If you do not have an annual board evaluation, it's a black mark."

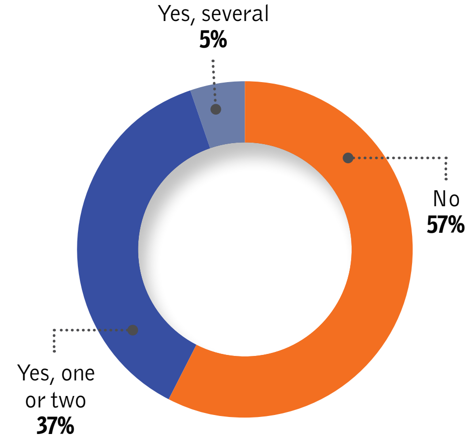
A board evaluation can be an effective tool to surface issues that effect the entire board, while also providing constructive feedback to directors who rarely engage in board discussions, have a habit of missing meetings or tend to be overbearing. Of those boards that have some type of assessment process, 79% use them to improve the governance process, 68% to assess committee performance, 68% to identify training needs for the board, 40% to identify underperforming directors, 38% to inform the strategic plan and 35% to conduct one-on-one conversations with directors.

Lakeland Financial performs a board survey every two years, asking such questions as do directors understand the bank's strategy, does the board operate in an effective manner, and do they receive enough information from management to come to proper conclusions. Directors are also asked to provide open-ended assessments of their peers' contributions to the governance process. "The board's governance committee looks at all of the responses for all the board members, and each board member gets unscripted feedback for him or herself," Kubacki says. "They don't see the feedback of anyone else."

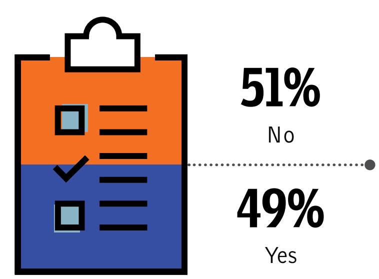
The Lakeland Financial board has adopted an assessment process because it has been identified as a best practice — one that can be helpful in managing director performance. "If we did have a problem emerge with a director, that's certainly not the right time to say, 'Well, now we have to invent a process in order to solve a problem,'" Kubacki says. "So, we've got a process in place that will address problems as they occur. Does that keep the board on its toes? Probably. But we want to be a best practices board."

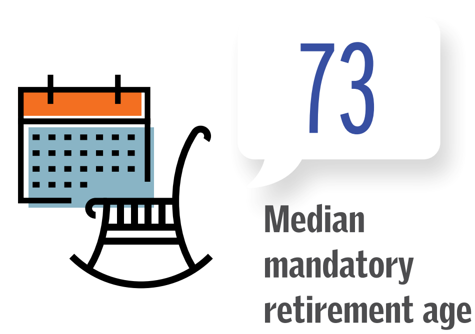
Are there individuals on your board who you believe are underperforming and should be replaced?

Numbers don't add up to 100% due to rounding.



Does your board perform an annual assessment of its overall performance?





FINAL TAKEAWAY

What concerned the survey participants the most about the long-term viability of their banks? Net interest margin pressure, cited by 53% of the respondents, followed by meeting the demands of their customers for digital options (40%), industry consolidation and the growing power of big banks (39%) and the ability to grow organically in their markets (36%). Directors and CEOs at banks over $10 billion in assets express more concern (73%) about margin pressure than smaller banks, while respondents from banks under $500 million are more concerned about consolidation (51%) than larger banks.

Of note, the survey was conducted prior to two important developments that might have shifted the participants' responses. The Covid-19 pandemic had yet to fully emerge as a serious health and economic threat, and the Federal Reserve hadn't yet cut interest rates to nearly zero. Both events will pressure the industry's profitability in coming years, creating a significant challenge for bank CEOs and their boards of directors.

It is Bank Director's belief that boards with strong governance practices are the ones most likely to safely navigate this rough water.

About the Survey

Bank Director's 2020 Governance Best Practices Survey, sponsored by Bryan Cave Leighton Paisner, surveyed 159 independent directors, chairmen and chief executives of U.S. banks under $50 billion in assets to understand the practices of bank boards, including board independence, discussions and oversight, engagement and refreshment. The survey was conducted in February and March 2020. More than two-thirds serve as an independent director, lead director or chairman; three-quarters are between 61 and 80 years old. Roughly half represent a bank over $1 billion in assets.

Questions About Our Research?

Contact Emily McCormick at emccormick@bankdirector.com if you'd like to know more about Bank Director's research initiatives.