BankDirector® Strong Board. Strong Bank.

June 2022
Research

2022 Governance Best Practices Survey

Fortifying Boards for the Future

KEY FINDINGS

CULTURE

54% believe that adding new directors to broaden the board's perspective would enhance its culture.

EVALUATING PERFORMANCE

47% conduct annual performance assessments; **23%** evaluate the board less regularly.

BUILDING KNOWLEDGE

Cybersecurity (**72%**) and digital banking/commerce (**68%**) are the top areas where boards need additional training and education.

ESG IN THE BOARDROOM

45% say their board doesn't discuss or oversee ESG, but **51%** believe it's an important issue for all financial institutions.

COMMITTEE STRUCTURE

81% say their board has enough directors to staff its current committees.

2022 Governance Best Practices Survey

Good corporate governance requires, among many other things, a strong sense of balance.

How do you bring in new perspectives while also sticking to your core values? How does the board balance responsibilities among committees? What's the right balance between discussion about the fundamentals of banking, versus key trends and emerging issues?

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There's an inherent tension between the introduction of new ideas or practices and standard operating procedures. We explore these challenges in Bank Director's 2022 Governance Best Practices Survey, sponsored by Bryan Cave Leighton Paisner LLP. But tension isn't necessarily a bad thing.

The survey polled 234 directors, chairs and chief executives at U.S. banks with less than $100 billion in assets during February and March 2022. Half of respondents hailed from banks with $1 billion to $10 billion of assets. Just 9% represent a bank above the $10 billion mark. Half were independent directors.

We divide the analysis into five modules in this report: board culture, evaluating performance, building knowledge, committee structure and environmental, social and governance oversight in the boardroom. Jim McAlpin, a partner at the Bryan Cave law firm in Atlanta and leader of the firm's banking governance practice, advised us on the survey questions and shared his expertise in examining the results.

We also sought the insights of three independent bank directors: Samuel Combs III, a director and chair of the board's governance committee at $2.8 billion First Fidelity Bancorp in Oklahoma City; Sally Steele, lead director with $15.6 billion Community Bank System in DeWitt, New York; and Maryann Goebel, the compensation and governance chair at $11 billion Seacoast Banking Corp. of Florida, which is based in Stuart, Florida. They weighed in on a range of governance practices and ideas, from the division of audit and risk responsibilities to board performance assessments.

The proportion of survey respondents representing boards that conduct an annual performance assessment rose slightly from the previous year's survey, to 47%. Their responses indicate that many boards leverage evaluations as an opportunity to give and receive valuable feedback — rather than as an excuse to handle a problem director.

Forty-seven percent of respondents describe their board's culture as strong, while another 45% rank it as "generally good," so the 30% whose board doesn't conduct performance assessments may believe that their board's culture and practices are solid. Or in other words, why fix something that isn't broken? However, there's always room for improvement.

Combs and Steele both attest that performance evaluations, when conducted by a third party to minimize bias and ensure anonymity, can be a useful tool for measuring the board's engagement.

Training and assessment practices vary from board to board, but directors also identify some consistent knowledge gaps in this year's results. Survey respondents view cybersecurity, digital banking and e-commerce, and technology as the primary areas where their boards need more training and education. And respondents are equally split on whether their board would benefit from a technology committee, if it doesn't already have one.

And while directors certainly do not want to be mandated into diversifying their ranks, in anonymous comments some respondents express a desire to get new blood into the boardroom and detail the obstacles to recruiting new talent.

"Our community bank wants local community leaders to serve on our board who reflect our community," writes one respondent. "Most local for[-] profit and not-for-profit boards are working to increase their board diversity, and there are limited numbers of qualified candidates to serve."

CULTURE

Culture can be a difficult concept to encapsulate, and even harder to cultivate. It can take time for a board's culture to develop, especially as boards respond to increasing pressure to add directors with a myriad of diverse factors.

The key is to intentionally foster board chemistry through trust and mutual respect. Directors must feel safe to ask questions and express opinions that further the bank's business.

"The chemistry of a board is born, in my opinion, of trust. It takes time to build that sometimes," says Combs. "If people don't have familiarity with each other and they haven't known each other, then you have to be intentional at times about trying to build that chemistry on your board."

A harmonious board leverages diversity of thought and experience to craft strategy for the bank, prioritizes prudent decision-making and manages disagreements around important topics in thoughtful, positive ways, says Steele.

"I don't think tension is necessarily a bad thing. I actually think [that in order to] get the greatest growth out of any organization, tension is a good thing. But it depends on how the tension is directed," Steele says. "The goal of any organization should be to have diversity of thought. ... When you have people with different perspectives, you will have healthy, robust discussions."

Board culture is an area of continuous improvement and focus for directors. Only 47% of survey respondents report that their board has a strong culture that helps drive the bank's success; another 45% say their board has a generally good culture but that there are areas where it could improve. More than half say that adding new directors that broaden the board's perspective is one way the culture could be improved, and 40% add that encouraging participation from certain directors who rarely engage in discussions would help. (Respondents could pick numerous applicable answers.)

Rapid changes in technology and the economy are pressuring banks to adapt and respond; banks need to incorporate numerous perspectives as they position themselves for future growth. This need for more information and different points of view is why bank boards of all sizes should prioritize diversity, says McAlpin. A lack of meaningful diversity can stunt a board and its culture.

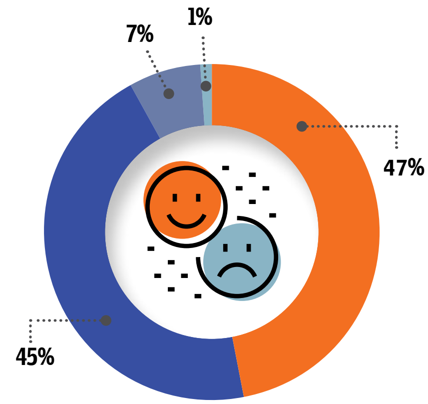
"If you're in a boardroom and feel as if everyone in that room is bringing something important to the table — that's very powerful," he says. "The boards that deliberately create such structure seem to have the best cultures."

Boards are "collegial animals," Combs says, and he knows that directors, especially at smaller banks, may feel trepidation about adding board members with different backgrounds or other attributes that draw a contrast to longer-tenured directors. But as a Black man, Combs often has the experience of being the only person of color in a room.

Since Combs joined, First Fidelity has added more women and younger directors to the board. He says the discussions now take "a different flavor," and the increased diversity has changed how the bank considers new and emerging risks and opportunities. That has been crucial as First Fidelity prioritizes customer technology and expands into newer business lines such as cannabis banking. Now, diverse backgrounds, geographies, skill sets and perspectives are some of the "most important elements" in First Fidelity's board matrix, a document that describes the various attributes of the board. The bank wants to grow its customer base and market, as well as attract and retain the best employees — and so, they are cultivating a board that resembles its customer base.

"We're very intentional about it. We have routine discussions about it and [ask] 'Do we have enough in this area?'" Combs says. "We're also looking to add the right mix and have the right composition. You want rich and productive conversations around issues in your boardroom."

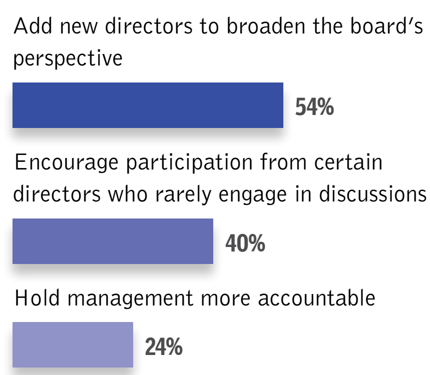
How would you describe your board's culture?



- Our board has a strong culture that helps drive the bank's success
- Our board has a generally good culture that contributes to the bank's success, but there are areas where we need to improve
- Our board culture is adequate, but the board has little/no impact on the bank's success
- Our board has a dysfunctional culture that holds the bank back from being successful

In which areas could your board's culture be improved?

Top three options.



EVALUATING PERFORMANCE

Composition, collegiality and how effectively the board governs as a whole can all be difficult concepts to gauge. Board members may not always feel comfortable raising a concern in a meeting. One way of handling this is to undergo regular board performance assessments. These evaluations are becoming more common, but this year's survey results also show some resistance to the idea.

While 47% of all respondents say their boards perform an annual performance assessment, there is also wide variation among the banks that do and do not make a practice of regularly evaluating their boards. Banks with over $10 billion in assets are much likelier to perform annual board evaluations, while privately held banks and those with less than $500 million in assets are less likely to perform them.

Thirty percent of all respondents say their boards do not conduct evaluations at all — a figure that does not surprise McAlpin.

"For most banks, change is not something they necessarily embrace, and boardroom change is embraced even more carefully," McAlpin says. "There has to be a reason. Many banks do evaluations for the first time when they have a problem director. In a collegial setting it can be hard to tell a person that he or she has become a problem director."

Peer evaluations are less common than board evaluations more broadly, with 29% reporting that their board uses this exercise. Just over half say they have not even discussed doing them, while 20% say they have considered it.

But there are also plenty of positive and constructive reasons that a bank might perform regular board evaluations, says Combs. Performance evaluations can give directors the opportunity to voice concerns or feedback they may not always get the chance to share in the boardroom. If a director feels the board spends too much time reviewing financial reports and not enough time discussing technology initiatives, an evaluation gives that person the chance to say as much.

While the exact details vary from bank to bank, board performance evaluations are often conducted by a third party to eliminate bias, and they typically ask directors a mix of qualitative and quantitative questions. Bank Director offers board evaluations through its Member Services program.

The privately held First Fidelity performs both board evaluations and peer evaluations, rotating those every other year so that directors don't get overwhelmed and start phoning in their responses. Hearing from "disparate voices," who are assured of their anonymity in the process, can be a major benefit to the board as a whole, Combs says.

"We ran into a situation where a board member was not satisfied that the bank was addressing innovation appropriately," Combs says. Raising that issue on an evaluation allowed the board to later initiate that discussion in an open forum, he adds.

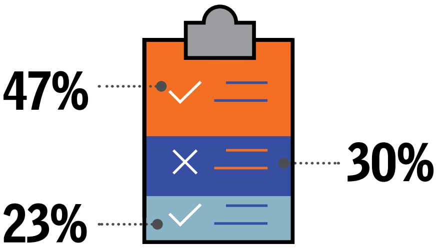
Community Bank System does not perform peer assessments, but it tends to get what it needs from its annual board evaluation, Steele says. The governance committee will typically work on an action plan to address any issues raised in the evaluation, like whether the board should update its skills matrix, a grid that outlines the skills and backgrounds in the boardroom.

"If you use it the right way, it's a great tool for improving performance, and actually just making people understand maybe why you do something the way you do it," she says.

Ultimately, board evaluations function best when they help the board hold individual directors accountable to their goals for the organization.

"If you're trying to be a high-performance institution, you have growth goals, you have a long-term vision for the institution, and you're going to want to hold each other accountable to move the enterprise forward," Combs says. "And that does require that we put ourselves to the test."

Does your board conduct performance assessments?



- Yes, annually
- No, we don't conduct performance assessments
- Yes, but not every year

How does the board use the results of its assessment?

Top five options.

BUILDING KNOWLEDGE

Learning the ins and outs of banking — and keeping up with the industry's changes — is imperative for independent directors' ability to provide effective oversight. But the 2022 Governance Best Practices Survey reveals gaps at some community banks: 27% of respondents report that some independent directors on their boards do not know enough about banking to provide effective oversight. Another 3% say most of the board lacks sufficient knowledge to oversee the bank.

At First Fidelity, building a director's knowledge begins with onboarding. Combs says the board's onboarding process includes assigning new directors a mentor who helps walk them through different aspects and operations at the bank. Similarly, Steele says that Community Bank System uses mentors and meetings with committee chairs to bring directors without banking backgrounds or public company experience up to speed.

Effective onboarding lays the groundwork for effective directors. But just 53% of survey respondents say that their board has an effective onboarding process; 13% have an ineffective onboarding process and 27% don't have a process at all. Responding to a separate question, 11% of survey respondents say their onboarding process for new directors lacks training on bank terminology and key measurements for bank performance; 79% report their new director onboarding process includes those items.

McAlpin suggests that bank boards should provide new directors with resources that explain common — but industry specific — terminology and key measurements. He also suggests that longer-tenured directors and executives like the CFO walk new directors through the bank's latest call report and the most recent regulatory exam report.

Beyond onboarding, First Fidelity continues building director knowledge by hosting in-house board training and makes online training tools — including Bank Director's board membership program — available for individual director learning. Directors also rotate committee assignments so they can learn about all areas of company oversight.

One advantage boards may have at their disposal is the passion and curiosity of individual board members. McAlpin points out that boards may have directors who are personally interested in topics like emerging technology, cybersecurity or other important strategic issues. He suggests that boards encourage these individuals to explore these topics further — perhaps by covering the cost for subscriptions to relevant trade publications or sending the board members to industry conferences and training events — so they can then share their increased knowledge and perspective with the full board.

This may be one way that boards can close their technology gaps, which is a major area where survey respondents indicate their board could use more knowledge and training as a whole.

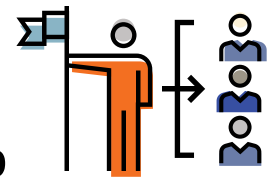
At Community Bank System, board leadership uses the agenda to prioritize director focus. Highlighting items on the agenda and carving out time to discuss them is crucial to making sure the board stays informed, outside of routine updates and regular reports.

As governance chair of First Fidelity, Combs is conscientious of the balance the board must strike in monitoring the fundamentals and key performance of the bank against the trends that are shaping the industry, especially when it comes to technology.

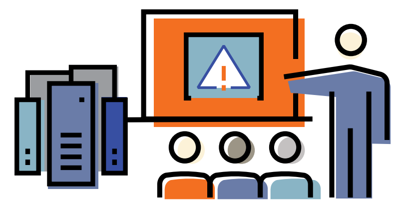
Going forward, Combs sees cybersecurity and risk architecture as being areas where the board can grow and improve. The governance committee at First Fidelity has responsibility for the risk architecture of the bank; Combs focuses on how various risk elements are situated and addressed by the board's various committees.

"One of the things I've learned about boards is [that] you can never have enough strategic discussions or trend discussions," Combs says. "You need to have an eye toward the business environment in the future, and those trends are critically important from a risk and opportunity standpoint. Yet, you have to get the business of the bank done that produces a sound banking institution."

70%

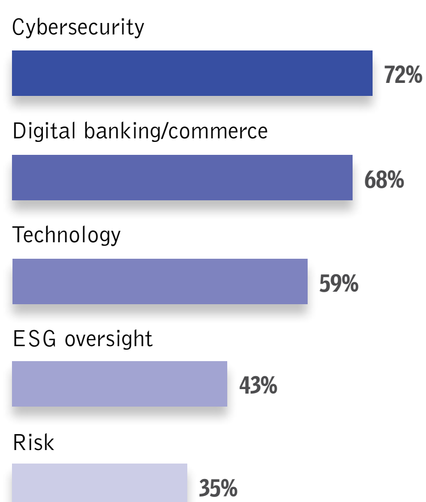


say most of their independent directors know enough about banking to provide effective oversight

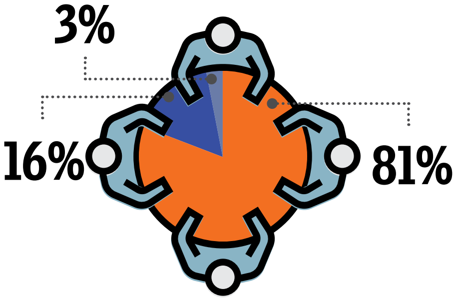


In which areas does the board as a whole need more knowledge and training?

Top five options.



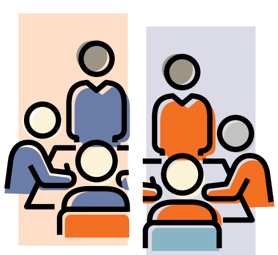
Does your board have a sufficient number of directors to adequately staff its committees?



■ Yes, we have enough directors to staff our current committees

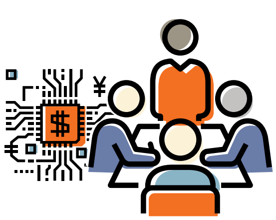
■ Yes, we have enough directors to staff our current committees, but not if we add another committee

■ No, we don't have enough directors to staff our current committees



54%

separate the audit and risk committees



50%

believe a technology committee would benefit their board

COMMITTEE STRUCTURE

About four years ago, First Fidelity's board made an unusual choice for a community bank: It decided to stand up a technology committee.

The decision was an "offensive move," says Combs. The committee helps the bank execute on its long-term vision about the products and capabilities it wants to offer customers, along with the infrastructure it needs to support that. The bank was also in a unique position to create this committee: The board had successfully recruited a second director with a technology background and could adequately staff the new committee.

"Our technology committee was stood up to say: 'Are we robust enough in this area? Are we forward thinking enough in this area? Are we deploying the tools so we can compete with the fintechs and the larger multinational banks?' And we believe we are," Combs says. "You have to be clear about your intentions with these committees and not say, 'We've got to do this because it seems to be the thing that others are doing' or, 'It's a regulatory matter.'"

Survey respondents flagged technology as a significant knowledge gap for their boards, and half believe their bank could benefit from having a standing technology committee. These institutions may need to consider how they can recruit a technologist to the board if they would like to staff a committee, which could become a real advantage and differentiator from other institutions. But not having a separate committee doesn't mean the board can't thoughtfully address the issue.

For example, Seacoast Banking Corp. of Florida addresses technology issues through its enterprise risk management committee, writes Goebel in an emailed interview. Goebel is an independent IT management consultant and chairs a technology committee at another public company board, giving her a unique perspective of how the same issue can be managed and overseen differently. She writes that it doesn't matter how banks address this topic — it just matters that it's addressed.

"I don't think it's necessary to be prescriptive to handle it through a separate committee, as long as it is addressed thoroughly by board members with the appropriate expertise," Goebel writes.

The main determinant of whether a bank should create a technology committee — or separate the audit and risk committee, for that matter — comes down to expertise and capacity, says McAlpin. Most community bank boards have 10 or less directors, and most of these banks divide risk oversight responsibilities among three committees: audit, loan and asset/liability (ALCO). Under that division, oversight of general risk — including cybersecurity risk — tends to be the purview of the audit committee for lack of a better fit, McAlpin says. But boards that have more directors, or directors with technology backgrounds, may find that they can separate general risk oversight and technology oversight into separate committees.

Sixteen percent of respondents report that their board has enough directors to staff its current committees but wouldn't if they add another committee. All of these respondents are directors at banks with less than $1 billion in assets. But there are potential risks involved with how the board divides oversight responsibilities, McAlpin says. A small number of committees with limited bandwidth may provide ineffective oversight because they are stretched thin and can't add new or emerging issues to their workload.

"At your typical community bank board, you just don't have enough depth and bandwidth for separate audit and risk committees," McAlpin says. "These are resource-driven decisions. If you have 10 directors with a typical assortment of backgrounds and experience, how many can effectively contribute to separate audit and risk committees?"

ESG IN THE BOARDROOM

There's broad agreement that it's important for at least some financial institutions to address environmental, social and governance issues, but there's less consensus about how to handle ESG issues at the board level.

Almost half of survey respondents say their board doesn't address ESG issues at all, while 27% say their board and management team are developing or will soon develop an ESG plan. Just 7% have actually set ESG goals for the management team.

With ESG in its early stages, that shouldn't be too surprising. ESG is a broad umbrella term that covers a lot of territory, from corporate governance to data privacy to lending for affordable housing. Moreover, bankers don't always see a connection between big-picture social or environmental issues and the business of running a bank.

While regulators are setting expectations for how the very largest banks should disclose certain risks, smaller institutions have far fewer expectations to meet — if they have any at all. For many community banks, it may not even be immediately clear what ESG issues are most relevant to them.

"All of the large banks are focusing on ESG because they have to. Their institutional shareholders are demanding it," McAlpin says. "But at most privately held banks, including most of the community banks in the U.S., no one's demanding it."

Still, ESG factors are emerging as an area of interest for some customers, would-be employees and other community stakeholders. This year's survey reflects a growing desire for more board-level education on ESG: 43% of all respondents believe their board could use more education about these issues. That figure is higher for banks with between $1 billion and $10 billion in assets.

Community Bank System's board has discussed ESG at its annual off-site retreats in recent years, although ESG more broadly falls under management's purview on a day-to-day basis, Steele says.

"You have to understand what it means to your shareholder base," Steele says. "We constantly look at it in terms of what's required from the board's perspective, from the governance side of things. And then how does it impact the business? Are there things there that you can use to improve the business?"

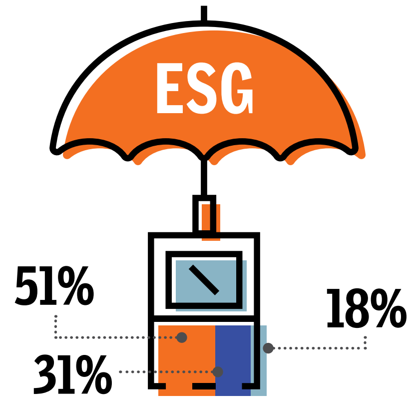
It can help to break ESG into discrete components and focus on the very basics, such as energy management and recycling in bank facilities, Combs says. Like many other community financial institutions, First Fidelity is still early in its ESG journey.

"For example, we operate in Arizona, so water use should be an important element of how we think about it," Combs says. "By being localized in your thinking about how you address ESG and how you make your statements about ESG, it says you're socially aware of the business environment and the general environment that you operate in."

While much of the broader discussion around ESG focuses on risks, it's just as important to focus on the opportunities, Combs adds. As an example, consider that women and minorities form small businesses at faster rates than white men do; these groups have historically faced more challenges accessing the capital needed to grow their businesses. That represents both a matter of social equity, in terms of wealth-building for marginalized groups, as well as a business opportunity.

"Are you going to be there as a bank to help grow them to the next generation?" Combs says. "If you're not open to at least monitoring the social trends, then you're at risk of missing some key business areas."

Do you believe that it's important for financial institutions to comprehensively measure and understand where they stand on ESG?



- Yes, I believe this is important for all financial institutions
- It's important for publicly traded entities and mission-oriented banks, but not all financial institutions
- No, I think ESG is a waste of time

45%

say the board doesn't discuss or oversee ESG

About the Survey

Bank Director's 2022 Governance Best Practices Survey, sponsored by Bryan Cave Leighton Paisner, surveyed 234 independent directors, chairs and chief executives of U.S. banks below $100 billion in assets, with the majority of respondents representing regional and community banks. The survey regularly explores the fundamentals of board performance, and this year examined board culture, committee structure, and how ESG is governed in the boardroom, along with practices such as evaluations and training that help boards improve their performance. The survey was conducted in February and March 2022.

Questions About Our Research?

Contact Bank Director's research team at research@bankdirector.com if you'd like to know more about Bank Director's surveys and other research initiatives.

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