Community banker December 2008

Digging Deeper Into Corporate Governance

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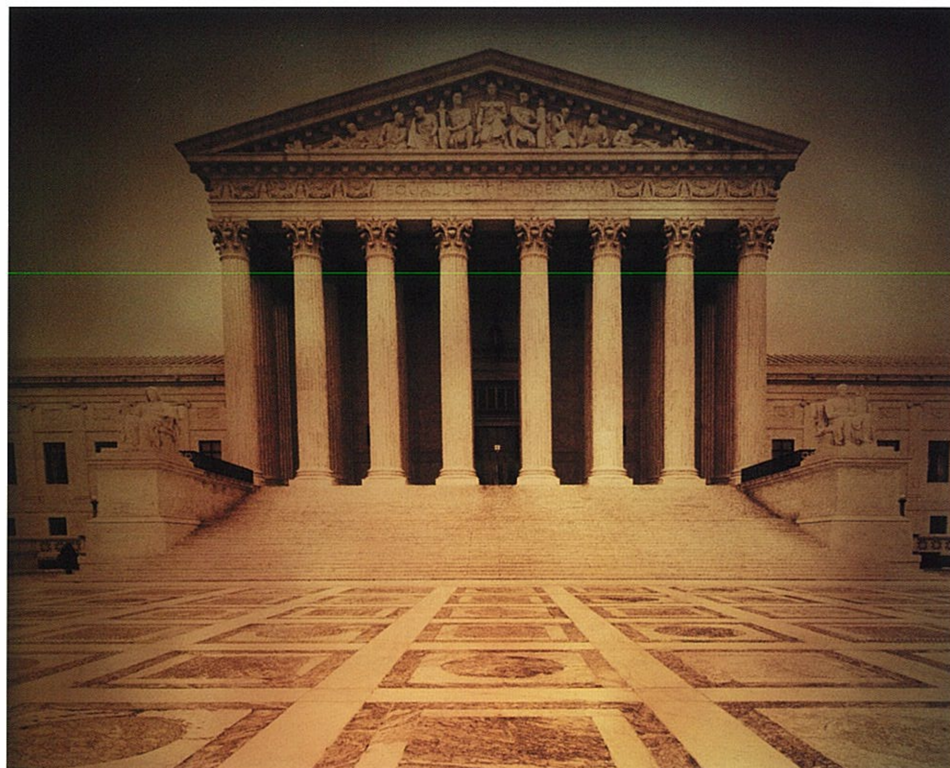


Corporate governance is at the forefront once again. Pundits and government officials are asking how proper governance processes could have resulted in the decisions of financial entities that contributed to the current economic crisis. The government investigations of Fannie Mae and Freddie Mac reportedly include corporate governance matters. The executive compensation provisions of Treasury's TARP Capital Purchase Program prescribe new requirements for compensation committees.

This resurgence of corporate governance is not a time for boards and management to merely dust off the rudiments of corporate governance found in the legal and fiduciary duties of bank directors and officers under state and federal laws and regulations, including the Sarbanes-Oxley requirements, and the written governance polices and charters of the financial institution or holding company. Good corporate governance is dynamic, not static. Though driven significantly by legal and regulatory concerns, corporate governance requires real-life implementation as well.

Corporate governance is the creation and maintenance of structures, procedures and relationships to provide appropriate oversight of a bank's operations and to enhance accountability, profitability and ethical conduct. When addressing corporate governance needs and concerns, boards of directors need to use good common and business sense. It is easy to forget that at the core of corporate governance is operating a healthy and profitable bank.

Corporate governance is about running a successful business. The decisions made and actions taken within a well-constituted corporate governance structure must still make business sense. Not only must the corporate governance structures of banks produce good business decisions, but they also must explore preventative and curative measures to employ if errors or economic downturns occur. The appropriate analysis of risks and the creation of procedures when things go wrong are critical for survival.

To address this aspect of corporate governance, a board must understand the essentials of the bank's business. No new areas of business should be pursued prior to adequate education of the directors on the new activity and its attendant risks. In addition, appropriate policies, procedures and review systems must be in place before the bank engages in the new activity. Directors must spend appropriate time on the aspects of the bank's operations that contribute most to income or that involve the highest risks. Business contingency planning is not limited to management succession or information technology.

The recent mortgage and housing crisis could be viewed as an example of corporate governance gone wrong. History shows the cyclical booms and busts in housing prices and economic conditions. The many years of record housing prices and expanded home ownership had to come to an end. The innovative and aggressive mortgage practices that fueled this boom placed borrowers and banks in greater jeopardy when the inevitable housing decline occurred. Recent events demonstrate the actual depth of the negative impact of this decline.

All boards should consider whether they spent any time contemplating the implications of a housing or economic decline on their banks' operations and condition. During strategic and business planning, did the

board receive input about the downside of economic projections and create contingency plans for that inevitable downturn? Were changes in operations or contingency plans implemented at the first sign of the current economic and housing decline? Though the full extent of this current decline may not have been projected, some preplanning may have lessened its negative impact.

Directors, acting independently, must take a dominant role in an entity's corporate governance. The task of formulating an entity's corporate governance procedures and attitudes must come from the board of directors. An integral goal of corporate governance is appropriate oversight of the entity's business. If the board leaves the formulation of the corporate governance environment to management and limits its role to just approving that formulation, the oversight role is defined by those who are being reviewed. The board members should have varied backgrounds and expertise to expand the scope of the board's oversight function.

The relationship between the board and senior management is particularly critical to maintaining good corporate governance. Corporate governance involves a healthy balance of honesty and trust with accountability and skepticism. Board members must be sensitive to the type of information that indicates increased risks or negative trends that warrant further attention. Directors must remember to ask questions, be wary of jargon answers, admit they do not understand, and seek multiple sources of information – including from outside consultants.

Regular evaluation of the board's independence is critical to successful corporate governance. Outside directors must meet alone in executive session and encourage all attendees, including the more introverted, to participate in frank discussion of the what-ifs of business matters under the board's consideration and review. Compliance officers, internal auditors, external auditors and, if deemed necessary, lawyers or consultants hired for the board should be invited to these executive sessions.

A board and management team serving together for a number of years naturally develop friendship, loyalty, cooperation and trust, possibly leading to less independent and critical evaluation by the board. Outside directors need to consider ways to minimize that trend, including considering term limits of directors, rotating directors' service on board committees, or seeking independent review of significant proposals.

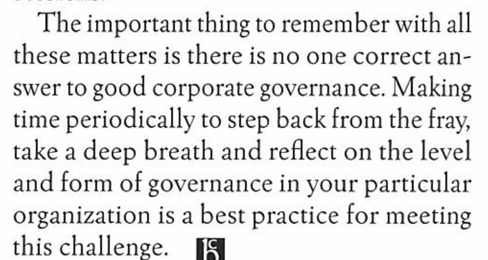
Board packages and meetings must be meaningful, informative and deliberative. Preparation of the agenda and information provided to directors for an upcoming meeting is a critical component of corporate governance. This involves careful consideration and determination of those matters that are the board's direct responsibility and those that are subject to board oversight. For any oversight function to be effective, the board of directors must receive appropriate information.

Board meetings should focus on matters requiring board action or reflection and not be wasted on reports of less significant matters that can be communicated at another time. The board package must contain the right amount and type of information and should be provided to members with enough time allowed for adequate review and consideration. Too much information provided in a disorganized fashion creates confusion and reduces critical evaluation. Too little information promotes bad decision-making. Financial information must be presented in a meaningful fashion, focusing on the matters the board regularly reviews. While no particular format or medium is required, a hard copy enables directors to refer to the materials and their notes while in attendance at the board meeting.

Directors should ask questions about the materials in the package prior to the meeting to highlight areas requiring additional discussion or disclosure at or before the meeting. All board members should come prepared and bring their hard copy of the package to the meeting. Meeting time should not be wasted on oral presentations summarizing or reading the contents of the package.

Maintain a balanced approach to oversight. Excessive board oversight is as dangerous as a lack of independent and critical oversight. Directors must avoid inserting themselves into the day-to-day operations of their financial institution or holding company out of fear of second-guessing by regulators or shareholders. This requires a careful consideration of the appropriate balance between oversight and interference. Directors and officers should be encouraged to openly discuss their concerns in this regard, and how to balance these two concerns might be discussed in annual strategic-planning sessions.

The important thing to remember with all these matters is there is no one correct answer to good corporate governance. Making time periodically to step back from the fray, take a deep breath and reflect on the level and form of governance in your particular organization is a best practice for meeting this challenge.



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