LOOKING IN THE MIRROR: CONDUCTING AN EFFECTIVE BOARD SELF-ASSESSMENT

OTS "HOW TO CONDUCT
A SELF-ASSESSMENT"
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BOARD SELF-ASSESSMENT   Setting the Tone

Self-assessment is an important and useful tool to improve the effectiveness and efficiency of a Board of Directors.

You are wasting your time if you are attending this conference because you think OTS will look favorably on you or your Board, or if you have conducted or plan to conduct Board self-assessment only in order to meet regulatory expectations. If self-assessment is viewed as just another regulatory requirement, you will not end up with the kind of robust review, dialogue and action plans that can make Board self-assessment something that adds value to your company and enhances your role as a director. The self-assessment process must address the views of all your constituencies, including your local community, shareholders, regulators, your employees and the members of the Board itself.

The tone of an assessment is critical to its success. If the tone of the self-assessment process is critical or negative, that will discourage meaningful participation and appropriate review. The self-assessment process is not the same as the review of directors in a regulatory examination. The focus of self-assessment is a review of Board effectiveness and value that should not start with a negative assumption of weakness. Rather, the process involves revisiting the Board's function and responsibilities to determine how the Board's input is most beneficial to the company. Self-assessment is a process to enhance board performance not judge performance.

The effectiveness of the Board is critical to the value and strength of a financial institution and its holding company. This kind of review should not be left to the regulatory examination process. Self-assessment assists directors seeking to improve the efficient and effective use of their time and skills through individual and group self-reflection.

The Board can examine its performance against standards of best corporate practices. The following are some areas usually addressed in corporate governance guidelines and best practices:

- Responsibilities and accountability of the Board
- Board terms
- Director independence
- Board structure and organization
- How the board functions
- Board committees
- Responsibilities and skill sets of individual directors
- Director involvement
- Director expertise
- Director integrity
- Board oversight
- Standards of performance

In order to build on this approach to self-assessment concept, I am going to review aspects of the who, what, when, where, how and why of Board self-assessment in order to give each of you the tools to formulate a self-assessment process that works best for you, your fellow directors, your Boards and Board committees and your companies.

WHY Conduct a Board Self-Assessment ?

The answer lies in some of the corporate problems just in the financial services industry over the last two years. Some of the biggest, most sophisticated financial institutions (with , we presume, well-qualified and well-equipped Boards) failed miserably on a number of levels. Both in these recent problems and in the corporate scandals that gave birth to Sarbanes-Oxley, a number of questions arise -- Where was the Board? Where was the Board's oversight function? Could more effective Board actions have prevented these problems?

Over the last 20 years, Boards of Directors, especially of public companies and financial institutions, have been under increasing pressure to enhance performance and corporate governance. Directors are held to a higher degree of accountability by Congress, regulators, shareholders and the general public. In recent surveys, about 30% of directors of public companies believe that Boards have been effective in meeting this new demand. An increasing percentage of these Boards consider self-assessment to be an important part of improving effectiveness.

Properly conducted assessments can promote civility and collegiality among Board members, if exchanges and reviews in the process are constructive and positive in tone. If the assessment is conducted at the bare minimum to satisfy regulators or shareholders or is too full-blown so as to distract the Board from its primary tasks, it would have been better not to have conducted the process at all. In either case, the results of the assessment will be of little use, and directors will lose interest in the process in the future. Poorly conducted assessments can be risky for they can erode credibility and working relationships among the directors.

Carefully planned assessments that work towards more effective and efficient Board functioning, especially in the areas determined by the directors to need retooling, will encourage better participation in the process over time. Directors are given the opportunity to step back from the grind of its responsibilities to determine and review as a group how to hone how it meets its responsibilities. Board members will be encouraged to participate in assessments if they see that their time is well spent. The assessment process can help the Board decide where to focus its recruitment and training efforts and how to streamline the time each director spends acting as a director, while improving the value that service brings to the company. It helps to reinforce the roles and responsibilities of the Board, highlighting what areas need to be prioritized or enhanced. Board self-assessment is a good partner to the strategic planning process.

Critics of the Board self-assessment process raise concerns about potential litigation or regulatory risks and the negative impact of individual director performance reviews. As to the first issue, I believe the concern is overstated. If a Board has a record of self reflection, identification of areas of improvement and actions to implement improvements, it shows a pattern of careful attention that will likely reduce regulatory criticism and litigation risk. A Board self-assessment will not be the cause of your regulatory or litigation problems. These problems will result from the Board's failure to conduct its responsibilities in an appropriate fashion. The self-assessment process could actually reduce these regulatory and litigation risks. Though these reviews are not privileged, courts generally have not found them to be probative in litigation and often shield them in discovery. Just about every other area of a financial institution's operations is subject to internal audit review and productive internal audits with follow-up actions that reduce regulatory risk in the examination process. That applies to Board self-assessment as well. Documentation of these issues does not have to consist of detailed criticisms and, for self-assessment to be complete, follow-up is mandatory. Also, the process should not create a report of evidence of failure or poor performance; should avoid numeric or check the box grading; should use short record retention periods; and should not take a negative tone.

As to the second issue, I do not believe that Board self-assessment should involve performance reviews of individual directors. The purpose of the review is to evaluate the Board's functioning as a whole. Though, as discussed below, the human interaction among directors and skill sets of each director impacts that functioning, individual critiques of directors in a group assessment are a sure path to ill will that will undermine the directors' ability to work together. An open self-assessment forum is not the place or process for critiquing individual directors.

WHO Should Lead the Self-Assessment and Who Is It For ?

The most important element of a Board self-assessment process is that it must be the product of the directors, particularly the independent directors. If management plans the process, the review will likely miss areas of special concern or interest to outside directors. Though the Board's relationship and interaction with management, and even all employees, may be an interesting matter to consider in a self-assessment, the process must be directed by the directors.

Though a small group of directors may conduct most of the organization of the process, every director must be involved in the planning, conduct and follow-up stages of the process. Each director should have a meaningful opportunity to discuss their views on the areas identified for review and on the follow-up conclusions and action plans.

This interaction in the self-assessment is an opportunity to improve team building. This can include work with personality and leadership tests, such as the Myers-Briggs Type Indicator, which measure how individuals think and communicate. Knowledge of these personality characteristics can assist Boards in improving interaction at meetings and reaching consensus.

Though directors should lead the process, the use of a third party facilitator can be fruitful. Candor and focus often increases with a neutral third party acting as an interviewer and moderator in the process. Guest presenters may be appropriate to provide expertise on certain areas being reviewed. The appropriate type of facilitator or presenter depends in part on the topics to be covered in the assessment.

WHEN Should a Board Conduct a Self-Assessment ?

NYSE listed companies are required to conduct a self-evaluation at least annually. OTS recommends that board self-assessments be conducted periodically.

Absent the formal NYSE requirement, Boards of Directors should decide for themselves the most appropriate timeframe for conducting assessments of the effectiveness of the Board and its committees. Self-assessments should not be conducted annually if there are no issues requiring review. Regular assessments every 18 to 24 months, rather than every 12 months, may be more appropriate. If an assessment is conducted just to do it once a year when there are no real issues to address, the directors might lose enthusiasm for conducting future assessments.

The formulation, oversight and direction of the strategic plan of a company are an important task of the Board of Directors. The strategic planning sessions conducted by the Board may be an appropriate time to conduct the Board's regular self-assessment.

Self-assessment does not necessarily have to be conducted all at one session. Each Board needs to consider how best to schedule its self review. For example, time might be allocated at one Board or committee meeting a quarter to conduct a portion of the self-assessment. Regular executive sessions of the independent members of the Board could be used to address certain Board assessment issues.

On an ongoing basis, each director should feel free and be encouraged to raise any issues and concerns about the Board's or its committees' effectiveness.

WHERE Should a Board Self-Assessment Be Conducted ?

The decision about where to conduct a self-assessment will depend on whether the Board wants a one-time event on a regular basis or splits the function out over time. It is critical that the location and structure encourage director participation. Because the effectiveness of the Board depends on good communication, the self-assessment process should be conducted, at least in part, at an off-site location. A session could be held at a local location with a meal or even at an overnight location. Combining the self-assessment with some social or leisure activities can enhance the process and improve communications going forward.

WHAT Topics or Issues Are Useful in a Board Self-Assessment ?

A list of topics or matters that can be included in the self-assessment process is on the next page. Obviously, the directors and other planners of the process will have to determine which ones to include in each assessment session. Certain topics may be addressed on a regular basis and others may be included on an as-needed basis. Only three to five issues should be included in any one assessment session.

Board Composition

- Expertise and skill sets of directors
- Independence and conflicts of interests
- Role of Chairman
- Training members
- Election and terms of service
- Effectiveness of structure and operations
- Workload

Board information

- Meeting agenda -- use time efficiently
- Executive officer attendance
- Board packages
- Access to useful and necessary information
- Quality and timeliness of data
- Overload -- too little
- Industry economic trends
- Access to management
- Access to "outsiders" -- annual auditors and others
- Minutes

Regular business

- Consider effectiveness of performance of regular duties
- CEO evaluation
- Fiscal management
- Risk management
- Strategic planning
- Vision
- Executive compensation
- Competition and trends

Meetings

- Open communication
- Meaningful participation
- Timely action
- Executive sessions

Board Interaction

- Personal dynamics - personality and leadership qualities
- How Board works as a team and team building
- How Board works with the CEO and senior management
- Relationship with employees
- Board conduct and interaction at regular meetings

Board Accountability

- Prepared
- Understanding
- Proper forums and delegation
- Use of compliance/audit personnel
- Follow-up
- Control over agenda
- Effectiveness of structure and operations
- Board responsibility -- are we meeting them?
- Board role in regulatory examinations

Committees

- Similar review
- Charters
- Help to Board
- Who participates - just committee members or full Board
- Role of committees
- Workload

Other

- Fair and adequate compensation
- Gaps in knowledge
- Succession on Board
- Board benefits
- Industry issues
- Trends in financial services

HOW Does A Board Plan and Conduct a Self-Assessment ?

Planning a self-assessment session is a time for creativity. Shake up the format, agenda and location to keep it interesting.

Self-assessment sessions should take on a different tone than regular board meetings. Though the purpose is important, you can still be light and have some fun. That kind of approach will enhance the assessment and the quality and degree of engagement among the directors going forward.

Good self-assessment must be meaningful, practical and engaging. It should be a robust process imbued with freedom for self evaluation and enthusiastic support. Though the tone of assessment should not be negative, self-assessment needs to be a hard, honest look at the Board and not merely a validation of existing practices.

If poorly designed, the process can damage the Board's dynamic, communication and credibility. If well-designed, the process can improve the Board's function and value to the company; while at the same time reduce the directors' exposure to potential liability.

Self-assessment requires careful planning, good organization and useful follow through. If a Board is planning its first self-assessment session, the first thing to focus on is an implementation plan that will work for that session and future sessions.

OUTLINE OF AN IMPLEMENTATION PLAN FOR BOARD SELF-ASSESSMENT

A. Preliminary Matters

- Assess Board readiness to commit to the process.
  - Directors must buy in or it will not work
  - Consider benefits and risks of process
  - Discuss misgivings of any directors
  - Resolve uncertainties with guidelines
- Adopt Corporate Governance Guidelines
  - Use them to set tone for the assessment process
- Goals of the Process
  - Ensuring effective and efficient Board actions
  - Encourage an air of trust and openness -- open discussion
  - Establish accountability in actions and process

B. Organizers

- All directors must participate in planning
  - Initial discussion without management and then with the full board
  - All directors should give input on topics
- Choose primary organizers
  - Small rotating group, so different directors organize the sessions each year
  - Steering committee
- Set goals, objectives and assessment criteria
- Decide confidentiality and documentation of process

C. Logistics

- Budget
- Place
- Time -- one to one and a half days -- no more than 5 hours in one day

D. Topics

- Each director must provide input
  - Directors' suggestions – not management or consultant driven
- Pick topics and issues –
  - Essential
  - Recommended
  - What adds to value of organization
  - Ones that will generate good discussion

E. Participants

- Who participates -- who sees results
- Evaluator/speakers/counsel
- Directors only
- Management and Executives
- Committee – just committee or full Board

F. Data Collection

- Data gathering
  - Qualitative and quantitative
  - Questionnaires
  - Interviews

- Group discussion
- Facilitator

G. Agenda

- Set agenda
  - Mix business and "down" time
  - Be mindful of time allotments

H. Conduct Sessions

- Conduct meeting

I. Follow Through

- Record of issues raised
  - Make a decision or action plan for each one
- Action plan of feedback and discussions
- Session and follow-up evaluation

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Digging Deeper Into Corporate Governance

By Marianne Roche

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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The opinions expressed in this article are solely those of the author and should not be relied upon as legal advice. For legal advice about corporate governance, please contact legal counsel.