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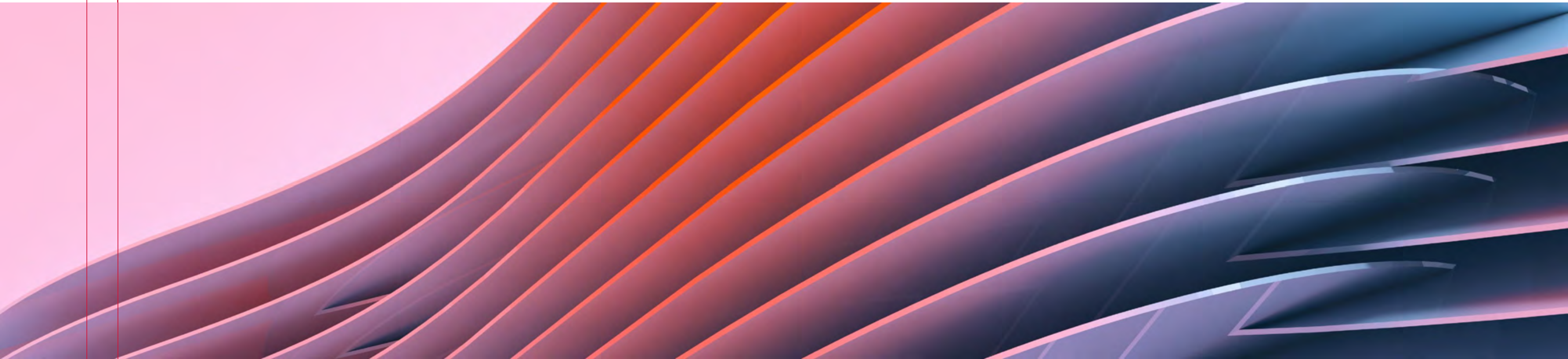
Strategic Planning and Governance: *Getting it Right in Today's Banking Environment*

PACB Pennsylvania Association of Community Bankers
CONVENTION 2024
September 19-21
The Homestead
Hot Springs, VA

September 19, 2024



OVERVIEW

- Effective ***strategic planning*** is important because it allows an institution to:
  - Set a direction and provide objectives and goals to assess progress
  - Be proactive by understanding opportunities and threats over both a short-term and long-term horizon
  - Better increase operational efficiencies, market share, profitability and overall sustainability

- Having a strategic plan alone is ***not sufficient*** — an institution's Board of Directors and executive management team must be *committed to implementing the strategy* and must *be open to change*

OVERVIEW

- Strong ***corporate governance*** — including effective succession planning and Board refreshment — can help an institution be well-positioned to implement and capitalize on its strategic plan and ***remain independent in the long run***

- Succession planning and Board refreshment challenges have been, and continue to be, an indicator that a Board of Directors may ultimately decide to pursue a sale of the bank

OVERVIEW

- Effective corporate governance practices with respect to succession planning and Board refreshment can facilitate strategic planning and the continued success of the institution:

STRATEGIC PLANNING

INTRODUCTION

- ***Strategic Planning*** is the process of defining an institution's strategies and making decisions and allocating resources towards the pursuit of these strategies
- An institution's strategic planning process should be overseen by the Board of Directors and should be reflected in a written strategic plan
- The strategic planning process should be consistent with the institution's risk appetite, capital plan and liquidity needs
- An effective governance structure is essential in implementing strategic planning and minimizing strategic risk

STRATEGIC PLANNING PROCESS

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

1. **Where are we now?**
   - Requires an evaluation of the bank’s internal and external environment and its strengths, weaknesses, opportunities and threats

2. **Where do we want to be?**
   - Requires forward-looking consideration of the bank’s missions, goals and objectives

STRATEGIC PLANNING PROCESS

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

3. **How do we get there?**
   - A strategic plan should be designed to achieve the bank's goals and objectives
   - An effective plan should be tailored to a bank's internal capabilities and business environment and be based on realistic assumptions

4. **How do we measure our progress?**
   - Requires regular measurement and reporting on bank objectives and achievements

STRATEGIC PLANNING PROCESS

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

STRATEGIC PLANNING PROCESS

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

STRATEGIC PLANNING PROCESS

- The absence of appropriate governance in an institution’s decision-making process can have significant negative consequences including:
  - Missed business opportunities
  - Financial losses or inadequate capital levels
  - Adverse regulatory treatment (civil money penalties, enforcement actions, etc.)

STRATEGIC PLANNING RESPONSIBILITY

- An institution's Board of Directors is responsible for establishing the bank's strategic focus and goals
  - However, in its 2023 Governance Best Practices Survey, Bank Director reported that only **33%** of directors surveyed responded that their Board was "very effective" at setting the bank's strategy
- The Board of Directors must ensure that the institution has the following components in place to carry out its strategic plan:
  - Qualified and capable personnel
  - Financial strength and support
  - Technological and operational capabilities

- *Source: Bank Director 2023 Governance Best Practices Survey*

STRATEGIC PLANNING IMPLEMENTATION

- Management is responsible for implementing an institution's strategic plan and should:
  - Develop policies and processes to guide the execution of the strategic planning process
  - Monitor the implementation of the strategic plan
  - Track outcomes, performance metrics and risk indicators against established targets and limits

STRATEGIC PLANNING CHALLENGES

- Strategic planning – and the management of strategic risk – does not exist in a vacuum
- In the last five years alone, significant national and global events have exasperated strategic planning efforts:
  - 2023 bank failures
  - COVID-19
  - Social unrest
  - 2020 Presidential election (with November 2024 on the horizon)
- Boards have been faced with these unprecedented obstacles while managing strategic oversight

STRATEGIC PLANNING CHALLENGES

- Current strategic planning challenges facing institutions include:
  - Succession planning
  - Board refreshment and attracting/retaining Board members
  - Accurate self-assessments of Board of Directors and measurement of progress towards strategic goals

- Each of these challenges can be addressed through effective ***corporate governance*** measures, which reduce an institution’s overall strategic risk

SUCCESSION PLANNING

EXECUTIVE SUCCESSION PLANNING

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

EXECUTIVE SUCCESSION PLANNING

- An effective succession planning policy should:
  - Identify potential employees capable of advancement (or rapid advancement) to positions of higher responsibility than they presently occupy
  - Ensure the systematic and long-term development of individuals to replace key job incumbents as the need arises due to deaths, disability, retirement, scandal and other losses (expected or unexpected)
  - Provide a continuous flow of talented individuals to meet the institution’s management needs
  - Promote discussion of the circumstances under which it is appropriate to look outside the institution (rapid growth, troubled condition, etc.)

EXECUTIVE SUCCESSION PLANNING

- Compensation and benefits reviews are also necessary as part of the succession planning process
- Large gaps in compensation between management positions can be uncomfortable for the Board
- Temporary compensation for interim positions should be considered
- A complete understanding of employment contracts and other compensation arrangements is important for both executives and the Board

EXECUTIVE SUCCESSION PLANNING

- The key executive officers covered by financial institution executive succession plans are the:
  - Chief Executive Officer
  - Chief Financial Officer
  - Chief Operating Officer
  - Chief Lending Officer
  - Chief Retail Officer
  - Chief Risk Officer
  - Chief Information Technology Officer

EXECUTIVE SUCCESSION PLANNING

- Obstacles to ***addressing*** succession planning include:
  - Comfort with the past
  - Management sensitivity
  - Management reluctance
  - More pressing issues for the Board and management
  - Lack of clarity/focus by the Board and management
  - Fear of internal competition
  - Fear of employee dissatisfaction and turnover

EXECUTIVE SUCCESSION PLANNING

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

EXECUTIVE SUCCESSION PLANNING

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

EXECUTIVE SUCCESSION PLANNING

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

EXECUTIVE SUCCESSION PLANNING

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

EXECUTIVE SUCCESSION PLANNING

- When evaluating candidates eligible to succeed key executive positions, the Board of Directors should consider the following ***core competencies*** an individual possesses:
  - Contributions to the range of talent, skill and expertise appropriate for management as needs dictate
  - Financial, regulatory and business experience and knowledge of the banking industry
  - Familiarity with the institution's market area and participation in and ties to local businesses and local civic and charitable organizations
  - Personal and professional integrity, honesty and reputation

EXECUTIVE SUCCESSION PLANNING

- When evaluating candidates eligible to succeed key executive positions, the Board of Directors should consider the following ***core competencies*** an individual possesses:
  - Diverse perspective and background
  - Temperament, charisma and attitude to manage, motivate and attract employees and act as a public face of the institution (i.e., the ability manage managers)
  - Ability to represent the institution’s best interests and devote sufficient time and energy to the performance of his or her duties
  - Interest in moving to a new position (don’t take for granted)

EXECUTIVE SUCCESSION PLANNING

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

BOARD SUCCESSION PLANNING

- Director succession planning is also a critical strategic governance tool, particularly in light of increased calls for Board refreshment and diversity
- However, in its 2023 Governance Best Practices Survey, Bank Director reported that:
  - Only **33%** of directors reported that their Board has three or more directors who are 55 or younger
  - **20%** of directors reported that their Board has not appointed a new director since January 2020
  - **34%** of directors reported that their Board does not cultivate an active pool of candidates for Board membership
- It is important for directors to have an understanding of – and input on – what the next generation of the Board will look like
- *Source: Bank Director 2023 Governance Best Practices Survey*

BOARD SUCCESSION PLANNING

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

BOARD REFRESHMENT

ROLE OF THE BOARD OF DIRECTORS

- The Board of Directors plays a significant and central oversight role in an institution's operations, governance and risk management
- The role of the Board of Directors is to oversee the bank's activities, provide credible challenges to management and hold management accountable
- The Board of Directors must ensure that the institution has the following components in place to carry out its strategic plan:
  - Qualified and capable personnel
  - Financial strength and support
  - Technological and operational capabilities

ROLE OF THE BOARD OF DIRECTORS

- The Board of Directors of a community bank has specific oversight authority with respect to:
  - Strategic planning
  - Capital planning
  - Operational planning (information technology, information security)
  - Recovery planning (disaster recovery, business continuity)
  - Risk governance (risk culture, risk appetite and risk management)

BOARD REFRESHMENT

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

BOARD REFRESHMENT

- In recent years, directors themselves have reported dissatisfaction with peers and have indicated that Board refreshment is needed
- In its 2023 annual survey of corporate directors, PwC reported that:
  - **45%** of directors indicated at least <u>one</u> fellow board member should be replaced
  - **18%** of directors indicated at least <u>two</u> fellow board members should be replaced

- *Source: PricewaterhouseCoopers 2023 Annual Corporate Directors Survey*

BOARD REFRESHMENT

- In addition to concerns from directors, recent survey results show that members of executive management also see the need to address Board refreshment
- In an April 2024 survey of C-Suite executives, PwC reported that while 8 in 10 executives say Board members understand corporate strategy:
  - **92%** of *all executives* surveyed indicated one or more Board members should be replaced
  - **62%** of *CEOs* surveyed indicated one or more Board members should be replaced (up from 39% in 2022)
  - Only **30%** of *all executives* surveyed rated their Board's overall performance as "excellent" or "good"

- *Source: PricewaterhouseCoopers, Board Effectiveness: A Survey of the C-Suite (2024)*

BOARD REFRESHMENT

- Challenges to Board refreshment include:
  - A reluctance to have difficult conversations with long-time and/or respected peers
  - An ineffective Board self-assessment process
- To make real change in this area, Boards must have open and honest communication about director expectations and contributions
- The COVID-19 pandemic provided a unique opportunity to assess director contributions, adaptability and technological skills/shortcomings

BOARD REFRESHMENT

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

BOARD DIVERSITY

- Board diversity also continues to be a key area of focus for directors and corporate stakeholders
- In addition to outside influences, surveyed directors strongly agree that Board diversity has significant benefits:
  - **93%** say diversity brings unique perspectives to the Board room
  - **84%** say diversity improves relationships with investors
  - **82%** say diversity enhances Board performance
  - **72%** say diversity enhances corporate performance
- Of those surveyed, **55%** also believe Board diversity has become politicized

- *Source: PricewaterhouseCoopers 2023 Annual Corporate Directors Survey*

BOARD DIVERSITY

- To improve Board diversity, institutions should:
  - Consider individuals with diverse perspectives and backgrounds when evaluating candidates needed to address a missing specific skill set on the Board
  - Assess the institution's community demographics when appointing a new director to replace a current Board member or to fill a vacancy resulting from an increase in Board size
  - Communicate with local businesses, civic organizations, business schools or other community organizations to expand the Board's current networking pool
  - Consult with organizations, if need be, that focus on the placement of diverse individuals on Bank boards

ATTRACTING AND RETAINING BOARD MEMBERS

RECRUITING AND MAINTAINING A STRONG BOARD

- Given the changing dynamics of the banking environment, the Board of Directors collectively — and each member individually — plays an important role in the overall success of a community bank
  - As a result, it is critical to attract and retain strong and qualified Board members to oversee the institution's operations
  - It is also important for community banks to think carefully — and regularly — about the ways they recruit and retain qualified and effective directors

ATTRACTING NEW DIRECTORS

- When it comes to recruiting new Board members, there is no ideal candidate profile for a community bank director
  – Diversity of background, perspectives and opinions among directors can enhance the overall strength of the Board
- Board recruitment should be institution specific, and potential new Board members should be considered in the context of the bank's strategic objectives, needs and culture
  – A new director's personal experience, education and other attributes should also be considered in light of the bank's existing Board composition and director skill set (and any gaps in that skill set)

CHALLENGES IN BOARD RECRUITMENT

- It has become increasingly difficult to recruit outside community bank directors in recent years
- The Federal Reserve and other regulators have identified certain areas where an individual's personal or business experience will prevent the individual from serving as a bank director:
  - Issues regarding an individual's integrity, financial responsibility or competence — or that raise doubt about the individual's ability to fulfill his or her duties as a director — have been viewed more carefully by regulators

CHALLENGES IN BOARD RECRUITMENT

- Federal and state regulators have placed a renewed emphasis on director character and fitness — both for new and existing Board members — in light of recent bank failures earlier this year
  - Regulators are sometimes requiring potential and/or existing Board members to submit comprehensive biographical and financial information in connection with a new director's appointment or a proposed change in the bank's operations (e.g., an acquisition, holding company formation or charter conversion)
  - In some instances, background checks have extended to matters involving an outside director's employer or family members
  - Some prospective and existing directors may become increasingly uncomfortable sharing personal and financial information in connection with their proposed or continued Board service

CHALLENGES IN BOARD RECRUITMENT

- To overcome Board recruitment challenges, Boards may have to spend more time emphasizing:
  - The bank's strategic direction and culture
  - The particular ways in which a potential director can contribute
  - The anticipated benefits of serving on the bank's Board of Directors (e.g., director compensation, strategic objectives, etc.)
- To provide potential director candidates with more comprehensive information about the institution, some community banks have entered into non-disclosure agreements with potential board members
  - This promotes open dialogue and allows Boards and director candidates to make informed decisions

EVALUATING NEW DIRECTORS

- When considering potential new directors, the Board should evaluate an individual's ***personal characteristics*** and ***experience and education***

PERSONAL CHARACTERISTICS

- Honesty and Integrity
- Engagement and Commitment
- Analytical and Communication Skills

EXPERIENCE AND EDUCATION

- Business Experience
- Community Relationships
- Banking Knowledge and Expertise

EVALUATING NEW DIRECTORS

- Boards should also focus on the following additional factors in considering potential director candidates:

CAPACITY TO SERVE

- Ability to Learn the Business
- Time to Devote to Board Responsibilities
- Desire to Pursue Professional Development

OTHER FACTORS

- Independence from Management
- Ability to Fill Gaps in Board Knowledge/Skills
- Promotes and Furthers Diversity
- Willingness/Ability to Invest in Bank Stock (if applicable)

RETAINING EFFECTIVE DIRECTORS

- Community bank boards should also focus on retention efforts for new directors and continuing qualified and effective directors
  - Retention efforts should begin shortly after a new director joins the Board and should continue over the course of a director’s term of service with the bank
- Effective retention efforts should emphasize:
  - New director **orientation**
  - The institution’s **culture and atmosphere**
  - Director **education and training**
  - Director **compensation**

NEW DIRECTOR ORIENTATION

- An effective director orientation program should be designed in proportion to the size and complexity of the bank and may include:
  - Individual meetings with other directors and/or executive management
  - Introductions to outside counsel, external auditors and other key third parties
  - Copies of the bank's governance documents, policies and procedures
  - Access to confidential Board materials that could not be provided during the director interview process (e.g., exam reports, strategic plan, capital plan, etc.)
  - Instructional sessions on technology utilized by directors in preparation for — and/or during — Board meetings (e.g., online Board portals, etc.)

BANK CULTURE AND ATMOSPHERE

- A strong bank culture helps promote director retention and should include:
  - An understanding of the Board’s oversight — and not management — role
  - Transparency among the Board, its committees and management
  - Timely receipt of sufficient Board materials to enable directors to make informed decisions
  - Respectful and open dialogue among Board members
  - Respect and acknowledgment of a director’s outside commitments
  - Appreciation of a director’s contributions, time commitment and input

DIRECTOR EDUCATION AND TRAINING

- To succeed, Board members should have sufficient knowledge of the banking industry and should receive ongoing director education and training
- An effective continuing director education program may consist of:
  - Direct training/educational sessions as part of regular Board meetings
  - Periodic Board retreats or special meetings designed to facilitate strategic planning and/or operational objectives
  - Access to third party training materials and/or industry publications
  - Attendance at industry conferences (or after-the-fact reports from management representatives in attendance)

DIRECTOR COMPENSATION

- Compensating Board members — to recognize their commitment and contributions to the institution — is also an important element of director retention
- Board compensation should be tailored to the size and complexity of the institution and should include:
  - Board retainers and meeting fees
  - Committee compensation (including Committee Chair fees)
  - Equity compensation (if applicable)

BOARD AND INSTITUTION SELF-ASSESSMENTS

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BOARD SELF-ASSESSMENTS

- Board self-assessments remain a critical tool in improving the Board’s overall performance and furthering an institution’s strategic objectives
- Boards should regularly (at least annually) undertake some form of self-assessment
- A meaningful self-assessment should evaluate:
  - The Board’s effectiveness and functionality
  - Board committee operations
  - Directors’ skills and expertise

BOARD SELF-ASSESSMENTS

- Board self-assessments affirm the “tone at the top” and help further an institution’s corporate culture and governance by:
  - Acknowledging the Board holds itself responsible for its performance
  - Emphasizing personal integrity and accountability even at the top of the organizational chart
  - Setting an example for directors’ and managements’ expectations for employee behavior

BOARD SELF-ASSESSMENTS

- Board self-assessments can take a variety of forms, including:
  - Individual written questionnaires
  - Group discussions and assessments
  - Formal interviews with each director
  - Peer evaluations
  - A combination of the above
- The most important goal is to create a process that results in *honest* and *thoughtful* director feedback

BOARD SELF-ASSESSMENTS

- Self-assessments should be tailored to an institution’s individual Board dynamics
  - For some Boards, it may be best to provide a self-assessment process that allows for anonymous director feedback
  - For more tech-savvy Boards, online or electronic self-assessment measures may be the preferred method
- In some circumstances, it may be beneficial to work with a third party – such as legal counsel or a Board consultant– to administer self-assessments and provide feedback to directors

BOARD SELF-ASSESSMENTS

- An effective self-assessment should address the following factors:
  - Director qualifications
  - The overall skill set of the Board and perceived gaps in collective Board expertise (e.g., technology/cybersecurity)
  - Level of director participation
  - Frequency of Board meetings
  - Quality of Board meetings and discussions (including whether a small group of directors dominates discussions)
  - Quality and timeliness of Board materials

BOARD SELF-ASSESSMENTS

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

BOARD SELF-ASSESSMENTS

- A critical component of any Board self-assessment is to address items identified to improve performance
- Self-assessments used to be "check the box" exercises but are now taken much more seriously
  - Many public companies disclose their Board self-assessment process in their annual proxy statements
- In its 2023 annual survey of corporate directors, PwC reported that:
  - **61%** of directors indicated that their Board made changes as a result of their self-assessment process (up from 50%) in 2014

- *Source: PricewaterhouseCoopers 2023 Annual Corporate Directors Survey*

BOARD SELF-ASSESSMENTS

- In response to self-assessment results:
  - **27%** of directors reported that their Board added expertise to the Board
  - **21%** of directors reported that their Board changed committee composition
  - **16%** of directors reported that their Board provided counsel to a director
  - **11%** of directors reported that their Board did not re-nominate a director
    - However, 45% of surveyed directors indicated that at least one fellow Board member should be replaced

- *Source: PricewaterhouseCoopers 2023 Annual Corporate Directors Survey*

ADDITIONAL ASSESSMENT PRACTICES

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

CONCLUSION

CONCLUSION

- Strategic planning remains as important as ever, particularly due to the challenges institutions of the current banking environment
- Effective corporate governance can help institutions reduce strategic and regulatory risk and capitalize on business opportunities
- A forward-looking institution can leverage challenges into changes in Board composition, revamped best practices and restructured priorities to best position the institution for future success

QUESTIONS

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