Credit Union Directors NEWSLETTER

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The case for inclusive governance

Fostering inclusion demonstrates commitment to serving members and communities.

Creating and sustaining an inclusive culture may be one of the most difficult challenges an organization can undertake.

A diversity initiative is more than a compensation review to evaluate pay equity. The ability to authentically engage diverse people and perspectives, and interact across cultures fosters inclusion and belonging, which are critical skills for our evolving world.

It's increasingly important for the board to learn and practice inclusive behaviors. In doing so we see how making changes or developing new skills will make a difference to us, our colleagues, and the credit union. Those who strive to improve diversity and inclusion discuss and evaluate how these efforts affect not only their marketplace, but also their business strategy.

Creating an inclusive governance model is not one–size–fits–all. It requires adapting the approach to each organization's unique characteristics. By advocating for and setting an example of inclusion at the board level, boards can move the organizational needle as it relates to diversity and inclusion.

Advocating for inclusion

Many employees see inclusion as a top factor in deciding where to work, and they want inclusion to be fundamental to their daily work experience. When boards think and act inclusively, it sends a clear message about what is important to the organization, according to the Deloitte Center for Board Effectiveness.

Consider these five questions to start the conversation:

1. What is the credit union's working definition of "inclusion," and what is its vision for an inclusive culture?

2. How do the credit union's mission, vision, and values reflect inclusion?

3. What is the credit union doing to advance inclusion and where is it making progress?

4. How can the board foster inclusion through its operating principles and behaviors?

5. What tools and resources do you need to effectively and thoughtfully engage in discussions around diversity and inclusion? Does the board encourage curiosity and courageous conversations?

> "The heart of **DIVERSITY AND INCLUSION** is about shifting our **BEHAVIORS AND MINDSETS**."
>
> Alison CARR

Cultivating inclusion

Building a culture of inclusion and belonging requires a shift from complacency to action.

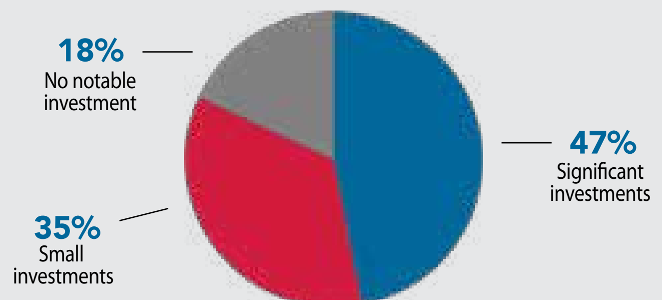
Consider taking these steps to cultivate inclusive governance:

▶**Establish** an organization-wide diversity and inclusion strategy and supporting practices.

QUICK TAKE for your next board meeting

Strategy, board development among top priorities

Strategic discussions and investing in the board are two top priorities for boards in a post-pandemic environment. Two-thirds (67%) say they'll spend more time discussing strategy over the next 12 months and more than 80% say they're making either small or significant investments to improve board composition, engagement, and education, according to the 2021 Board Effectiveness Survey from OnBoard.



Source: OnBoard 2021 Board Effectiveness Survey

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▶**Form** an inclusion-specific committee or designate an inclusion champion on the board as a starting point.
▶**Review** and/or update board composition, recruiting, and succession practices to include a focused effort to build a pipeline of diverse candidates.
▶**Prioritize** inclusion on the board agenda by regularly scheduling time during meetings to discuss and monitor diversity and inclusion goals and efforts, and measuring your progress.

Why it matters

By fostering inclusion and building a diverse organization, we demonstrate our commitment to creating equity and fulfilling our mission of serving our members and communities in a strategic and sustainable way. The heart of diversity and inclusion is about shifting our behaviors and mindsets, and ensuring these efforts are at the center of decision-making.

It's time for boards to recognize both their potential for influencing inclusion and their responsibility to do so, not only for the sake of employees but for their members and the communities they serve.

ALISON CARR *is the chief strategist and consultant with Your Credit Union Partner. Contact her at* alison@yourcupartner.org.

Some positives arise from pandemic

Survey shows boards became more effective, collaborative during COVID-19.

The coronavirus (COVID-19) pandemic pushed boards into adopting digital transformation more quickly than planned. But it also allowed boards to experience and recognize the benefits technology offers.

Between March 2020 and March 2021, boards have become more effective and collaborative, and are spending more time on strategic issues, according to the 2021 Board Effectiveness Survey from OnBoard.

Fifty-nine percent of survey respondents say moving to a remote work and virtual meeting environment during the pandemic had a major impact on their organization's success. This shift has enabled boards to improve their collaboration, with 54% indicating they've seen some improvement and 12% noting they've seen substantial improvement in collaboration efforts, according to the survey.

Almost half of boards are spending more time discussing strategic issues, and 40% are discussing organizational risk more often.

Boards also are giving other issues, such as fiduciary topics, investments, talent management, board reinvention, and board education the same amount of attention, according to the survey.

While operating in a digital environment, boards can still achieve an acceptable level of governance. Fifty-four percent say they have achieved "good" governance under challenging conditions and 38% have maintained a consistent level of governance compared to pre-COVID-19.

Only 8% of respondents say governance has been difficult and challenging throughout the pandemic.

With the gains made during the past year, some boards may continue to operate under a hybrid model, with some board members attending meetings in person and others attending virtually.

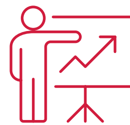
There are pros and cons to each meeting environment, but communication and collaboration work best when all board members participate in the same manner, says Matt Fullbrook, manager of the David & Sharon Johnston Centre for Corporate Governance Innovation at the University of Toronto's Rotman School of Management.

"When you get everybody on the same platform, effectiveness increases," Fullbrook says.

Think twice before adopting a blended model, he adds. "Don't let the fact that virtual meetings are good distract you from the fact that blended meetings are bad."

Instead, Fullbrook suggests boards consider adopting a split approach, with a designated number of in-person meetings and a designated number of remote meetings each year.

Boards during the pandemic



79%
Improved effectiveness

54%
Achieved good governance under challenging conditions

66%
Improved collaboration

47%
Spent more time discussing strategic issues

Source: OnBoard 2021 Board Effectiveness Survey

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Use efficiency ratio with caution

Adopting metric as a benchmark measure can harm members.

Many credit unions strive to improve efficiencies, particularly through digitization. Credit unions have significant experience attempting to measure efficiency.

As the saying goes, "what gets measured, gets done." But when it comes to efficiency, this makes me apprehensive.

Ratio analysis can be a handy way to uncover areas that need attention and to track progress toward goals. That's because ratios allow us to make useful comparisons by normalizing financial and operational information.

But we need to use ratios carefully. It matters how they're calculated. And, when making comparisons, it's important to choose peer groups carefully.

The efficiency ratio

When credit unions track efficiency, they often use a metric benchmark referred to as the "efficiency ratio," which is widely used in the banking world.

> "While the efficiency ratio is easy to calculate, it's notoriously difficult to decipher."

The efficiency ratio is calculated by dividing operating expenses by total revenue (i.e., the sum of interest income and noninterest income).

All else equal, a higher efficiency ratio indicates greater inefficiency and a lower efficiency ratio indicates greater efficiency.

The credit union movement's collective efficiency ratio was 61% in 2020, though this number varies substantially by asset size. It has been trending down from a high of 66% in 2015.

But while the efficiency ratio is easy to calculate, it's notoriously difficult to decipher. And it doesn't necessarily measure what it claims to measure.

For instance, institutions that slash costs aren't necessarily efficient, and excessive cost cutting can severely damage service quality and cause earnings to plummet.

Similarly, peer comparison groups comprised of institutions with dissimilar strategic focus can lead to false signals of inefficiency and may produce poor decisions.

More generally, unlike banks, credit unions seek to maximize member service, not profits. This makes the efficiency ratio not only difficult to interpret, but nearly irrelevant.

Because of their key structural difference, credit unions strive to offer more service (and more services), which puts upward pressure on the numerator of the efficiency ratio.

And because they are not profit maximizers, this puts downward pressure on the denominator of the efficiency ratio.

Combined, the effect of these two pressures is to increase apparent (but not real) inefficiency.

Any credit union, small or large, that wants to drive the efficiency ratio down to appear more efficient could do so by cutting back on service (and services) and/or by boosting income (i.e., raising fees, lowering dividend rates, increasing loan interest rates).

These ideas are especially important in the wake of the coronavirus (COVID-19) pandemic.

Certainly, efficiency may be a desirable goal, and most agree there's always room for improvement. But it's clear that using the efficiency ratio as a benchmark measure can harm members.

Use this measure with extreme caution, if at all. Your members will thank you.

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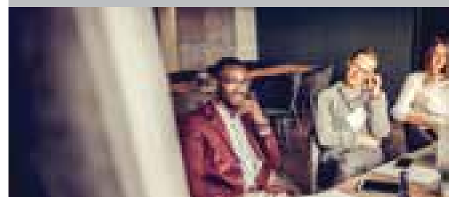
Resources

CUNA board and committee solutions: *cuna.org/board*

CUNA Credit Union Finance for Boards & Committees eSchool: *cuna.org/cufeschool*

CUNA Environmental Scan resources: *cuna.org/escan*



CUNA Board of Directors Community: *community.cuna.org*

Credit union finance 101

Every director must have a basic understanding of several financial concepts.

Credit union directors come from all walks of life. Some are familiar with business and financial issues, some aren't. Even if you come from a business or financial background, there's a good chance that background isn't in banking or credit unions.

I'm a certified public accountant, and when I began to audit credit union clients 30 years ago, I realized the methods, issues, and key ratios credit unions use aren't the same as what other businesses use.

I had to learn the nuances of credit union finance—and you do, too.

Directors have a legal obligation to understand key financial information. It's even written into law with NCUA regulation 701.4.

Here are some important financial concepts every director and supervisory committee member needs to know:

▶**Capital or net worth.** Know why capital is important, where it comes from, and how much is enough for their credit union.

Capital comes from profit. Once credit unions make a profit, it becomes "historical" and converts to capital. This is the stabilizing factor that keeps credit unions afloat in bad economic times. Capital is king.

▶**Return on assets (ROA)** is a measure of profit. Capital comes from profit, and ROA is how we report profit. What most directors don't know is that ROA is the end result of an equation called the spread analysis, which contains the "five puzzle pieces of profitability:"

1. **Yield.**
2. **Cost** of funds.
3. **Provision** for loan losses.
4. **Operating** costs.
5. **Noninterest** income.

These five puzzle pieces are the only things you have to manipulate to achieve the ROA you need.

You also need profit. Profit is not a bad word or a bad thing to earn from your members. Profit is essential to survival.

▶**Allowance for loan losses (ALL).** This is an amount that revalues your reported loan portfolio balance to what you are likely to collect.

This large negative number on your balance sheet is a bit of a mystery for most directors. It is scheduled to change, and will likely become a bigger negative amount by Jan. 1, 2023. That's when the new current expected credit losses (CECL) method comes into use.

▶**Asset/liability management (ALM).** This is the rocket science of credit union oversight. It's one of the more complex areas to understand, yet vital to know where your credit union may be headed financially as interest rates change.

What you essentially look for is how much capital is at risk as interest rates change. Credit unions make fixed-rate loans in a variable-rate world. The effects of changing interest rates must be projected so you can predict what will happen to your credit union as time marches on.

Financial ratios and statements may seem like a foreign language. But once you become familiar with the key elements, you can trust your knowledge of how your credit union is performing.

TIM HARRINGTON *is the founder and CEO of TEAM Resources (*forteamresources.com*). Contact him at* tharrington@forteamresources.com.

> "Once you become familiar with the key elements of finance, you can trust your knowledge of how your credit union is performing."
>
> Tim Harrington

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