The

# Chairman's Forum

Newsletter

*Opening the door to new ideas*

**Gerrish McCreary Smith, Consultants and Attorneys**

*September - October 2016*

This edition of *The Chairman's Forum Newsletter* marks our yearly "pre-Forum" edition. On November 14 and 15 at the beautiful Meritage Resort and Spa in Napa, California, we will be hosting our annual Community Bank Chairman's Forum in conjunction with the Independent Community Bankers of America. This is the annual event that prompted us to start *The Chairman's Forum Newsletter* which has been gaining in popularity each year. For those of you who haven't signed up for the Forum, there may still be a few spots remaining, so please let us know if you are interested, check our website or contact the ICBA directly.

In this month's edition of *The Chairman's Forum Newsletter*, we look at some questions specifically raised by directors and Chairmen in some recent conferences we have held as well as in some boardroom meetings. We think you will find these questions relevant to some of your own situations and we might even want to discuss some of these further at the upcoming Chairman's Forum in Napa. We look forward to seeing many of you in the coming weeks and hope the rest of you find this information valuable.

Happy Reading!

Philip K. Smith and Jeffrey C. Gerrish

*Gerrish McCreary Smith*
*700 Colonial Road, Suite 200*
*Memphis, TN 38117*
*Phone (901) 767-0900*
*www.gerrish.com*

The

# Chairman's Forum

Opening the door to new ideas

Newsletter

Gerrish McCreary Smith, Consultants and Attorneys

September - October 2016

## Chairman's Summary

- Incentive compensation works, make sure it is based on sound principles!
- Your private communications may not be private, be careful.
- Keep your board minutes not too short and not too detailed.
- Don't hesitate to do your job even in the face of criticism.
- Consider all alternatives in allocating capital resources, not just management's pet projects.

## A Wrong Compensation System

We have all been reading a lot lately about Wells Fargo and their "incentive" compensation system tied to the employees' ability to open new accounts. But, let's ask this question: Did the incentive compensation system work? The answer is, yes, it worked incredibly well. Employees were told that they would receive additional and higher levels of incentives for the more accounts they opened. Wells Fargo saw revenue opportunities, cross-selling opportunities, fee income opportunities and other benefits by having a greater number of accounts so they incented employees for opening more accounts. Guess what happened. The employees miraculously were able to open thousands of accounts and create more incentives for themselves. So, it's arguable that the system worked exactly as it was supposed to work. The problem, though, is that obviously the system was not monitored in a way to prevent fraud, the implementation of the system may have been founded on an improper strategy and other flaws.

For community banks, the lessons are clear. Incentive compensation systems generally work and do create the types of employee behavior we want. However, it is important to ensure that our incentive compensation systems are based on sound policy with an appropriate motive behind it. We should make changes where appropriate. Therefore, it's appropriate to have the Board of Directors consider the organizational issues involved with the types of incentives created, the type of employee conduct that will occur from the incentives and the type of organizational culture it will create.

Recently, a client of ours described their compensation system as the "anti-Wells Fargo system". They described it as being intentionally informal. Rather than having mandatory targets for performance or specific goals to be met to achieve certain levels of additional compensation, their system provided rewards and incentives on a holistic basis looking at all factors, both tangible and intangible, as well as specific employee evaluations conducted each year. In addition, they provided incentives throughout the year as performance occurred rather than waiting until year-end. So, for example, if an employee was performing well on a particular loan or product, they might receive an additional thousand dollars compensation the week after it occurred. The result is that this bank found that their system created a positive culture, did not result in competition between officers, promoted officers' seeking to help their fellow employees rather than undercutting them and improved the overall organizational morale. As Chairmen, consider the type of culture that might be created by a faulty incentive compensation system and make changes where appropriate.

## ***Be Careful of Emails***

We have all certainly had our overload of discussion on the political front about emails, when they are kept and when they are deleted, if they are on a private server, who sent what to whom and when, etc. Are there lessons we can learn from that in a community bank environment as well? Are your email correspondences as Chairman of the Board to your bank President, to loan officers or to others in the bank "discoverable" by the regulators? Would you want those correspondences to be reviewed and scrutinized by the regulators?

In a recent case with which we were involved, the regulators began reviewing emails between employees of the bank because of an ongoing fraud investigation. Unrelated to the fraud were some email correspondences between the Chairman of the Board and some of the loan officers in the bank. Those emails gave the impression to the loan officers that they would probably want to make sure that the Chairman's outside business was receiving appropriate referrals and business from the bank. As you might imagine, the regulators viewed that as potentially being a breach of the Chairman's fiduciary duties because it appears as though the Chairman may have been trying to influence the bank through his position as Chairman in a way that he might not otherwise have done. So, the lesson here is that even email correspondences are relevant and important, and we need to take the lessons from what is happening on the national political stage as a warning in how we conduct our correspondences within the bank as well as among directors. In this day of electronic communication overload, there are no secrets anymore. So, always do the right thing and make sure your fellow directors and management are doing so as well.

## *Usefulness of Board Minutes*

We have received a number of questions recently regarding the fundamental process of how to appropriately take minutes of board meetings. In one situation, a client of ours was criticized by regulators for having board minutes that were not detailed enough. This client had been advised years ago by a bank consultant (not us) that they should not put very much information in their board minutes because to do so would expose the board to potential additional legal liability if they said too much, said the wrong thing, etc. Therefore, their goal was to put as little information in the board minutes as possible. However, in today's community bank environment, that is not the right approach. The rule of thumb is that "if it ain't in the board minutes, it didn't happen".

Regulators as well as stockholders and officers should be able to get a full flavor for the conduct of board meetings by reading the minutes. That may require you to write them in a way that is somewhat self-serving, but that is wholly accurate and appropriate. For example, rather than saying "*The Board reviewed the watch list*". It might be better to say "*The Board spent quite a lot of time reviewing, in detail, the watch list. There were many questions asked by the directors regarding past due relationships as well as specific questioning of the Chief Lending Officer of loans that might fall to the watch list in the coming months*". You can see how that level of detail provides a more clear and full picture of what actually transpired at the meeting. It is our view that giving more detail actually provides more protection to the board. However, a verbatim transcript of the meeting would be inappropriate because it would tend to chill discussions on key matters. We also do not see the necessity of having an outside board member take the minutes of the meeting. In a community bank environment, it is totally appropriate to merely have the President's administrative assistant sit in on the meetings and take the minutes provided that he or she is aware of and is bound by the same confidentiality requirements of board members. Then, to the extent the organization meets in Executive Session, which it should on a recurring basis, the minutes of the Executive Committee may be more "topical" in nature rather than detailed in nature and it would be appropriate for one of the outside board members to take some basic minutes for those purposes.

## *Embarrassed Loan Officers?*

We recently received a question from a bank about the role of the Board of Directors in the loan approval process and how much questioning the board should do of management. In this particular case, it was indicated to us that the loan officers in the bank felt as though they were constantly being critiqued by the board members. If a loan had already been reviewed, the loan officers had agreed it was a good credit and decided they wanted to make the loan, the loan officers said they were embarrassed to then go to a board meeting and have the board members begin asking them a lot of questions, wanting to know why the loan was being made, quizzing them on various aspects of the loan, etc. The question was whether the directors should be that directly involved or, if the loan has been reviewed and recommended by the management team, should the directors only be looking at bigger picture, systemic risk-type issues rather than peppering loan officers about their decisions to recommend it. This is probably a good place for the Chairman to exert some leadership.

Our recommendation was that it is absolutely within the purview of the directors and arguably part of their fiduciary obligations to not rubber stamp recommendations from management and to question loan officers. To the extent that it is not some type of verbal harassment, if the loan officers are embarrassed by the questioning or defensive about having their judgment questioned, we believe the focus should be on getting the loan officers to have a little more backbone rather than having the directors throttle back their inquiry.

## *Allocation of Capital*

We have always been proponents of the idea that one of the important jobs of the Chairman and the board is the appropriate allocation of capital of the bank. That includes the financial capital in terms of how to utilize the equity of the bank as well as the managerial capital of allocating management's time toward various strategic initiatives. Until recently, the focus on true allocation of equity capital was not very difficult. Through the crisis, we were simply managing to a minimum capital number, ensuring that we kept regulators happy, we may have limited dividends, we deferred payment on debt obligations or took other steps to simply "manage" our capital level. However, now that we have emerged from the crisis, there is a renewed focus on the best uses of our capital. For some banks, that has been a specific focus on accelerating debt repayment. For others, it has been to stockpile capital as a source for using the cash to make an acquisition. For other banks, it has been to repay lost dividends that were foregone in lean years. The exciting thing for many of us now is that we have options to consider and the future is a bit brighter. As Chairmen, make sure your board members are specifically focused on this fiduciary and strategic issue of how we want to use our capital throughout the year.

## ***Meeting Adjourned***

The Chairman's role and the role of directors are constantly evolving. We are looking forward to addressing many of the hot topic issues at the upcoming Chairman's Forum in Napa and, if you are unable to attend, we hope you will look for one of our Chairman's Forums or Directors Conferences in 2017. In addition, we are always available for strategic planning sessions, board meetings, private board training and similar functions. Please don't hesitate to call on us anytime we can be a resource to you.

Until next time,

Philip K. Smith and Jeffrey C. Gerrish

*Gerrish McCreary Smith*
*700 Colonial Road, Suite 200*
*Memphis, TN 38117*
*Phone (901) 767-0900*
*www.gerrish.com*