The

Chairman's Forum

Opening the door to new ideas Newsletter

Gerrish McCreary Smith, Consultants and Attorneys

March 2016

We have recently returned from the Independent Community Bankers of America (ICBA) Annual Convention in New Orleans where, among other things, we had the opportunity to deliver presentations on "How NOT to Sell Your Bank!", "Ten Warnings for Community Bank Directors and Officers" and "A Director's Guide to Compliance and Fiduciary Duty". In addition, Jeff Gerrish and Philip Smith also had the opportunity to have an open forum discussion in a large packed room where the topic was "The Most Important Thing You Need to Know Is … ". As part of this, we distributed cards to the attendees ahead of time where they could ask a question about the most important thing they wanted to know.

This presentation was a big success and we received some very important and timely questions as part of that event. As you might suspect, many of those specifically related to the role of the Chairman, big picture organizational themes and other topics necessary for a Chairman to know. Accordingly, in this month's edition of *The Chairman's Forum Newsletter*, we look back at that event and highlight some of the key questions asked by people just like you from all across the country and show you the responses we provided to them either in the public forum or in follow-up correspondence afterward. We hope you will find this Q&A helpful as you look at similar issues.

Happy Reading!

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Chairman's Summary

- Branches of the future may need to accommodate less foot traffic and thereby decrease overall operating costs.

- Subchapter S should be a consideration in terms of the economic and stockholder benefits it provides.

- A community bank can be perpetuated by providing a liquidity mechanism and proper board management and ownership succession.

- Term limits for Chairmen, presidents or board members generally are not preferable. Rather, an evaluation process is best.

Questions and Answers for Chairmen

Question: **In terms of the total asset size (earnings being equal), where do you see the sweet spot three years from now in terms of sale multiples?**

GMS Response: It is always difficult to have a crystal ball to predict the future, but generally we do see pricing multiples increasing in the coming years, but not exponentially.

We would suspect that in the next three years, average pricing multiples might be approximately one and a half times book value and somewhere in the mid to lower teens in terms of a multiple of earnings. Generally, banks in more urban areas are commanding slightly larger premiums.

Question: **How do we evolve our retail strategy as transaction activity declines (in branch) and we have to pay universal bankers more? How do we accomplish more without simply driving up costs?**

GMS Response: We foresee many banks rethinking their branch model. Not necessarily to do away with branches, but to downsize the branches or make them more functional for less traffic. That will decrease costs to some extent. The other factor will be continuing to drive the use of technology as a way to lower overall operating costs which may require a greater financial investment on the front-end in order to get the cost savings and efficiencies on the back-end.

Question: **How do you fight the Federal Reserve Board (FRB) when they insist on expanding my CRA assessment area?**

GMS Response: This sounds like a situation where you might have to simply stand your ground. In these types of circumstances, in order to stand up against the regulators on something like the expansion of the assessment area, the best way to fight them is to fight them with "paper". That may mean fully documenting what your current CRA assessment area is, why it's appropriate, why it does not need to be expanded, how you are otherwise meeting the convenience and needs of the community, etc. In essence, creating a much stronger paper trail to support what you are doing.

Question: **Should my board consider S Corporation status? If so, why?**

<u>GMS Response</u>: The short answer is yes because it reduces the overall tax liability of the entity and thereby increases distributions that might be available as additional dividends to stockholders, more capital retained for growth and expansion or similar techniques. In 2015, we had five or six clients that we restructured into Sub S and we have a number of other banks looking at it this year. The S corporation structure typically also helps you limit your stockholder base size, can provide liquidity to stockholders desiring liquidity and drives overall earnings performance which enhances stockholder value.

Question: **Who is going to contain the regulators, certainly not the politicians?**

GMS Response: Cynical, yes, but accurate? Probably. It is really going to be difficult for the politicians to make much headway with the regulators without the support of a strong banking lobby. Therefore, national trade associations such as the ICBA in conjunction with state community bank associations and the strong support from bankers across the board will be the best way to achieve some regulatory relief from regulatory burdens which fall disproportionately on community banks.

Question: **How do we take a bank that has been around for over 100 years and keep it alive for 100 more?**

GMS Response: Several key strategies come to mind.

- First, focus on profitability. As long as earnings are strong, stockholders are happy and there is no need to sell the shares.
- Provide a liquidity mechanism so stockholders can sell their shares whenever they want. That might mean forming a bank holding company to repurchase shares, engaging in periodic repurchase transactions and the like.
- Plan appropriate board, management and ownership succession. Ask the tough questions now about ownership succession in particular, do not just assume

the kids of the largest stockholder are going to want to perpetuate that family ownership.

- Invest in technology. It is not a passing fad. It is a new way of doing business.

Question: **Is incentive compensation a plus or minus for hiring millennials or is flexibility more important?**

GMS Response: We believe both are important. First, it seems with the millennial generation that certain elements of flexibility that have not been required in the past are more necessary for hiring the highest quality individuals. That may mean flexible work hours, flexible schedules, flexible work environments and the like. However, it remains a truism that incentives drive performance and incentive compensation systems tend to drive organizations toward better performance whether we are talking about millennials or older generations. Therefore, an overall compensation structure that has base salary and some equity component as well as incentive compensation is best.

Question: **Should we start charging a monthly fee on deposit accounts to offset all of the free technology we provide?**

GMS Response: Why not? The greater question is whether it is important to strategically focus on fee-based income. We think it is. If we are giving away technology, why not charge a fee for it or use an offsetting fee somewhere else. The days of giving away free toasters or free services are past. The smart banks will find ways to recoup costs from customers without driving them away.

Question: **Should our organization have term limits for the Chairman?, the bank president?, the directors in general?**

GMS Response: Most organizations do not have term limits in any of those cases. Some have mandatory retirement for directors, but not term limits. We feel that would probably be a waste of time for directors and we do not advocate term limits because there is such a large learning curve that it takes several years to get up to speed. However, we do advocate director evaluation processes in order to ensure a well-educated and informed board.

For the Chairman of the Board, we are not opposed to term limits or to rotating the Chairmanship. However, we believe the Chairman's role should not be ceremonial, but should have true duties and responsibilities. To the extent you have affirmative duties and responsibilities and have a Chairman who is carrying those out appropriately or is evaluated on a yearly basis as to his or her performance, then mere term limits are not necessary.

As to executive management and the president, we would argue that they have a one year term limit subject to being reappointed each year if they have a successful evaluation. But, if you have a president who is not performing well, it further hurts your organization to allow the individual to continue to serve. Make the tough choices.

Question: **What is the best way to pick a Chairman of the Board?**

GMS Response: We think we said that you should take a five minute bathroom break and whoever is the last one to return is appointed Chairman by all the others. In reality, though, the job of Chairman should not be that much of a mystery. You should have a well-defined set of duties and responsibilities and the individual on the board who has the skillset that best matches those is the candidate who should be selected. The ways we have picked Chairmen in the past (acquired the most stock, is the oldest, has the most gray hair, is the best known in town, has the biggest house, etc.) are now no longer relevant. It is a real job with real responsibilities. Simply match the person with the best skillset to the job functions you want to have exemplified.

Meeting Adjourned

We hope your institution is off and running on a strong 2016. Keep focusing on what is best for stockholders and keep your management and fellow directors focused on the organizational mission. If we can help, let us know.

Until next time,

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