
GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Florida, Kentucky, West Virginia, Washington, Michigan, and Nebraska!

REGULATION BY INTIMIDATION

As we have noted in numerous *Musings* of late, the regulators have ramped up their enforcement posture, particularly as it relates to community banks. In the last three or four weeks, we have seen numerous community banks who have historically been rated 1 or 2 get knocked down a rating notch. These banks have not changed a single thing they are doing, as a practical matter, yet the regulators have come in and criticized them for a variety of issues in a variety of different areas—compliance, safety and soundness, BSA, etc. Keep in mind that a change in a CAMELS rating from a 1 to a 2 really does not cost much other than a bruised ego. The rating change from a 2 to a 3 will likely, depending on the size of the bank, involve a significant increase in deposit insurance premiums (i.e., real money).

With the regulators freely distributing both formal and informal enforcement actions, they are back to their old ways of regulation by intimidation. As we have often mentioned in *Musings*, enforcement actions are all “by consent.” In other words, the board has to agree to them or they do not get implemented, unless the regulator wants to go through an administrative hearing process. The regulators, however, will try and intimidate the board into believing that they must consent to whatever the regulators have proposed—without negotiation and without discussion. This is simply not the case.

The regulators have historically regulated by intimidation because, in their mind, it simply “takes too long” to give a bank its due process rights. Keep that in mind if your bank ever receives a proposed enforcement action.

LENDERS AS DEPOSIT GATHERERS

Virtually every bank in the country is looking for deposits. The recent strategic planning sessions we have facilitated have all included a healthy dose of discussion on deposit gathering strategies. This discussion most often includes recognition that in today’s environment it is important to try and obtain an entire customer relationship, including both deposits and loans, rather than just lending to a customer. In other words, banks are not looking simply to lend their existing cash; they are looking to tie new deposits into new loans as part of the overall strategy to achieve deposit growth.

This exact topic was being discussed in a recent strategic planning session we facilitated. During the conversation, one of the lenders gave what we thought was an excellent and insightful point. The lender basically said, “Our entire career, we have been trained to lend money. We have never been trained to gather deposits. But now we are being asked to do so. That makes sense. But, we need training on how to effectively gather deposits just like we have had training on how to effectively lend money.”

The lender’s point made perfect sense to us. Many banks are asking lenders to now place a heavy emphasis on deposit gathering. Some are even tying lender compensation into new deposits. If your community bank is doing something similar, we recommend you do not forget to train your lenders on how to gather new deposits. Like lending money, generating new deposits is a learned skill. Failure to provide that training does not provide the highest probability of success.

SHAREHOLDER MARKETING

During one of our recent strategic planning sessions, we had a discussion on shareholder succession. Like many other community banks, this particular community bank has an aging shareholder base and is concerned that the next generation of holding company shareholders does not have the same level of affinity or relationship with the holding company and bank as do the current shareholders. During the session, we asked what the holding company and bank are doing to “market” ownership of the holding company common stock and the bank to the next generation

of shareholders. The answer was that neither the holding company nor bank is doing anything specific in this regard.

We are not bringing this up in order to chastise the bank that is not marketing to its next generation of shareholders. Frankly, most community banks do not. We raise the issue because we believe effective marketing to be a very sound shareholder succession tactic. It is important that community banks market the ownership of the holding company stock and the benefits of the community bank to the next generation of shareholders almost just as actively as they do their products and services to their existing communities. Basically, the strategy is to highlight how the community bank does great things for the markets in which it operates and represents a sound financial investment going forward, causing the future shareholders to form a view that ownership of the stock is worthwhile and should continue.

TARGETED BANK EXAMINATIONS

This *Musings* article is about targeted bank examinations. No, this is not in the context of a bank examination that targets asset quality or capital or even compliance or BSA or IT. This is a bank examination that targets the executive officers. We have had several clients contact us in the last few weeks about bank examinations that are taking an undue focus on the activities of the bank executive officers. These examinations focus on the executive with respect to a variety of issues, including compensation, bonuses, equity grants, and the like. When we begin to see the friendly federal regulators target, as they have in several recent examinations, the executive's expenses (i.e., credit cards, business development, lunches, dinners, golf club outings, and the like) we know they are targeting the executive. We generally feel that the examiners should have something better to do than decide whether or not the bank executive should have had chicken cacciatore instead of a prime New York strip and a fine bottle of wine with a bank client for dinner. It is beginning to border on ridiculous.

ESOP VALUATIONS

It is the time of year where many Employee Stock Ownership Plans ("ESOPs") receive their annual valuations. We recently had a discussion with a banker regarding their ESOP valuation we thought was interesting. This particular holding company receives both an ESOP valuation and a valuation for the shares held by non-ESOP shareholders from the same valuation expert. There

is a difference in price between the two valuations, which is to be expected. This is because, technically speaking, the ESOP has a put option to the holding company that requires the holding company to purchase these shares if the ESOP does not do so. This put option reduces the marketability discount on the shares held in the ESOP, which increases the overall value.

As noted, the difference in value between the shares owned by the ESOP and the shares owned by other shareholders is to be expected. What was a little bit interesting about this particular situation is the amount of difference between the two values. The shares held in the ESOP were valued at almost 20% higher than the shares held out of the ESOP. Frankly, we cannot recall seeing that much difference between the two values in the past.

We are not questioning the valuation experts or their tactics. We have no basis to argue against their values. Still, the values do result in a number of interesting considerations for the holding company and bank. For example, if the holding company is going to repurchase shares from shareholders, which price should it use? Similarly, if it is going to sell shares to the ESOP, what price should it use?

These are interesting considerations that are present any time there is a difference in the value of the shares inside the ESOP and outside of the ESOP. The issues just become magnified as the difference between the two values grows.

STOCK LIQUIDITY CONSIDERATIONS

We recently had an interesting discussion with a community banker that was somewhat frustrated with stock liquidity issues. This particular individual has been a long-time *Musings* reader and understands they are not licensed to act as a broker-dealer. Therefore, they do not work to directly negotiate trades between shareholders. During our discussion, we talked about the fact that the individual does act as somewhat of a middleman by trying to bring buyers and sellers together, but they do not go so far as to negotiate the deals and act as a broker. We recognize that is an acceptable process and one that a lot of community banks follow.

During the call, the individual asked whether it would be easier just to essentially establish a policy that any shares that go up for sale are first to be repurchased by the holding company, and then the holding company can figure out what to do with them, either keeping them or selling them to another shareholder. Unfortunately, that does not present the best alternative either. This particular holding company has shareholder preemptive rights, which means that any time the

holding company were to repurchase and then resell shares, the shareholders would have to be given the opportunity to purchase their pro rata portion of the shares to be sold. It would also bring the share registration exemption issues into play any time there was a transfer transaction.

The individual was a little bit exasperated. They talked about the difficulty in trying to facilitate an efficient means to transfer shares. As they put it, there is no real easy path in order to ensure an appropriate and legal transfer of shares from one shareholder to another. Unfortunately, this is something that frustrates a number of community bankers around the country.

AFTER-TAX CASH FLOW TO SHAREHOLDERS

We have the opportunity to work with a number of family-controlled banks. At a recent planning session with one of those banks, we were discussing the need to keep the next generation interested in owning the shares after the current generation goes “to the great beyond.” Often in family-owned banks there is, unfortunately, a significant failure to plan for ownership transition. Part of that transition, if the long-term strategy is for the bank to remain independent, is to provide the next generation with a community bank holding company stock they want to keep because they cannot find a better alternative investment. This, in all cases, involves some kind of after-tax cash flow coming off the stock. As one of the outside directors noted in this particular discussion, the importance of having cash flow coming off the shares to the next generation of shareholders is so that once they get that stock, it is not just a “heirloom on the shelf” that they have to hold onto because there is nothing else they can do with it. They don’t want something that is pretty to look at that is illiquid because eventually they will figure out how to liquidate it by possibly liquidating the entire bank.

If your bank is closely-held and you are paying a small dividend or a small dividend equivalent distribution in a Subchapter S, your holding company board may want to evaluate that in view of the need to keep the next generation interested.

COMPLIANCE, COMPLIANCE, COMPLIANCE

We have utilized a significant amount of electronic ink in *Musings* regarding compliance issues raised by the friendly federal regulators. We often put these issues in *Musings* because we believe the regulators are inappropriately flexing their muscle or aggressively interpreting existing regulations, contrary to their regulatory stance in the past.

For those *Musings* readers who are interested in compliance, and particularly those who are FDIC banks, we direct you to the recently published FDIC’s Consumer Compliance Supervisory Highlights. This fits in the category of “if you have nothing else to do this weekend”. The following link, [FDIC Consumer Compliance Supervisory Highlights](#), will take you to this particular publication. The interesting thing about this particular publication is that it identifies the “most frequently cited violations and other consumer compliance examination observations from FDIC exams.” It also provides information on some of the forward-thinking issues before the FDIC in the compliance area. If you are curious about what this particular friendly federal regulator is thinking or has done recently on compliance examinations, feel free to peruse this particular publication. It is fairly interesting.

CONCLUSION

It is hard to believe it is the end of the first quarter and Easter weekend all wrapped into one. We hope all of you have a wonderful weekend with your friends and family.

Stay safe. See you in two weeks.

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Upcoming Webinars and In-Person Presentations

- April 2, 2024 – Graduate School of Banking at Wisconsin (Online Seminar) – “Creating Value for Community Banks: M&A and Beyond” (Philip Smith, Presenter). Registration: [Creating Value for Community Banks - M&A and Beyond](#)
- April 4, 2024 – Graduate School of Banking at Wisconsin (Online Seminar) – “Strategic Planning in Uncertain Times” (Greyson Tuck, Presenter). Registration: [Strategic Planning in Uncertain Times](#)
- April 11, 2024 – Graduate School of Banking at Wisconsin (Online Seminar) – “Strategies and Planning for Closely Held and Family Banks” (Philip Smith, Presenter). Registration: [Strategies and Planning for Closely Held and Family Banks](#)
- April 16-19, 2024 – Independent Community Bankers of America Credit Analyst Institute (Virtual) (Cliston V. “Doc” Bodine, III, Presenter, April 17) Registration: [Credit Analyst Institute](#)

- April 23, 2024 – Independent Community Bankers of America (Webinar) “Community Bank Compensation Issues” (Cliston V. “Doc” Bodine, III, Presenter) Registration: [Community Bank Compensation Issues](#)
- May 6-8, 2024 – Indiana Bankers Association 2024 Mega Conference “Ten Things Every Community Bank and Its Directors Need to Know Now” (Philip Smith, Presenter, May 7) Registration: [Indiana Bankers Association 2024 Mega Conference](#)
- May 9-10, 2024 – Independent Community Bankers of America Enhancing Organizational Value Conference at Embassy Suites in San Antonio (Philip Smith and Greyson Tuck, Presenters) Registration: [Enhancing Organizational Value Conference](#)