GERRISH'S MUSINGS

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October 31, 2024, Volume 523

Dear Subscriber:

Greetings from Florida, Georgia, Alabama, Louisiana, Texas, Oklahoma, Arkansas, Missouri, Arizona, and California!

DISPARATE TREATMENT: THE RECENT BANK FAILURE

On October 18th a small national bank ($100 million or so in total assets) was closed by the Comptroller of the Currency. The FDIC, as required by statute, was appointed Receiver. This small bank had approximately $7 million in uninsured deposits. Unlike the three major large bank failures of 2023 (Signature, First Republic, and Silicon Valley) where all uninsured depositors were made whole, in this small bank failure, the uninsured depositors were not made whole.

The FDIC resolved this failure through an "insured deposit assumption only" with the acquiring bank. That means what it sounds like – that only insured deposits became deposits in the new bank, and the uninsured deposits, or uninsured portion of the deposits, became a creditor against the receivership estate. So large bank depositors get made whole 100%, and small bank depositors get stiffed. The FDIC did say that they would pay out 50% of the uninsured portion immediately (anticipating collection on certain assets), but the other 50% either won't be received by the uninsured depositors or will take a short time (like forever) to get any recovery. We fully understand the mechanics and FDIC's statutory obligation to do the least cost resolution, but it certainly does not seem fair to us to treat those large "too big to fail" depositors different than the smaller bank depositors.

To ensure compliance with the requirements imposed by the U.S. Internal Revenue Service, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (1) avoiding tax-related penalties under the U.S. Internal Revenue Code or (2) promoting, marketing or recommending to another party any transaction or tax-related matters addressed herein.

COMMUNITY BANK BOARD GOVERNANCE RESEARCH

Last Friday, FDIC published a "Working Paper" entitled, "Inside the Boardroom." The Working Paper indicates that "Community banks are critical for local economies, yet research on their corporate governance has been scarce due to limited data availability." We understand that.

The Abstract continues, "We explore a unique, proprietary dataset of board membership and meeting minutes of failed (emphasis added) community banks to present several stylized facts regarding their board structure and meetings."

We are always glad when some independent party does research on community banks, particularly their governance. We think it odd, however, that the research focuses on community banks that failed. Not that there haven't been a lot of them over the last 20 years, but extrapolating from activities of failed banks to those that deal with corporate governance of current banks seems a little bit of a stretch for us. The abstract continues, "During times of distress, community bank boards convene less often in regularly scheduled meetings in lieu of impromptu meetings, experience higher turnover, particularly among their independent directors, and their meeting tone switches from neutral to significantly negative." Really? You think?

If anybody would like a copy of this study, please let us know.

MANAGEMENT STUDIES

Management studies are in vogue again. Many of those we have provided over the last several years have been voluntarily commissioned by the Board of Directors of the community bank. More recently, however, the current flock of management studies have been regulatorily mandated. The last heavy dose of management studies occurred during the Great Recession when virtually every formal and many informal enforcement actions by the friendly federal regulators required a management study by an independent third party. We conducted dozens of management studies during that time.

A review of the FDIC's recent enforcement actions indicates that management studies again are on the friendly federal regulator's checklist. These studies generally require an independent third party (like Gerrish Smith Tuck) to conduct the study and the Board to implement the recommendations. As we have mentioned in prior *Musings,* over the last several years we have completed a number of management studies where the Board simply wanted an independent third party to review management and organizational issues. That was for the Board's benefit. The current crop of management studies will be more regulatorily directed and not only be for the

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"benefit" of the bank, but also to appease the regulators in situations where they believe management is lacking or needs additional "adult supervision."

We have a lot of experience with these management studies. Please let us know if we can assist your community bank.

SPEEDY APPLICATIONS

A significant concern for many community bankers is the inordinate amount of time it takes the FDIC in particular to process an application for a merger transaction or a de novo bank (i.e., a deposit insurance application). Recently, the FDIC Vice Chairman, Travis Hill, recognized this issue and proposed that any merger or deposit insurance application that had been pending with the FDIC for longer than nine months be reported (i.e., a briefing) to the full Board of the FDIC during the closed session of the board meeting. Vice Chairman Hill's statement indicates there were "11 covered applications pending that have been outstanding for no more than nine months, with a dozen more poised to cross the nine-month threshold between the June and October board meetings if not resolved sooner."

We applaud Vice Chairman Hill for taking some action toward accelerating the processing of applications. We hope this will put enough pressure on the staff to move the applications along instead of leaving them in regulatory limbo.

If anyone wants a copy of Vice Chairman Hill's statement, please let us know.

DIRECTOR COMPENSATION

We recently had an interesting discussion with a client regarding director compensation. This particular client is giving consideration to potentially increasing the amount the directors are paid. They have done what we see as the appropriate research, particularly in looking at compensation surveys that show director compensation for similarly situated banks. The Board is considering something that would allow their directors to be properly characterized as paid higher than average.

During a discussion on the topic, one of the directors asked about the regulatory view of director compensation. Basically, the question was how much could directors be paid without buying themselves a regulatory problem?

Our experience is that the regulators do not have a specific dollar figure for director compensation that they view as appropriate. Each organization does things a little different, and

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the regulators generally respect corporate autonomy. Our experience is also that the regulators generally do not criticize compensation levels when the bank is safe, sound, and profitable. Basically, if everything is going well at the bank, the regulators generally leave compensation levels alone.

In our experience, regulatory criticism of compensation levels generally comes when the bank is in trouble. If a bank is not operating in a safe and sound manner or is operating at low levels of profitability or at a loss, the probability of criticism as it relates to compensation levels is higher.

The level of compensation paid within your organization is a corporate decision. There are no brightline rules the regulators follow (other than safety and soundness). Generally speaking, as long as the bank is doing okay, you probably are not going to have a problem. If the bank begins to exhibit problems, it is an area you can expect will draw regulatory scrutiny.

THE PROBLEM WITH GROWTH

We recently had an interesting discussion with a client regarding asset growth. Like many community banks, this particular bank has grown pretty significantly over the past five or so years. The bank has not specifically been pursuing growth but has also not specifically avoided it. The bank really has operated with a view towards serving customer needs, and those needs have resulted in much higher than historical growth.

The directors generally took a positive view of the growth. The overall sentiment among the group is that bigger is better, and that growth equates to value. However, in discussing the growth, there was one significant problem that was identified - you have to have capital to support the growth. This particular community bank's asset growth has far exceeded its capital growth, and the bank now is operating at levels of capital that are much lower than historical levels.

The discussion was a great example of the problem with growth, which is that you have to have capital to support it. For many banks, that capital comes from retained earnings. However, the past couple of years have seen many banks experience margin compression and reduced overall profitability. That has led many community banks to have lower than historical capital ratios. Of course, the bank can go out and raise capital, but for many banks, now is a tough time to do that due to reduced profitability. That leaves banks in this situation as really having an option of slowing growth. When you have had four or five years of very fast growth, switching to a strategy

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of specifically looking to slow growth is difficult. For many banks in this situation, it feels defeating.

Growth is a good thing, provided it is from relationship growth that improves overall profitability. However, growth is not completely and totally free of problems. Unfortunately, there are a number of community banks right now that are realizing the problem with growth is that you have to have capital to support it.

GETTING THE HOOKS IN

There is a lot of conversation and good discussion at many community bank board meetings with respect to retaining key employees. The key employees are the ones that you would hate to see leave and go to a competitor, or even leave and go to a non-banking position somewhere else. So the question becomes, how do you retain them (i.e., get the community bank's hooks in while they are still in your employ)?

One bank we were with recently indicated that if an employee stays beyond three years then they are likely to be a long-term player. So the question is, how do you get them so immersed in the bank they get to that point where not only is it difficult for them to leave financially, but they simply don't want to? Various suggestions include making sure the employee is emersed in the culture, providing a career path upward, providing training and education, providing mentorship (a formal program would be nice), and last, but certainly not least, providing some financial disincentive to leave.

As hard as community banks work to attract key personnel, it is equally imperative to figure out how to retain them (at least the ones you want to) once they are there.

LANE CLOSURES AHEAD

As noted in prior *Musings*, the war for talent is a common topic among community bankers, particularly in the long-term planning context. We have recently met with several banks, both large and small, that have discussed various issues associated with the war for talent. An issue generally discussed is the talent the bank is trying to obtain, particularly on the younger end of the spectrum, the Gen Y (Millennials) and Z. This group's work ethic is often a topic of discussion. More recently, however, the topic of discussion has primarily been once your community bank retains these younger people, how do you keep them long enough to get them solidly within the culture and keep them for the long term to be the future leaders for the bank.

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One major issue discussed has always been "lane closure." This is a simple way to describe how the route to the top or to the desired position of this younger banker is blocked because of the failure of a more seasoned banker to get out of the way (i.e., retire or move into another position). In order to continue to retain these younger bankers, there must be a way to get through that lane closure, get around it, or understand that it will eventually reopen for their upward mobility. It is a dangerous practice just to assume that these younger bankers understand their career path. It is a much better practice to sit down and discuss it with them to make sure that everyone is on the same page.

THE COMMUNITY BANKING BOARD CHAIR FORUM

We are looking forward to the Gerrish Smith Tuck facilitated, Barret School of Banking sponsored, in-person Community Banking Board Chair Forum. Keep in mind, it is probably very cold where you are in January and typically very nice/warm in Florida. This discussion will be facilitated by the three of us (not a lecture or seminar) for community bank Board Chairpersons, Vice Chairs, Directors, and Chief Executive Officers on January 9-10, 2025 at the JW Marriott Marco Island Beach Resort, on Marco Island, Florida. If you would like to register for the Forum, there are still a few slots left - please follow the link: 2025 Community Banking Board Chair Forum

CONCLUSION

Musings is coming out today on Halloween. Please be mindful of the trick-or-treaters and others roaming around in the dark. Also, Tuesday, November 5th is Election Day. Please appropriately exercise your constitutional right and vote for the candidates of your choice.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and In-Person Presentations

- January 9-10, 2025 – Barret School of Banking, Community Banking Board Chair Forum at the JW Marriott Marco Island Beach Resort, Marco Island, Florida (Jeff Gerrish, Philip Smith, and Greyson Tuck, Facilitators) Registration: Community Banking Board Chair Forum

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