# *E*-Memo

**TO:** INVESTORS/MEMBERS/PARTNERS AND FRIENDS

**FROM:** Jon Bruss

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**Subject:** Management, Markets and Metrics (Part 3)—Trust

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Banks have traditionally garnered the **trust** of their customers and a banker has always been a respected member of the community whose word is his bond. For good reason. Bank deposits are insured and banks themselves are heavily regulated. Along with interested and proactive investors, these factors combine to create trustworthy institutions that provide the fuel for our economy. This month we examine some of the reasons banks are considered the bulwark of our financial system and ways in which banks can become even better at cultivating trust.

**Trust**

Since the advent of the Federal Deposit Insurance Corporation in the early 1930s, bank customers have been assured their deposits would be safe. FDIC insurance provides bank customers and banks with comfort about the security of depository funds. It tells depositors that even if the bank makes poor investment decisions or the economy tanks, their deposits won't evaporate.

Aside from the FDIC's deposit insurance, there are regulation-driven reasons we trust banks. In exchange for insuring deposits, the FDIC exerts substantial regulatory control over banks. To the FDIC's oversight add the Federal Reserve System, Office of Thrift Supervision, Office of the Comptroller of the Currency, Securities and Exchange Commission, and various state regulators. No bank is regulated by all of these bodies, but most are regulated by two or three, making banks among the most heavily regulated companies in our economy. Bankers are prone to bristle at what they view as overbearing Fed, FDIC, OTS, OCC, SEC, and state regulators, and we as investors often complain about the shortsightedness and bureaucratic preening of those same regulators.

Regulators do play a vital role in maintaining the integrity of the American banking system by monitoring capital and loan loss reserve levels of banks, by ensuring banks employ proper underwriting practices and follow the banks' own written policies, and by working collaboratively with the banks under their supervision. Both publicly traded and privately held banks are required to provide regulators with exhaustive quarterly financial statements commonly referred to as "Call Reports". (It is our experience as bankers that these reports are reviewed after submission by real people in the supervision and regulation departments at the appropriate regulator who help assure the consistent accuracy of the reports.) The reporting requirement, periodic on-site examinations, and the regulatory framework, ensures that banks maintain the requisite liquidity for their depositors and borrowers, and earnings and growth potential for their investors.

The exception proves the rule: it was the rare failure of regulators (yes, they too are human) to vigilantly exercise their responsibility that partially caused the current credit crisis. There is the additional factor of the regulatory gap. While depository banks and thrifts are heavily regulated, mortgage "bankers" and investment "banks" are not. They merely wear the name bank like a mantle of trust. While we don't wish to wade into the debate here about the wisdom of that scheme, it is an undeniable fact that lack of oversight exacerbated the effects of poor underwriting policies by sub-prime lenders. By and large, however, regulators did not neglect their oversight of small banks like those in which we invest. As a result, our portfolio banks remain sound with strong franchise value created by core deposits and strong earnings potential. There is much to criticize regulators for and much to dislike about the regulations they enforce. But the American banking system is stronger and safer because of the basic regulatory framework that insures deposits and compels bankers to maintain minimum levels of capital and loan loss reserves.

Sound business practices also promote trust in areas regulators touch less often. When we look at a bank, we consider not only its performance, its intrinsic value, and its relations with regulators; we also evaluate corporate structure to make certain that controls are in place to prevent management from arrogating too much power to itself. One way banks can assure investors they are serious about preventing that situation is to split the roles of CEO and chairman, which establishes a check on the CEO's power. The chairman should be a non-executive chairman and should not be a handpicked golfing buddy of the CEO.

Another way a bank can promote investor trust is with its board composition. Boards should be dominated by outsiders. While it is certainly not a bad thing to have a couple members of management—CEO and perhaps the CFO, or Chief Credit Officer, or General Counsel—on the board, management should be in the habit of answering to the board, not to themselves. When the board members are predominantly outsiders, their primary concern is bank and shareholder welfare. When the board members are predominantly insiders, there is a risk their primary concern is self-preservation and self-aggrandizement. Moreover, outside board members bring a different perspective to the bank's performance, one informed by their knowledge of the local economy and the needs of the market.

Which leads to a second point about boards: it is not enough that board members simply come from outside the bank. They must also bring with them expertise appropriate to the task at hand. Small community banks frequently seek out board members who are prominent in the local community and have a high net worth to support sizable ownership of the bank's stock and large bank deposits. Such board members, through their contacts in the community and by their knowledge of local business conditions, can provide strong support for shareholder value. But it is not enough that board members be prominent members of their community. Small community banks must also seek out members with relevant expertise and experience. The more experienced the board member, the more investors can trust him or her to provide management with constructive criticism and insight. A director who had a long tenure at another bank or a CPA from a multi-person practice with cross industry audit experience are two types of highly sought after directors. Such individuals bring the intellectual wherewithal and industry experience to the table that is necessary to balance the insider expertise of management.

The board of a small community bank is immensely important, but it will be entirely useless without intelligent, experienced bank management. Bankers with deep experience—those who have successfully guided banks through difficult times like the current credit crisis—are irreplaceable. Some large banks seemed to have forgotten the value of such experience. Investors should be suspicious of bank managers who have never made a loan, much less tried to collect one. Take Citigroup, for example. It was run for four years by Chuck Prince, a lawyer who, despite whatever other good traits he may have, was not a banker. Citigroup paid the price and today its health is a far cry from the days when it was run by Walter Wriston (1967 to 1984), a lender and banker of great renown. It is no less important (and maybe more) for small community banks to have highly competent and experienced bank managers. Citigroup and other money center banks are so large and complex that the negative effects of a CEO's misjudgments may sometimes be absorbed by successes engineered by others in the organization. Small banks do not have this luxury. They can only earn investor trust by maintaining a high level of experience, intellect, and integrity at the management level.

Finally, to justify its position of trust, a bank must be transparent (see July 15, 2008 E-Memo). A transparent bank cannot hide financial problems—indeed, it has affirmatively decided against doing so. When banks disclose their strategies and financial positions to shareholders, they foster investor trust.

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