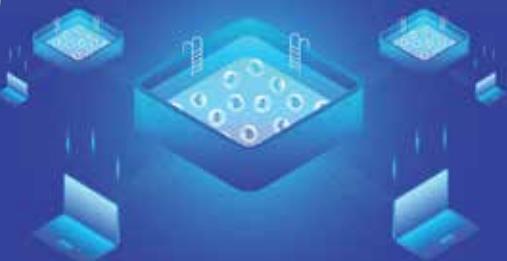


ALTERNATIVE LIQUIDITY STRATEGIES FOR COMMUNITY BANK SHAREHOLDERS

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Introductions

Privately held community banks throughout the Midwest face increasing pressure to provide liquidity to their shareholders due to an aging shareholder base, management succession challenges and limited secondary markets. Under these circumstances, banks may feel compelled to choose liquidity options that do not ultimately benefit the bank's local community, its customer base and its larger legacy. This article explores six strategies community banks can consider to provide liquidity to their shareholders as an alternative to a sale to or merger with another financial institution. These strategies, although not exhaustive, include stock repurchase programs, private listing platforms, ESOPs, tender offers and the bank's sale.

Why Liquidity Matters

Without an effective strategy to provide liquidity to its shareholders, a bank risks disgruntled shareholders, succession instability, valuation pressure and difficulty attracting new investors.

Many closely held community banks have aging shareholders feeling the urgency to cash out their stock and enjoy the fruits of their investment in their lifetime. Or, a long-time major shareholder dies and passes stock to a succeeding generation of shareholders who lack ties to the bank and look for an immediate sale of their stock. In either situation, without a clear liquidity strategy, the bank can face disgruntled shareholders and succession instability.

Other closely held community banks seek to attract new investors from time to time to increase their capital base for growth or added stability. Capital raising for a closely held bank is more difficult if the bank does not have a clear-cut liquidity strategy. Illiquid shares reduce attractiveness to investors and limit capital-raising options.

Liquidity Options for Community Bank Shareholders

The following are six liquidity options for privately held community banks:

Walk-In Stock Repurchase Programs

A Walk-In Stock Repurchase Program authorizes a designated officer of the bank, usually the president or CEO, to repurchase shares of the bank within board-approved parameters. This approach can provide nearly immediate liquidity to minority shareholders who express an interest to the bank's management that they desire to sell their shares while preserving the bank's overall ownership structure. Clear board of directors oversight and documented policies must be in place to prevent insider conflicts. Transaction size and frequency should be limited to avoid capital adequacy issues.

Regulators will closely monitor repurchase programs because they directly impact a bank's capital adequacy and liquidity profile. Excessive buybacks can erode Tier 1 capital ratios, triggering supervisory concerns or even enforcement actions. To mitigate this, banks must maintain robust capital planning and document stress tests showing resilience under adverse scenarios. Pricing fairness is another critical area of regulatory concern. Regulators expect independent valuations or fair opinions to prevent insider advantage and uphold fiduciary duties. Additionally, insider transaction rules under federal banking law and securities regulations require strict controls to avoid conflicts of interest. Detailed board documentation and transparent shareholder communications are essential to demonstrate compliance and governance integrity.

Voluntary Stock Repurchase Programs

A Voluntary Stock Repurchase Program involves a formal written offer by the bank to buy back shares at a predetermined price during a defined period. These programs often target shareholders holding small stakes to reduce the bank's administrative burden and consolidate its ownership structure. Like a Walk-in Program, share pricing in these programs must ensure fairness and transparency, requiring full disclosure and equal access for all shareholders. Although the bank would be repurchasing the stock with excess capital, it should monitor and stress-test capital and liquidity adequacy when instituting the program to avoid regulatory concerns.

Formal repurchase offers can fall under federal and state securities laws, requiring clear disclosures and equal access for all shareholders. Regulators scrutinize these programs for discriminatory practices and capital adequacy risks. Larger programs may necessitate prior notice or consultation with the bank's regulators, especially if they materially affect capital ratios.

Private Listing Platforms

Private Listing Platforms allow shareholders to post buy and sell offers through a third-party service, creating a market-driven pricing mechanism with minimal bank involvement. The bank must be diligent in selecting a platform with robust compliance features, cybersecurity protections and transparent buyer/seller matching algorithms. The bank should establish governance protocols to monitor transactions and prevent insider trading. Valuation accuracy can be enhanced by requiring independent appraisals before listing shares. The bank should consult with legal counsel to ensure compliance with securities laws and to avoid any appearance of operating as an unregistered exchange prior to using a private listing platform.

Regulators will expect adherence to state Blue Sky laws governing private securities transactions in these platforms. The bank should implement strict monitoring protocols to ensure that nonpublic financial information is not misused and that no insider trading occurs. Cybersecurity and vendor risk management are increasingly emphasized by regulators for banks using private listing platforms. Due diligence on platform providers, including SOC reports and penetration testing, is recommended.

ESOP Transactions

Employee Stock Ownership Plans (ESOPs) provide liquidity for shareholders while promoting employee ownership and succession planning. ESOPs offer significant tax advantages to both the selling shareholder and the bank. Sellers may defer capital gains under IRC §1042 by reinvesting proceeds in qualified replacement property and contributions to the ESOP are tax-deductible for the bank. In S-Corporation ESOPs, income attributable to ESOP-owned shares is exempt from federal income tax. Additionally, ESOPs can reduce estate tax exposure by creating liquidity for heirs.

ESOPs introduce a unique regulatory overlay combining ERISA fiduciary obligations with banking supervision. A bank should consult ESOP industry experts when considering an ESOP. Regulators expect annual independent valuations and trustee independence to safeguard employee participants. Leveraged ESOPs often require prior notice or approval from banking

authorities due to their impact on capital and liquidity. Tax compliance under IRC §1042 and S-Corp ESOP provisions must be meticulously documented to avoid IRS challenges. Furthermore, regulators increasingly focus on repurchase obligation planning — banks must demonstrate that future ESOP-related liquidity demands will not compromise safety and soundness. Failure to address these obligations can lead to regulatory concern.

Tender Offers and Secondary Sales

A Tender offer allows the bank or investors to purchase shares at a fixed price, creating a structured liquidity event. This strategy allows new investors into the bank and allows a level of liquidity for current investors tendering shares. If possible, the bank should time its tender offer to coincide with strong financial performance and should consider obtaining a fairness opinion to validate the offering price.

Regulators scrutinize these transactions for fairness, transparency and potential shifts in ownership control concentration. The banks must monitor post-offer capital adequacy and ownership thresholds, as significant changes can trigger additional regulatory considerations or changes in control determinations. Comprehensive disclosures are required, including detailed offering documents and adherence to securities regulations.

Full Bank Sale to an Investor Group

Selling the entire bank is the most consequential liquidity event, often driven by shareholder pressure, succession challenges, management fatigue or increased operational costs. Until recent years, bank sellers gravitated toward selling almost exclusively to another bank or credit union. Although a sale to another financial institution provides a viable solution for the bank, its shareholders and its customers, a sale to a private investor group can provide some unique advantages.

First of all, private investor groups are most often willing to pay a significantly higher price for a bank than a financial institution buyer. An investor group's purchase offer weighs the cost-benefit of buying an existing bank rather than seeking approval of a de novo charter. An existing bank already has a bank charter, physical location, depositors, loan customers and some level of profitability. The capital required to buy an existing bank is very often less expensive than the capital required to obtain regulatory approval of a new bank charter. Additionally, de novo charters historically lose money for the first five or more years of operation.

As opposed to a financial institution buyer that likely has redundant operations and employee roles, private

DID YOU KNOW?

In 2024, 78% of 367 banks in the U.S. said liquidity was a "extremely important" or "very important" risk. This is lower than the 84% reported in 2023, though still a significant spike from the 35% in 2022.



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“Comprehensive disclosures are required, including detailed offering documents and adherence to securities regulations.”

investor groups are usually willing to keep all or most of the bank's employees after the sale, often including the bank's senior management. Private investor groups are generally seeking to incorporate a particular niche product into a bank's existing business lines without disrupting the bank's core business.

Selling to a private investor group, however, requires a longer approval process time and greater regulatory scrutiny than the sale to a financial institution. A bank seller should weigh the likelihood of regulatory approval of the investor group, their business plan and the additional time required for approval, against the higher purchase price offer when selecting a buyer.

Key Takeaways for Decision Makers

Liquidity planning is a strategic imperative for community banks and should be top of mind for the bank's board of directors and senior management. Bank boards should adopt a multipronged approach combining short-term options, including repurchase programs with long-term strategies, such as ESOPs and potential whole-bank sale scenarios. Regulatory considerations must be embedded in every decision, from capital adequacy monitoring to ERISA fiduciary duties. Proactive board involvement and understanding of the bank's available liquidity options are critical to preserving shareholder value and institutional stability. ■

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