GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Florida, Tennessee, Georgia, North Dakota and Kansas!

CHAIRMAN/CEO ROLE

One of the perpetual discussions in community banking (and even with the larger banks) is whether the Chairman and the CEO should be separate positions held by separate individuals. The last time I checked the statistics, the Chairman and the CEO positions were occupied by the same human being in about 75% of the banks in the country. To my knowledge, until recently, the friendly federal regulators have never weighed in on this particular issue. They have instead left the decision where it should be—in the hands of the company's shareholders and board of directors. Apparently, that is no longer the case. OCC Comptroller of the Currency, Thomas Curry, has now weighed in. Curry has indicated that "… regulators should consider whether splitting the roles of board chairman and CEO makes sense for all federally supervised banks, or at least the largest and most complex ones." It looks like this issue is squarely in the crosshairs of the OCC. We will keep an eye on it for you.

THE TRUMP EFFECT

I am getting regular inquiries from clients as to what will be the "Trump Effect" as a result of the election of President-Elect Donald Trump and a majority Republican House and Senate. It seems to me this needs to be analyzed from two time perspectives. That is to say, what is the immediate effect of the surprise election of Donald Trump, and what is the long-term effect for community banks? The immediate effect that we noticed was a bit of optimism and a "wait and see" attitude. Most community bankers predict a reduction in the corporate tax rate, but the issue is how much of a reduction is on the table. Most of the bankers I have visited with lately do not think the corporate tax rate will drop to 15%, but maybe 22% to 25%. Most of them, with a few exceptions, are putting things on hold until they see what Trump can do in his first 100 days.

Over the long term, it seems to me the effect will be lower taxes, less regulation, and hopefully a better place to operate. We will see.

THE TRUMP EFFECT - PART 2

One additional effect of the election of the new President, in my experience, will be a bit of a slowdown in acquisitions. Most acquisitions of community banks are driven by a number of factors, including the traditional reasons for selling—no management succession, no board succession, no share liquidity, no cash flow, better alternative investments, the hassle of the regulatory burden, etc. I have spoken to a couple of bankers in the weeks since the election who confided to me that had the election gone the other way (i.e., had Hillary Clinton won) they probably would have sold their banks because the regulatory burden is simply crushing. Now that the country appears to be taking a different direction, they are taking a "wait and see" attitude as to whether to keep going or pursue other alternative strategies.

MERGERS OF EQUALS

Although you *Musings* readers certainly know there is no such thing as a merger of equals, there have been a couple of deals announced lately that look like they are halfway close. One Virginia transaction announced yesterday involves a couple of multi-billion dollar banks coming together. One bank will own about 48% of the company, and the other will own 52%. The Board is split 6 to 5, and the CEO of the smaller company will become the CEO of the larger company, with the larger company CEO moving to Chairman.

This one looks like the typical "unequal" merger of equals. It will be interesting to see how cultures mesh on this one. Putting the deal together is the easy part. Putting the cultures together is the difficult part.

REGULATORY APPROVALS

Let me let you in on a secret in the community bank world: during the month of December, it is very difficult to get the regulators to do pretty much anything. We are working on a number of acquisition transactions that we really did not expect to get closed this year (nor did the client). In fact, with the Trump election, we are delighted to delay them to next year to see if we get a better tax treatment on the sale consideration. Nevertheless, we have multiple applications filed with the regulatory agencies. Again, trying to get anything done with the regulatory agencies during the month of December is difficult. It is not that they are not cooperative. It is just that they are not there. It seems that most of them have checked out, if not physically, at least mentally. Fortunately, we do not have any pending transactions we must get approved prior to year-end, so at least this annual phenomenon is not really adversely impacting our clients currently.

AFFILIATED BANK COMBINATIONS

One trend we have seen in 2016 is the merger of affiliated banks that had previously operated separately under either the same holding company or related holding companies. We have put a number of deals together where either two separate holding companies are owned by the same individual or family, or the single holding company has multiple banks under it that may have different charters (i.e., one national, one state, one Federal Reserve member, etc.) With the regulatory burden, a lot of the owners of these types of companies are looking at the possible cost and hassle savings for putting the banks together under a single regulator. My general recommendation is this. Unless there are some unusual circumstances, it is best to end up with a state charter, if you have one now, and a Federal Reverse member subsidiary bank. That way, you are regulated by the Federal Reserve at the holding company, the Federal Reserve at the bank, and the State at the bank.

The interesting thing about these types of transactions is that the owners generally approach the transaction as being "a very simple deal." Unfortunately, the regulators approach it as though it was merging JPMorgan Chase and Citigroup together. Although the benefit of putting the banks together is significant, the cost of doing so because of the regulatory "hoops" associated with the vetting of these tiny transactions is enormous in view of the banks' size and profitability. Nevertheless, over the long term it seems that these types of transactions make sense and will continue for these affiliated owners.

ACQUISITIONS CONTINUE TO MARCH ON

The last couple of weeks we have gotten calls and emails from numerous clients asking us to "run the numbers" on a combination of their bank with a potential target. These are all in the "acquisition" category. That means nobody is trying to talk about a merger of equals or anything similar. These would be outright purchases—some for stock, some for cash. The interesting thing is that most of these that have come in the last couple of weeks have been opportunistic transactions. In other words, it is not that our client was seeking out the target, it is that something occurred with the target (e.g., death of a CEO or principal owner) that has caused the opportunity to come to the front.

In connection with your strategic plan for mergers and acquisitions, make sure you are prepared to take advantage of opportunities—opportunities that are unique and will not be around for long. I liken it to owning the family farm and wanting to buy the farm next door, which only comes up for sale once every 50 years. Keep your eyes open for opportunities in your community bank acquisition strategy.

INTEREST RATE RISK MANAGEMENT

Interest rate risk management has been a "hot topic" in the industry for some time. Given the results of the election, as well as the Federal Reserve's December meeting, many banks are thinking about how they are positioned for the increase in interest rates. This is certainly the heart of interest rate risk management. However, some of my recent work has reminded me that thoughts alone are not sufficient to satisfy the regulatory expectations regarding interest rate risk management.

The regulators expect every bank, regardless of size, to have "robust" interest rate risk management practices. For most banks, this means having a third-party provide an interest rate risk management model on a no less than quarterly basis. Many banks stop there. Unfortunately, the regulators do not consider the model alone to be enough. The regulators also expect banks to have a third-party review of their interest rate risk management practices on a no less than annual basis.

The first part of December is typically a busy time around our Firm because we are assisting a number of community banks in the third-party review. There are a number of different factors we look at when evaluating a bank's interest rate risk management practices. The model is certainly a component of the review, but is not the entirety. The regulatory expectations for the third-party review are boiled down to about a 20 item checklist that has various subcomponents within each item. The regulators expect banks to consider all of the items on the checklist to ensure appropriate interest rate risk management. If you are not having a third-party review your interest rate risk management practices, you should consider doing so. We have had many banks that have been criticized in exam reports for their failure not to get this done. Let us know if we can assist your community bank.

REQUIRED DISCLOSURES

We are currently assisting a holding company in the sale of its subsidiary bank to another bank. This holding company is small and has a fairly concentrated ownership group of about 30 shareholders. We recently drafted the proxy materials for the shareholders and provided them to our client for review prior to distribution. The client was a bit surprised at the length and amount of disclosure in the proxy materials. They wondered whether it was really necessary for us to make all of this disclosure given the fact that they have a small ownership group and everyone "basically knows what is going on with the bank," or at least trusts that the directors know what is in their best interests.

In short, our answer was "yes, it is required for us to include all of these disclosures." Regardless of the number of holding company shareholders, if you have any shareholders that are not on the board of directors, it is appropriate to provide those shareholders detailed proxy materials when they are considering whether to sell the bank. It is not enough to simply say those shareholders know what is going on or just trust the directors to make the decision for them. Failure to produce the required disclosures introduces a lot of unnecessary risk into the transaction.

If you are thinking about selling your bank at some point in the future, keep in mind the proxy materials are going to have to disclose a whole slew of information. It is not enough to simply draft a couple pages that indicate the shareholders should "trust the board" and vote in favor of the transaction. The whole crux of the issue is that the shareholders must have enough information to make an informed decision.

THE OREO DECISION

I recently facilitated a strategic planning retreat for a bank that has been dealing with elevated levels of OREO for quite some time. This particular bank has about six or seven OREO parcels that it simply cannot sell. The bank has appraisals that support the carrying value, but the discussion during the planning retreat revealed the actual price at which the parcels could be sold was believed to be significantly less than appraised value. That begged the question on whether to sell the OREO at a fairly significant loss or keep on keeping on with the OREO and hope for something to shake loose at some point in the future.

The past three or so years, the strategic discussion has resulted in a decision to keep the OREO. Although a decision has not finally been made, this may just be the year where the tide turns and the bank is ready to sell it. The bank has returned to pretty nice levels of profitability and has plenty of capital. This means it can now afford to dump the OREO at a loss, where it could not a couple years ago. The board is evaluating all of their options, but I would not be surprised if they were finally at a point where they were ready to just sell the OREO at whatever it took to get it off the books and out of their lives. I think this is a perfect example of the idea that capital and earnings really can cure all ills.

CONCLUSION

Thanks to all of you for allowing us to come into your email inbox every two weeks. We enjoy communicating with you and appreciate your feedback and inquiries resulting from matters we have addressed in *Musings*.

We also wish all of you a very Merry Christmas and a Happy New Year! We will see you next on New Year's Eve (*Musings* never sleeps).

Jeff Gerrish *and* *Greyson Tuck*