GERRISH'S MUSINGS

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October 14, 2016, Volume 330

Dear Subscriber:

Greetings from Wisconsin, Pennsylvania, West Virginia, Tennessee, North Dakota and Minnesota!

THE MODEL COMMUNITY BANK

I recently facilitated a strategic planning retreat for what the organization's President described as the "model" independent community bank. This bank is located in a small town in the Upper Midwest. It is a good earning bank with solid asset quality. It does not do anything exotic. This bank simply sticks to the basic blocking and tackling of the industry, and it does that well. It has a loan portfolio that is entirely made up of local loans, provides great service to the bank's customers, supports the local communities in which it operates, and employs a good number of people.

I told this Bank President that I did not disagree that the bank represented the quintessential community bank. Luckily, I have encountered many, many more banks just like this across the country. This is just a small reminder of the great industry in which we work.

THE HARD DECISION

I was recently with a board of directors of a community bank holding company that got into a healthy discussion with respect to whether or not the holding company should consider changing its ownership structure. The real issue is whether the holding company should remain SEC reporting, which has been its structure for quite some time. This is a bank holding company and bank with less than $500 million in total assets. As best the directors could tell, the holding company had, when counting non-objecting owners and guessing at some of the street name shares, probably 800 to 900 human being shareholders.

The argument for continuing to be SEC reporting and listed on an exchange is that it provides market liquidity for your shares and provides the holding company access to the public capital markets. Unfortunately, if you studied most community banks and holding companies the size of this one with this number of shareholders, neither of those benefits appear. They do not have any market liquidity even though they are listed on an exchange (maybe trade 500 shares a day), and they certainly do not have access any better than any other community bank to the "public" capital markets. So what is the benefit? The real issue is what is the board's long-term vision for the bank? If the long-term vision is to be a multi-billion dollar public NASDAQ listed holding company, then certainly keeping the ownership structure as SEC reporting makes sense. If that is not in the cards, however, then why would the community bank and holding company spend north of $200,000 a year for the privilege of being SEC reporting with no offsetting benefit? This particular organization is still discussing it at the board level. The good news for them, if they decide to do it, is it simply requires the filing of one form with the SEC to suspend registration.

THE "CONCERNING" AG ECONOMY

Over the last couple months, we have been working with a couple community banks that are looking to sell. In each of these situations, the selling bank is what I would describe as an Ag bank. In three separate instances over the last couple weeks or so, we have had potential acquirors voluntarily walk away from these potential acquisition opportunities due to what the potential acquirors describe as the "concerning" agricultural economy. Each of these three potential acquirors indicated it is not yet experiencing significant problems as a result of agricultural credits, but they appear to be gearing up for the fight. Each of these potential acquirors indicated that the expected problems in the agricultural economy put the bank in a position where it simply cannot pursue an acquisition at this time.

If this happened one time, I would probably chalk it up more to an excuse than an actual issue. However, given the occurrence of these events, it appears that community banks that are Ag banks are having some real concerns about what may be happening in their loan portfolios over the next couple years.

FAMILY OWNED BANK ISSUES

I am currently assisting a family that owns almost 100% of a community bank with navigating a situation that has the potential to end up badly. The family currently has five shareholders. Four of the shareholders are aging and want liquidity. One of the shareholders is a millennial that recently inherited the stock and really wants the community bank to remain independent. The very interesting aspect of the situation is that the ownership of these five groups is approximately equal. However, the holding company has both voting and non-voting common stock, and the millennial that recently inherited the stock controls about 60% of the voting stock.

During our meeting in which we were working to create a resolution that works for everyone, all the family had cool heads. I told the family that I hope those cool heads continued, because this certainly has the potential to become, as I told them in the meeting, a "good old fashioned family fight." We are working to see if we can craft some solution that makes everybody happy, which would essentially be facilitating the repurchase or transfer of the shares from the four older shareholders that want liquidity, while allowing the millennial shareholder to retain or increase ownership of the great community bank holding company. This may be a tall task, but we are going to put the pen to paper and see what can be done. If we cannot figure that out, this could be one of the more interesting situations we have seen in a while. I will keep you updated.

ESOP LOANS

We are currently helping a couple different clients shop for an ESOP loan. If you are not familiar, an ESOP loan involves a transaction where an Employee Stock Ownership Plan or a 401(k) ESOP borrows money from a third party lender (not from its own bank, as that is a violation of Regulation W and Section 23 of the Federal Reserve Act) and uses the loan proceeds to purchase holding company common stock. The holding company then takes the cash proceeds from the sale of the common stock and uses it in any appropriate way the Board sees fit.

One of the difficult aspects of an ESOP loan is finding a lender who is willing to make the loan. Many traditional bank stock lenders are not interested in making ESOP loans because the collateral available to the third party lender is less in an ESOP loan than it is in a traditional bank stock loan where the lender obtains 100% of the bank stock as collateral. In an ESOP loan, the applicable regulations require that the shares purchased with the loan proceeds be held in a suspense account. The shares are released from the suspense account and allocated to the ESOP participants as the loan is paid down. The regulations provide that the only collateral available to the ESOP lender is the shares held in the suspense account. In other words, the loan to value ratio on an ESOP loan is always at or very close to 100%. This is a very different situation than a bank stock loan, in which the lender often has a loan to value of less than 50%.

Because of the issue involved with the regulations noted above, this is why most ESOP loans are made, as a practical matter, directly to the holding company where the third party lender secures 100% of the bank stock as collateral. The holding company then makes the loan to the ESOP.

We are optimistic that we can get all of the ESOP loans completed under one structure or another.

HOW LOW CAN YOU GO?

We were recently reviewing a target bank's financial position for a community bank holding company client. One thing we noticed about the target bank (it was pretty obvious) is that it had about a 30% loan to deposit ratio and a massive securities portfolio. It was basically a personal investment bank for the ownership group. Our client was a bank in a market where they had about 110% loan to deposit ratio and about a 90% loan to assets. They needed funding. So the question was, if our community bank holding company client acquired this bank and paid some slight premium to obtain the funding and the low cost source of deposits that this rural organization had, would it make financial sense? The answer to that is it probably would at some price. Unfortunately, that "some price" was not a price at which the sellers were willing to sell. They are going to keep their bank, and our client is going to keep searching for core deposits or alternative means to fund their growing loan portfolio.

THE DYSFUNCTIONAL BOARD

I recently had the opportunity to meet with a board of directors of a community bank that could be best described as dysfunctional. As I like to say, they put the "fun" in dysfunctional. This is a board where the outside directors did not get along with each other, and the inside directors who got along with each other did not get along with the outside directors. The board was heavily loaded (compared to most) with inside directors. It did not really seem to matter what the issue was – they had to fight about it. I put some of the blame in this case on the Chairman, who was an independent outside director, for not better controlling the situation among his directors. I got to be the referee while I was there, which worked out fine. This is a situation, however, that is likely to go on in a bad way for some period of time if they do not make some hard decisions and resolve their differences. I will keep you posted.

WELLS FARGO

Aren't you glad you are not Wells Fargo? I have been in many, many banks over the last two years that have had discussions about establishing or improving their "sales/service culture." Most of them want to establish a strategy to improve their sales and service culture, but the normal refrain is "we want to help our customers, but we do not want to be Wells Fargo." In contemplating the Wells Fargo problem, it seems that there are at least five lessons that could be learned, including: 1) It takes a long time to build a reputation and a short time to lose one; 2) Corporate culture starts at the top; 3) Your bank will get what it incents; 4) Apologize quickly, make amends, take responsibility, and move on; and 5) Be glad you are a community bank and not Wells Fargo.

I will likely expand on these five lessons in my next blog for Banking Exchange at www.bankingexchange.com.

CONCLUSION

I have had the opportunity over the last couple of weeks to spend some time in the Northern and Upper Midwestern parts of the United States. Fall is definitely here. The leaves are beginning to change, and a crisp chill is in the air in the mornings. I assume the snow will not be too far behind.

As we march toward the end of the fourth quarter, have a great two weeks.

Jeff Gerrish *and* *Greyson Tuck*