GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from New Mexico, Colorado, Mississippi, New York, Ohio, Kentucky, and Louisiana!

HELP IS HERE AT LAST

Help is here at last. Not quite what we expected, but something is better than nothing at this stage. What we are referring to, of course, is the community bank leverage ratio Notice of Proposed Rulemaking recently published by our three friendly federal regulators. As many of you may recall, in the recent Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155) the regulatory agencies were directed to come up with a community bank leverage ratio concept which would allow community banks, if they met a certain minimum leverage ratio designated in the legislation as somewhere chosen by the regulators between 8% and 10%, to not have to fool around with the rest of the risk-based capital rules.

The regulators, to our surprise, picked 9% (we thought they would pick 10%). We would rather see 8%, and the trade associations are still working in that regard. Regardless, if this rule goes through and your community bank has a 9% capital to assets ratio (as defined by the rules, of course), then you will be relieved from the Basel calculations and requirements. If anybody wants a brief Memo to Clients & Friends on this, please let us know, and we will send it on.

MARKETING STRATEGY

What is your bank's marketing strategy? We have participated in numerous planning sessions lately where the marketing strategy is a significant issue for the bank. Some banks still market through traditional channels (i.e., newspaper, radio, TV, cable, etc.). Some market almost exclusively digitally. We have found that virtually all true community banks market through relationship building, sponsorships, and charitable giving.

Most of our clients are evolving in their marketing strategy from traditional to digital. The question is how far and how fast? One big benefit of digital marketing as we understand it is you can at least determine who is viewing the marketing pieces, generally what kind of penetration you are getting, and what kind of feedback response it actually achieves. We are also having a number of clients around the nation going through a rebranding or renaming of their bank. This is always an interesting topic for discussion and a significant one for any board.

THE QUINTESSENTIAL COMMUNITY BANK

We recently facilitated a planning session for what we could only describe as the quintessential family-owned community bank. This particular community bank is a very high performer, having an extremely strong ROAA and very high levels of capital. The financials are great, but we view this as the quintessential community bank because of the sincerity with which the family owners approach their responsibility to support the community.

As oftentimes occurs with strategic planning for family-owned banks, the "first step" in the planning process is actual meetings with the family owners to determine their views on important ownership issues, such as independence, stock liquidity needs, and the like. What struck us here is that during our discussions with the family owners they were just as worried about doing things to help the community as they were themselves. Their attitude was essentially "as goes the community so goes the bank," and vice versa.

The family's approach to the importance of supporting the community is reflective of community banks all across the country. We truly believe that the industry embraces these important corporate ideas. This particular meeting was a reinforcement of our belief that community bankers are both great people and great businessmen and women. The best of both worlds!

EARNEST MONEY IN M&A TRANSACTIONS

The payment of earnest money at the time of signing an acquisition agreement is an issue that sometimes comes up in M&A transactions. Based on our experience over the last three to four years, this is really a regional issue. If you are doing a deal in the Midwest, particularly the Upper Midwest, the issue of earnest money is likely to come up regardless of the target bank's asset quality or other transaction closing concerns. For most other parts of the country, earnest money is rarely an issue.

If the seller wants earnest money in a transaction, the issues are two-fold: how much and under what circumstances does the seller get to keep the earnest money if the transaction does not close? Like any other aspect of an acquisition transaction, this is all a matter of negotiation. The amount of the earnest money is directly tied to the transaction consideration, but generally 3% or less of the transaction consideration is a good bogey. As to the circumstances for which earnest money is kept by the seller if a transaction does not close, that is not quite so easy to define. The earnest money is generally kept by the seller for any breach of the agreement by the buyer. However, some sellers want to go beyond just a breach and try and keep the earnest money if the transaction does not close for any reason other than a breach of the agreement by the seller. Like many other aspects of the transaction, the devil is in the details, but there are lots of issues to consider.

If you are a buyer or seller give some thought to earnest money. Our recent experience has been that it is not a part of the transaction unless the seller is located in the Upper Midwest. We credit this to the attorneys in those regions seeing other deals with earnest money and it snowballing into a trend.

RATE CAPS THREATEN EFFORTS TO SERVE THE UNDERBANKED

As many of you are aware, 1989 changes to the Federal Deposit Insurance Act dealt with brokered deposits and rate caps. In particular, banks are limited as to the rates they can pay, particularly if the bank is deemed to be less than well-capitalized. This really hampers a bank that may be trying to serve the unbanked population because they need to obtain funding for the lending, and the funding is not going to come from the depository base. It is going to have to come from somewhere else.

There was an excellent article in a recent *American Banker* on this specific issue. The article was authored by Jonathan Baird, Chief Financial Officer at The Peoples Bank in Magnolia, Arkansas. If anybody wants a copy, please let me know.

GEOGRAPHIC PREFERENCES

We recently had an interesting discussion with a community bank director and executive officer. We were talking about a number of strategic issues, including geographic expansion. Our discussion focused on various opportunities to enter into new markets, either by buying branches, establishing new branches, or otherwise. During the discussion, the CEO essentially indicated that his preference is to bank in markets where he dictates the rate to the customers, not where the customer dictates the rate to him. In other words, he said his preference has always been to avoid getting in the fray in markets where customers can walk in and essentially say the bank next door offered this rate, so I expect you to match it or I will walk back across the street and borrow their money at that price. We have heard a number of bankers take this type of approach, but we are not certain we have heard it stated so directly. We thought the individual's approach to market selection was very interesting, and it seems to have served him well up to this point.

CAPITAL ALLOCATION

We recently facilitated the annual strategic planning session for a community bank that we have worked with for a number of years. This particular bank is one that was in a troubled condition a number of years ago but has since recovered quite nicely. They now are making good money, have plenty of loan demand, and recently paid their first distribution in quite some time.

The interesting thing about this planning session was the discussion on capital allocation. This company's financial capital needs are three-fold: (i) bank holding company debt service, (ii) shareholder distributions, and (iii) retained earnings to support growth. Although this bank has recovered nicely, they are not yet to a point where there is enough capital to go around to fully satisfy all of these capital needs. Much of the planning session involved discussion on prioritizing these needs for the benefit of the shareholders.

This bank is not unlike many other community banks (or many people's personal lives for that matter!). The financial resources were not quite enough to satisfy all the "wants" in their lives. The good thing is that the group had lengthy discussion concerning the priority of wants and developed a plan that we believe is a very appropriate allocation of capital given the circumstances. This was the exercise of fiduciary duties at its finest.

CONCLUSION

We hope all of you had a wonderful Thanksgiving holiday weekend. It is now time for all of us to push through to year-end.

We look forward to seeing many of you in upcoming months at various trade association gatherings. Those of you who are Chairmen, Vice Chairmen, Directors or CEOs, please do not forget about the upcoming Chairman's Forum in Naples, Florida. You can register at the following link: https://barret.ws/landing/chairman/

Have a great two weeks.

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