GERRISH'S MUSINGS

Jeffrey C. Gerrish
Philip K. Smith
Greyson E. Tuck
Gerrish Smith Tuck
Attorneys/Consultants
700 Colonial Road, Suite 200, Memphis, TN 38117
♦ Phone: (901) 767-0900 ♦ Fax: (901) 684-2339 ♦
♦ Email: jgerrish@gerrish.com ♦ psmith@gerrish.com ♦ gtuck@gerrish.com ♦
Website: www.gerrish.com

October 31, 2019, Volume 403

Dear Subscriber:

Greetings from Texas, Kansas, Virginia, Ohio, Illinois, Iowa, Missouri, and Washington!

COMMUNITY BANK LEVERAGE RATIO

As many of you know, on October 29th, the friendly federal regulators (i.e., Federal Reserve, FDIC, and OCC) finalized their rule to provide for the Simplified Community Bank Capital Ratio. The bottom line of all this is that if the community bank is less than $10 billion in total consolidated assets, has a limited amount of off balance sheet exposure, and has a leverage ratio of greater than 9%, then it qualifies for the Simplified Capital Calculations. As noted by the agencies, "the Community Bank Leverage Ratio Framework removes requirements for calculating and reporting risk-based capital ratios for a qualifying community bank that opts in to the framework."

Keep in mind, this is an "opt in." If your community bank opts in and its capital ratio drops below the 9% Community Bank Leverage Ratio, then it has a two quarter grace period before it is considered less than well-capitalized. If anybody wants any further information about this, please let us know. If we can assist in making the decision whether to opt in, please let us know that.

DON'T BE AFRAID TO QUIT

Fall is what we refer to as "planning season" around our firm. We have been and continue to travel around the country meeting with Boards to facilitate strategic planning sessions. One piece of advice we give all of our planning clients is to not be afraid to quit.

We suspect you are curious as to this advice. It relates specifically to the time and discussions at the planning session. What we mean is at a planning session you certainly need to devote enough time to cover all of the key topics in detail and to appropriately formulate strategies to address them. However, once you have done that, do not be afraid to quit. Our recommendation is not to keep your directors and officers engaged in some discussion that is not efficient or productive simply because on the front-end it has been decided that the strategic planning session will run until some predetermined time. This will move the discussion from being efficient to boring at best and painful at worst. Neither of these are a good precedent for the planning session.

A CHANGE OF STRATEGY

Speaking of strategic planning, over the past couple weeks we facilitated the planning session for a group that resulted in a pretty significant change in strategy. In previous planning sessions, this particular group had essentially adopted a strategy to be an acquirer. We had recently vetted some acquisition opportunities for them, but they were really not convinced that the opportunities were beneficial to the organization. During the planning session, the group engaged in lengthy discussions regarding the acquisition strategy. The results of the discussion were essentially to abandon efforts to further pursue an acquisition. This was the appropriate result for a couple reasons. First, the bank had spent time trying to bring an acquisition together, but they were just not getting much traction. Second, during the discussion it was recognized that the organization itself was not operating at "peak operational efficiency." Instead of spending time trying to pursue acquisitions, the group instead adopted a strategy of getting its own house completely in order before going out and thinking about making an acquisition. The thinking was essentially that the existing bank operations needed to be operating at peak operational efficiency before the organization would be ready to go buy someone else and have the transaction enhance shareholder value. The strategy and decisions made all the sense in the world to us.

CHARTER CONVERSIONS

We recently received a call from one of our community bank clients that is considering a charter conversion. This particular community bank is a national bank that is thinking of converting to a state charter. However, as you likely know, a charter conversion can also go the other way, with a state chartered bank converting to a national bank. This client called us to ask our thoughts regarding the charter conversion. In summary, our view is that charter conversions typically boil down primarily to regulatory relations and, to a lesser extent, potential cost savings.

Most charter conversions that we have seen are driven by a desire to leave an existing regulator based on the belief that the bank will get better or fairer regulatory treatment during examinations from the new regulator. We do not see a charter conversion as providing the opportunity to operate in a substantially different business manner. Due to the similar laws and regulations, and the fact that most states have a national bank parity statute that allows a state bank to do anything permissible for a national bank, a charter conversion does not typically provide the opportunity to operate in a substantially different capacity based on the actual charter. Charter conversions also may provide for reduced expenses, depending on the particular circumstances, in the form of lower regulatory assessments. It may also provide the opportunity to go from two federal regulators (Federal Reserve at the holding company and FDIC or OCC at the bank) to one (Federal Reserve) if the bank elects to be a Federal Reserve member bank.

If you do not think you are getting fair treatment from your current regulators, by all means consider a charter conversion. However, if you are thinking about it, keep in mind that the charter conversion is really all about the regulators. It is not common to see a situation where a bank engages in a charter conversion because it wants to engage in some activity that necessitates that strategic transaction. Also, keep in mind that Dodd-Frank places certain limitations on charter conversions, and essentially bans charter conversions if the bank is under any type of formal or informal regulatory enforcement action.

TERM LIMITS

We often get asked whether term limits for directors are appropriate. As many of you know, many community bank holding companies, as an "anti-takeover" defense, have staggered terms for their directors. Often, these are three year terms with a third of the board elected each year. The anti-takeover nature of this is that if a party begins to control the stock, then they cannot control the board for at least a three year period.

We recently ran into a community bank that actually does have "term limits." When directors are invited on the board, they are invited for a three year term. At the end of that term, the board will decide whether or not they continue on in that position. Under most staggered terms for boards, there is still "directorship for life." This appears to be different. It appears to be much more of a true "term limit" corporate governance arrangement.

EMPLOYEE LIFT OUTS

We often hear about, and our clients often participate in, not the acquisition of another bank but the acquisition of employees. In the community bank industry, this is affectionately known as an "employee lift out." There is no conceptual problem with encouraging employees to come to work for your community bank. There is a conceptual and legal problem, however, with bringing those employees over with trade secrets they may have obtained from their previous community bank employment. Trade secrets can be anything from customer lists, detailed information on operations, loan files, or anything else that belonged to the community bank from which they exited.

As we previously mentioned in *Musings*, stealing trade secrets from your former employer is a pretty significant offense. In at least one situation that we are aware of, the not-so-friendly federal bank regulator stepped in, removed the offending employees, and banned them from banking for life. If your community bank is going to engage in an employee lift out, be careful about how you do it.

THE PERFECT BRANCH

We were recently with an organization that had several locations, one of which could only be described as the "perfect" branch in the perfect location in the growing section of their community and in an area in which they produced a lot of business. Unfortunately, although this branch otherwise is perfect, it had never developed in the way that the bank had hoped. What are the alternatives with the "perfect branch" that is underperforming? The community bank can sell it, the community bank can continue to operate it the way it does now (at a loss), or the community bank can fix it. This group wisely decided to explore how to fix the problem with the perfect branch. Hopefully that fix will come easily and profitably.

ACQUISITION CAPACITY

Often when we visit with community bank boards of directors about acquisitions, particularly by one community bank of another, the issue of "capacity" comes up. "Capacity" can be defined in a number of ways. Generally, it always focuses on financial capacity (i.e., can the bank generate enough cash to do the transaction within the regulatory constraints even for a small bank holding company). Other capacities also need to be addressed, however. These include the board's capacity for risk (i.e., is leveraging the holding company going to "stroke them out") and the capacity of the employees to integrate the acquisition while trying to maintain their existing jobs. This is clearly the case in most community bank acquisitions since most community banks do not maintain an acquisition task force or anything similar.

When you are looking to be a buyer in the community bank M&A game, consider the issue of capacity.

DIRECTOR EMERITUS

We have had numerous discussions over the years with community bank clients regarding board succession. Often, it is difficult to convince older directors that they need to get off the board or do something else, particularly when they have an ownership interest in the company. We have often found that moving the more mature directors into a Director Emeritus slot works for everybody. Director Emeritus, of course, is not technically a "legal" director. As a result, the Director Emeritus has no vote, but neither does he or she have liability. With respect to preserving a director's estate, that is generally attractive. With respect to other terms of Director Emeritus, they are whatever the board determines is appropriate. A Director Emeritus can be paid the same as a regular director, attend meetings, and participate in the discussion as though they were a regular director. The benefit to the bank of a Director Emeritus is retaining the corporate knowledge and advice of more mature directors, but also opening a slot on the board to bring on a younger director, a director with a different perspective on life, or a director with different expertise than the other directors. Think about the Director Emeritus for some of your more mature directors. It may just work.

SOCIAL MEDIA USE

Most community banks now take advantage of social media of some sort - Facebook, Instagram, Snapchat, and the like. For most, the social media is used for branding, not for specific product advertising due to some of the compliance issues involved.

We were recently with a community bank that found a way to use their social media, particularly Facebook, to not only their advantage but also their customers' advantage. In connection with customer calls by the bank personnel - Lenders, Marketing personnel, and the like - they would take various pictures of a customer's business and post them on the bank's Facebook page. This generated additional traffic to not only the bank's website, but to the customer's website, resulting often in additional business for the customer and additional referrals for the bank. A win-win for everybody. You might think about your own social media strategy, but that one seems to work for this particular organization.

MORE FRAUD

As we have noted in *Musings* previously, for some odd reason it seems that our experience with community banks suffering fraud losses has increased during the boom economic times to a much higher level than it ever was during the Great Recession. We were recently at a planning session with a larger community bank that had a full-time Human Resources Officer and staff. When the issue of fraud came up, the Human Resources Officer's explanation was pretty simple: the quality of employees that the bank is currently hiring, for virtually all positions, because of the full employment economy in the U.S., is not quite the same as the quality of employees had been hired previously. In the H.R. Officer's mind, that is contributing significantly to the fraud. Maybe so. It is as good an explanation as any we have heard.

PLANNING PERSPECTIVE: TOP DOWN OR COLLABORATIVE?

Does your community bank's board of directors understand its role in strategic planning? Is the strategy to be dictated by the board and implemented by the executives, or should it be a collaborative effort between the board and the executives with the board, of course, having the final say? We have seen community banks do it both ways. For some banks it is totally "top down." This is where the board meets first, determines the strategies, and then announces them to the management team who executes on them. We believe the better approach is a collaborative approach, where the board and management get together. This approach gives the board the benefit of management's thought process, particularly as to whether the bank has the financial and human capacity to execute on whatever strategy the board is heading toward. It also provides buy-in for the officer group that often does not exist if the board dictates the strategies.

Think about how your bank engages in its long-term planning. It may be time to make a change.

CONCLUSION

Tonight is Halloween night. Please be careful when you are driving with respect to all the little "ghosts and goblins." We hope your "treats" are many and the "tricks" are few. Have fun with the kids and grandkids.

Have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

