GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from California, Florida, Wisconsin, Georgia, Alabama, New York, and West Virginia!

EXECUTIVE SESSIONS

The term "executive session" is used often in community banking. Technically, the executive session is a meeting of independent outside members of the board of directors of the community bank/holding company (without inside directors) on a regular basis. The executive session, as a practical matter, was born of Sarbanes-Oxley in 2002 (hard to believe that was 18 years ago). For SEC reporting companies, which most *Musings* readers are not, an executive session is required on a regular basis (we deem this to be quarterly). For non-SEC reporting companies, executive sessions are completely optional.

We still view it as a best practice that the board meet in executive sessions. Some of our client community bank holding company and bank boards meet in executive session at every monthly meeting. The last item on the agenda is simply "adjourn into executive session." Some meet quarterly, some meet on the call of the Chair or any director, and some do not meet in executive session at all except to deal with the CEO's compensation. Do what is appropriate for your bank. The goal of the executive session is to eliminate the formerly secret meetings at the Chairman's home to discuss issues that the board needed to discuss outside the earshot of the inside officers.

The term "executive session" is also used in connection with strategic planning sessions. In connection with the planning session, "executive session" has a different context. The open session of the planning session is generally all the senior officers (however this is defined in your bank) and the directors. The executive session of a planning session is generally simply the directors.

Executive sessions are prevalent in community banking. Think about how they might work for your bank if you are not doing it already.

SELECTIVE REGULATORY ENFORCEMENT

We recently had a client ask us to assist them in taking a look at the possibility of moving their mortgage operations from the bank into a separately chartered holding company subsidiary. They were thinking about this because, frankly, they felt like there was not a level playing field as it relates to advertising and other aspects of the business between the bank and non-bank mortgage competitors. We took a look at the issue, and the results were disappointing but not terribly surprising.

In summary, what we found is that the rules applicable to mortgage operations are the same whether mortgage operations are being conducted through a bank or a non-bank mortgage company or mortgage broker. In fact, there are technically some additional rules and regulations that are applicable to non-bank mortgage companies and mortgage brokers that are not directly applicable to banks. However, what is definitely different is the enforcement of these rules. To put it plainly, our research shows that banks are actually regulated for compliance with these rules, where practically mortgage companies and mortgage brokers are not. The situation appears to be somewhat akin to posting a speed limit, but also posting signs that say the area is not patrolled for speeding.

There are certainly advantages to having a bank charter. However, the fact that banks have a functional and active regulatory scheme means there are going to be times where banks are not competing on a completely level playing field.

INDUSTRY PROFESSIONAL ROUNDTABLE

Over the past couple weeks, a number of us from our firm had the opportunity to participate in what was essentially an industry expert roundtable. This was an afternoon and morning discussion where we talked exclusively about the current state and future of community banking. There were all types of professionals involved, including lawyers, accountants, consultants, IT professionals, and credit experts.

The overall consensus of the group was that community banking is in a pretty good place right now. Some of the words used to describe the industry were optimistic, stable, well-positioned, and similar synonyms. The usual suspects also rose to the top when talking about areas of concern, such as cybersecurity, FinTech competition, credit unions, and the possibility of being near the end of a credit cycle.

Overall, it was a very good group discussion. What sticks out the most to us is the overall consensus of the group related to the stability of the industry and the optimism for the continuation of that stability going forward. (Of course, that can always change with one or two unexpected events.)

WHY NOT A BANK HOLDING COMPANY?

We recently had a lengthy discussion with a community bank officer group that is considering reorganizing into a bank holding company structure. During the call we talked about all the benefits of a community bank holding company, including the ability to borrow funds at the holding company level to increase capital at the bank, the ease of repurchasing shares to offer stock liquidity when compared to a bank-only structure, the more friendly nature of corporate laws when compared to bank laws, and the like. During the discussion we mentioned that approximately 80% of the banks in the country are in a holding company structure, which led to the next logical question: "Why are the other 20% or so of banks in the country not in a bank holding company structure?"

Although we have not recently polled these 20% of banks to determine why they are not taking advantage of the benefits of a bank holding company, our speculation is that those banks that are not in a holding company generally fall into two camps. The first camp is banks that have never had a need to take advantage of the benefits of a bank holding company. In other words, these banks have never needed to increase capital at the bank for expansionary or other activities, have never had a need to facilitate liquidity, and the like. The second camp is that the individuals running the bank are, for whatever reason, fundamentally opposed to the bank holding company structure. We believe this to be a very small group of bankers, but we have in the past seen instances where bankers have resisted a holding company structure because that was what was taught to or engrained in them.

Following our answer, the next question was very logical, which was are there any downsides to a bank holding company structure. Our belief is no, there are not any downsides. The greatest downside, if it can be called that, is the fact that if you are not currently a Fed member bank you will pick up another federal regulator in the Federal Reserve. However, for those holding companies that have no significant activities, it is all an off-site and "piggyback" examination off the bank exam that is usually of no significant consequence. Other downsides include the cost (nominal in the big picture), and the fact that your holding company has to file a couple of brief regulatory reports.

Overall, we have been and continue to be proponents of the community bank holding company structure. We think it is a preferable structure to being in a standalone bank.

CHANGE IN CONTROL ISSUES

Over the past couple weeks, we have received the same question a couple different times related to the Change in Bank Control Act. The question is essentially what is required if a holding company engages in a share redemption that causes a change in control. This could happen under a couple different scenarios. The first is where any individual that is currently a control shareholder has all or a portion of their shares redeemed and their ownership is reduced such that another individual becomes a control shareholder. The other is where there is currently no control shareholder in the organization, but due to a share redemption there will be a reduction in the number of shares outstanding and a shareholder will exceed the threshold for control purposes.

Technically speaking, in either of these scenarios the required notice is an after-the-fact notice. Practically speaking, we believe the better course of action is to give the regulators a heads-up prior to the actual share redemption that will cause the change in control. We do not necessarily advocate for a full application prior to the share redemption, but our experience is that things usually go a little bit smoother when the regulators are involved on the front-end.

The important thing to keep in mind is that share redemptions can cause a change in control. It seems that there are a number of holding companies that are thinking about share redemptions at this time, and it is important not to lose sight of the notice and application requirements. We also think it is a good idea to give the Federal Reserve some type of heads-up if you believe a share redemption is going to cause a change in control.

MANAGEMENT TRANSITION

We often use *Musings* as a platform to discuss several of the major issues with respect to keeping your community bank independent in a consolidating environment. One of those major issues we generally refer to is management succession. Our general conclusion is community banks are doing better on the management succession issue. (To be frank, this was largely by necessity – many couldn't do much worse.) One of the bigger components of management succession, however, is the management "transition" piece. What does the current CEO who is transitioning out of the bank do once he or she leaves that CEO slot? There are, of course, lots of alternatives. The CEO could simply retire - go off into the sunset and never be seen again. The CEO could remain on the board. The CEO could move into the Chairman slot (or retain it if he or she had it to begin with).

One significant issue that we believe needs to be addressed if the CEO is going to stick around is the relationship/job description of the duties for the former CEO, now board member or Chairman, and the current CEO. We have seen that transition work well when the CEO has remained on the board and understands his or her duties. We have also seen it work poorly, when the CEO remains on the board, either as a director or Executive Chairman. CEO succession is not the only issue. The CEO transition also needs to be addressed in significant detail.

FEEDBACK APPRECIATED

Apparently the last few *Musings* struck a chord with a number of *Musings* readers for different reasons…some good, some bad.

Whatever the feedback, we appreciate receiving it. Our goal as representatives of the community banking industry from the consulting, legal, and financial advisory perspective, is to understand and promote what is on community bankers' minds. We are very appreciative of *Musings* readers' feedback on all areas. Thank you much.

CONCLUSION

For those of you who may not be paying attention, today is Valentine's Day. Please do something even nicer than normal for your significant other. Have a great day and don't forget.

We look forward to seeing many of you at the upcoming ICBA Convention in Orlando. Also, please mark your calendars for the Mergers and Acquisitions Workshop sponsored by the ICBA and presented by Gerrish Smith Tuck. This is a workshop suitable for CEOs, outside directors, Chief Operating Officers, and certainly Chief Financial Officers, with respect to the nuts and bolts of community bank mergers and acquisitions, particularly from the pricing and financial advisory side. The next Workshop will be held in Minneapolis at the W Hotel (the Foshay) on June 15 and 16. Registration is open. Please follow the link to sign up. M and A Workshop Registration

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

