GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Ohio, Texas, Michigan, California, Wisconsin, and Minnesota!

BANK FAILURES

Over the last month there have been two additional FDIC insured bank failures, which makes for a total of four for 2020. We often get asked whether this portends some horrible economic collapse and the death nell to community banks. The answer to that question is "no." If our recollection is correct, the first two failures this year involved fraud issues at smaller community banks. The last two failures, a bank in Florida and one in Kansas, are much more familiar to us. Both these banks involved asset quality issues that had lingered on for, in one case, almost 10 years. We can assure you, at least as to the Florida bank, that heroic efforts were made to save it. Its death nell was the 2009 Great Recession and the Horizon oil spill in the Gulf of Mexico. It never did recover.

Communicating with community bankers across the nation, we are still advised that asset quality is strong, notwithstanding the pandemic and the uncertainty created by it. Time, of course, will tell, but although there are in the neighborhood of 50 banks on the problem bank list, many of which by definition could fail at any time, we anticipate there will be very few failures between now and the end of the year.

COME BACK DEALS

Prior to the pandemic, we had a number of community bank merger and acquisition transactions in the works. By "in the works," we mean that the client had contacted us on one side of the deal or the other and asked us to assist them in running the numbers, negotiating a transaction, and the like. As you can appreciate, most of those deals stopped dead in their tracks with the pandemic. Some of those deals moved forward notwithstanding the pandemic, and now it seems like the rest of them are coming out of hibernation. For some of those transactions where we did not quite have a meeting of the minds pre-pandemic, we are now back to working on to see if we can reach an agreement on price, terms, and mitigation efforts associated primarily with asset quality. We never anticipated those deals would be "dead," simply on "pause." That appears to be what has happened. The pause button is now coming off, and the transactions are moving forward. Keep in mind, virtually all these transactions are for cash and involve community banks under $750 million. The big players - i.e., the publicly traded companies - are still out of the market for the most part because their stock prices are depressed.

VOLUNTARY REPURCHASE PROGRAMS

Many of our community bank clients across the country are looking to deploy excess capital into voluntary repurchases of their holding company shares. As most *Musings* readers know, creating liquidity for your shareholders is an obligation of the board of directors when there is no market liquidity (which there isn't for most community banks). Allocating capital for a voluntary repurchase generally makes sense as a way to return equity to the shareholders. The other prominent way, of course, is through dividends. The question often comes up on a voluntary repurchase as to how does the board set the purchase price. We are significant proponents that community banks need to establish an appropriate purchase price for their stock. Keep in mind, in a voluntary repurchase at the holding company level, two issues are in play. The first is that the holding company cannot defraud the selling shareholders. Sellers must be given adequate information as to the condition of the company and the like. The second is the repurchase must be at a price at which the shareholders who do not sell (i.e., the remaining shareholders) also benefit financially. Generally, that is a wide range on a scale where the bank holding company board can set the price. If the board wants to be aggressive, then it may be at the higher end of the scale. If it wants to be less aggressive, then maybe the price will be at the lower end of the scale. Keep in mind, as your holding company board sets the price on your holding company voluntary repurchase, you are also typically setting a floor on the stock price for future trades.

MANDATORY RETIREMENT

We have been with a number of community bank boards lately that have director succession issues. Some of these are caused by directors voluntarily getting off the board, death, or mandatory retirement. As most *Musings* readers know, we are not big proponents of mandatory retirement. We believe the best practice is for the Chairman or Lead Director to address issues with directors who are disengaged, unprepared, or otherwise not fulfilling their duties as directors. We view mandatory retirement as a bright line test that often does not make sense. Also, what we have seen over the years is that mandatory retirement is mostly honored in the breach. That is, if the bank has a mandatory retirement age but the bank has one director that the board does not want to let retire, then the board makes an exception.

We have also seen mandatory retirement work well for many community banks. It certainly does provide for a turnover in the board. The age that we typically see for mandatory retirement these days is 75 (up from 70 ten years ago).

MANDATORY RETIREMENT – A DIFFERENT SPIN

We recently had an interesting discussion related to mandatory retirement. This discussion was in the context of a strategic planning "pre-meeting," where we were talking with a couple executive officers in preparation for a forthcoming strategic planning retreat. The topic of mandatory retirement came up, but in somewhat of a unique context.

During the discussion, one of the executives indicated their board had implemented mandatory retirement for directors a number of years ago. They thought mandatory retirement had worked well as it relates to their directors. However, he wondered aloud, half-jokingly, why the bank had never implemented a mandatory retirement age for employees. His quip was if it serves the board so well, wouldn't it do the same for the employees?

To be entirely clear, we are not advocating for mandatory retirement for employees (likely illegal anyway). However, we thought the comment worth passing along, as it does put the thought of mandatory retirement in somewhat of a unique context.

ABUNDANCE OF CAPITAL

We have been with several community banks over the last several weeks that have what can only be described as an "abundance" of capital. These banks are more than well-capitalized. These banks have excess capital at the bank level and, for the most part, have unleveraged holding companies and the additional ability to raise equity through common or preferred stock sales. The question of course for these boards is how do they allocate that capital they have or can get to enhance the value for their shareholders? Of course, capital must be allocated to support balance sheet growth and to offset credit issues. The uncertainty associated with the current pandemic has caused many of our community banks to toss a little more of the current earnings into the loan loss reserve, which seems to make sense. Once the board moves past the mandatory capital allocations, then the big three discretionary capital allocations are acquisition of another bank or branch, acquisition of the holding company's own stock through a voluntary or forced repurchase, or the payment of dividends. As we have indicated often in *Musings*, the board's job is to allocate that capital appropriately to enhance the value for the shareholders. If there are no uses for the capital, particularly capital that is on the balance sheet (i.e., not capital you have to go out and get), then we believe it should be returned to the shareholders either through dividends to go to all the shareholders or through stock repurchases to go to those who desire liquidity.

CORRECTIVE CHANGE IN CONTROL FILINGS

Over the past several months, we have assisted a number of different clients in corrective Change in Control filings. What is a corrective Change in Control filing? It is a filing where an individual or group acting in concert owns enough stock to be considered a control shareholder for purposes of the Change in Bank Control Act but has never officially filed the required Notice of Change in Control with the Federal Reserve. The filing is an after-the-fact notice to remedy what should have been filed prior to obtaining status as a control shareholder.

One question we often receive is whether this type of corrective filing is really necessary. Our advice is yes. We believe that if you are in a circumstance where you are a control shareholder but have never been approved as such, you need to remedy the situation.

Why is filing an after-the-fact notice important? It is so for a couple reasons. First, a violation of the Change in Bank Control Act can technically result in the Federal Reserve's imposition of Civil Money Penalties. Luckily, this almost never happens. The second, and more important issue, is one of future strategic transactions. We see completing a required control filing as important because you do not want the Fed or some other regulatory agency to hold any future strategic transaction hostage in order to get the filing completed. In other words, you want to be sure to avoid a circumstance where you file an application for some strategic transaction and that application is put on hold and not processed until the Notice of Change in Control is completed.

The Change in Bank Control Act has some complex provisions related to control shareholders, groups acting in concert, and the like. It is important to understand these and to remedy a Change in Control filing if appropriate. You want to avoid the unlikely situation where Civil Money Penalties are imposed, and certainly should look to avoid the more likely circumstance of a strategic transaction being slowed up to wait for a corrective filing.

ATTRACTING & RETAINING TALENT

We are currently working with a number of different community bank clients to develop equity- and incentive-based compensation plans. These plans are all being put in place in an effort to attract and retain talent. The central goal of the plan is to provide an initial benefit to lure new employees into the organization. However, that initial benefit has to be structured in order to act as “golden handcuffs” and tie the individuals into the organization on a longer term basis. It is pretty obvious that it does no good to simply give a new employee shares of stock that they could turn around and take if they were to leave the bank three months later.

The great thing about equity-based compensation programs is that they are extremely customizable. In other words, the board can implement various alternatives in order to achieve exactly what it is that they are looking for. Some of the compensation programs are geared toward achieving growth, some toward income, and some other strategic alternatives.

We have created a comprehensive Clients & Friends Memo that talks about the various alternatives available in this type of program. It includes good information on ESOPs or KSOPs, stock options, stock appreciation rights plans, phantom stock, restricted stock, and similar compensation alternatives. Please let us know if you would like a copy of the Memo. We think it is a pretty succinct and straightforward discussion on the alternatives, and we are happy to provide it.

THE HIGH PERFORMER DILEMMA

We recently facilitated the planning session for what is properly characterized as a high performing bank. It is a very profitable organization, and it typically runs an S corporation ROA of between 1.6% and 2%. With this in mind, the board previously developed an incentive compensation program for the bank that is largely driven off ROA. As you might suspect, the higher the bank ROA, the better the employee benefits.

During the planning session, one of the primary topics of discussion was the opportunities to deploy excess cash. This bank, like virtually every other community bank in the United States, has seen significant asset growth over the past six or so months. In fact, this bank’s assets are up almost 20% since the beginning of the year. One of the byproducts of this significant asset growth is a materially reduced ROA. As you might suspect, the bank’s significant pile of cash is not earning at any appreciable return. This has significantly dropped the ROA, like it has for many other banks. However, on a dollar-for-dollar basis, the bank is on budget and doing essentially what they did last year, which was a great year.

During the planning session, we advised that our opinion was that bank employees should not have their bonus pool cut or eliminated completely because of this anomaly. You will not be surprised to hear that the employees at the planning session readily agreed.

In all seriousness, if your bank has a bonus plan that is driven off ROA, we recommend the board take the significant events of this year into account in determining bonus compensation. In many instances, we are seeing bank employees work harder this year than they ever have. The banks are making the same amount of money on a dollar-for-dollar basis, but the ROAs are reduced because of increased assets. We do not think the anomalies of 2020 should work to the detriment of the employees.

THE COMMUNITY BANK BOARD CHAIR FORUM

As many *Musings* readers know, Gerrish Smith Tuck and the Barret School of Banking are sponsoring a Board Chair Forum currently scheduled as an in-person live event on January 14-15, 2021 at the Ritz-Carlton in Naples, Florida. Although the venue will be large enough to provide for social distancing and the like, the number of participants will be limited. The Forum, which is primarily a discussion led by the three of us, is appropriate for community bank Chairmen, Vice Chairmen, Directors, and CEOs. There are still a few slots left. If you would like additional information, please follow this link: Community Banking Chairman's Forum

CONCLUSION

If you haven't done so already, we encourage you to exercise your rights in this democracy to vote. As most *Musings* readers are well aware (how could you miss it), the election is Tuesday, November 3rd. We encourage you to vote for the national and local candidates of your choice.

Have a great two weeks!

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars:

- November 5 – Graduate School of Banking at Wisconsin webinar – "Liquidity Strategies for Illiquid Community Bank Stocks" Registration link: Liquidity Strategies for Illiquid Community Bank Stocks
- November 9 – Mississippi Bankers Association (Zoom) – "Ten Threats to Independent Banks and Strategies to Overcome Them" Registration link: Ten Threats to Independent Banks and Strategies to Overcome Them
- November 9 – Mississippi Bankers Association (Zoom) – "Maximizing the Community Bank Holding Company Structure" Maximizing the Community Bank Holding Company Structure