GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Illinois, Kentucky, Missouri, South Carolina, Georgia, and North Carolina!

INDUSTRY CONSOLIDATION / NEW BANKS

When our consulting and law firms were formed 33 years ago, there were approximately 13,000 FDIC insured institutions. At year-end 2020 we anticipate the records will reflect that there are approximately 5,000 FDIC insured institutions still in operation. Of course, over that 30 plus year time period, while the number of charters has consolidated, the number of branches has expanded.

The industry, particularly the community bank sector, has been through multiple periods of consolidation over this particular time horizon. It is currently in another period of consolidation. We are often asked what causes community banks to sell. As *Musings* readers know, we are strong proponents of independent community banks. Nevertheless, we also realize there comes a time in some banks' lives (or the ownership's life) when it is time to partner with somebody or simply outright sell for cash. Typically driving those decisions are what we term the "traditional" reasons (i.e., no share liquidity, no management succession, no board succession, an aging shareholder base that has not been addressed, ownership succession of closely-held banks that has not been addressed, and the like). Toss into that a few of the "non-driving", thought certainly influential, factors of the need for scale, increased technology demands, increased regulatory costs, and the like, and there is a fairly good recipe for a bank sale.

Historically, periods of consolidation have been followed by periods of a significant number of new banks. In the industry, these are referred to as de novos (a fancy French term meaning "new"). Since the Great Recession, there have been exactly 32 new banks chartered. There are currently 13 applications pending. Compare this to the number of new banks chartered in 2005, 2006, and 2007, which each year averaged about 170.

So, what is the impediment to chartering a new bank these days? There are three big ones: 1) obtaining an experienced management team and an experienced board; 2) obtaining regulatory approval (any FDIC insured bank is required to obtain FDIC approval plus approval of their primary federal—if a national bank–or state chartering authority); and 3) raising the necessary capital. For virtually any bank in this day and time, capital requirements would be a minimum of $15 million to $17 million, and more likely in the $25 million range (a de novo is required to start with enough capital to, based on its projections, provide an 8% capital to assets ratio plus a fully funded reserve by the end of its third year of operations). Not surprisingly, when a de novo bank has seasoned management, a strong board of directors, and has received the blessing of the regulators, raising capital seems to be much easier. We have consulted with a number of de novos recently who anticipate exceeding by a significant amount their minimum capital required by the regulators. Establishing a de novo bank is certainly a possibility for those who may have sold their bank for a significant premium and are now playing with "house money." If anyone wants further information on de novos, please let us know.

A FOLLOW UP ON CORE PROVIDERS

The last edition of *Musings* recounted our time at the Board Chair Forum and the discussion on core providers where not one of the participants said they would recommend their core to a peer. Following publication of this last *Musings*, one of our community banking friends reached out to follow up on the core processor issues. For about the past three years, this individual has served on a committee for one of the national trade associations that was formed specifically for the purpose of evaluating and improving core product offerings, particularly for community banks. Based on their time on the committee, this individual provided the following comments relative to community banks and their relationship with their core providers:

- Community banks have more choices than they realize; non-disclosure clauses in contracts do not promote good communication between banks.
- The larger core providers really have only one "go to" platform that gets their research and development investment dollars.
- Shorter and coterminous contracts are a good thing.
- A correctly structured contract with Open API ability allows community banks more access to smaller fintech companies.

There have been multiple articles published on these issues. Please let us know if you would like a copy of one of the articles. We are happy to provide it.

DIRECTOR BUSINESS DEVELOPMENT/DIRECTOR LOANS

We were recently meeting with the board of directors of a high-performing community bank. The topic in the executive session with the directors only involved directors' obligation to develop business for the bank. As most *Musings* readers know, community bank directors have various duties related to the bank, including the duty of care, duty of loyalty, and duty of confidentiality. Within those lie the duty to hire the best management they can get, establish policies and procedures, and, last but not least, develop business for the bank. This generally also means using the bank for their own company's deposit and loan business.

Many directors in this type of discussion lament the fact that they are (somewhat) happy to do business with the bank, but they can get better rates, terms, and conditions for their loans at other banks. This is primarily due to the constraints of Regulation O, which among other things, provides that a loan extended by the bank to a director not only have prior approval from the board with the interested director abstaining, but also (i) is made on substantially the same terms (including interest rates and collateral) as, and following credit underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions by the bank; and (ii) does not involve more than the normal risk of repayment or present other unfavorable features. In other words, Reg. O prohibits favoritism in favor of directors. (Those of you who are old enough to remember can thank Bert Lance for Reg. O.)

Over the years, we have assisted many community banks in defending criticized Reg. O loans, particularly when the friendly federal regulators allege the loans are not made on similar terms and conditions as loans to other borrowers. What that basically means is that if your community bank makes a loan to a director, you must be able to establish that other similarly situated borrowers at the bank receive the same terms, conditions, structure, rates, and the like.

Keep in mind, one of the very few exceptions to this, which is for a limited time, is directors obtaining PPP loans. Until the end of March 2021, PPP loans will be an exception to Reg. O, as long as they meet the SBA guidelines.

Notwithstanding the difficulties of borrowing from your own bank as directors, the expectation is that you will do your own business there to the extent you can, as well as refer other business. It's your job.

CEO EVALUATIONS

Over the past year, we have assisted numerous boards of both banks and holding companies in connection with their attempt to come up with an effective way to provide feedback, through an evaluation or otherwise, with respect to the performance of the Chief Executive or Senior Executive Officer. Because each community bank is different, as are the personalities, none of these engagements are cookie cutter. In other words, we cannot simply send a form and say "use this." In order to be effective, for each one of them, we are required to get involved with the bank, understand it, and understand the dynamic between the CEO and the board. Once that occurs, then we generally recommend the best approach for a CEO evaluation.

Interestingly, over the years, we have found that most community banks do not do any type of CEO evaluation. The evaluation, if any, occurs at the annual board of directors compensation committee meeting when the CEO finds out whether he or she gets a raise. A best practice, of course, is to formalize the process so the CEO has some feedback, at minimum from the board or a select portion of the board, and possibly in a 360 evaluation, from the CEO's subordinates. If your bank is not doing any type of CEO evaluation, you may want to give some thought to it for the future.

COMMUNITY BANKS WIN AGAIN

We recently read with interest an article in the *American Banker* that reflects PPP borrowers' satisfaction with their lenders. The article and the related research provided by a Federal Reserve survey prove that community banks have won the day once again. The short answer is that about 88% of PPP borrowers were either satisfied (70%) or neutral (18%) with their experience with a community bank that is a CDFI for their PPP loan process. For small banks, 89% were either satisfied (61%) or neutral (28%). The numbers go down for credit unions and large banks and are significantly lower for fintechs. Specifically, approximately 42% of borrowers were dissatisfied with their PPP loan process with a fintech lender. In that category, only 18% were satisfied, and 40% were neutral.

These numbers prove what community banks have known for quite a while. Their competitive advantage is personal relationships and customer service. Fintechs have long been argued as a threat to community banks. While they should not be completely dismissed, we believe they have a lot of ground to make up if more than four out of ten borrowers are dissatisfied with their PPP experience.

SUBCHAPTER S

Many *Musings* readers know that our firm believes an election to be taxed as a Subchapter S corporation is one of the best strategic alternatives available to a community bank holding company. Approximately one-third of the banks in the country have elected to be taxed as an S corporation. This is for good reason. The S election generally lowers the overall tax burden and gets more of the bank's earnings into the pockets of the shareholders, increasing shareholder after-tax cash flow and, in most circumstances, increasing the shareholders' tax basis, which will reduce the tax burden at the time of sale.

We have assisted scores of community bank holding companies across the country in making the election to be taxed as an S corporation. Over the past couple years, we have seen a slowdown in the number of banks and holding companies that have made the election. This is because most that can get Sub S eligible have already made the S election. For those that have not, the reduction in tax rates that went into effect in late 2017 took it away from the forefront of thought.

Over the past couple months there has been a pretty significant renewing of interest by community bank holding companies that are considering the strategic alternative of electing to be taxed as an S corporation. We are currently assisting a number of clients in "running the numbers" on this potential strategic alternative. Apparently, there is a renewed interest in Subchapter S conversion due to a belief that there is likely action forthcoming by the new President and Congress to increase current tax rates. If this happens, we anticipate Subchapter S will become even more beneficial.

EXPENSE CONTROL STRATEGIES

We recently facilitated a strategic planning session for a very well run and profitable community bank. During a portion of the planning session, we discussed non-interest expense control. This bank has a pretty low efficiency ratio and is very lean with its non-interest expense. During the session, we discussed their strategy for expense control. This bank keeps a close eye on expenses by utilizing a bank committee of employees that is charged with investigating and appropriately pursuing strategies to reduce non-interest expense. The committee members are rotated on somewhat of a regular basis, which provides new thoughts, ideas, and insight. This seemed to us to be a very appropriate strategy for non-interest expense control. The numbers certainly support the logic.

RESPA

Most *Musings* readers are familiar with RESPA, the Real Estate Settlement Procedures Act, a federal statute that governs the real estate settlement process. One of the issues that is always confusing and sometimes comes back to create a problem is the provisions of RESPA that prohibit kickbacks or fee payments for referral of customers to a real estate lender. In a nutshell, the issue is whether the payments to a referral source constitute permissible payments for "leads" or impermissible payments for "referrals."

We have recently had a number of clients ask for our assistance in connection with contracts with their various referral sources, which are generally fintechs of some nature. The general issue is whether the contract with the lead generator can be characterized as a lead generation only or whether it is more than that. This is a significantly complex area (which we can't do justice to in *Musings*), but it is one that at least everyone in the bank, including the board of directors, needs to be fully aware of. We anticipate under the new administration issues like RESPA, Fair Lending, Equal Credit, and other matters will be more heavily scrutinized than they were for the prior four years.

CONCLUSION

We assume most *Musings* readers know that Valentine's Day was yesterday (February 14th). If you missed it, there is still a possibility (slight as it is) to redeem yourself. Good luck with that.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars:

- March 3, 2021 – Graduate School of Banking-Wisconsin Webinar – "Community Bank Capital Raising Simplified" (Greyson E. Tuck) Registration link: Capital Raising Simplified
- March 4, 2021 - Graduate School of Banking-Wisconsin Webinar – "Practical Tips for Community Bank M&A" (Philip K. Smith) Registration link: Practical Tips-M&A
- March 31, 2021 – Graduate School of Banking-Wisconsin Webinar – "Liquidity Strategies for Illiquid Community Bank Stocks" (Greyson E. Tuck) Registration link: Liquidity Strategies