# 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



January 29, 2021, Volume 433


Dear Subscriber:

Greetings from South Carolina, Illinois, Georgia, Florida, Nevada, Kansas, and Iowa!

## APPEALS TO FRIENDLY FEDERAL REGULATORS

As most *Musings* readers know, each of the federal regulatory agencies has an appeals procedure that allows an aggrieved bank to appeal any "Material Supervisory Determination." That generally means a significant loan classification, criticism of the allowance for loan and lease losses, a component rating of the CAMELS rating or the CAMELS rating itself, alleged violations of law, and the like. In our humble opinion, none of the friendly federal regulatory appeals processes are adequate for community banks.

Last week, the FDIC's Board of Directors adopted revised "Guidelines for Appeals of Material Supervisory Determinations." The guidelines are designed to overcome some of the criticisms that our firm and others have heaped upon the regulators for their kangaroo court system of appeals as it currently operates. The new guidelines include the establishment of an independent body within the regulatory agency to review appeals by community banks and others of Material Supervisory Determinations. We suppose this is a positive step. We anticipate the regulatory environment will heat up and appeals will become more frequent. If any *Musings* readers would like a copy of the FDIC guidelines, please let us know.

## REGULATORY GUIDANCE #2

The information that we are about to convey in this short article should allow community bankers to sleep better at night. All of you should remember that prior to/during the last recession the regulators came out with "Commercial Real Estate Guidance." This "Guidance" involved how much in certain buckets a community bank could have in commercial real estate without being criticized. The regulators initiated multiple enforcement actions and substantial criticism of multiple community banks for violation of the Guidance.

Recently, the friendly federal regulators determined to codify their September 2018 statement indicating that, guess what - "the guidance is just guidance." It does not have the effect of the rule of law or regulation, and the regulators cannot bring an enforcement action based on violation of the Guidance. It appears to us it is a little late for this "Guidance on the Guidance," after the horse is already out of the barn and circled it a few times. Nonetheless, community banks should be aware that the examiners in your bank should not be harassing you with "regulatory guidance." Let us know what happens.

## BRANCH SALES

To sell or not to sell? That is the question. No, this is not a discussion about selling the whole bank. This is a question about disposing of an individual branch. We have had numerous conversations with community banks around the nation who, after experiencing COVID for a year or so, are realizing that perhaps some of their branch locations may not be necessary under the "new abnormal." As most of the customer base has been forced into digital channels and now has found out they like it, do we really need all these brick and mortar branches? Some of our clients are looking at disposing of branches that could best be considered outliers (i.e., a few miles from a large branch).

The strategic question is do you sell it or close it? If you close it, then the hope is that all those customers in that branch will come to one of your other locations. If you sell it, you introduce a new competitor into the mix. Your community bank as a seller would receive a premium (generally 3% to 5% of core deposits), but it would also certainly pass on the relationships with the deposit customers to the new bank and possibly some of the loan customers as well. Tough decisions. As an alternative to selling the branch, some of our community bank clients around the nation are simply repurposing the branch. They are shortening the hours, reducing the number of personnel, reducing the onsite services that can be provided, and the like. This is likely a precursor to closing the branch, but it is an initial step.

## CAPITAL PLANNING

Over the past several months, particularly around year-end, we assisted numerous community bank clients with respect to capital planning. The analysis of capital planning should always involve short-term capital needs versus longer-term capital needs. For most of our client base (under $3 billion in total assets), the Small Bank Holding Company Policy Statement simply allows the board of directors to assess alternative ways to generate cash at the holding company level, which cash can then be pushed down to the community bank where it magically appears as Tier 1 capital. With the pandemic inflating community bank balance sheets significantly and the corresponding reduction in the leverage ratio, capital planning has become more critical. Although the regulators have indicated they will take somewhat of a "blind eye" to a reduced leverage ratio resulting from an artificially inflated balance sheet, we suspect the regulators will be critical of reduced capital ratios for whatever reason. From a short-term standpoint, the question is, does the board need to increase the bank's capital level? If the pandemic has grown the balance sheet so much that the capital leverage ratio has slipped to 6.5% or so, then clearly, from a regulatory perception standpoint, the bank's capital ratio needs to come up. This can be the result of increasing capital in the community bank or reducing assets. That is the short-term issue. After the short-term capital issues are addressed, then the community bank board needs to look at the long-term capital uses to determine whether any additional capital may be required and what is the easiest and least costly way to obtain it.

## SHAREHOLDER COMMUNICATIONS

A community bank client recently sent us a copy of the letter the bank had prepared to accompany their annual dividend checks. This letter is sent to all the community bank holding company shareholders. We thought the letter was a great example of effective shareholder communications. One portion of the letter described why the company had decided to significantly increase dividends when compared to past practice. The short answer is that the company had been stockpiling capital to complete an acquisition, but given the lack of targets and other factors, the community bank board did not believe an acquisition in the near future would be likely. The company explained in summary fashion to the shareholders that there was no need to hoard capital for an acquisition that was unlikely, so they were returning the excess capital to the shareholders in the form of increased dividends.

The second part of the letter (which we really thought was great) was the request for the shareholders to do business with the bank and to refer others to do business with the bank. It was a straight forward request, but it was a reminder to the shareholders that if they move their banking business to the bank, or convince others to do the same, the company they owned would benefit. It was a simple reminder that you will never get that for which you do not ask.

Shareholder communication is important. There is value in the shareholders having insight into the company's strategies. We also see it as very appropriate to ask shareholders for their business and referrals.

  

## INCREASING DIVIDENDS PART 2

We have a number of community bank clients that at the end of the year made significant increases to the level of dividends paid. A couple of these were considered one-time, extraordinary dividends. Others represented a fairly significant change in strategy where the board determined to allocate significantly more of the company's net income to dividends than retained earnings. In each of these situations, the community bank holding company chose to increase the dividends because they felt the return of earnings to the shareholders to be the highest and best use of capital.

In each of these situations, our recommendation was to inform the shareholders as to why the dividend was significantly changing. In the instance of the one-time extraordinary dividend, we also recommended making it very clear to the shareholders that it was a one-time dividend and would not occur on an annual basis. We see all of this as important to set shareholder expectations. The shareholders need to be informed as to the dividend strategy of the organization. The shareholders need this information to determine the value of the stock to them and to plan on the anticipated cash flows coming from share ownership.

## SHAREHOLDER LIQUIDITY

For years our firm has preached that the fundamental duty of community bank directors and executive officers is to enhance shareholder value. One of the fundamental tenets of enhancing shareholder value is offering share liquidity, which is the ability of the shareholders to convert their shares to cash at a fair price in a timely manner. Frankly, many community banks struggle with shareholder liquidity. Most community banks do not have true market liquidity. Instead, these holding companies either support their own share liquidity or simply go without.

Our firm recently completed a new Memo to Clients & Friends on the options that are available to provide liquidity for illiquid community bank stocks. We anticipate the article will be published in a number of different publications around the country. However, we are happy to provide a copy to you. Please let us know if you would like us to send you one.

## NOT A SINGLE HAND

The three of us recently facilitated the Community Bank Chair Forum in Naples, Florida. This forum, which is presented in conjunction with the Barret School of Banking, is essentially a day and a half free-flowing discussion among community bank Chairmen, lead directors, and executive officers on whatever topics they believe are appropriate. There was one moment that struck us as being particularly notable during the session.

During the first morning, the discussion turned to technology. Of course, the discussion eventually got around to core systems and core providers. We took a quick poll and asked the bankers to raise their hands if they had a core provider they were satisfied with and would recommend to anyone else in the room. Not a single hand went up.

We point this out not to "pile on" to the core processors. Instead, we point this out to show the challenges community bankers feel they are facing with their core. The industry is only becoming more reliant on technology. However, community bankers seem incredibly dissatisfied with the central technology within the bank. This is a real challenge for many banks, and it is one that really deserves a good solution. Hopefully something will change soon. There are certainly a number of folks that would like to see it.

## DON'T LET YOUR MONEY GET MAD

One of the smarter bankers that we know once gave what we have thought to be a pretty sage piece of advice: "Don't let your money get mad." What the banker was saying is that it is smart to avoid situations where financial decisions are made with emotion. We were recently reminded of this saying in an M&A transaction where we are currently involved. The buyer was requesting that the seller do some things that, frankly, the seller did not want to do. We pointed out to the seller that the agreement does not technically require what the buyer is asking. However, we also pointed out to the seller that taking the actions would not have any material impact on the transaction or the sales price. We went back to the well and reminded the seller that it was not smart to let your money get mad. In the end, the seller decided to go along and get along, which produced the best result given the circumstances.

Community bank M&A transactions are like anything else in life; there is a significant amount of give and take. Not all issues in a transaction are controlled by the agreement. When those come up, we think it is best not to let emotion cloud your financial decisions. This is particularly true when you are a director or executive officer and are making decisions that affect other people's money.

## PEOPLE PERISH FOR LACK OF A VISION

We have helped multiple community banks over the last year with respect to management succession, including many situations where the board is seeking a successor for the existing CEO. Most boards initially look internally for the CEO replacement. Virtually all community bank boards also at least test the waters externally. In addition to the normal skillsets a board of directors looks for in a

  

CEO, we have uniformly found that the one trait the directors are interested in is a long-term vision for the community bank and its holding company. Directors do not appear to be interested in a potential CEO who manages quarter-to-quarter or transaction-to-transaction. Most community bank boards want an incoming CEO who is not only a long-term player, but a long-term player with a long-term view toward enhancing shareholder value over a long-term time horizon. Based on our experience, there are multiple potential candidates available with appropriate skillsets that can mechanically provide the necessary services of a Chief Executive Officer. There are not as many with a strong long-term vision.

## IN-PERSON MEETINGS

Members of our firm began again to have in-person meetings in June of 2020. Recently, we have had multiple in-person meetings and have always found the in-person meetings are the most effective, if they are feasible. As we have indicated to most of our clients, we believe written correspondence is the least effective, phone call/conference call is next, Zoom call is next, then hybrid Zoom call, and then in-person meetings on the list of effectiveness. Many of the in-person meetings we have had in the last couple months have been "hybrids." A hybrid meeting is one where several of the participants participated on Zoom or a different platform and many are present in person along with a representative of our firm.

Although things appear far from normal, we are glad that things are moving in the direction again of face-to-face communication. Now if we can just see those faces without masks after a while, that would be even better.

## CONCLUSION

It is hard to believe that the end of January 2021 is already upon us. Lots of changes in just the last few weeks. A new national administration, a vaccine rollout, an economy that is still struggling along looking probably for more stimulus, and many other issues impacting all of us. We are optimistic that things will continue to improve for community banks. We look forward to "seeing" many of you at the upcoming community bank national gatherings, both of which are going to be virtual this year. See you there.

Stay safe and healthy. See you in two weeks.

*Jeff Gerrish* *Philip Smith* *Greyson Tuck*

Upcoming Webinars:

- February 2, 2021 – Mississippi Bankers Association Mergers & Acquisitions Seminar – "Community Bank M&A Past the Pandemic" (Greyson E. Tuck) Registration link: Mergers and Acquisitions Seminar

- February 10-11, 2021 – Iowa Bankers Association (Zoom) – "Top Community Banking Strategies for 2021 and Beyond" (Greyson E. Tuck) Registration link: https://www.iowabankers.com/aspx/iba/events.aspx?ed_key=10727

  