GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Indiana, Illinois, Ohio, Iowa, Kentucky, Tennessee, Florida, and Texas!

SHAREHOLDER COMMUNICATIONS

We recently had the opportunity to attend in person an annual meeting of shareholders for one of our community bank holding company clients. The annual meeting was fairly routine. However, what struck us about the annual meeting was the excellent corporate communications this community bank holding company provided to its shareholders. They had a very well put together and informative Annual Report that was a great mix of both shareholder information and company marketing. They also put together a professional video that was about five minutes in length and covered the holding company, bank, and all they have been doing over the past year. The link to the video will be emailed to each of the holding company shareholders so they can access the video online at any time.

This holding company has been gracious enough to allow us to share copies of this excellent corporate communication with any *Musings* reader that would like to see it. Please let us know if you would like to receive a copy of the Annual Report and a link to the video, as we are happy to provide it.

DON'T LET THE EXAMINERS RUN YOUR BANK

We have been in a number of community banks lately that have had recent examinations. To say that the boards of directors and senior management were "spooked" by the friendly federal regulators and their examination team is an understatement, at least for most of them. We are not ready to declare this a trend, but based on these several recently examined banks, we would say the regulators are certainly back in business in a big way. As we have indicated in connection with every heavy-handed regulatory cycle, it is not up to the regulators to run your bank. It is up to management to run the bank and the board to provide oversight. Banking is a risk business. Just because the regulators point out a risk in a particular activity does not mean that your community bank cannot engage in it. It simply means you must address the issues and how that risk will be addressed by the bank. In the past, we have seen periods in community banking where the regulators, as a practical matter, have run the bank - indicating what the bank can invest in, who it could loan to, etc. We hope we are not seeing another one of those periods. In any event, it is the Board and management's job to keep control over your own organization for the benefit of the shareholders. The regulators are not your shareholders.

STRATEGIC PLANNING

As *Musings* readers know, the three of us facilitate numerous community bank strategic planning sessions each year. Over the past month or so, we have seen a marked increase in the number of requests for strategic planning assistance. The requests themselves are pretty typical in that they come from a community bank that is seeking someone to facilitate their strategic planning session. What is a little bit unusual is the sheer number of requests that we have received lately.

We believe the increase in requests is primarily due to two factors. First, there were a number of community banks that put off their strategic planning in 2020 because they were unwilling or unable to hold the type of planning session they wanted to hold (e.g., in person at a nice location) due to the pandemic. Second, and more importantly, we believe the pandemic has led many community banks to really increase their focus on their strategic direction and the specific strategies that will be pursued to achieve the desired results.

We see the increased focus on strategic planning as a great thing for community banks. For a number of years, we have held the belief that organizational success requires active pursuit of the chosen strategic directives. Passivity will not achieve the desired results. The increased focus on strategic planning is great because it is evidence that community banks are taking to heart the importance of identifying a strategic direction and the specific action items that will help achieve the chosen strategic direction.

THE SLIPPERY SLOPE

We have had numerous meetings with community boards of directors in the last several months. One topic at each meeting has been the issue of whether the bank should remain an independent community bank or sell. If the answer is to remain independent, then the board needs to discuss how proactively to do that. As we have noted often in *Musings*, the community bank merger and acquisition sector is alive and well. Currently, there are a lot more buyers than sellers. As most *Musings* readers know, we are staunchly in favor of independent community banks. As such, we would hate to see a bank in an exploratory mode get on the slippery slope toward sale when that is really not what ownership wants to do. The slippery slope toward sale usually involves some manner of "testing the water" regarding price. Our recommendation is don't "test the water" unless you are prepared to sell the bank. Testing the waters is a slippery slope. If the word gets out, it may result in an unsolicited offer, a push by some of the directors (who have already spent the money they would get in a sale) toward a sale, or other unintended consequences. If your community bank's strategy is independence, then make sure that you have a way to execute on that strategy by enhancing shareholder value, including creating liquidity for your shareholders that do want to exit.

DIVERSITY AND INCLUSION

Certainly a hot topic in the current administration and the current political and social environment is diversity, equity, and inclusion. We have recently seen t-shirt slogans in airports that state "Assets Minus Liabilities" (i.e., the wearer is promoting "equity").

Diversity, equity, and inclusion is also becoming a hot topic and will be so in the community banking sector. In fact, legislation has been recently introduced to require the friendly federal regulators to include a diversity and inclusion component in the CAMELS rating system. This would rate institutions in part on whether they have policies to encourage diversity and inclusion in their hiring practices and the like.

We have our doubts (but who knows) that there will be an additional CAMELS rating on diversity, equity, and inclusion, but we have no doubt that diversity and inclusion will become a part of the Management component rating under the CAMELS rating system. Management is the catch-all CAMELS component and is one of the few non-financial (unlike Capital, Asset Quality, Earnings, Liquidity, and Sensitivity) parts of the CAMELS system. Diversity and inclusion will probably fit in that catch-all Management component rating. Keep an eye on that, particularly if you are over $1 billion. This particular bill proposed in the House would require a bank with over $1 billion in assets to establish a committee for diversity and inclusion that holds quarterly meetings with the CEO and Diversity and Inclusion Officer. The real issue, as brought to our attention by a *Musings* reader, is whether it is appropriate for community banks to "get out in front" of this surging wave. We think probably so.

SUBCHAPTER S

We have written many times in *Musings* about Subchapter S. There are still a number of banks in the country that could easily convert to Subchapter S but have not yet done so. We are working with several now. We anticipate that as the tax changes are proposed and implemented by the current administration, Subchapter S for community banks will simply continue to be an even more appropriate way to enhance shareholder value.

For those who are currently in Subchapter S, one of the strategic initiatives for your community bank should be to keep an eye on the tax issues to make sure Subchapter S continues to make sense after Congress gets done doing whatever it is going to do with taxes.

LEVERAGING THE HOLDING COMPANY

We often discuss holding company leverage with community bank boards of directors. The discussion is in a variety of contexts. Often, it is in the context of a planning session where the board is trying to figure out the sources of potential capital, as well as the uses and how that capital should be allocated to enhance shareholder value. The good news with respect to holding company leverage is that the suppliers of that debt are readily available. Bank stock lenders and other purchasers of debt are available, and the rates are reasonable. We have run into a couple of community bank boards of directors of late that have an aversion to debt. Frankly, one of the purposes of maintaining a community bank holding company is the ability to leverage it to generate cash into the holding company to use for any appropriate purpose, including increasing the capital in the bank, redeeming shares, or acquiring another institution or line of business. We suggest that those community bank boards that have a reluctance to incur debt at the holding company for any purpose reconsider that strategy. It seems to us that the incurrence of debt makes sense if it can be demonstrated to the community bank board that the holding company shareholders would be better off leveraging the company and that the transaction makes sense. In other words, do not exclude a potential opportunity simply because it involves holding company leverage.

TAX ALLOCATION AGREEMENTS

The friendly federal regulators have recently raised their head and issued some proposed revisions to the rules that apply to intercompany tax allocation agreements. Each community bank that is owned by a bank holding company should have in place a tax allocation agreement. This is simply a commitment by the bank and the holding company that the bank will pay its share of taxes that it would have paid on a "standalone" basis had it not been subject to the holding company's interest or other income sheltering due to the consolidated tax returns. This allows cash payments from the bank to the holding company that are not dividends – they are simply payments under the tax allocation agreement. This is another way for the holding company to generate cash. Every bank, typically when it forms the holding company, enters into a tax allocation agreement. The regulators in the most recent proposal want a review of those agreements to make sure they include certain provisions. Our preliminary review of the proposal indicates that those provisions are really designed to protect not the bank or the holding company, but the friendly federal regulator (in this case the FDIC) as Receiver of failed banks. In the last recession where the country experienced hundreds of bank failures, there were a few of the larger ones where FDIC got into litigation over who was entitled to a tax refund for the consolidated organization. We anticipate the most recent move on tax allocation agreements is to assure (as best they can) that they avoid this problem in the future. If any *Musings* readers would like a copy of the proposal by the regulators, please let us know. The takeaway is that once that proposal becomes finalized, your community bank's tax allocation agreement should be reviewed to make sure it is in compliance.

THE UNTIMELY OPPORTUNITY

We are currently assisting a community bank board that has been presented an acquisition opportunity. Due to some events that are happening at the holding company, it is frankly not the ideal time to consider the opportunity. However, the board's concern is that if they do not pursue the opportunity, even though it is not ideal timing, they will lose the opportunity altogether.

We recently spent time working with the board to talk through all of the issues. The board decided that they would move forward with pursuing the opportunity, notwithstanding the fact that the timing is not ideal. In our view, this was the right decision. The board did not commit itself to anything, but it avoided committing itself to losing the opportunity altogether, which would have happened had they simply refused to even give it consideration. Kudos to this board for making what we see as the right call in somewhat difficult circumstances.

CORPORATE STRUCTURING

The past couple weeks have given us two different opportunities to assist clients in working through the thoughts and considerations related to structuring "new" corporate activities. One of the opportunities involves a strategy to originate government guaranteed loans. The other involves a strategy related to secondary market mortgages. Each of these strategic alternatives involves either the bank or the holding company becoming a partial owner in an existing corporation.

There are two common issues when considering this type of business arrangement. One is whether the existing company should become a subsidiary of the bank or the holding company. The other is how much of the existing organization the holding company or bank should acquire.

The specifics of the transaction dictate the appropriate structure. However, generally speaking, whether the existing company should become a subsidiary of the holding company or bank depends upon the cash needs for the business venture. If the business venture involves a significant amount of cash that will come from the bank, then it is typically structured as a subsidiary of the bank. This is to avoid a circumstance where the bank has to pay a dividend up to the holding company and the holding company then has to pay a dividend down to the bank subsidiary in order to provide the subsidiary cash. If that happens, the dividend from the bank to the holding company reduces bank equity and Tier 1 capital, which is typically not palatable for the bank. The other alternative, which is even worse, usually is to go to a third-party lender and pay a rate significantly higher than deposit rates at the bank.

The other primary issue related to structure is one of taxation. The general rule is that the payment of any dividends from a subsidiary are tax-free if the parent company owns at least 80% of the subsidiary. If owning less than 80% but more than 20%, 65% of the corporate dividends are excluded for tax purposes. If owning less than 20%, 100% of the dividends are taxed to the receiving entity.

Be sure to give consideration to these two primary concerns if you are thinking about engaging in some type of joint business venture. You certainly want to avoid a circumstance where you are unnecessarily giving up some of the financial benefits of the transaction due to an incorrect corporate structure. Also, don't forget to vet some of these more unusual transactions with the regulators. They don't like surprises.

CONCLUSION

We look forward to "seeing" many *Musings* readers at the virtual ICBA Merger & Acquisition Workshop next Tuesday and Wednesday. You can reach registration for this virtual event through the following link: ICBA Mergers & Acquisitions Workshop

Have a great two weeks!

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Workshops:

- May 19, 2021 – Independent Community Bankers of America – Webinar: "Practical Tips for Your Next Strategic Planning Session" (Greyson E. Tuck) Registration link: Practical Tips for Your Next Strategic Planning Session
- May 26, 2021 – Independent Community Bankers of America – Webinar: "Strategies for Closely-Held and Family Banks" (Philip K. Smith) Registration link: Strategies for Closely-Held and Family Banks

