GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Texas, Mississippi, Iowa, Michigan, California, Minnesota, and Maryland!

COMMUNITY BANKING IN 2041

We were recently asked to speak at an in-person annual conference for one of the state banking associations. It was great to be back in person! This association asked us to pull out our crystal ball and make predictions on what community banking would look like 20 years from the date of the conference, in April, 2041.

Our predictions for the industry in 20 years are that there will be about 3,500 FDIC-insured banks, FinTechs and others currently operating in the "shadow banking industry" will be subject to regulation and examination similar to commercial banks, there will be a government-issued cryptocurrency, and community banking will be much less defined by geography than it will be by catering to the specific interests of the bank's clientele, whether those interests be personal or professional. The most important point we conveyed is that we believe there is absolutely a future for community banks, provided they are willing to put in the work and strategically plan to remain relevant to their stakeholders.

The presentation was accompanied by a PowerPoint slide deck. Please email us if you would like to see a copy. We are happy to share it.

REGULATORY PRE-FILING MEETINGS

We recently represented one of our clients that we are assisting in acquiring a community bank in a regulatory pre-filing meeting. If you are not familiar with "pre-filing" meetings, a pre-filing meeting with the regulators is an opportunity to discuss with the regulators your proposed transaction. This gives the regulators opportunity to provide any comments or feedback they may have. Many application submissions are preceded by a pre-filing meeting. Many are not. From a practical perspective, whether a pre-filing meeting is appropriate depends upon whether there are any issues in the transaction that the regulators might take a hard look at or view with some level of skepticism in the application process. Keep in mind, the regulators do not like "surprises."

If there are any issues in an application or strategic proposal that may create some friction in the regulatory application process, the best move is to request a pre-filing meeting with the regulators. This allows presentation of the business plan for the transaction, and to specifically focus on the issues that may draw closer regulatory scrutiny. The pre-filing meeting allows the regulators to provide their comments and feedback on the proposal overall, but particularly on the issues in question. Most importantly, it allows the regulators the opportunity to somewhat show their hand as to whether they are comfortable with the proposal. The regulators will never say yes or no to a transaction at this type of pre-filing meeting, but if they have serious concerns about the proposal, they will frame their comments in such a way as to let you know that the proposal, as presented, would be very tough to get approved.

If your community bank is contemplating moving forward with an acquisition or some other type of strategic transaction that involves an application and you foresee potential regulatory concerns with the proposal, we recommend you request a pre-filing meeting with the regulators. We believe it is beneficial to get in front of the regulators and talk with them about how they might view the issues. This follows the rule of an ounce of prevention being worth a pound of cure.

BACK IN BUSINESS

They are back in business for sure. Who, you may ask? The friendly federal regulators, of course. FDIC, the friendly federal regulator for state non-member banks (most of the community banks out there) recently issued a press release regarding a civil money penalty and reimbursement requirement against Umpqua Bank, a very forward-thinking (historically at least) bank in Oregon. The claim was that Umpqua engaged in unfair deceptive practices in violation of

Section 5 of the Federal Trade Commission Act. Umpqua agreed to pay a $1.8 million penalty and reimburse $1.628 million to 16,000 customers who were charged unfair fees.

They're back!

MANDATORY RETIREMENT

A lot of electronic ink has been spilled in *Musings* over the last 20 years or so on the issue of mandatory retirement. As most *Musings* readers know, in a perfect world we would totally eliminate any type of mandatory retirement (age-based) as it relates to our community bank board of directors. We firmly believe that the best practice in the perfect world (where none of us live) is to have a strong Chairman who can assess the performance of the individual directors and when they are not performing, request that they leave the board or certainly not stand for election the next go-around. Unfortunately, in connection with many of our community banks, we still have the situation of directorship for life. In those cases where that is combined with a Chairman not as strong as we would hope, the result is an aging board of directors, which we have found to be one of the triggers often tending toward a sale of the bank.

If your board determines for whatever reason that mandatory retirement is necessary, then the question becomes, at what age should mandatory retirement be required? When we formed these firms 33 years ago, the most common age was 70. It gradually crept up to 72. Now the most common age we see for mandatory retirement is 75. We have also seen some 78 year requirements and 80 year old requirements along with some certification by medical personnel that the director has not "lost it." Mandatory retirement, if you are going to use it, can be designed any way that works for your bank. We are often in banks that indicate they have implemented mandatory retirement but all the existing directors are "grandfathered." Aside from the fact that mandatory retirement will not "kick in" for 20 plus years, in those circumstances then we suppose it could be effective.

MINORITY DEPOSITORY INSTITUTIONS

Over the years we have worked with multiple minority depository institutions. These are institutions that are principally owned by minorities, either African-American, Asian, Latino, or some other designated minority. In the recent government stimulus packages and with the current ESG movement, there have been significant funds available for minority institutions. This is a tremendous opportunity for them to expand their business and do so profitably, which we hope they take advantage of. We are assisting a number of them now with respect to some of the special programs.

RISK REVIEW

Community banks are in the risk business. As such, community banks are required/supposed to engage in a fairly continuous risk review. This is generally in connection with an overall program typically entitled "Enterprise Risk Management." The friendly federal regulators encourage this strongly.

It is good to know that the friendly federal regulator (FDIC in this case) practices what it preaches. The FDIC this week came out with an 80 page Risk Review of the industry. The FDIC identifies and addresses specifically the primary key risks to banks as credit risk, from agriculture to small business lending, and market risk, including interest rate, net interest margin, liquidity, and deposits. If you would like to review the FDIC's Risk Review for 2021, please click here: [2021 Risk Review (fdic.gov)]

CHANGE IS DIFFICULT

We have had the opportunity, particularly in strategic planning, to work with a number of community banks over the past 12 months that are well in excess of 100 years old. Many of them operate with a legacy core processing system, but also many other "legacy" systems in the way they do things. Some of these banks in just the last 25 years have gone from $100 million to $1 billion or so. For some of these community banks, change continues to be difficult. When we often ask the question of "Why do you take this particular approach to that particular issue?" we do not typically get the answer back "Because we have always done it that way." (We think this is primarily because everybody knows that is not the right answer.) Frankly, however, that is the reality for many community banks.

Our encouragement, as simple as it is, is to keep an open mind with respect to change in your community bank. If somebody suggests a change and you have an adverse reaction to it, give some thought to whether you are reacting to change on its face or whether you are reacting to the fact that it is simply an ill-conceived idea. These days, change is often good, provided it is not simply change for change's sake.

ANTICOMPETITIVE CONCERNS

Over the past couple weeks, we have had a couple different clients come to us and ask us about the Herfindahl-Hirschman Index. If you are not familiar, this is typically referred to as the HHI Index. It is a mathematical calculation that guides the regulators in evaluating whether a proposed acquisition transaction is presumed to be anticompetitive. The HHI mathematical calculation essentially sums the square of each commercial bank's market share in the market both before and after the transaction. The general rule is that any transaction that results in an HHI over 1,800 where the HHI has increased more than 200 is presumed to be anticompetitive.

The discussions we have had with clients over the past couple weeks involve whether a presumption of a transaction being anticompetitive can be defeated. In each of these deals, our client was considering a transaction that violated the HHI rules, so they were essentially asking whether it was worth the time to pursue the transaction because of the anticompetitive presumption.

The short answer is "yes." The presumption of a transaction being anticompetitive can be overcome. That is typically done in a couple different ways. First, you argue against the Federal Reserve's definition of the established banking market. The argument is that the Fed has incorrectly defined the market and needs to alter the market definition. The second argument is that the HHI Index, which looks only at commercial banks, does not adequately capture the financial services providers in the market. You would then look to other financial services providers, such as credit unions, payday lenders, FinTech companies, online banks, insurance agencies, and the like, to show the Fed that the combination of the two banks does not limit the financial products and services that are available to consumers within the market.

Defeating a presumption that a transaction is anticompetitive based on the HHI is difficult. However, it is not impossible. There have been instances in the past where we have been successful in convincing the regulators that a transaction that is presumed to be anticompetitive is not.

EMPLOYMENT AGREEMENTS

One of our community bank clients recently worked their way into an opportunity to make what they consider a very strategic and exciting hire. This bank is hiring the "franchise player" in a very strategic market. They are investing quite a bit to make this happen, so they want to appropriately protect their investment by utilizing an Employment Agreement with this individual.

The Employment Agreement has most of the typical provisions. It includes sections that cover salary, benefits, car allowances, country club dues, change in control provisions, noncompete provisions, and confidentiality requirements. There were also some unique provisions in the Agreement, such as bonus payments based on the profitability of the market, equity-based compensation, and some other unique provisions.

A common question we often receive is whether unique items can be included in an Employment Agreement. The answer is absolutely yes. An Employment Agreement is a contract between the bank and an individual, so the two parties are generally free to contract for whatever it is they can mutually agree upon. There are some federal regulatory rules that impact employment contracts, particularly involving safety and soundness and troubled institutions, and some states contain time limits on the length of agreements for bank executives whereas others do not. Generally speaking, however, whatever is legal and can be agreed upon is fair game for inclusion.

CONCLUSION

2021 certainly seems to be flying by. We are back traveling extensively across the country to visit with our community bank clients and their boards of directors. We are glad to see things opening up somewhat. We hope all of you continue to stay safe and are very careful, as are we.

See you in 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

- June 15, 2021 – Independent Community Bankers of America – Webinar: "The Role of Community Bank Directors in Compliance" (Cliston V. "Doc" Bodine, III) Registration link: The Role of Community Bank Directors in Compliance

