GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Wisconsin, Minnesota, Mississippi, Alabama, Pennsylvania, Georgia, Florida, and Texas!

THE FDIC "CAPITAL STRATEGY"

The most recent edition of *Musings* described the capital issues and considerations many community banks are dealing with because of an inflated balance sheet. As a quick reminder, most banks' balance sheets have grown 20% to 30% over the past 15 or so months, and this supercharged growth has resulted in lower than typical capital ratios. Apparently, community banks are not the only ones that are dealing with inflated balance sheets and lower than typical capital ratios.

You may not be aware, but the FDIC is subject to a Congressional mandate that the Deposit Insurance Fund always equal or exceed at least 1.35% of insured deposits. If you think about it, Congress has essentially mandated the Deposit Insurance Fund always have at least a 1.35% capital ratio. If the ratio falls below this amount, the FDIC has the ability to impose assessments on insured banks in order to increase the Deposit Insurance Fund and the ratio above 1.35%.

At its latest board meeting, the FDIC acknowledged that the Deposit Insurance Fund is below the Congressionally required minimum. According to the information provided by the FDIC, the Deposit Insurance Fund sat at about 1.3% of insured deposits at June 30, 2020. The staff memo provides, "Extraordinary growth in insured deposits during the first and second quarters of 2020 caused the reserve ratio to decline below the statutory minimum as of June 30, 2020."

The FDIC Board recently voted not to raise deposit insurance assessments in order to recapitalize its Insurance Fund. Instead, the FDIC Board voted to hold steady on assessments because it believes it possible the Deposit Insurance Fund ratio will increase as a result of decreases in insured deposits. Specifically, the staff memo provides, "Staff expect the surge of insured deposits – those deposits resulting from extraordinary growth associated with the pandemic – to eventually recede and insured deposit growth rates to normalize in the medium and long term."

Keep these issues in mind at your next examination, particularly if your examiners begin to gripe at you about your capital ratios that are lower than typical based on an increase in cash and deposits. If the FDIC can justify a lower than statutorily required Deposit Insurance Fund ratio based on an anticipated decrease in insured deposits, we believe community banks absolutely have the right to do the same. What is good for the goose is good for the gander!

THE FRIENDLY FEDERAL REGULATORS - AGAIN

A CEO of a large size community bank recently reported to us that his bank had undergone a recent examination by one of the friendly federal regulators. Of course, the impact of the pandemic on the bank was on both the bank's and the regulator's minds. In reviewing the regulator's approach to the traditional CAMELS rating (Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity), the CEO reports that with respect to the Liquidity rating, the regulators backed out the liquidity due to the inflated balance sheet as a result of the pandemic and rated the Liquidity component of the CAMELS rating a 2. With respect to the Capital rating, however, because the bank's balance sheet had been inflated literally by hundreds of millions of dollars in this case and its capital ratio dropped several hundred basis points, the regulators did not back out the impact of the liquidity from the pandemic on the inflation of the balance sheet (which caused the reduction of the capital ratio). Instead of rating the bank a 1 on Capital, it rated the bank a 2 and criticized the bank for its rapidly reducing capital ratio. It appears the friendly federal regulators are back in their "friendly" state. Look out for your next exam.

PREPARING FOR GROWTH

We recently facilitated a planning session for a smaller community bank. The session involved a significant amount of discussion related to the desired growth of the bank. This less than $100 million bank very clearly has a desire to grow the overall assets of the bank. The group did not adopt a hypercharged growth strategy where they were looking to be a $300 million bank in five years. Instead, the group adopted as a strategy measured, sustained, and profitable growth, likely around 6% to 10% per year. Given the size of the bank, we see that as achievable without taking on unnecessary risk.

Although the group adopted a strategy of growth, that will not happen immediately. This is because much of the planning session involved a discussion as to whether the bank was currently positioned to properly handle additional asset growth. The central question was whether the bank had its current affairs in such an order that it could continue to grow the loan portfolio and geographic footprint of the bank while maintaining profitability and safety and soundness.

After much discussion, the general answer was "no," the organization did not currently have its house in order to the extent necessary to facilitate the desired growth. With this in mind, the group adopted what was essentially a two-fold strategy. The first strategy, which will likely take about the next 12 months, is for the bank to get its current house in order and set the stage for appropriate growth. The second step of the strategy is then to move forward in actually achieving the desired growth.

We viewed the organization's decision as being very wise in this regard. We believe that if you are not prepared to get larger, any additional asset growth will only magnify existing problems. We think it best to first get your house in order in preparation for growth, and then to move full speed ahead in looking to achieve the desired growth.

BOARD PORTALS

If your community bank's goal is to have a well-informed, efficient, and productive board of directors (and it should be), then one small sliver of that is the use of a board portal. We have been with a number of boards lately where the board still receives paper board packages. We have no objection to that and are not going to complain about killing trees, etc. Our focus is on the content and efficiency of information received by the board of directors. Often, a printed board packet has to be prepared, printed, mailed, or FedEx'd to the directors (we still refer to FedEx in general since the firm is based in Memphis, FedEx's home). Some community bank boards we have been with recently still only receive their package on the day of the meeting, which we believe to be totally inappropriate from an efficiency standpoint.

The benefit of using a board portal, of course, is that information can be uploaded onto the portal all month long. The directors can read it at their leisure. It is certainly confidential. (It is at least more confidential than leaving your board package in the local coffee shop after you are done reviewing it.)

Also, our general recommendation is the board receive the information for the board meeting at least three or four days prior to the meeting so the board members can review it and be prepared for the meeting. If that occurs, then the Chairman or CEO or whoever runs the meeting can also utilize a consent agenda, which is based on the assumption that the board members have read the material and are prepared and only need questions answered, if any, before the matters are approved.

There are a number of different board portal companies available. We are not pushing any one in particular. We do have a Memorandum to Clients & Friends with regard to the use of board portals. If anyone would care to receive it, please let us know.

FAMILY DISCUSSIONS

We are currently assisting a number of different very closely-held community banks that are giving consideration and discussion to their strategic future. Each of these clients generally follow the same pattern. They are family-owned banks that are in the third or fourth generation of family ownership. They generally have a member of the family running the bank on a day-to-day basis that is looking toward retirement. In some of the instances, they have loose possibilities of management succession. In others, there is really no family member that wants to be a part of the bank on a day-to-day basis. All of them are trying to figure out whether now is the time to sell the bank or continue to remain independent.

The business ownership issues for a family-owned bank are the same as the business ownership issues for any other community bank. The central question is whether the shareholders are better served by buying another institution, selling or remaining independent. However, family-owned banks also have the dynamic of familial relationships outside the company. Sometimes this makes things a little bit easier. Most of the time it is a complicating factor that makes the business discussions a little bit tougher because family issues tend to become intertwined with the business issues.

We have seen many family-owned community banks around the country that do quite well. Some are because of the familial relationships. Others are in spite of the familial relationships. Either way, family-owned banks have a certain dynamic that adds in another layer of complexity and consideration in addition to the purely business issues. Navigating that additional layer can sometimes be tough.

UNSOLICITED OFFERS

Each community bank needs to have a strategy with respect to independence. That strategy will either be to be proactive looking for a buyer or to remain independent subject to the receipt of an unsolicited offer. As we have noted previously in *Musings*, unsolicited offers are not "hostile" offers. In fact, there have only been, if our recollection is correct, three hostile offers involving community banks in the last 20 years. We were involved in defending two of the banks who were approached. A hostile offer general involves going unsolicited in a threatening manner to the board of directors or, worse yet, going directly out to the shareholders attempting to acquire stock. These rarely happen in community banking for a lot of reasons, some of which are cultural and most of which are procedural (i.e., the need to obtain regulatory approval before control can be exerted). The regulatory piece slows down the hostile offer considerably.

More typically used in community banks is the unsolicited offer. The unsolicited offer is simply what it sounds like (i.e., an offer that the board of directors did not go out and proactively look for but that was brought to them by a prospective purchaser or a financial advisor on that purchaser's behalf, with or without having laid the appropriate groundwork).

We recently had a client receive an unsolicited offer through the financial advisor for the potential buyer. The client contacted us and asked us to analyze the offer since on its face it appeared to be from a credible source and was at a price that was at least in the ballpark. We did so. We advised the community bank holding company board that we believed that based on the offer that the community bank shareholders would be better off holding their current stock than they would be taking what was being offered. As such, we prepared a brief response on behalf of the holding company board that was basically "thanks, but no thanks." Upon receipt of the response, the potential purchaser and its financial advisor contacted us and asked why the offer was not at least considered. We told them that there were two problems. First, the offer did not chin the pole with respect to price. Second, the offer offended the board since no groundwork was laid, no courting occurred, and they were being asked to "marry up" with a party they hardly knew.

Unsolicited offers do not work very well most of the time. They especially do not work when no groundwork has been laid. Keep that in mind for the future.

MANDATORY RETIREMENT

We have recently had discussions with numerous community bank boards with respect to the issue of mandatory retirement. As we have often said in *Musings*, we are not a big proponent of mandatory retirement. We believe the better practice is for a strong Chairman to take appropriate action, when necessary, with respect to directors that need to or should retire.

Notwithstanding that, we have been in several banks recently that did not have mandatory retirement and had several board members well into their 80's. Not surprisingly, those directors who were still on the board well into their 80's were very sharp and contributed significantly to the board decision making process. The big benefit of the seasoned directors is their institutional knowledge since most of them had been on the board for anywhere between 30 and 40 years.

We have never utilized these *Musings* pages to rail against older directors. What we have railed against is directors who are not engaged, not competent, not prepared, and not contributing. Those directors need to have a chat with the Chairman and decide whether they should continue on the board. For some community banks, mandatory retirement may be the answer because it is a bright line test and somewhat easier to administer. In a perfect world (where none of us live), the responsibility of board composition starts with the Chairman. Directorship for life is not a good strategy.

DIVIDENDS OR DISTRIBUTIONS

We have had numerous conversations with community bank boards of late with respect to the holding company's strategy with regard to paying dividends to their shareholders (in a C corporation) or distributions to their shareholders (in an S corporation). Your community bank holding company's dividend in a C corporation is "theoretically" 100% discretionary on the part of the board. They could pay all of what they have paid historically, no dividend, or increase or decrease it at the board's will. In an S corporation it is also theoretically discretionary, but it seems to us that as a practical matter the tax distribution portion of the distribution (versus the dividend equivalent portion) is not discretionary. If a Subchapter S bank wants to remain independent, then it needs to make sure it gets enough cash to its shareholders to pay the shareholders' taxes on the profit of the organization.

The dividend/distribution discussion generally comes up in connection with a discussion of allocation of capital for the organization. A dividend/distribution is clearly an allocation of capital. Once financial capital has been allocated toward that, it is no longer available to allocate toward anything else, such as a repurchase of shares or acquisition of another organization or a line of business. We have recently visited with several boards who have over the last several years ramped up their dividend/distribution yet now are looking to spend capital someplace else. Although theoretically a dividend/distribution is discretionary, as a practical matter, we have not run into a whole lot of community bank boards that want to reduce the dollar amount of the dividend/distribution. As we have often said, dividends/distributions are addicting. It is very difficult to get the shareholders weaned off them. Also, we have never seen a shareholder send a check back. In view of that, the board of directors needs to take a very long-term view when establishing a dividend/distribution strategy. Keeping in mind that although a good portion of those funds are purportedly discretionary allocations, once the decision on a dividend or distribution has been made, it is very difficult to get the shareholders to understand when a reduction occurs.

ADDITIONAL CAPITAL PLANNING CONSIDERATIONS

The previous *Musings* dealt with, among other things, capital planning issues. Most of the capital planning discussion dealt with whether or not the institution really needed to inject capital and what the capital plan should contain. That brief *Musings* article did not deal with one obvious issue: the capital ratio is a function, in part, of the size of the balance sheet. Shrinking the balance sheet is certainly a viable way to raise the capital ratio. In fact, historically in "troubled bank" times, that was generally the only way to raise the capital ratio because no external "real" capital could be raised. A couple of *Musings* readers pointed this out to us. We thought we would reconfirm that balance sheet shrinkage is a viable strategy, whether it is simply by attrition or intentionally.

CONCLUSION

The Fourth of July is just ahead. We hope all of you have the opportunity to get some rest and relaxation and spend time with friends and family. Be careful with those fireworks, particularly around little ones. Stay safe and healthy.

We'll see you in two weeks.

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Upcoming Webinars:

- July 13, 2021 – Independent Community Bankers of America Webinar – "Succession Planning for Community Banks" (Cliston V. "Doc" Bodine, III) Registration link: Succession Planning for Community Banks