GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Florida, Iowa, Kansas, Illinois, Washington, Pennsylvania, Texas and South Carolina!

THE RACE IS ON!

Those of you that are country music fans likely have familiarity with George Jones' country classic "The Race is On." For the unfamiliar, it is George's conveyance of love lost in the style of a frantic horse race. While we will avoid completely the issue of love lost, we will steal George's song title to provide an apt description for what we see as the current community bank M&A environment. The race is certainly on!

Why is it that we see the race is on as an apt description for today's community bank M&A environment? It is because almost everyone is sprinting to get deals done prior to year-end. We have multiple deals in the works, and in each one of these deals the seller in particular is worried about getting the deal closed prior to or on December 31st.

Why does December 31st matter in all of these deals? A simple look to Washington provides the answer. The general belief is that there is going to be an increase in tax rates, particularly among well-heeled individuals making more than $1 million in a year. Many of these bank transactions involve sellers that are going to make more than $1 million. The fear is that if the deal does not close prior to year-end that tax rates will increase and they will recognize a decrease in after-tax cash flow in the transaction. For this reason, everyone is sprinting to get the deal closed as quickly as possible.

We expect the fourth quarter will be rather busy for closing all manner of M&A transaction, including those for community banks. We expect you will see a number of M&A deals close in the month of December. Hopefully Congress will do their part and will not make any sort of tax increase retroactive. Only time will tell on that issue.

FRIENDLY FEDERAL REGULATOR ENFORCEMENT ACTION

As we have mentioned in prior *Musings*, we have anticipated for some time that the friendly federal regulators under the current administration will get more aggressive with their enforcement actions. That appears to be the case.

The FDIC in particular recently released its enforcement actions occurring during the month of July. One of those actions involved the issuance of a Notice of Charges against a Midwestern bank. Keep in mind with the friendly federal regulators, when they propose an enforcement action, the bank (hard to believe) is really in control. The regulators can't simply "impose an enforcement action." They either have to get the bank's consent to the enforcement action (i.e., a "consent order") or the bank has a right to its day in court. This bank apparently decided it would like its right to its day in court (i.e., an administrative proceeding in front of an administrative law judge) in order to dispute the charges of the FDIC in this case. To initiate a proceeding where a bank fails to consent and a negotiated settlement is not obtained, each of the friendly federal regulators issues a Notice of Charges. This is like a complaint in a civil action. The FDIC's Notice of Charges in this particular matter focused on most of the CAMEL areas including Management, Capital, Liquidity and Sensitivity to market risk. The charges, which we anticipate the bank if it hasn't already will answer and dispute, are basically a case study into the FDIC's perception as to what a bank of this size (north of $1 billion) should be doing as it relates to management, corporate governance, funding the balance sheet's liquidity, sensitivity to market risk and capital levels. We found the FDIC's allegations and this Notice of Charges and its proposed cease and desist order to be interesting in the current environment. We are happy to provide a copy to anyone who would like one. We will also address in *The Board Chair Forum Newsletter* some of the governance issues addressed in the proposed order and existing Notice of Charges.

Keep in mind that when a bank refuses to consent and the friendly federal regulator wants to move forward, as noted, they initiate a proceeding through a Notice of Charges. The bank has the opportunity to answer. Some limited discovery occurs and a hearing occurs before an administrative law judge, at which the bank gets to put on its evidence and cross examine the examiners. (Always fun!) We are not involved in this particular administrative proceeding but have been involved in many across the nation over the years. It will be interesting to see how this one shakes out.

DIFFERENT APPROACHES TO PLANNING

We have recently worked with a number of mid- to large-sized community banks that still want to remain community banks. In connection with their planning sessions, several have never involved the board, several have involved the board way too much (in our opinion), and several are simply looking for some kind of middle ground. We believe one of the best approaches is for the board with senior management to get together to identify the long-term strategies at a 30,000 or 40,000 foot level. The last thing you want is the board of directors involved in the weeds.

One way to keep the board at a high level is to set a meeting that is structured as a discussion of four or five major issues on which they need to opine. This could be geographic expansion, additional acquisitions, independence, other lines of business, and those types of major issues. The goal is to get the board set the direction but not to tromp around in the weeds where management operates on a daily basis. Most of these meetings are successful. When we are approached by a community bank and the CEO indicates that he or she wants to make his or her board more engaged, we always caution "be careful what you wish for." We do that somewhat tongue in cheek but not totally. We want the Board to be a credible challenge to management, set the strategic direction and the like. We don't want to give them the opportunity to micromanage.

THE DREAMER STRATEGIC PLANNING MEETING.

We have had a couple of good and different strategic planning meetings lately with some of our good-sized community bank clients. These were not nuts and bolts meetings as much as they were "dreamer" meetings. As many of you recall in the recent *Board Chair Forum Newsletter*, we identified various types of strategic planning. One was to look out to the future and dream about the possibilities that could be utilized from a strategy standpoint and then figure out how to execute on those dreams.

One of the recent ones involved just that. The group came up with some good and very unique ideas. It will be interesting if they can figure out how to execute on them and what it looks like when they do. The goal for this group, and should be for all community banks desiring independence, is to remain relevant to their customers, community and shareholders/investors.

ARE CDs RELEVANT?

We recently had the opportunity to be involved in what was essentially a community bank officer operational and tactical planning session. This is different from a strategic planning session. This was essentially a day-long meeting among the bank management team where they discussed in detail issues related to the bank's operations. The discussion is more in the weeds than in a bank strategic planning session, but the general concept of identifying action items is the same.

During the operational and tactical planning session the group discussed in detail the bank's deposit programs. Like many other community banks, this particular bank has a pretty good percentage of its deposits in the form of CDs. What was most interesting about this discussion is the fact that this group identified CDs as becoming almost irrelevant in the not too distant future. The group took the position that CDs are on their way out for a couple different reasons. First, the rates being paid on a CD are so low that customers are not willing to tie up the cash for such a low return. The group adopted a belief that customers see it as better to keep funds in non-interest or low interest accounts that have immediate access to the funds if needed rather than tying it up longer term and having to pay a penalty to access the funds. Second, the group identified that CDs are basically, to put it nicely, an "aging generation's product." They basically took the position that younger customers do not really have an interest in CDs, and would rather have their funds in other products.

As a result of this discussion, the bank management group adopted some pretty detailed action items as it relates to demand deposit growth. The group recognized that seems a little counterintuitive given the level of liquidity in most banks today. However, the group viewed the excess liquidity as more of a short-term issue, and believe over the longer term that demand deposits will only increase as a percentage of overall deposits. It was an interesting discussion.

EQUITY INCENTIVE PLANS

We’ve had a number of clients recently ask for our assistance with respect to creating incentive plans for their employees to not only boost performance but attract and retain key employees. Incentive plans come in all shapes and sizes. As a subset of incentive plans, equity plans also come in a variety of alternatives. These include stock options, restricted stock, synthetic equity, i.e., phantom stock or stock appreciation rights, and multiple versions of each.

Our general recommendation to a bank that is contemplating implementing an equity incentive plan is to determine exactly what they are trying to incent. Because most of these plans are “non-qualified,” the Board or Compensation Committee setting the parameters has a lot of latitude as to what they do to allow the employee to receive the incentive or equity award. We are firm believers that employee ownership is a good thing whether it is real, through equity, or phantom, through synthetic equity. Anything we can do to get the employees in our community banks to think like owners and align their interest with the ownership makes sense.

IMPACT OF COVID

Over the last 18 months one of the significant external factors for most of our community banks around the country is the COVID-19 pandemic and the new Delta variant (we understand that it was named by American Airlines). We often inquire at planning sessions, with respect to the impact of COVID on the bank, from the perspective of what good occurred and what do we need to carry forward into the future. Is remote working a standard for future operations? Did the technology improvements we were forced to make accelerate our adoption and our customers’ adoption of technology and those types of things? We also address the risks associated with COVID including credit quality, on-balance sheet liquidity and economic uncertainty. We are happy to report that in virtually all of our clients, COVID has had more positives than negatives. We are not minimizing the illness, death and destruction that it has caused, but with respect to the impact on the bank itself, including the adoption of technology that otherwise would have been delayed and the early acceptance of the technology by the customer, it has been on balance a positive. Asset quality, according to most of our community bank CEOs, remains eerily, or as one CEO indicated, “freakishly” good. The on-balance sheet liquidity is more of a nuisance than it is a significant risk issue and the economic uncertainty does not seem to be a major risk factor at this point.

Certainly no one would classify COVID as a non-event by any means, but it has not been a disastrous event by a long shot for community banks. A number of positives have resulted.

LENDING BOOTCAMP

We recently facilitated a strategic planning session for a well-run and profitable community bank. Over the past three or so years, the bank has experienced some appreciable change in the lending staff.

During the planning session there was in-depth discussion regarding the bank's lending function. During the discussion the group recognized that the recent turnover has resulted in the bank having lenders that do not have a unified approach in their lending process. In other words, the bank recognized that particularly these new lenders were doing things in a way that was not exactly the same as the more seasoned lenders. The group recognized that was not an ideal situation, and that it would be better for the lending staff to have a unified approach to the bank's credit process.

The discussion resulted in what is somewhat of a unique strategic planning action item. In summary, the plan is for the bank to have a "lending bootcamp" for its lenders. The idea is for the bank's Chief Credit Officer to prepare for about a one-day meeting with the lenders that goes through, in detail, the bank's processes, policies and procedures for the lending function. The group essentially viewed this as somewhat of a reset on the lending function to ensure that all of the bank's lending staff are unified in their credit underwriting and administration. We saw this as a particularly appropriate strategic action item.

ALTERNATIVE LINES OF BUSINESS

A number of our recent strategic planning sessions have included extensive discussion on the options to engage in alternative lines of business. There is a particular level of interest in these options in today's environment due to the extensive amount of excess liquidity on most bank's balance sheets and a related decrease in net interest margins. One of the issues that often comes up when discussing the potential for engaging in alternative lines of business is a question as to the level of regulatory scrutiny that will accompany engaging in this new line of business. The question is essentially how close are the regulators going to review these business activities.

In our experience, the answer to this question depends on the level of experience the organization has in conducting whatever non-banking activity it may choose to pursue. If neither the board nor management team has any experience in operating an alternative line of business, such as an insurance agency, we expect the regulators will keep a fairly close eye on the activity for a few years. If the organization has experience in these types of activities, the regulatory scrutiny is often much lower. Of course, the regulator's primary aim is to ensure that the new activity is being conducted in a safe and sound manner, and that it is not creating collateral damage by taking management's time away from satisfactorily running the bank.

FILLING THOSE KEY EXECUTIVE SLOTS

Management succession is top of mind for most boards. It is often an issue of succession for the CEO or one of the top C level officers. Based on our firm's representation of over 2,000 banks around the country in all 50 states plus territories over the last 33 years, we often get asked by various banks and boards if we are aware of any high-quality execs that may be available. It is always critical to make sure there is the best match as possible for a new executive coming in. We do not fancy ourselves as placement agents or headhunters. That's not our expertise. We do often play a "matchmaker" role, however, based on what we know. If you have an opportunity to fill one of these C-level slots, let us know and we might be able to help. If we can't help, then we have good relationships with some excellent financial institution headhunters that focus on the executive level.

CONCLUSION

Labor Day weekend is upon us. It's always good to get that three-day break. We hope you get to spend time with friends and family. As we are all aware, COVID is still a factor. Be careful and stay safe.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars:

- September 8, 2021 – ICBA Webinar – "M&A Advice for the Current and Future Environment" (Greyson E. Tuck) M&A Advice for the Current and Future Environment
- September 15, 2021 – Community Bankers of Michigan Directors College – "Stay Independent? Stay Relevant!" (Philip K. Smith) Stay Independent? Stay Relevant!
- September 22, 2021 – ICBA Webinar – "Board Governance and Structure: An Update on Best Practices" (Philip K. Smith) Board Governance and Structure: An Update on Best Practices
- September 23, 2021 – Graduate School of Banking-Wisconsin Webinar – "Community Bank Capital Raising Simplified" (Greyson E. Tuck) Community Bank Capital Raising Simplified