GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Kansas, Iowa, South Dakota, North Dakota, Minnesota, Alabama, Mississippi, and South Carolina!

ACQUISITION OF BANKS: THE PERFECT POSITION

As most *Musings* readers know, we have a very active acquisition practice, both on the buy and the sell side, and in both the financial and legal arenas. On the buy side, we are fortunate that most of our clients are buying because they want to. They are not buying because they "need to." Buying because you want to leaves all the options open. If your community bank is looking at a transaction and you decide not to do it, that may be your best alternative. It may, in fact, be the best transaction ever. Many of our clients weigh the allocation of capital between buying themselves (i.e., buying their own stock back through the holding company) and buying another bank. Obviously, buying another bank has significant additional risk, but it may also improve value of the franchise significantly (we would hope it would anyway). Buying your own stock back is simply a financial transaction that benefits the remaining shareholders. If you are looking to execute on an acquisition strategy, try not to have a bias toward the acquisition. The best position to be in is one where you can walk away if you need to because you "don't have to buy."

THE LITTLE BANK THAT GREW UP

We have been with multiple community banks lately that are well north of $1 billion in total assets. Of course, these banks did not start that way, nor did our representation of them start when they were large sized community banks. Most of them have grown from a few hundred million dollars in assets now to well over a billion or multi-billion. The ones that have been successful are the ones that have been able to change significantly along the way. This is not a reference to a change in community bank culture. It is a reference to organizational structure, a change in the way things have been done in the past, and the like. Keep in mind that a billion dollar community bank can, but shouldn't, operate the same way it did as a $250 million community bank. Also consider your board of directors. If your community bank has been around for 30 years and you were a couple hundred million dollars when your board got together but you are now $2 billion, do you still have the right board with the right skillset for a bank of that size? You may very well, but that is something that needs to be assessed. The board assessment also applies if your bank is going to be a public entity. If your bank holding company is going to move to SEC reporting and listed on a major exchange, then the issue is whether the board members are capable and have the appropriate skillsets in that environment. Don't be afraid to evaluate the issues, particularly as it relates to the board organizational structure and operating issues.

COMMERCIAL LENDING LIFT-OUTS

Every community bank strategic planning retreat we have facilitated this year has involved extensive discussion concerning loan growth strategies. Not surprisingly, every community bank is trying to figure out how to put excess liquidity to work to earn better yields. Many of these recent discussions have included an action item to pursue a commercial lending team lift-out.

A commercial lending team lift-out properly falls under the "why buy it when you can steal it" category. This is a loan growth strategy that essentially calls for a bank with excess liquidity to go into a new market and hire a team of commercial lenders from an existing bank. The idea is that this group of commercial lenders will leave their existing bank and come to work for the new bank, and their loan customers will follow. If the strategy goes according to plan, the bank will experience fairly significant loan growth in a short amount of time, typically 12 to 24 months.

In our view, a strategy to execute on a commercial lending team lift-out is a great strategy if it can be successfully completed. However, the significant unknown is whether it is a strategy that is actually capable of execution. In our view, a successful execution of the strategy involves a good mixture of relationships, skill, and luck. The central reason we believe it is hard to execute is because so many different community banks are looking to achieve the same strategy. It is really a supply and demand issue, where the demand for a group of commercial lenders far out paces the supply.

If your community bank is giving consideration to loan growth opportunities, we recommend you think about a commercial lending team lift-out. However, be sure to recognize the challenges to successfully completing the strategy. It is difficult to identify and hire a team of commercial lenders that are capable of bringing over a material amount of loans in a short amount of time. If an opportunity does exist, it is also one that is going to have fairly fierce competition (and be expensive).

STOCK AWARDS

As we move toward year-end, many boards and bankers are turning their thoughts toward annual bonuses. Over the past couple weeks, we have had a number of different discussions with clients that are thinking about rewarding directors and/or executive officers through the issuance of holding company common stock. Holding companies that are thinking about providing these types of incentives have a couple different issues to consider.

One of the primary questions we often receive is what is an appropriate level of stock to be issued. This is purely a board decision, with shareholder dilution being the primary factor. Any time shares of stock are awarded, it increases the number of shares outstanding. Since these programs involve an award of stock, not a sale, the number of shares outstanding increases without a corresponding increase in equity. This, of course, lowers book value per share and earnings per share for the remaining shareholders. The offset is the continued involvement and compensation of the individual receiving the award.

The second issue that should be considered is taxes. If shares are awarded to a director or officer, the fair market value of the shares at the time of the award will be counted as taxable income to the individual. This increases their personal tax liability. Considering the IRS does not accept shares of stock as payment for taxes, the source of cash for the payment of taxes should be considered. The cash could come from the individual's existing cash. However, the more common occurrence is to pair a cash bonus with the grant of shares to provide the individual cash to pay the applicable income taxes. (Keep in mind this is a circular calculation, as the cash is also taxable income.)

If you are thinking about awarding stock to your directors or executive officers, keep these couple issues in mind. Also keep in mind any applicable securities laws. The general rule is that the securities laws are only applicable to a sale of shares. If no consideration is received from the recipient, it is typically not a sale. However, securities laws should be considered.

THE REGULATORY DUST-UP

If you have not been paying attention, over the past week or so we have seen an interesting situation with regard to the various federal banking regulators. Specifically, there appears to be partisan bickering between the Chairperson of the FDIC and the heads of the Consumer Financial Protection Bureau and the OCC, both of whom are FDIC board members. The short story is that the CFPB and OCC recently issued a request for comments on the guidelines to review bank merger applications. This was styled as an interagency notice, coming from all the bank regulatory agencies. Very shortly after this request was made public, the FDIC went public with their own announcement, indicating the FDIC Board of Directors had never approved or agreed to join in to the request for public comments on the bank merger guidelines. In looking a little further into the story, it appears that the FDIC Board has a couple members that are attributable to the Democratic party that take a different view of the need to review the applications than do the individuals appointed by Republicans.

This is causing an interesting dust-up in Washington for a couple reasons. The biggest issue we see is that, historically, the FDIC Board has largely avoided partisan behavior. In the past they have not publicly displayed action that is reflective of one political party or the other. This recent action is a break from that tradition, and we hope is an isolated incident. It would be nice if the friendly federal regulators could get their act together.

INSIDER TRANSACTIONS

Over the past couple weeks, we have had a couple different discussions with clients concerning Regulation O. If you are not familiar, Regulation O governs a bank's transactions with insiders. Regulation O used to be applicable only to extensions of credit. However, the Dodd-

Frank Act extended Regulation O to basically cover all transactions with insiders and requires those transactions to be on market terms.

During one of our recent discussions with a client, they mentioned that their bank board has pretty much taken the position of avoiding Regulation O transactions altogether. Their general comment is they do not see the efforts to ensure compliance and related risk as worth the benefit to the bank. They essentially made the decision that it was better to send the insiders to another bank for any loan they may need.

We were asked whether this was the prevailing view in community banking. We do not see avoiding Regulation O covered transactions altogether as the common practice for most community banks. However, we did comment to the banker that we have seen a number of banks stub their toe and create problems for themselves with Regulation O, so we do not see a strict avoidance of Regulation O transactions as a misstep. It is really a question of risk tolerance, and this organization simply decided the risk was not worth the reward.

MANAGEMENT SUCCESSION

In the last several months, we have been in several community banks that have done an excellent job transitioning from one management team to the next. For some of these, but certainly not all, it is family-based. The successful banks that appropriately execute on management succession are those that put thought and work into it. Some of it involves mentoring the incoming management. Some involves training the incoming management on new skillsets over a period of years. Most of all, though, it involves planning for the future management of the community bank. If your community bank has a management succession issue or will over the next five years, then the time to begin to plan for it, think about it, and structure it, is now, not three years from now.

THE INDEPENDENT COMMUNITY BANK

We have been with a number of community banks lately that have had a long-term independence strategy. Although we are staunch supporters of independent community banks, we also realize there are times and "triggers" that cause community banks to sell. Most often, these are the basic ones, such as lack of management succession, lack of board succession, lack of share liquidity, and the like. We have watched several community banks in the last several months agonize over a sale decision. It is often not unanimous. It is never without significant angst on the part of all the participants, even those who decide a sale is in the best long-term interest of the shareholders. Keeping a bank independent is challenging, particularly for an older board of directors who may need to find new management, new board members, and new source of share liquidity. It seems the sale decision for a community bank is never an easy one.

CONCLUSION

These past two weeks, particularly this past weekend, we all have seen significant natural disaster devastation in the mid-part of the country. Many of our clients and friends were adversely affected by the tornadoes. Our thoughts and prayers are with them. We hope you will support them as well.

This will be the last *Musings* before the Christmas holiday. We wish you and your families all the best. Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming:

- January 13-14, 2022 – Community Banking Board Chair Forum (Jeff Gerrish, Philip Smith, and Greyson Tuck) Registration: Board Chair Forum

