GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from California, Georgia, Florida, North Carolina and Wisconsin!

WHAT DO YOU DO WITH THE CAPITAL?

We had a number of banks over the last year or so that have gone out to the market to raise capital. Several of them did this in anticipation of being able to consummate an acquisition, and they wanted a ready source of capital available. If you need capital to do an acquisition, the question is, generally whether you raise it ahead of time hoping you will get a deal, or whether you wait until the deal is struck and then raise the capital to fund it. Different boards come down on different sides of that equation. If you raise it before you need it and you do not get a deal or a deal large enough to use it, then you are going to have excess capital that needs to be allocated. The usual suspects for capital allocation to be considered are those that are fixed costs such as balance sheet growth and dividends or distributions (in Subchapter S) and those that are variable such as allocating excess capital for share redemptions. Some banks will maintain excess capital as a "rainy day fund" in the event they ultimately need to redeem a large shareholder or otherwise. Some will simply want to pull their capital down to a reasonable level to make sure the return on equity is appropriate.

THE UNSOLICITED OFFER

As I mentioned in prior *Musings*, for some reason, this must be "unsolicited offer season." We have had a number of clients who have received unsolicited offers over the last couple of months. The purchasers who made the unsolicited offers have taken a number of different tacks with the prospective targets. Some have just dropped the unsolicited offer like a bomb coming out of a B-52 and landing on the desk of the potential target with little, if any, notice. Others have done all the spade work of wining, dining, and courting before they bring the unsolicited offer. From my experience over the years, I can tell you the latter works a whole lot better than the former. If you want to drop a bomb on a board table that kind of kicks things off on the wrong foot. If you are looking to buy a bank, do not aggravate the target and its directors in the process.

MANAGEMENT SUCCESSION PLANNING

We have had a number of clients in the last couple of weeks engage us to assist in management succession planning. These are mostly CEO slots. Although we have contemplated being headhunters in the past, we are not and we do not profess to be that. We do, however, "manage the process" for our clients. This is managing the process for the outgoing executive as well as managing the process for the incoming executive. This includes vetting the prospective candidates, determining severance for the outgoing, and drafting or negotiating contracts and benefits for the incoming. We will be seeing more of this as we all continue to "gray" and our banks have more management succession issues.

CAPITAL ALLOCATION

As alluded to above, we have had several clients wrestling over the last month or so with issues of capital allocation. Each of our community banks has a finite amount of capital. This includes excess capital at the bank level (however you define that) and the ability to obtain capital (usually through debt leverage). Each of these institutions has a need among their shareholder base for share liquidity. Each also has the opportunity to potentially acquire another institution. Which alternative do you choose? They may not be mutually exclusive, or they may be, depending on the ability of the bank to obtain capital. In one of the situations, I clearly advised the board that I thought the alternatives were mutually exclusive and that they should spend their capital buying themselves back instead of buying an institution that they are simply attempting to acquire due to its low cost deposits. In another situation, I advised the Board that I felt because of the strength of their capital and their ability to obtain capital, the alternatives of a significant redemption or liquidity event for their own shareholders was not mutually exclusive and could be coupled with the purchase of another bank. Each of these boards is continuing to wrestle with many of these issues. In general, I take the position that a redemption of shares is almost always a good thing for a community bank. It provides cash to the shareholder selling, and for the remaining shareholders it provides an increased ownership, increased EPS, increased return on equity, the illusion of liquidity, and if the holding company has a percentage of earnings dividend policy, an increase in the dividend. Pretty much a win-win for everybody. I will keep you posted on what they decide.

LONG-STANDING CEO

I recently learned that the long-standing Chief Executive Officer of a bank that I had worked with off and on over the years finally "got the boot." Frankly, he really needed to "get the boot" numerous years ago when the bank got in serious trouble. This particular CEO is intimidating both to his staff and the Board of Directors. He always reminded the board that he knew far more than any of them ever did about banking, that his position was always right, and that there was no need to discuss it. I had had the opportunity to be in several of their board meetings over the years for several different purposes. The CEO basically ran roughshod over the board. During one of the meetings, the board had appointed a new director as Chairman who tried to be a strong Chairman leading the bank and getting some controls over the CEO. It never happened.

Well, apparently it finally did happen, as I learned recently that that particular CEO has been sent packing. I am concerned it may be a little bit too little and too late.

KEEPING YOUR EMPLOYEES AND SENIOR OFFICERS HAPPY

I was recently with a bank who was really concerned that their senior officers were getting disenchanted. Over the years, the bank had a number of stock option plans. The senior officers had options that were "in the money," but they could not get the money to exercise them without having to borrow enormous amounts of money. Although it is not a perfect solution, I suggested that the bank allow us to review the option plan (which we did not create) to see if it allowed for a "cashless exercise" of the options. This would allow the employees to use the "in the money" portion of the options to exercise and obtain stock. Although it would not allow them to obtain the full amount of stock under option, it would at least be some so they did not have to go out and get in hock up to their eyeballs in debt. We are currently looking at this possibility. Hopefully it will resolve the issue with the employees and everybody ending up satisfied.

EXAMINATION RATINGS

I am currently assisting one of our clients in preparing for an upcoming examination. This client was hit pretty hard by the recession but has bounced back nicely. The bank currently has good asset quality, plenty of capital, strong earnings, and plenty of liquidity. Although the bank is very strong, the holding company is not. It is extremely leveraged with bank stock loans and trust preferred securities. The holding company has positive equity, but not much.

Given the holding company's leverage, the regulators are keeping their foot on this bank's throat pretty firmly. They have not offered them any sort of regulatory relief at the bank level. Given the fact that the holding company is so leveraged, I think the regulators are assigning the bank CAMELS that are generally about one number below where they ought to be. The client questioned me as to what, if anything, we could do about this.

My response to the client was that we should consider fighting the examiners by using their own definitions in the Uniform Financial Institutions Ratings System. As you may or may not know, all of these CAMELS ratings are based on the Uniform Financial Institutions Ratings System. This system provides an explanation on each of the individual component ratings, as well as the composite ratings, and gives specific direction on the characteristics of each rating. My general experience has been that the examiners often eschew the Uniform Financial Institutions Ratings System and instead assign grades based on what was assigned in the last examination and whether there have been any material changes since then. This is an incorrect way to grade the bank. According to law, the examiners are to follow this Uniform Financial Institutions Ratings System.

We will see if we can have any success with the examiners in this situation. I have had pretty good success in the past in getting examination grades raised by pulling out the definitions from the Uniform Financial Institutions Ratings System. Hopefully the same will happen here.

THE CHAIRMAN'S SON

I recently facilitated a strategic planning retreat for what I would describe as a quintessential community bank. During the planning retreat, we got to the topic of director succession. Based on our discussions prior to the meeting, I knew the Chairman was a bit nervous about this particular piece of the discussion. The Chairman had someone that he thought to be a very qualified director nominee. This individual is a young businessman in their community who is very successful. He has an extensive history with community involvement, community service, financial knowledge, and the like. He is a very qualified young director on paper. The only "issue" with this nominee is that it is the Chairman's son.

During the discussion, the Chairman laid out all the ways this individual would qualify and be an asset as a bank director. He then finished by indicating it was his son. The Board welcomed the idea with open arms. Each of the members have known the Chairman's son for a long time and thought he would be an excellent addition to the Board of Directors.

I have seen some instances where family members are about the last person in the world that you want to put on the Board. Luckily, that was not the case here. The good thing is that the directors all recognized that this individual would make a good director for his attributes, not his familial relationships.

SHAREHOLDERS AGREEMENTS

We were recently requested to review a Shareholders Agreement that was drafted for a bank holding company reorganization. Generally speaking, the Shareholders Agreement looked fine. However, it was missing one component that the Federal Reserve has recently considered an essential element to a bank holding company's Shareholders Agreement. That element was a limitation on the effective time of the Agreement.

In summary, the Federal Reserve has recently been looking at Shareholders Agreements to ensure they do not last longer than 25 years. Why 25 years? The Federal Reserve interprets some guidance that was issued 30 to 40 years ago that basically indicates if a Shareholders Agreement lasts more than 25 years, the Fed will consider the Shareholders Agreement a company that qualifies as a bank holding company. How in the world a Shareholders Agreement qualifies as a "company" I have no idea. However, the Fed takes this view.

The important thing is that you know this is currently on the Fed's radar. If you have a Shareholders Agreement that does not have some type of termination date, you may want to consider adding it. I have not seen a situation where the Fed is reviewing existing Agreements for these provisions, but they certainly could if they want. Please let us know if you would like our assistance in any type of review.

CONCLUSION

Well, I can say one thing about the election that is positive - it is over. Whether your candidate won or lost, the United States, as it always does, will continue to move forward. I anticipate we will have somewhat of a "honeymoon" with the new President for a short period of time (probably a day or so). From a financial services standpoint, it is also likely that we will have some further support for regulatory relief, particularly for the community bank sector. That is good news.

Jeff Gerrish *and* *Greyson Tuck*