GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Nevada, Kentucky, Indiana, Illinois, and Arkansas!

DIRECTOR SUCCESSION

How long does it actually take a new community bank director to "get up and running" and be effective as a director? Unless the director is a former banker or formerly involved in the industry in some way, the answer is generally "a long time." Practically speaking, if the board only meets once a month and the director is not on committees that meet more often, that "long time" could be 24 to 36 months. There are numerous tools and resources available to help directors get up-to-speed more quickly, including regulatory publications and private publications (provided the directors are willing to put in the time necessary to read, study, and learn).

This whole area of getting "up-to-speed" should be a discussion that the board has with a potential new director at the time of the interview. Although all our community bank clients around the country seem to want a younger, business-savvy, technology-savvy director with his or her own business in the community, those folks unfortunately typically do not have the time necessary to invest in a new venture such as being a community bank director. It may take some convincing.

WHY IS AN ESOP SO HARD?

I have been with a couple of boards lately where the topic of employee stock ownership plans (ESOP) or a combined 401(k) and employee stock ownership plan (KSOP) came up. Each of the boards agreed that employee ownership is a good thing, but neither one of them could get their arms around the ESOP or KSOP concept. Granted, anything that is governed by the

Department of Labor, Internal Revenue Code, and multiple other regulators is not the easiest thing to understand. Is there a cost associated with the employee benefit? Of course. There is also a cost associated with annual raises, signing bonuses, and other typical fringe benefits.

For these two boards, it was really a question of whether they want employee ownership and whether they want to lock in their senior people. If the answer is yes, then the ESOP can be a tremendous wealth builder, particularly in a Subchapter S, and the boards need to look hard at it, even if they are not ESOP or KSOP experts. After all, that's what we are for.

THE AGING SHAREHOLDER BASE

I was recently meeting with a board of directors of a community bank. The bank was fairly typical. It was on the smaller end of the size range. The board was enthusiastic and engaged. The main problem for the bank is that its shareholder base averaged probably in the 80's, there was no liquidity for the stock (the holding company had done nothing to create any), and as the shareholders were dying off, the deposit base was also beginning to erode or anticipated to erode. Combine that with no internal management succession, and the board is faced with a decision: do we do something to address each one of these issues - share liquidity, core deposits, management succession - or do we sell the bank? These are legitimate issues, and this board was having, understandably, legitimate discussions about that. Although I am a staunch supporter of independent community banks, I also realize there may come a time when it is necessary to pull the trigger. After all, our job as directors of community banks and their holding companies is to do what is in the best interest of our shareholders. Sometimes that may be a sale transaction if we cannot solve the other critical issues.

EXCESS CAPITAL

How much capital is too much? As we have indicated in *Musings*, there is such a thing as excess capital (although such a term is not in the vocabulary of your friendly federal regulators). I was recently with a bank that had a 14% leverage ratio. In anybody's book that is pretty high. As I suggested they may want to lower that to 10% or 11%, you could see the shock on the faces of the directors who were contemplating that. They had been through the bad times but weathered them well. They have never had a capital problem. The asset quality was pristine. They also actually had something to allocate the capital toward (likely repurchase of shares). Why wouldn't a community bank board acknowledge that they have some excess capital and something to work with from a capital allocation standpoint? This board finally did. It will be interesting to see if they decide to do anything productive with the excess capital.

THE STRONG AND EFFECTIVE CHAIRMAN

We have been with a couple of boards in the last couple of months that had what I would consider the prototype strong and effective Chairman. Unfortunately, that category of individual is in the minority for most of our community banks. Most of our community bank Chairmen are simply those who gavel the meeting open, turn it over to the CEO, and gavel it closed. A couple of the Chairmen we have been with recently, however, are strong, strategic thinkers and good leaders for their boards. That has to be the goal for each one of us as it relates to a strong and effective Chairman. If anybody wants a job description and some information about the Chairman's role and the way it should be in this day and time, please feel free to email us.

DON'T TRY THIS AT HOME

We have had a couple of situations over the last month or so where we have given advice to our community bank client and they have decided that they really want to try whatever it is on their own, whether it is preparation of proxy material, insertion of anti-takeover devices, or even sale of their bank. In each of these situations, I have told them that there is a category of things you really shouldn't try at home. There are tax issues, securities issues, other legal issues associated with anything the board might do. My advice is don't be penny-wise and pound foolish on matters of this nature. At least let your professionals look over your shoulder, even if you want to keep them in the background. Mistakes can be far more costly than the cost of getting good advice on the front end.

DUE DILIGENCE REVIEWS

Over the past couple weeks we have assisted a number of clients in due diligence reviews. Each of these clients is considering acquisitions of community banks, and the client has asked us to assist in better understanding what it is that they are buying. As many of you likely know, the due diligence process is akin to the home inspection when buying a new home.

Completing a successful due diligence review is no easy task. There are numerous things that have to be considered. These reviews are much like bank examinations, as we are looking over all aspects of the bank's assets, liabilities, systems, processes, policies, and operations. The most critical aspect of the due diligence review is the loan review, since that is typically the single largest asset in the bank and the area that presents the most financial risk. However, there are lots of other risks that need to be considered.

If you are thinking about making an acquisition, be sure you complete an appropriate due diligence review. You should look at all aspects of the target bank to fully understand what it is that you are buying. If there are any issues with the target, the due diligence review will identify and assess them prior to your signing the acquisition agreement. This is a much better position than the alternative of contractually agreeing to a deal and then discovering problems with the target. Our firm has an extensive due diligence checklist that lists the various different areas of review in an appropriate due diligence. Please email us if you would like a copy of the checklist.

POOLED SUBORDINATED DEBENTURES

Over the past couple years we have seen a resurgence in subordinated debentures. We have previously noted in *Musings* our involvement with numerous bank holding companies or community banks that are either issuing subordinated debentures to raise cash at the holding company level (whether to increase bank capital or to use for other purposes) or buying subordinated debentures from another organization, which means they are essentially buying unsecured holding company loans. The subordinated debenture is very similar to a traditional bank stock loan, with the difference being repayment structure. A bank stock loan is typically a term loan that requires both principal and interest payments over the life of the loan. Subordinated debentures are typically interest-only for five or ten years with a bullet principal payment at maturity.

The *American Banker* Daily recently had an article about a fund that has pooled community bank subordinated debentures and is selling the pool as a collateralized debt obligation. The structure of this pool appears to be exactly the same as the structure of pooled trust preferred securities. The CDO has multiple tranches that have different payment priorities, and the payment of the CDO obligations depends completely upon the underlying bank holding companies making payments on their subordinated debentures. This is exactly the same as the pooled trust preferreds, with the only real difference being the term of the underlying debt instrument (trust preferreds are 30 years whereas subordinated debentures are typically five to ten years).

A subordinated debenture CDO is good for investors because it allows diversification of credit risk. The downside for the borrowers of participating in a pooled offering through a CDO is typically the inability to customize the debt. For example, if you are issuing a subordinated debenture to one creditor, you and that creditor can agree on various terms relative to the subordinated debenture. Pooled transactions do not give this flexibility, because each of the underlying subordinated debentures in the CDO need to be the same.

If you are thinking about issuing debt at the holding company level, keep subordinated debentures in mind. Ideally they would be issued to one creditor so you and that creditor can agree upon terms that work for each of you. If you cannot find a creditor willing to take all of the credit risk individually, it may be that you could get into a pooled issuance, although you likely would not have any ability to customize the debt to your needs.

Keep in mind, however, subordinated debentures are typically more expensive from an interest rate standpoint than straight bank stock debt. The interest rate on subordinated debt will likely be 200 to 300 basis points higher than a bank stock loan. Currently, if your community bank holding company is under $1 billion (likely to move to $3 billion if the House of Representatives can get its act together) then there is no need for subordinated debt at your holding company level because the holding company is not tested on a consolidated basis for the capital. Why pay 300 basis points more in interest to obtain an instrument that you don't need? Think about it.

REGULATORY RELIEF

I assume many of you have been watching with interest the current bipartisan regulatory relief bill that is making its way towards law. The Bill, entitled the Economic Growth, Regulatory Relief and Consumer Protection Act, makes a number of changes that would provide much needed regulatory relief for community banks. The Bill has passed the Senate, and the companion bill is currently in the House of Representatives. There has been some recent "chatter" about the House making changes to the Bill, which will slow the process. Hopefully that will not happen.

If you have not contacted your Representative in the House and encouraged them to pass the Bill, please do so. The passage of this Bill is an important step for community bank regulatory relief. Please let us know if you have questions about the Bill or would like to further discuss how it might impact your institution.

DIRECTOR OATHS

I recently received an email from the President of a national bank regarding director oaths. For those of you that may not be national banks, the directors of a national bank are required to take an oath of office at the time of their election or appointment. The oath essentially says that the director will "diligently and honestly administer the affairs of such association and will not knowingly violate or willingly permit to be violated any of the provisions" of the National Bank Act. The oath also attests as to the director's compliance with the stock ownership requirements applicable to national banks.

We reorganized this particular national bank into a bank holding company structure in 2016. They have their first holding company annual meeting of shareholders coming up in the next couple weeks. The President was asking me whether the Federal Reserve has any type of similar oath for directors of bank holding companies. If so, this holding company would have each of the directors take the oath since it would be their first annual meeting as directors of the holding company.

In short, the Federal Reserve does not have any requirement for a holding company oath of directors. In fact, national bank directors (and state bank directors, where the state law follows the National Banking Act) are the only bank directors required to take an oath of office. The FDIC does not require an oath for directors of FDIC insured banks.

Notwithstanding the fact that the oath is not required, many community banks ask their directors to take an oath of office at the time of their election to director. The banks view this as a best practice as it relates to corporate governance. It also reinforces the directors' understanding of their duties and responsibilities as a bank director.

If you are not a national bank (or a state bank where an oath is required), you should give some thought to having your directors take an oath of office at the time of their election or on an annual basis. It certainly does not hurt anything, and serves to reinforce the importance of the position and the directors' duties and responsibilities relative to their election.

CONCLUSION

We were hoping with the end of the first quarter that spring would be here in all parts of the country. I was halfway convinced of that until last Saturday; after leaving a client meeting, I got caught in the middle of a blizzard in the Midwest. Hopefully, in the next two weeks we will continue to warm up.

We hope each of you and your families have a wonderful Easter weekend. See you in two weeks.

Jeff Gerrish *and* *Greyson Tuck*

