GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Florida, Indiana, Kentucky, New York, Maine, Tennessee, and California!

SMALL BANK HOLDING COMPANY POLICY STATEMENT

As most of you are aware, the President signed the Reg Relief bill into law right before the Memorial Day weekend. Part of that bill that significantly impacts several hundred community banks directly is the increase in the Small Bank Holding Company definition from $1 billion to $3 billion. Now any consolidated bank holding company less than $3 billion can take advantage of the Small Bank Holding Company Policy Statement, which basically provides that capital testing at a Small Bank Holding Company will be at the bank only, not on a consolidated basis. In other words, your consolidated bank holding company has no capital test if you are under $3 billion; the only test is at the bank level. That means, as we have discussed often in *Musings*, that the holding company can leverage, i.e. borrow, money at the holding company level, generate cash, and contribute that cash to the bank, increasing the bank's capital. This is a significant benefit with respect to raising capital without having to go through more expensive alternatives such as subordinated debt or issuing equity to shareholders with its attendant dilution.

We have a number of clients who are on the cusp of $1 billion. We have received several emails asking whether the FDICIA requirements for bank holding companies over $1 billion (e.g., independent audit committee, attestation of internal controls, and the like) will also be raised to $3 billion. My general response was a definitive "probably." I do not anticipate this will occur anytime soon, but my guess is the entire regulatory scheme for small bank holding companies will eventually be reevaluated. This is an issue that needs to be addressed.

If any of you would like a Memo to Clients and Friends our firm has prepared on your additional responsibilities of going over the $500 million mark and the $1 billion mark, please let us know.

USE OF THE BANK HOLDING COMPANY

We recently met with the board of directors of a bank that we converted from a bank-only structure into a bank holding company structure in 2017. The purpose of the meeting was to discuss all of the ways the bank holding company could be utilized for the benefit of the organization and its shareholders. In other words, the discussion at the meeting was essentially "now that the holding company is in place, what are we going to do with it." It was a good meeting. This bank has plenty of capital and some opportunities to put it to work. We discussed using the bank holding company to provide stock liquidity and the potential to engage in alternative lines of business. The board also discussed the possibility of using a good amount of their excess capital to convert from a C corporation to an S corporation and really increase shareholder after-tax cash flow and value.

Overall, there are many practical uses for a bank holding company. This meeting was very effective in helping the board understand the uses of the bank holding company and how they enhance shareholder value. If you have a bank holding company, make sure you are thinking strategically about whether you are fully utilizing it for the benefit of the shareholders.

BANK-OWNED LIFE INSURANCE

We are currently working through the sale of two community banks to a larger community bank acquirer. These two community banks are owned by the same bank holding company and collectively hold as assets about $3 million worth of bank-owned life insurance ("BOLI") with a cash surrender value of about half the value of the death benefit. Last week the question came up as to the treatment of the BOLI in the transaction. As you long-term *Musings* readers probably suspect, the general answer is that you get what you negotiate.

As it relates to the BOLI, there are generally three options in an acquisition transaction. The first is for the BOLI to stay with the two target banks as assets. This causes the acquirer to "step into the shoes" of the target as it relates to ownership. The policies can stay in place, and the death benefit pays out once the individuals covered by the insurance die. The second alternative is for the acquirer to take the BOLI and then cash it in sometime after closing, typically immediately. This allows the acquirer to take the cash from the BOLI and reinvest it at its discretion. The third alternative is for the two target banks to cash the BOLI in prior to closing.

There are numerous factors that may make one of the alternatives more appealing than the other, including the fact that each has different tax implications. If you are involved in a bank merger or acquisition as either a buyer or seller where BOLI is involved, be sure you understand all of the various options. There is no standard treatment of this asset. It is completely negotiable based on what makes sense for the parties under the circumstances.

THE SERVICE LINE

I recently met with a well-run community bank for the purpose of facilitating its long-term planning discussion. During the course of the meeting, one of the outside directors noted a strength of the bank was its relationship banking and its high level of customer service, not atypical for a community bank. This director, however, suggested they go one step further. He suggested they basically set up an "at your service" line. This would be a line that any bank customer in any of the bank's markets could call. It would ring into the bank's headquarters and be answered by a very knowledgeable person with interpersonal skills and knowledge of the bank's products and services. The goal of this particular "at your service" line (similar to hotels) would be to address the customer's issue within a timeframe of 60 minutes. Some of you may already have something similar. If so, please let me know how it works. This particular organization will likely investigate its feasibility.

DEPOSITS! DEPOSITS! DEPOSITS!

You may be asking why we are screaming about deposits. It is because we have noticed within the last three to six months that the importance of deposits, and the value placed on the collection of new deposits, has increased significantly. From 2008 until about 2017 deposits were mostly a given. The discussion was not how to obtain new deposits, but what to do with existing cash. Over the last six months or so that has pretty radically changed. We have had many discussions over the past couple months with bankers that are devoting a substantial amount of time, effort, and resources towards gathering new deposits. If your bank is flush with cash and deposits, you are somewhat of an anomaly at this point and potentially an acquisition target. If you are like most other banks, you are probably either formulating or implementing a strategy to increase deposits. That certainly has been a large part of the discussion over the last six months or so.

DOWN TIME IN THE BRANCHES

I was at a recent meeting with the Board and senior management of a well-run larger community bank when one of the directors, while discussing the branches, asked "What do the employees of the branch do now that we are having so many fewer branch transactions, and so much less foot traffic in the branch?" I think he had visions of them playing solitaire on their iPad or being on Facebook all day. Management's response was they have an excellent method to keep those employees productive throughout the day. One thing they do in some of the branches is to route calls that come into the 800 number to branch personnel with expertise in the matter at issue. In essence, they act, in part, as a de facto Call Center. They also mentioned a number of other issues that these particular employees do on downtime, such as reviewing appraisals on home mortgages (if they are qualified, of course) and the like. Interesting discussion regarding the productive use of personnel.

EXPENSE SAVINGS

I have been with a number of bank holding companies in the last couple of months who had their eye on the above-referenced Small Bank Holding Company Policy Statement. These holding companies were all over $1 billion and had issued some form of instrument at their holding company level to generate cash to increase the bank's capital. Because at the time they issued the "instrument" they were over $1 billion therefore excluded from the Small Bank Holding Company Policy Statement, they needed to do something that "looked like capital" at the holding company level. This is typically either subordinated debt or perpetual preferred stock. Subordinated debt for these entities generally carried an interest rate in the 8% range. The perpetual preferred stock carried a dividend rate (non-tax-deductible) also north of 8%. Each of these institutions are now ecstatic that they can refinance those obligations with straight debt. This should save them about 300 basis points and result in significant increased profitability.

THE FAMILY BANK

I was recently having a detailed discussion with the CEO of a family bank. We were discussing issues of share liquidity primarily. His bank is a high performer and normally capitalized (about 9%) and he reasonably believes the bank would have a purchase price somewhere in the 160% to 180% of book value range if the family wanted to sell it. Because of that, he is going to set the holding company repurchase price at 150% of book value. His theory is that if he does that, any family members who want to get out can do so at a fairly decent price, without forcing the sale of the entire bank. One of the great concerns in a family bank is often the family members do not want to sell their individual shares because they do not want to sell them at a discount to the holding company. The end result is, however, they collectively want to sell all their shares at a premium. This particular CEO's theory was that this should head off that problem. I do not necessarily disagree with him. We will have to see how it works out.

TECHNOLOGY IN COMMUNITY BANKING

I was recently in a meeting on the West Coast in what would be properly characterized as a "technologically advanced" area of the country. Part of the discussion in the meeting turned to the future of community banking and how it will be impacted by technology. One of the meeting participants made the comment that he believed community banking would largely be replaced by technology in the next ten to 15 years. I (somewhat politely) told him I could not disagree more. I told him that I did not think technology would at all replace community banking! Instead, I told him my outlook was that technology would supplement the business relationships that have always driven community banking. In other words, technology will not be a replacement for relationships and will not wholesale replace the community banking industry. The general consensus was that my theory was a much better reflection of what would likely happen than was his.

In summary, I do not believe technology is going to in any way kill the community banking industry. Instead, I think community bankers are going to figure out how to appropriately incorporate technology into their banks in order to better serve our customers' needs. Community bankers have been doing this for a long time, and I do not see that changing. I also do not think that ten or 15 years from now we will be down to a very small number of very large banks where meaningful customer relationships are replaced by technology.

CONCLUSION

We hope everyone had a wonderful and relaxing Memorial Day weekend. We look forward to seeing many of you at the ICBA's M&A Workshop hosted by Gerrish Smith Tuck to be held in St. Paul, Minnesota at the beautiful, historic St. Paul Hotel on June 11th and 12th.

Have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*