# GERRISH'S MUSINGS

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August 15, 2018, Volume 374

Dear Subscriber:

Greetings from New Mexico, Texas, New York, Minnesota, Wisconsin, and North Carolina!

## FORWARD-LOOKING SUPERVISION

Forward-looking supervision may be a mysterious concept to many of you. It refers to the friendly federal regulators assessing not only a bank's condition currently, but also what they anticipate it may be in the future due to existing risk factors. Historically, at least prior to 2011, the bank regulators only looked at the condition of the bank at the time of examination and requested supervisory actions on the basis of the condition at that time. Following the financial meltdown, the regulators decided to close the barn door somewhat (ignoring the fact that the horse was already out of the barn at that point) and began to implement forward-looking supervision. This basically involves assessing the condition of the institution as of examination date, then speculating, projecting, crystal-balling what the institution's condition may look like in the future. Based on that future (i.e., the forward-looking view), the regulators began applying enforcement actions.

One of our favorite run-ins with forward-looking supervision was a community bank that we represented that had a recent examination where all the numbers were fabulous. In anybody's book it would have been a CAMELS 1 or possibly a CAMELS 2 at worst. The examiners rated it a CAMELS 3. They acknowledged that the bank's condition today would have justified something between a 1 and a 2 but they were concerned about the future, so they rated it a 3.

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Forward-looking supervision is the height of subjectivity by your friendly federal regulators. The FDIC's Office of Inspector General just put out a report on their assessment of that agency's application of forward-looking supervision. If anybody wants a copy, please let us know.

## MORE INTEREST IN MICROBANK ACQUISITIONS

Our streak continues. This is another couple week interval for *Musings* where we have been contacted by at least one fintech type company that is considering a microbank acquisition. This latest call was almost identical to a call we received about a month ago. It is essentially a mobile app that has developed a payment system and is looking to either start a de novo (not the preferred route) or make an acquisition of a microbank to give them a platform for the launch of their products and services. What was somewhat unique about this call is that it was the first of these types of calls we have received after the announcement of the OCC "fintech charter." This particular company looked at the OCC fintech charter, very quickly decided it essentially did nothing for them, and now want to explore the possibility of acquiring a small bank.

We do not know how much legs these types of transactions will gather. Thus far, there has been a lot of tire kicking but no deal actually completed. We think the tide will continue to turn on that, so we expect in 2019, if not sooner, we will begin to see some of these deals actually come together and close. We will keep you updated.

## STOCK SALE DOCUMENTATION

Many prior *Musings* have touched on various issues relative to the documentation necessary for the sale of your holding company or bank common stock. We were recently reminded of the importance of "stock sale documentation" in the context of repurchasing your common stock. In this particular instance, one of our holding company clients mentioned to us that they were repurchasing shares from a shareholder that received the shares through inheritance. The shareholder had very little knowledge about the holding company or bank. The shareholder also did not know about the potential acquisition transaction where our client was in "hot pursuit."

Our recommendation to this client was that we put together a Stock Purchase Agreement to document these important issues. We did not go out and tell the shareholder about the acquisition the bank is pursuing, or who the transaction involves, but we did give appropriate disclosure to the shareholder about the fact that the bank was confidentially considering an acquisition transaction, the value of the shares may go up in the future, the per share repurchase price is not represented or warranted to be the fair market value, and the like.

As you can imagine, this is simply protection for the company. It really is also a way to ensure you are not trading on insider information. If your holding company is thinking about repurchasing shares, give this some thought. You need to have some type of documentation with the shareholder to generally and confidentially disclose the existence of material, nonpublic information. Otherwise, you are significantly increasing the risk of running into problems down the road.

## BOARD DOCUMENTATION IN THE DIGITAL AGE

We recently read with interest an article regarding Board documentation and "corporate housekeeping" matters in the digital age. The article was basically a listing of best practices for corporate documents, particularly in regards to cyber security. The article had a couple key takeaways, such as the importance of remembering your "digital footprint," how to protect your footprint, and that management, not the Board, is responsible for corporate recordkeeping. The document also highlighted the need to ensure directors are reminded regularly of digitally protecting sensitive information.

Overall, we thought this was an informative and timely article. Please contact us if you would like a copy.

## NO TIME TO REST

I was recently with a high-performing, good-size community bank that had been putting out tremendous numbers and was on a very good trajectory going forward. I was a little concerned going into the meeting that I may find the officers and directors a little bit complacent since things were going so well. Instead, I found a hard-charging board and senior management team destined to do better from a financial performance standpoint than ever. It was refreshing to see this renewed energy and commitment, notwithstanding the bank's current and past successes. There is no time to rest on your laurels.

## EMPLOYEE USE

As we were recently conferring with a senior officer of a good-size community bank, he was lamenting the fact that he felt one reason the bank could not sell some of its products and services, particularly in the technology area, is that the employees did not know how to use them because they did not use them themselves. As we all know, it is one thing to train an employee on how to utilize a technology product or service, and another to have them actually understand how to use it. Clearly, if they used a product (e.g., bill pay) themselves on a daily basis, they would certainly be able to convey how it works to anyone else. This also led into a discussion of whether employees could be mandated to have an account at the bank (the general consensus of this group was they could not). We would be interested if any *Musings* readers have any "silver bullets" on either of these issues - i.e., the use of bank products by employees and the maintenance of their account/business with the bank. Please email if you do.

## LEAD WITH DEPOSITS

One of the major topics we hear discussed at planning sessions across the country is the need/concern with respect to generating core deposits. Deposits have not been a material concern for community banks since the Recession until recently. During the Recession, significant funds were parked as deposits in the bank. At that time, we noted that these were "surge" deposits, meaning they would surge out when rates began to rise. Until recently there has not been a significant concern with respect to deposit outflow. With the rise in rates, however, competition for deposits has gotten much fiercer. On top of it all, the regulators are continuing to nose around with respect to on-balance sheet liquidity and demand that banks increase core deposits or something that looks like core deposits.

I was recently with a high-performing community bank when one of the officers suggested that historically their bank had always led with loans - i.e., let's get the loan customer in the door and either mandate or hope they bring their deposits with them. This particular executive suggested that his bank lead with deposits. In other words, the funding for new loans is so critical that the focus needs to be on leading with deposits in order to fund those loans. That needs to be a cultural issue instilled in bank personnel from the top down.

## THE UNFAIR ACQUISITION PROPOSAL

We are assisting a client in the potential sale of their holding company and bank and recently received a proposed Indication of Interest for the transaction. The Indication of Interest was fairly standard, with one exception. The acquirer proposed to price the transaction based on our client's equity, which is not that uncommon. The problem is that the buyer capped the purchase price it would pay, giving itself upside protection, but did not establish a floor on the purchase price for the target, which would give the target full downside protection. The obvious problem here is that there is no parity between the buyer and seller. If the buyer gets full upside protection, why should we as the seller not get full downside protection by setting a floor purchase price? As I told my client, what is good for the goose is good for the gander.

We are still in the process of negotiating this Indication of Interest and are hopeful we can get something that is a little more fair for everyone. We will keep you updated.

## SUB-DEBT

In view of the definitional change of a Small Bank Holding Company to now include holding companies up to $3 billion (resulting from the recently enacted regulatory relief law), we have been getting a lot of inquiries lately as to whether a Small Bank Holding Company should issue straight debt (i.e., bank stock debt), debt to individuals, or subordinated debt. Keep in mind, since the holding company, by definition, is a Small Bank Holding Company (under $3 billion) it does not need any capital treatment at the holding company level since only the bank's capital is tested for capital adequacy. So what goes into making the decision whether you issue sub-debt or get a bank stock loan, for example? Since capital treatment is not required, then it really comes down to rate, terms, and complexity. The rate on sub-debt would typically be significantly higher than a bank stock loan. The terms for a bank stock loan may be a year or two of interest-only but will eventually term out. The collateral for a bank stock loan will be bank stock, where the sub-debt would be unsecured. The term for sub-debt will likely be 10 years with a call feature after a few years. With respect to complexity, arguably, the sub-debt can be done with minimal disclosure and a one page note, where the bank stock loan will take lots of pages and have default triggers and the like.

My general recommendation continues to be to not use subordinated debt because the rate is so much higher. Rather, simply use a bank stock loan, or better yet, a line of credit. At least with the line of credit you only pull down the capital you need. With subordinated debt you get it all at once whether you need it or not.

## M&A WORKSHOP

Gerrish Smith Tuck in conjunction with ICBA will be again providing a Community Bank Merger & Acquisition Workshop. This is a hands-on focus on community bank acquisition transactions from the buyer's and seller's perspectives. It is not for the big banks. It is not going to tell you you have to sell your bank. It is simply going to educate your CEO, CFO, and Directors on how to approach an acquisition transaction from both the buy and the sell side.

  

The Workshop will be held at a hotel in Downtown Nashville, Tennessee on October 29-30, 2018. Registration will be open very soon so please mark these dates on your calendar.

## CONCLUSION

It has been an interesting two weeks for us personally and professionally. School is back in, or seems to be for most. Summer vacations are wrapping up, and we are all looking forward to the Labor Day Weekend.

Stay safe, and have a great two weeks.

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