GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Missouri, Wisconsin, Minnesota, Alabama, Georgia, Louisiana, Texas, West Virginia, Colorado, and New Mexico!

THE FUTURE OF COMMUNITY BANKING

What will the future of community banking look like? We were recently asked to discuss this with a community bank board of directors. As most *Musings* readings know, we are bullish on the future of community banking. We encourage all our clients and friends to stop listening to the "pundits" who are saying you cannot survive at whatever size you are at and you have to be twice as big (i.e., let us help you do an acquisition).

As we told this group, the fundamental question is whether there will be community banks 20 years from now. We answer that in the affirmative. Will things be different? Of course. Everything will be heavily technology-based and mobile. Branches will still exist but be different. Bank employees will be universal banker types. Many employees will be working remotely. Community bankers will continue to be "fast followers" with respect to technology. Community bankers will also continue to follow their relationship banking strategy, which, notwithstanding technology, will be necessary in the future.

We believe in a strong future for community banking. Don't let any of the discourse discourage you.

THE STRAW THAT BROKE THE CAMEL'S BACK

We have recently been assisting one of our clients in negotiating the acquisition of another community bank. There is nothing terribly notable about the acquisition itself. However, what is notable is the "vigor" with which the seller negotiated the acquisition. The seller exerted a tremendous amount of effort in making sure he did not leave a single dime on the table. He worked hard to extract every possible penny from the deal. The problem is that the seller worked just a little too hard and got to the proverbial straw that broke the camel's back. This is certainly not the first time this has ever happened, but it served as a good reminder to us that good deals get done and bad deals do not.

If you are looking to buy or sell a bank, keep in mind the fact that you always want the deal to be a good deal for all parties, particularly if you actually want to get it closed. Our experience is that a party that tries to extract every possible penny out of a deal significantly increases the chances that the deal falls apart. We are by no means advocating that laying down in the negotiation is an appropriate strategy. Instead, our recommendation is to take a measured and level headed approach to the process. Keep in mind, our experience is that a deal that is unfair or "bad" to one party or the other will simply not close.

MUTUAL INSTITUTIONS

Over the last several months, we have facilitated numerous planning sessions for mutual institutions. These are institutions that have no shareholders but do have stakeholders. Their stakeholders generally include their deposit customers (their owners), their loan customers, their employees, and their community. Most of the mutuals are not necessarily strongly profit-driven. They want to make enough money to serve their stakeholders well. For most, if this means a 75 basis point return on assets instead of 125% return on assets, then that is fine. Most treat their employees well (high benefit costs), their communities well (significantly high contributions and sponsorships), and their deposit customers great (higher rates, low fees, and the like). Many of the stock-owned institutions are probably jealous of the flexibility of a mutual. That is understandable. As we were reminded at a couple of these recent meetings, mutuals are just like credit unions with a big exception - they pay taxes.

DIVIDENDS

We recently were meeting with a bank in connection with an acquisition transaction when they announced the leadership group it is contemplating paying the bank's first dividend.

This bank has been in existence for a long time (not exactly a de novo), but they have never paid their shareholders any kind of cash dividend. The bank has continued to reinvest its retained earnings in balance sheet growth, holding company debt servicing, liquidity, and capital support for the bank. They "returned equity" to the shareholders through share redemptions, but never through a dividend.

The general consensus of the board was they could really "afford" at this point to pay a dividend. Their leverage ratio was in the 11% to 12% range. The question was whether they wanted to. The general concern was if they started paying a dividend, it would become "addicting" for the shareholders. This board ultimately decided to begin paying a small dividend (i.e., about 10% of earnings) with the idea that the dividend continue to accelerate as a percentage of earnings. They also determined strategically that the dividend should be a percentage of earnings, not a fixed dollar amount. They are fully aware that if the earnings go up the dividend goes up and if the earnings go down the dividend goes down. The Board's evaluation each year regarding the dividend will simply be a determination of what percentage of earnings is appropriate.

Many community banks that do not have any further significant need for capital or are in slow growth markets pay significant dividends or distributions. We have several clients that are in the 90% range. A typical community bank will often indicate they are going to pay about a third out in dividends, hold back a third for the redemption of shares to create liquidity, and use a third to support bank growth. That works as well.

BANK HOLDING COMPANY DEBT

Several times over the past couple weeks, we have been reminded of the Federal Reserve's tolerance for new debt in an acquisition transaction. In a couple different recent instances, we have assisted in the evaluation of merger transactions where the buyer has looked to fund a significant portion of the transaction purchase price with new bank holding company debt. This is no problem at all, provided the borrowings comply with the Small Bank Holding Company Policy Statement (applicable to bank holding companies with consolidated assets of less than $3 billion).

Generally speaking, the Statement has two requirements the Federal Reserve will follow in a transaction. First, the acquisition debt is not expected to exceed 75% of the total purchase consideration. In other words, at least 25% of the purchase price needs to be funded with existing or new equity. Second, the financial projections in the transaction should show the holding company's debt-to-equity ratio being reduced to less than 30% within 12 years of incurring the debt. In other words, the debt cannot remain outstanding forever - it has to be paid down to an appropriate level within an appropriate time frame.

If you are thinking about making an acquisition that involves debt, be sure to keep these rules in mind. If you are thinking of structuring a transaction with debt that violates these rules, the regulatory approval process is going to be significantly more difficult, if not impossible.

WORKING REMOTELY

We were recently contacted by a reporter for one of the national banking publications for an interview with respect to community bank employees working remotely. In our nationwide consulting and law practice, we are beginning to see more employees working remotely. Remote working for employees is not a new issue, however. We can remember 25 years ago when lenders in particular worked remotely in the region they were trying to service. This was when cell phones were still carried in large bags and a laptop was nothing of the sort the way it is today. We think there are other benefits to working remotely also, including a recruitment and retention tool as basically an important part of a well-balanced compensation system. We have also seen the promise of working remotely be used to attract employees into community banks who may otherwise have family responsibilities, as well as attract urban area employees to rural areas.

Of course, most lenders are working remotely these days, at least those who get outside the office. Technology now provides the tools (eSign, transferring documents, and the like) to allow the individual loan officers to be their own "loan production offices."

Of course, some positions of community banks do not lend themselves to working remotely, but a number will.

PROTECTING AGAINST PERCEIVED RISK

We recently facilitated the strategic planning session for a very well-run and profitable community bank. One of the topics of discussion during the planning session was the possibility of a branch closure. Like many other community banks, this particular community bank has a branch that would properly be characterized as a low performer. This branch does not generate much in terms of deposits and does not produce anything in the way of loans. This branch also loses money, although the bank has not specifically calculated the extent of the losses.

During the session, we discussed the possibility of closing the branch. We weighed the benefits (cost saves) of closure against the detriments, which were primarily identified as the reputational risk of closing the branch and the fact that closing the branch would essentially be shuttering the nicest building in town. After a thorough discussion, the group concluded that the potential detriments outweighed the cost associated with keeping the branch open. The group concluded that they were willing to lose a little bit of money on this branch in order to continue to support the community and avoid the public perception associated with closing a branch.

This recent discussion was not much unlike many other similar discussions we have had previously. There are many community banks that choose to keep unprofitable branches open for a variety of different reasons. We know on paper it may not make the most sense, but we do not think that is necessarily the controlling issue all the time. Our comments to a board on this issue are generally that they first need to recognize the loss associated with keeping the branch open. If they decide that those losses are not greater than the damage that would be caused by closing the branch, we have no problem with making an informed decision to keep it open.

THE COMMUNITY BANK LEVERAGE RATIO

Over the past couple of weeks (particularly after our last comments in *Musings* about the Community Bank Leverage Ratio), our firms have received a number of comments and questions about the proposed rulemaking related to the community bank leverage ratio. One particular comment was a concern that a bank currently considered "well-capitalized" with an 8% tier 1 risked based capital ratio would only be considered "adequately capitalized" under the proposed rule's 9% community bank leverage ratio threshold. We think there are a couple of beneficial distinctions to be made here.

First, don't forget about the capital conservation buffer. Under BASEL III, even though an institution can be considered "well-capitalized" with a Tier 1 risk-based capital ratio of greater than or equal to 8%, if that institution has a Tier 1 risk-based capital ratio of less than or equal to 8.5%, then it is subject to payment restrictions on dividends, share repurchases, and discretionary bonus repayments. What this means is that even though the "well-capitalized" threshold for prompt corrective action purposes is one thing, the current framework makes the practical requirement higher.

Second, even if your bank meets the "well-capitalized" threshold for the Tier 1 risk-based capital ratio under the current rules, it still has to establish compliance with the other three capital ratios. Under the proposed capital framework, if your bank has a 9% community bank leverage ratio, your bank is well-capitalized. No other calculations are required.

The new framework is much more in line with the realities of community banking. There may be unique situations where a bank ends up holding more capital, but we believe by and large that will be the exception, not the rule. We will see how the final rulemakings shake out.

THE UNSOLICITED "OFFER"

We recently received a copy of an interesting letter received by one of our community bank clients. The letter was completely unsolicited, and it essentially said that the sender of the letter (who identified itself as a bank financial advisory firm) represented a large bank looking to make cash acquisitions and that the sender thought the characteristics of this particular client would fit the mold for what their buyer was looking for. The letter then asked that our client respond to the letter by indicating either they were or were not interested in a sale of their organization.

Our client asked whether this was the type of letter that rose to the level of requiring the Board to respond in accordance with its fiduciary duties. Our answer was no, this is not the type of letter that rises to that level. It was not an unsolicited Expression of Interest, had no specific details concerning a transaction, and was otherwise just a vague and general inquiry. Our advice was to either ignore the letter or simply respond with a courteous "no." Keep in mind, with respect to an unsolicited offer, the board's fiduciary duty does not kick in unless the offer is from a credible purchaser at a credible price.

CONCLUSION

We have rapidly found ourselves in the midst of the Christmas/Holiday season. We hope all of you are prepared. The next *Musings* will be out on New Year's Eve (*Musings* never sleeps)! We hope you all have the opportunity to spend a great Christmas with your family and loved ones.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*