GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from California, Illinois, Indiana, Minnesota, Wisconsin, and Montana!

COMMUNITY BANK LEVERAGE RATIO

Over the past couple weeks the federal regulators have finalized the rule related to the Community Bank Leverage Ratio ("CBLR"). If you are not familiar, the CBLR rule is essentially a rule that provides a community bank (less than $10 billion in total assets) is Well Capitalized if the bank's tangible capital is at least 9% of total assets. The benefit of the CBLR is that a community bank that meets the 9% minimum is not required to calculate risk-weighted assets and risk-weighted capital ratios in accordance with the Basel III Capital Framework. In other words, a qualifying bank is considered to be Well Capitalized based only on the tangible equity exceeding 9% of total assets and is not required to calculate a Tier 1 Risk-Based, Common Equity Tier 1 Risk-Based, or Total Risk-Based Capital Ratios.

We have received a number of questions over the past couple weeks related to the CBLR. The most common question comes from banks that do not meet the 9% ratio. The question is essentially whether they ought to take action to increase capital, either through leveraging the holding company or through the sale of common equity, to get above 9% and opt-in to the CBLR. Our response is generally no. We do not believe the benefits of the CBLR are worth the effort, time, and expense associated with increasing capital to meet the 9% threshold.

In summary, our belief is that those banks that qualify will probably elect to take advantage of the CBLR because there is no down side to doing so. However, for those banks that do not qualify, we do not expect they will take significant measures in order to reach the threshold. We think it will be easier for these banks to simply continue calculating the Risk-Based Capital Ratios. Please let us know if you have questions or if we can assist in analyzing this alternative for your institution.

CATCH PHRASES

We have recently been involved in several planning sessions (‘tis the season). In a number of these, in connection with different topics, one of the bank officers has announced some phrase we can only describe best as a “catch phrase.” It “catches” the bank’s culture and thought process with respect to some pretty significant issues. One of the catch phrases we recently heard was in connection with a discussion of the bank’s lending philosophy. It was described as “optimistically conservative.” We view that as being conservative, but also being optimistic enough to try new things, structure new transactions, do things that the big banks will not, and the like. We thought it was a pretty good description of community banks’ lending in general.

The other catch phrase we picked up in the last few weeks dealt with technology. Every planning session deals with where the bank is and should be on technology. We were discussing technology with a community bank board and senior management, and the IT guru for this particular bank evidenced frustration we have heard from virtually every other bank about their core processor (at least those banks that are with the “big three”). The technology guru summed it up by indicating that the bank was suffering from “core limitation frustration.” It was pretty clear what that meant. The bank is limited by what the core processor can provide and the timetable for when it will provide it. For this bank, as for many others, the solution was to go to other vendors for bolt-on products. Although that has been very successful for them, it is still very frustrating.

NATURAL DISASTERS

Unfortunately, the United States and community banks are not immune from the impact of natural disasters. Our firm has had a lot of experience in dealing with banks that have suffered through natural disasters, whether they are hurricanes, floods, fires, or otherwise. The interesting thing about community banks and natural disasters is that they, in virtually every circumstance, “step up to the plate” and become the leaders in their community, not just from a financial standpoint, but from participation in the community and resolving the issues created by the disaster. These disasters also typically involve a significant influx of insurance money, as well as contractor money and activity trying to rebuild the area from whatever the problem was. This is not all bad, but it does present some interesting challenges for banks that have to deal with these issues. One of those challenges is capital as the balance sheet balloons. As most *Musings* readers know, there are multiple ways to address that issue, both from the debt and equity standpoint.

Although the general approach for most of these community banks is they are glad to help in the community and that "this too shall pass," the big question is what do things look like once the recovery has gotten significantly underway. That is one of the great unknowns and risk factors any community bank involved in a natural disaster has to factor into their long-term planning.

THE TUNE-UP

As most *Musings* readers know, our firm facilitates dozens of long-term planning sessions a year for community banks. Many of these banks only engage in the exercise with an outside facilitator once every two or three years or so. We often get asked "what is the best practice?". Our general recommendation is the best practice is to have a "full-blown" planning session at least once every couple of years, but to have a short form or "tune-up" planning session annually. Our recommendation is based not totally on shameless self-promotion, but also on the fact that things are changing so rapidly in the industry that strategies may need to be tweaked or adjusted. Waiting three years for that to happen simply does not make sense. A tune-up session can simply involve reviewing the results of the prior full-blown session and determining whether any changes are needed as a result of the tune-up. We recommend that as a best practice.

ENHANCING SHAREHOLDER VALUE

We are reminded constantly by our clients that enhancing shareholder value, an issue about which we continuously pound the table, is really the key to remaining an independent community bank. If our community banks and holding companies do what is right for our shareholders, then it is not likely they will look for an alternative investment - that is, they are unlikely to sell their stock so that someone other than your existing community bank directors, officers and shareholders controls that bank in your community. Almost by definition that kind of change results in less support for the community. If the community bank and its holding company does enhance the value for its shareholders and the shareholders determine to continue with their investment, that also allows the community bank to be the employer of choice, the economic engine in the community, and the good corporate citizen. We think that is a preferable alternative.

A SUCCESSION STORY

We recently had the opportunity to hear two prominent community bank executives provide a first-hand account of their executive succession plan in action. The discussion was a description and retelling of the transition from the former bank President to the current bank President. It was very interesting and practical on a number of different levels.

Although there were a number of beneficial takeaways from the discussion, what we liked most about the discussion was the practicality of the Board's approach to the succession plan. The Board identified the need for a succession plan, created the succession plan, and generally followed it to execution. There was some amending the plan along the way, but the overall strategy never changed. By account of both the old and new Presidents, the transition has worked very well.

Succession planning qualifies as a "hot topic" in the industry today. Many banks are giving consideration to their shareholder, director, and executive officer succession plans. Kudos to this Board for recognizing the need and formulating an achievable and winning strategy to address the issue.

CORPORATE SOCIAL RESPONSIBILITY

Corporate social responsibility is a buzzword in today's corporate world. What is corporate social responsibility? It is essentially the idea that a business should be conducted in a socially accountable manner. In other words, it is operating a business in a way that has a positive effect on social, economic, and environmental factors. This is the antithesis of Gordon Gekko's "Greed is good" mantra made famous in *Wall Street*.

Business Roundtable is a group of nearly 200 CEOs representing the United States' largest companies. This year these CEOs released their new "Statement on the Purpose of a Corporation." It was essentially an adoption of corporate social responsibility and a pledge to operate their businesses in a socially responsible manner. We were recently asked whether we think community banks need to pursue corporate social responsibility. Our response was no, we do not think community banks need encouragement or direction in this regard. We view community banking as the original corporate socially responsible industry. What is more responsible than taking in insured deposits from your local community and lending those out within the community in a manner that enhances the community, provides jobs, provides economic returns, and other benefits?

In our view, community banks do not need to adopt a strategy of corporate social responsibility. Instead, we see it as many other businesses trying to catch up and mimic the model.

ESOP TRUSTEES

We are currently assisting a number of different community banks in setting up ESOPs or KSOPs. As you *Musings* readers know, this is an employee benefit that is essentially a trust where the bank makes tax-deductible contributions to the trust to provide it with cash to purchase holding company common stock for the benefit of the employees. One of the issues in establishing an ESOP is who serves as the ESOP trustees. This is important because the trustees have discretion over the administration of the ESOP, including the voting of the shares on most routine matters.

There are essentially two options for ESOP trustees. The first is to keep it "in house" and have two or three of your existing directors or officers serve as the trustee. The second option is to go to a third party that is compensated for serving as trustee. Our recommendation is to go with the former and keep it in house rather than going with a third party. We think this for a couple reasons. First, the directors and executive officers are going to know the corporation and the issues associated with running the corporation much better than will any third party. Second, we have seen numerous instances where the third parties have frustrated the purpose and operation of the ESOP through their decisions and actions. Of course, in all of these situations it is hoped that the third party is making the best decision for the ESOP, but we are often convinced that is not the case.

If you have an ESOP, or are thinking about setting one up, our recommendation is that your existing directors or executive officers serve as the trustees. Our experience is that this produces much better results and operational efficiencies than does trying to bring in a third party. We also believe the risk is manageable.

REGULATORY ENVIRONMENT

As all of you know, since the change in Presidential Administration two years ago, the President has had the opportunity to appoint new heads of all the federal regulatory agencies: Comptroller of the Currency, Joseph Otting; Chairman of the FDIC, Jelena McWilliams; and Chairman of the Federal Reserve, Jerome Powell. Each of these regulators is saying "all the right things" as it relates to the community bank regulatory burden. The question, as always, is whether the conversation at the top of the agency filters down to the examiners who actually walk into your bank.

We have had a couple of recent experiences with banks who have been examined. One we simply asked the CEO whether the examiners had an attitude. The response was, "yes, they had an attitude; it just wasn't the same attitude." He proceeded to say that it was not a "gotcha" exam like they used to be.

We had further experience with another banker who just completed an exam (albeit a State exam), who indicated the experience was simply "wonderful." We had never heard the terms "wonderful" and "bank examination" utilized in the same sentence previously. In any event, it looks like there is a little bit of hope for some on-the-ground regulatory relief/understanding. That is all good news.

CONCLUSION

The end of the third quarter is upon us. As we march into the fourth quarter and year-end, we realize that it will be a busy time for many of you. We look forward to seeing many of you out on the road or in your bank's planning sessions.

Have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*