GERRISH'S MUSINGS

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May 28, 2021, Volume 441

Dear Subscriber:

Greetings from Texas, Ohio, Michigan, Louisiana, Florida, Colorado, Oregon, and New Mexico!

CAPITAL PLANNING

Over the last several months, we have assisted numerous community banks in connection with capital planning. Capital planning should be an ongoing and regular activity for community bank management and boards of directors. Capital planning these days is prompted by regulatory expectations (as most *Musings* readers know, FDIC stands for Forever Demanding Increased Capital) and the current environment involving inflated balance sheets of community banks. Virtually every community bank client we have assisted in connection with long-term planning or capital planning over the last three or four months is suffering from an artificially inflated balance sheet. Mathematically, through the increase in average assets, this has reduced their leverage ratio. Fortunately, in these circumstances, the capital ratio is not being reduced by asset quality issues (i.e., charge-offs and the like). For most of these banks, earnings are also strong.

For most of the community banks (at least those under $3 billion in consolidated assets), the Federal Reserve's Small Bank Holding Company Policy Statement applies. This means that the only capital test is at the bank level (not the consolidated capital at the holding company). What this means is that to increase the bank capital, the holding company simply needs to generate cash in some fashion that it can downstream into the bank's capital account. It automatically is reflected as an increase in tier 1 capital, and the leverage ratio goes up.

To ensure compliance with the requirements imposed by the U.S. Internal Revenue Service, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (1) avoiding tax-related penalties under the U.S. Internal Revenue Code or (2) promoting, marketing or recommending to another party any transaction or tax-related matters addressed herein.

Many of the community banks we have assisted in capital planning have already had discussions with the investment bankers who are pursuing in earnest the use of subordinated debt. As we have commented on in *Musings* previously, we have no objection to subordinated debt (in fact, we are assisting several community bank holding companies with their subordinated debt offerings currently) as long as the bank has a significant use for this one-time capital injection and does not mind the cost of issuance of the debt and the cost to carry it. Our general preference for incremental capital needs is a line of credit, either from another community bank or a bankers' bank or something similar.

However, the fundamental issue in capital planning these days, when virtually every community bank's balance sheet is artificially inflated, is whether there is even a need for capital. Some of the capital plans we have reviewed lately appear to be a solution in search of a problem. In other words, if the community bank's leverage ratio has dropped to a hair below 8% and it is due primarily to an artificially inflated balance sheet – and assuming asset quality is good and earnings are strong - is there a problem that needs to be addressed?

What we have pretty much found thus far is that the regulators understand why the capital ratios are dropping and have not (or not yet, at least) started pounding the table. Many of the community banks we have talked to, once the boards understand the issue with respect to the temporarily reduced capital ratio, realize they really do not want to pay the cost of increasing the capital account through incurring debt at the holding company when they do not really know yet that they need it. The ones who want a safety net will typically establish a line of credit so that if the leverage ratio gets below some trigger point, the holding company can at least draw on the line and only pay for the cash draw at the holding company as they need it for capital in the bank. Keep in mind, your capital plan should not be a permanent solution to a temporary problem. If we can assist, let us know.

RULE 15c2-11

Some community bank holding companies are traded or quoted on one of the various OTC markets. Most are either on the OTCQX or Pink Sheets. If your community bank holding company has stock that is quoted on the Pink Sheets, you probably received correspondence from the OTC in the recent past regarding a requirement to comply with the "new disclosure requirements" that will become effective once the amendments to SEC Rule 15c2-11 go into effect on September 28th.

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We have had a number of bank holding companies contact us over the past couple weeks in regard to this correspondence from the OTC. The central question they have asked is what the amendments to Rule 15c2-11 mean to them. In short, the amendments, at least according to the SEC, enhance disclosure and investor protection in the OTC Markets by ensuring that broker/dealers do not publish quotations for a security when current information for the issuer is not publicly available.

The OTC has taken the position that the amendments to this Rule require non-SEC reporting banks to meet certain disclosure guidelines by June 30th. This reminder is also accompanied by a request for a $5,000 application fee, as well as a requirement that all of the company's directors, officers, and greater than 5% shareholders undergo a background check. As you can imagine, this correspondence from the OTC has been met with suspicion by a number of community bank holding companies.

The main question we get from community bank holding companies is what happens if they fail to pay the $5,000 fee or fail to have their directors, officers, and greater than 5% shareholders go through the background check process? The answer is that the OTC may choose to prohibit allowing the stock to be quoted on the OTC Markets after September 28th. To some community bank holding companies, this is wonderful news. To others it is not. The real issue is whether the holding company sees any value in being quoted on the OTC.

If you receive this correspondence from the OTC, be sure to give consideration to the meaning and what is really going on. Also give consideration to whether you view your community bank holding company being listed on the OTC Market as a benefit or a detriment. For some community banks, getting off the OTC Market and getting control of their stock price (i.e., making their own market) may be the only way to get their stock price to a reasonable level. In any event, the community bank board's answer to whether being on the OTC Market is a benefit or a detriment will certainly impact the next steps.

SUBCHAPTER S

With the noise about the potential tax increase under the Biden Administration, a number of clients are wondering whether Subchapter S is still the favored tax status for community banks and their holding companies. Most recently, this came up in connection with the significant Trump Administration tax cuts. At that point, we analyzed dozens of our community bank clients specifically and determined for virtually all of them that, notwithstanding a significant cut in the

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corporate tax rate, Subchapter S still made sense as one of the better ways to enhance value for the shareholders, particularly as it results in more cash into their pocket after tax, as well as an increase in the basis of their stock.

We have had discussions on a theoretical basis with a number of clients lately about the likely Biden Administration tax increases. We believe that if the current Administration increases the corporate tax rate and/or the individual rate, Subchapter S (depending on the numbers) will still be the most appropriate way to enhance the value for the shareholders from an ownership standpoint. We are also advising our clients, however, to keep an eye on exactly what happens so that we can run their bank through our Subchapter S model to make sure it still makes sense when whatever happens, happens.

INTERCOMPANY SERVICES AGREEMENTS

We are currently assisting a client in drafting an Intercompany Services Agreement. This is a multi-bank holding company that sees the opportunity to gain efficiencies by moving certain redundant functions that are currently conducted at the bank up to the holding company level. In addition to gaining efficiencies, this will also ensure uniform processes and procedures across the subsidiary banks.

The movement of certain business functions from the banks to the holding company will be accompanied by certain of the employees of the separate banks becoming holding company employees. This will move their expense up to the holding company. Each of the banks will then pay a management fee to the holding company for the services provided.

For a holding company and set of subsidiary banks that utilize this approach, the regulators are going to pay close attention to the expense reimbursements paid by the bank to the holding company. In order to comply with the various regulations, most notably Regulation W and Sections 23A and 23B of the Federal Reserve Act, the expenses paid by the bank must be on market terms and represent fair market value for the services received.

One of the issues to keep top of mind in this type of setup is ensuring appropriate recordkeeping to prove to the regulators that the expense reimbursements paid to the holding company are fair and equitable given the circumstances. If that is not the case, whatever efficiencies you gain will probably pale in comparison to the regulatory headaches that are almost certain to come.

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CONVERSION CHARGES

The past couple weeks have presented two different opportunities for us to review a core service provider's charges for conversion services. If you are not familiar, these are services the core provider for an acquiring bank provides to convert all of the target bank's data and core processor information into the acquiring bank's core. Put more plainly, it is the charge for marrying two different sets of data into one.

In both of these instances, the data service provider's charges for the conversion services were in excess of $200,000. In each instance, our client was surprised at the level of charges and reached out to us to ask if we had the same shock. Unfortunately, our answer was no in both instances. We have seen enough of these core conversion charges to know that the fees are typically well in excess of what community bankers consider to be appropriate given the circumstances.

If you foresee a core conversion in your future, particularly due to an M&A transaction, do not be surprised if you receive a higher than anticipated conversion fee charged by your core provider. These are often well in excess of six figures for community bank transactions. Also, keep in mind that the conversion fee is just on one side of the transaction, which is the survivor side. The core providers also charge a deconversion fee for the core system that will not survive the merger. The cost for the deconversion fees is generally about the same.

THE CONTINUOUS SEARCH FOR NONINTEREST INCOME

Most community banks, particularly in this timeframe when interest rates are extraordinarily low by historical standards and margins are compressed, are looking for some source of noninterest income. We generally suggest they look in two areas. The first is fees: Are we a fee-charging or a fee-waiving bank? Do we have appropriate fees for appropriate activities? Should we be compensated for work we do through fees? Some banks do not like to charge fees. Others like to waive them and not collect them. Some say they "get it on the rate" not the fee. Whatever analysis is done needs to identify how the community bank can increase revenue through increasing or collecting fees more efficiently, if possible.

The second category of noninterest income we generally lump into "other lines of business." This is typically securities through a third party brokerage, insurance agency business (generally through an acquisition of an agency), trust, and wealth management. We have recently been in numerous banks whose trust and wealth management area has continued to blossom such

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that it becomes a material contributor to the bank's overall income. It also provides a diversification of the earnings stream and a place for bank deposits when they leave the bank to go and stay under bank control.

When your community bank is looking to increase revenue and thus profitability, it needs to look at all opportunities. Whether or not to pursue them is a different question.

ATTRACTING AND RETAINING KEY PERSONNEL

We have worked with a number of community banks over the last several months with respect to the issue of attracting and retaining key personnel. For many community banks, it is an issue of attracting key personnel to grow the community bank's business. For some, it is attracting key succession to keep the bank independent. What we generally advise in its most simplistic terms is that the bank needs to pay fair cash compensation, have some type of incentive system that incents what they want (and that the employee understands), and some kind of equity or equity-like program that will allow the employee to build wealth.

Many of the community banks that we have assisted lately and that are "desperate" to attract key personnel, for whatever reason, have none of these programs in place, not even fair cash compensation. Some boards and senior management are understandably concerned that if they pay the going rate for cash compensation, for example, it will totally "disrupt" the existing compensation system. Legitimate concerns but still ones that need to be addressed, as opposed to becoming a barrier to attracting key players.

The concept of fair cash compensation is generally based on survey data. Of course, the problem with survey data is that it is typically at least a year old. The issue of incentive systems vary from bank to bank and plan to plan. The incentive plan could be as simple as a cash bonus tied to bank-wide performance or individual performance, however the bank wants to design it. However, the caution with respect to incentive systems is be careful what your community bank incents because that is what you will get.

The third category of equity or equity-like programs generally includes restricted stock, stock options, ESOPs or KSOPs, phantom stock, or stock appreciation rights (the synthetic equity category). Synthetic equity is generally used in closely-held banks where the ownership does not want to give up any type of control. For more widely-held banks, actual equity programs make sense. Again, the goal is to provide the employee or senior manager your community bank is trying to attract or retain some incentive in the way of growing his or her wealth as the bank grows.

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We have dealt with all these plans, both implementing and advising. Please let us know if we can help.

THE FUTURE OF COMMUNITY BANKING

The last edition of *Musings* offered up the PowerPoints for a recent presentation we did that included our prognostications on the outlook for community banking over the next 20 or so years. There were a great number of you that requested copies of the slides. As a follow up to this presentation, our partner, Greyson Tuck recently was a guest on the NContracts podcast where he discussed in more detail these various issues. Please click here if you would like to access a copy of the podcast. It is about 30 minutes long, but we think is worth a listen if you are interested in our thoughts as to the major issues that community banks will face over the next 20 or so years.

CONCLUSION

2021 is moving rapidly. It is hard to believe Memorial Day Weekend is already upon us. We hope all *Musings* readers have a great and relaxing weekend with family and friends. Stay safe, and stay healthy.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Workshops:

- June 15, 2021 – Independent Community Bankers of America – Webinar: "The Role of Community Bank Directors in Compliance" (Cliston V. "Doc" Bodine, III) Registration link: The Role of Community Bank Directors in Compliance

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