THE

Board Chair Forum

NEWSLETTER

Opening the door to new ideas

Gerrish Smith Tuck, Consultants and Attorneys

May 2021

It appears summer is rolling in and we are seeing many more in-person meetings scheduled. That's a good thing for all of us. In this month's edition of the *Board Chair Forum Newsletter*, therefore, we address a number of hot topic items that are being discussed by Boards more than we have seen in the past. These include a discussion of diversity, equity and inclusion ("DEI") and its impact on boards, how organizations that were thinking about selling prior to the pandemic but who had to put things on hold, may now be reaping additional benefits, and how many community banks, rather than being fearful of having to sell to a fintech company, are choosing to find ways to partner with them. We also provide a warning of a situation where a growth strategy with a lift-out of employees of a bank in a target market proved to be a bad idea.

So, as we begin to look for ways to navigate these unchartered waters into a new future, we are pleased to report that we are seeing increasing optimism. It seems we are all now focused on the future rather than lamenting all of the difficulties of the past. It's time to move onward, and we are looking forward to doing that with you in person or through these newsletters!

Happy Reading!

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Board Chair's Summary

- Is a DEI Exam Coming?
- Patience in Selling May Pay Off
- Positioning Your Bank for Nontraditional Partners
- Not All Expansion Strategies Are Good

More DEI Information

DEI (the acronym often used for a discussion of diversity, equity and inclusion) is gaining more popularity in a number of places, but importantly for many of our readers is the recognition of the growing calls for a focus on DEI in banking circles. Earlier this year in the Board Chair Forum Newsletter we asked the question of whether more diversity was a good thing. The obvious conclusion: of course it is. Then we discussed how banks can continue to promote diversity in a number of different ways, whether that is diversity of gender, race, ethnicity, professional experience, geographic upbringing, religion, or anything else. But, while most of us envisioned a greater growth in areas of diversity, equity and inclusion as somewhat of a corporate governance "best practice," as Board Chair you might want to re-orient your thinking and strategies around the possibility for future regulatory exams relating to DEI.

Legislation has been introduced in the U.S. House by a member of the Financial Services Committee which would require federal banking regulators to include a diversity and inclusion component in the CAMELS rating system. The idea is to specifically evaluate (and thereby regulate) how federally insured depository institutions promote diversity and inclusion. So, as Board Chair, think for a moment about the ways in which your organization might possibly be examined and rated on elements of DEI. What kinds of things come to mind? Is it an objective decision based on numbers of employees and number of people who might otherwise be designated as "diverse"? If you are a minority depository institution, does that qualify you as already being "diverse," or does your institution need to promote diversity by ensuring non-minority participation? You can see how complicated this might become, specifically if more subjective evaluation points are introduced.

In looking at what the proposed legislation requires, it indicates that institutions could be rated on whether banks have policies to encourage diversity and inclusion in their hiring practices, whether banks provide training to their employees on diversity and inclusion, and whether banks have designated an individual to serve as a Diversity and Inclusion Officer who reports to the CEO. Likewise, institutions of more than $1 billion in total assets would be required to establish a committee for diversity and inclusion that holds quarterly meetings.

Whether this proposed legislation ever becomes law still remains to be seen, and there is some doubt about whether it becomes a true examination factor that is legislatively required. But as Board Chair, you should be aware of these types of evolving trends with a recognition that even a failed piece of legislation can often be viewed as somewhat of a best practice that could be imposed by regulation, if not by statute. So be on your toes and continue looking for opportunities to stay out in front of issues like this.

Patience Pays Off

As most of you know, we are strong proponents of the long-term independence of community banks. Notwithstanding that position, we still often find ourselves representing both buyers as well as sellers in community bank M&A transactions, and often that comes at the price of selling a long-term client.

In many of those circumstances, an organization may not be choosing to sell necessarily for a specific strategic reason, but merely because it is time, there is no succession, or other reasons. Often, we find when a bank finally gets over the mental hurdle of deciding whether to sell, they then want to move as expeditiously as possible to get their money and get the transaction behind them. In many cases that can prove beneficial by streamlining the process, but in other circumstances it may be short-sighted where a more strategic and patient seller may reap much more substantial financial benefits.

We have had a number of situations just this year where the idea of the "patient seller" paid off for an organization. These were organizations that began initial discussions perhaps as early as 2019, could not quite get comfortable with a potential buyer or a potential structure, somewhat put the transaction on hold, then COVID-19 came and put all transactions on hold, and only recently have the transactions reignited some interest.

In those cases, we have found that the environment in which we find ourselves now means that these patient sellers who were unwilling to jump at the first dollars thrown at them have found much bigger paydays on the back end with more appropriate structuring, more settling of the financial markets, and more access to capital by the purchasers. While we never recommend that sellers try to "time the market" because none of us know what is really going to happen, being a patient and deliberative seller can ultimately pay benefits in the long run by keeping more of the negotiating power in the hands of the sellers, who may then seek out numerous opportunities, and ultimately select the one that is best in the long run.

Taking that approach also means that for any organizations that might have some idea of a potential sale at some point in the future, it is not really a race to the finish line where you make the decision and try to have it completed in six months. You probably should be strategically planning for the potential transaction at least a year or two ahead of time.

Positioning Your Bank for Nontraditional Partners

It seems there are plenty of potential purchasers of bank charters these days. These range from strategic acquisitions by other financial institutions on a traditional basis, to nontraditional buyers such as fintech companies, mortgage or insurance companies, and, of course, even credit unions. For many of our smaller community bank clients, there has historically been a sense of fear that the fintech companies would expand rapidly, acquire almost all the small bank charters, and really damage community banking. Yet, we have not seen that come to fruition for a number of reasons. Rather, we think even the smallest community banks should be focused on positioning their bank to partner with some of these fintech companies and other nontraditional purchasers to be able to offer these entities access to the benefits of your bank charter without losing your focus as a community bank. In essence, think of partnering with their products rather than selling out to them.

This idea holds especially true given the difficulty of nontraditional buyers in making an acquisition. While there have certainly been a few fintech companies make an acquisition of a bank, and obviously we continue to see a growing number of credit unions as buyers, each of those kinds of transactions has huge reputational and execution risks associated with it. A fintech company as a buyer must demonstrate not only that it has a wonderful product that everyone is going to want, but it also needs a core banking operating plan of how to continue to run the banking business. Very few of those type of entities are able to demonstrate that. So the better route, rather than the fintech acquiring control of the bank, would be to form some type of alliance or partnership.

Similarly, in light of the wave of credit union acquisitions of banks, we are seeing more financial institutions becoming aware of the risks associated with trying to do a deal with a credit union. The primary benefit that credit unions bring to the negotiating table is simply more cash than most of the other buyers. Yet, the transaction will likely be subject to double taxation, and if the credit union is unwilling to offset the double tax, the true net economic benefit may be no greater with a credit union.

Likewise, we are seeing more legislative efforts to restrict the ability of credit unions to acquire banks and thereby take away a taxpaying entity, so it is far from certain that a credit union could now gain regulatory approval to make an acquisition. So, as you position your organization, and perhaps if you are receiving unsolicited offers from various parties and a credit union happens to propose the greatest price, we simply recommend negotiating with transparency with the other entities to let them know they are competing against a credit union who has offered more cash. The Board might accurately decline to negotiate with an entity like a credit union or a fintech company that poses a threat to the reputation of the potential seller and demonstrates huge execution risk of ever being able to get a deal done. The result is that you often are much better off trying to negotiate a better price with a more traditional buyer.

The bottom line, whether in an acquisition context or simply strategically moving your organization forward, is positioning yourself to be able to defeat unwanted suitors and to partner with new technology companies in a way that preserves your independence.

Expansion Strategies Gone Wrong

Normally, we consider growth and expansion opportunities to be positives. We even consider the strategies we build around those through movement into new markets, hiring new employees and the like, to be very positive steps for our organization. However, one recent example shows how even the most well-intentioned strategies can have negative consequences if things are not managed appropriately.

A bank looking to grow and expand in a new market began a process where they would consider a "lift-out" of a number of key employees of a target organization and bring them over to their organization in the new territory to begin successful operations. The problem with that type of transaction is that some of these new employees took some of their current materials from their former employer for the purposes and benefits of their new employer to be able to "hit the ground running" in their new location. As you might suspect, the former employer sued, claiming theft of trade secrets, damage to the business, etc.

Normally in these kinds of circumstances, if a case is successful there may be some civil liability attached to the alleged wrongdoings by the individuals. However, in this case, not only was there a potential for civil liability, but from a bank regulatory standpoint, at least two of the key employees were subject to additional punishment by the regulatory agencies where an order of removal was filed against them so that they can no longer work in the financial services industry. That seems like quite a harsh punishment, but it may be a sign of things to come, with increasing competitive pressures. The bottom line is that an employee leaves one job for another, they basically cannot take anything with them.

The point is that even your positive growth strategies need to be planned in a way that does not impose potential risk to your organization. If it seems like it's a bad idea, it probably is.

Meeting Adjourned

We are happy to report that we will be seeing many of you in the coming months now that summer is rolling in, with some in-person strategic planning sessions, in-person conference presentations, and visits to your bank. We are looking forward to seeing a few more real faces and having fewer Zoom meetings, and along with you, we are saying our prayers and keeping our fingers crossed that the worst is past us. So here's hoping that we see all of you face-to-face very soon!

Until next time,

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