GERRISH'S MUSINGS

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July 15, 2021, Volume 444

Dear Subscriber:

Greetings from Michigan, Vermont, Washington, West Virginia, Mississippi, Alabama, Montana, Arkansas, and Wisconsin!

CALL REPORTS

We recently received an email from a long-time client/friend that had been doing some research on his bank's history. He forwarded to us the first Call Report ever filed by their bank in June of 1934. It was actually the first Call Report filed by any bank (Form 64-Call No. 1), and of course it was handwritten. The interesting thing about this was the attached letter from the newly created FDIC and the instructions for the Call Report. The letter contains, in part, this statement: "It is not the purpose of the Federal Deposit Insurance Corporation to burden banks with requests for data, reports or information covering various matters . . .". Wow! It appears things have certainly changed. Next time you get an obnoxious data request from your friendly federal regulators, remind them of their origins.

EXCESS CAPITAL

As most *Musings* readers know, the term "excess capital" is a term your friendly federal regulators have never heard of or acknowledged. As we work with community banks around the country, a constant theme is how do we best allocate excess capital to enhance the value for our shareholders. Multiple alternatives are available once the available capital is identified. These include the acquisition of another bank, the acquisition of a branch, the acquisition of another line of business to increase non-interest income, and the like. We were recently visiting with a couple of boards who are trying to determine their excess capital. One of the board members, who is fairly astute and familiar with the regulatory capital regulations, indicated that the way he read the Reg, the bank's minimum leverage ratio needed to be somewhere in the 5% range. Their bank had nearly a 10% leverage ratio which means, in his opinion, that there was 500 basis points of excess capital on their $400 million bank or $20 million.

After listening to this discussion of how the board was determining excess capital, we advised that their interpretation of the Reg was absolutely correct from a technical standpoint, but if they operated at 5% or 6% leverage ratio or thereabouts, they would have the friendly federal regulators pitching a tent in the bank's lobby and camping out there for the duration. As a practical matter, the regs are irrelevant when it comes to what the friendly federal regulators (and most states) consider to be appropriate capital levels for a community bank. Of course, appropriate capital levels depend also on a variety of other things, including asset quality, speed of growth, and the like. Generally, we are advising our clients these days if you want to operate your community bank at an 8% leverage ratio, please do so, but be advised the regulators will likely "fuss" at you a little bit. That fussing is generally not deemed to be a requirement to increase the capital at the bank. Below that, they will probably do a little more than fuss at you. Something in the 8% to 10% range is generally where they are comfortable, depending on the asset quality. So, this particular bank where the director felt they had 500 basis points of excess capital, the reality is they more likely, if the Board has the appetite for a little bit of the friendly federal regulator fussing, would be in the 200 basis point excess capital range, or about $8 million. The regulators are great at ignoring the letter of the regulation when they feel like it benefits them. They are also great at setting on their own standards.

OTHER LINES OF BUSINESS

Most of our community bank clients around the country, particularly in view of the lack of loan growth and the compressed margins, are looking for ways to increase non-interest income. Often, this involves the acquisition or the consideration of the acquisition of another line of business. Many times, this other line of business acquisition will be at the bank holding company level. When you are contemplating an acquisition or the creation of a line of business at the holding company, the first step is to determine whether it is a permissible activity for the holding company. The general rule for a "non-financial holding company" is that the activity must be "closely related to banking and a proper incident thereto". The Federal Reserve's Regulation Y has a laundry list of activities it has already deemed to be closely related to banking in a proper incident thereto. Other activities can also be added to that list. In fact, what gets on that list is whatever the Fed, at the time, thinks should be on that list.

As your community bank looks to increase non-interest income possibly through other lines of business, the second step is to determine how the acquisition of that activity is going to be financed. If the holding company is going to receive a significant dividend for the bank, then bank capital needs to be considered - i.e., don't drop it below the regulators squeal factor. If the holding company is going to make the acquisition through debt, that will likely receive less regulatory scrutiny because it does not adversely impact the bank's capital. In fact, it's generally irrelevant unless your community bank is greater than $3 billion in total assets.

DIRECTION OF MANAGEMENT

As most *Musings* readers know, many of the community banks in the country are closely held through families or closely held ownership through various partners who have been together for a long time. Not surprisingly, often those groups don't necessarily get along together or have the same long-term goals. This often will leave management in somewhat of a quandary as to where the ownership wants the bank and holding company to head. It's not a healthy situation for retaining management, particularly when one of the issues surrounding the uncertainty is whether or not the bank is going to remain independent.

Our advice is to get the ownership together and give some concrete direction to management so management knows what is expected of them. Hopefully, this will reduce any anxiety. Combine that with some assurance that the management will be protected if there is any type of change in control and your management team should remain comfortably in place.

EMPLOYEE TRAINING RECOGNITION

Many community banks view employee training and development as a key strategic priority. One of the challenges we hear from many community banks is how to get employees excited about putting the time and effort into completing the additional training. We recently experienced one community bank supervisor that was addressing this challenge by giving appropriate recognition to individuals in their bank that completed training certification programs. In this bank, any individual that completes a certification program receives public recognition of their accomplishment in front of all the other bank members at the next bank staff meeting. At that time, they are also presented with a cash bonus (bribery has its benefits!).

Apparently, this method of employee recognition has worked pretty well for this bank. The public recognition and cash bonus has motivated a number of the employees to complete additional training and development programs. We see this as a great example of a community bank that is willing to incent what it wants to accomplish.

IDENTIFYING CORE PROFITABILITY

The community bank M&A market is very active. We are currently assisting a number of different clients with live transactions on both the buy and sale side. Over the past couple weeks, we have "run the numbers" on a number of different acquisition opportunities.

One of the key factors in properly completing the financial analysis of a potential acquisition transaction is determining the target bank's "core earnings capacity" - i.e., core, sustainable earnings. As you might suspect, this is important because the target's core earnings capacity typically has a larger impact on the financial viability of the transaction than any other component. It significantly impacts the projected earnings per share accretion and return on investment that will be realized as a result of the acquisition.

One of our clients recently put it best when they mentioned there is a lot of "noise" in a target bank's earnings for 2020. We thought this a very apt description. This particular target bank had a very strong net income for 2020, which was bolstered by one-off earnings due to PPP loans, secondary market mortgage originations, gains on bank-owned life insurance, and a couple smaller but similar issues.

When looking at a target bank that has this noise, it is important to be able to separate the noise from core profitability to really understand the target bank's core, sustainable earnings. Any acquirer that fails to do so will likely be sorely disappointed with the actual profitability of the combined organization following closing of the transaction. If you are running the numbers or otherwise considering an acquisition transaction, be sure to keep these important issues in mind as you complete your financial analysis.

MARKETING TIMELINES

As mentioned, we are currently assisting a number of community banks in running the numbers and otherwise considering acquisition transactions. Over the past two weeks, two of these situations have been particularly notable. Each involves a circumstance where a professional advisor is representing a community bank that has made the strategic decision to sell. These advisors have followed what is a pretty typical marketing process by putting together a Confidential Information Memorandum and sending it to potential acquirers. What we see as atypical in these transactions is the amount of time the professional advisors and target bank have chosen to give potential acquirers to evaluate the opportunity and submit Indications of Interest. In each circumstance, it was less than two weeks from the date the potential acquirer first received the Confidential Information Memorandum.

In our view, two weeks is not enough time to consider a potential strategic transaction. It is not because the work cannot get done. In each of these circumstances, we were able to complete the financial analysis and work with the potential acquirer to evaluate the opportunity. However, we do not believe two weeks gives the board and executive officer group enough time to really think through and vet the general terms under which the transaction makes sense. We think the board and officer group of a potential acquirer needs a little bit more time to be able to fully think through and discuss all of the relevant issues to determine how and why the transaction makes sense for them.

When we run the marketing process for a community bank that has chosen to sell, we typically give potential acquirers three to four weeks to consider the transaction. We think this strikes the right balance between moving the process forward in a timely manner and giving potential acquirers the opportunity to fully consider and think through all of the relevant issues.

PRESIDENT BIDEN'S EXECUTIVE ORDER

This past week, President Biden announced an Executive Order that has a number of different items that are purported to increase competition among businesses for the benefit of American citizens. In looking at the Executive Order, we see two particular items of note to community banks. The first is the provision of the Executive Order that seeks to make non-competition agreements unenforceable. As we understand it, the President's position is that all non-competition agreements should be void and unenforceable as a matter of public policy because they restrain American workers from taking a better job. The second notable provision is one that encourages regulators to increase scrutiny of bank merger transactions. We do not know exactly what the support is for this, but we understand the President is of the belief that a bank merger reduces credit to small businesses by 10%.

As it relates to the non-compete agreements, we will go on record and say that we disagree with the principle that all non-compete agreements should be void as a matter of public policy. We have seen a number of circumstances where non-compete agreements serve an entirely appropriate purpose. This often comes up in situations of new employment or in M&A transactions. We believe if banks are willing to invest resources into an employee or pay a premium to acquire another business, that investment should be protected by enforcing non-compete and non-solicitation agreements that the individuals freely entered into in order to gain the benefits of the investment.

As it relates to the bank mergers, we do not anticipate that will have a significant impact on community bank M&A transactions. For larger bank deals (e.g., BB&T and SunTrust), these issues may come into play. For small deals, we think tax policy will have a much more profound effect on whether a deal does or does not get done.

It will be interesting to see what happens with these two particular provisions of the Executive Order. We do not see any immediate impact to community banks, and our belief is that the long-term impact will be minimal as well. We think what happens with the tax laws will have a more material impact than this Executive Order, provided some of President Biden's tax strategies come to fruition.

REGULATORY AMNESIA

We have concern that some of our friendly federal and state regulators may be suffering from amnesia. Our concern is rooted in several recent discussions we have had with community bankers concerning their recent experiences in their examinations. It seems that the regulators have largely or completely forgotten much of their regulatory speak from about 15 months ago regarding forbearance and borrower accommodations due to COVID. We have heard several stories recently where asset quality has been downgraded and specific COVID-related borrower accommodations criticized during an examination.

Thinking back to about 15 months ago, the regulators gave quite a bit of lip service to regulatory forbearance, COVID borrower accommodations, and the like. Back then we voiced our skepticism to the reality of this regulatory approach. It seems that skepticism may be well-founded. If you have an examination coming up, keep these issues in mind. We do not want you to be caught flatfooted in the belief that the regulators are giving any type of real regulatory forbearance for COVID borrower accommodations.

CONCLUSION

Summer is certainly upon us. We have had the pleasure over the last couple of weeks to crisscross the United States. Some spots are cool. Some spots are very, very warm. It's good to see many of you personally again instead of through Zoom or over WebEx. Have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars:

- August 13, 2021 – Oregon Bankers Association Northwest Bank Directors Series – "Governance, Director Liability and Strategic Planning: What You Really Need to Know" (Greyson E. Tuck) Registration link: Governance, Director Liability and Strategic Planning