
GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Minnesota, Wisconsin, Ohio, Pennsylvania, Vermont, Kansas, Texas, and Illinois!

REDLINING IS ALIVE AND WELL

Recently the friendly federal regulators and the Department of Justice settled a redlining case with a $17 billion bank in Mississippi. The bank was required to pay a civil penalty of $5 million, invest $3.85 million in a loan subsidiary fund, and implement other mechanisms to increase mortgage credit in the affected communities. The allegations in the redlining case are fairly standard. It alleges that for a four year period, (2014-2018), the bank "engaged in a pattern or practice of unlawful redlining." It had four of 25 full-service branches in minority areas in the affected city, where half the census tracts were made up of majority-minorities, either Black or Hispanic residents.

The fact that a redlining case has been brought is not surprising. The takeaway is that we are likely to see many more of these. These will not just be for multi-billion dollar banks; it will also be for a couple hundred million dollar community banks. The press is on. In the event the friendly federal regulator finds a "pattern or practice" of discrimination, for the most part they are obligated to forward it on to the Department of Justice. At least prior to the current Administration, the Department of Justice typically took no action unless it was extraordinarily egregious. We believe that the "egregious test" has been moderated significantly and will be in the future. Just a word of warning to the wise.

NONINTEREST INCOME

Community banks are for-profit entities. Even those non-stock companies (i.e., mutuals) need to make a profit in order to serve their communities and their ownership base. Generally when discussing profitability, the analysis assesses both interest income (i.e., loan growth) and noninterest income. Noninterest income is generally broken down into two major categories – fees and other lines of business. We were recently with a community bank discussing growing fee income and/or reducing fee waivers. One of the participants recounted a mechanism they used at their prior bank to reduce fee waivers. As a practical matter, what they did is give every individual who had authority to waive fees (i.e., frontline personnel, CSRs, etc.) the opportunity to do so, but when they did so they also had to write a check out of a checking account they were given that contained a finite amount of money. If they waived a fee, they would write the check and have it deposited back into the customer's account. It was as though they were paying with their own money. As a practical matter, they were, because at the end of the year, if there was any money left in that checking account, guess where it went? An unusual approach to reducing fee waivers, but apparently an effective one.

DIRECTION TO SENIOR MANAGEMENT

As most of you know, part of the board's job, in addition to enhancing shareholder value, is to provide strategic direction for the bank. This includes direction to senior management on the direction of the bank (not micro-management). We have been in a number of board meetings lately where the board has determined on its own to give direction to management that, frankly, is unattainable. In most of those meetings, we advise the board that while they can give that direction to management, of course, by setting unattainable goals or strategic direction, they were basically setting management up to fail.

Some of these unattainable goals involve factors or decisions over which management has no control. Whereas a goal from the directors to increase earnings, increase non-interest income, diversify the revenue stream, or improve earnings per share, are within the realm of management, a goal that, for example, the directors want management to complete an acquisition within the next 12 months is not within management control. If the board is going to give management direction, then let's not set management up to fail.

THE DIVIDED BOARD

Over many years working with community banks across the nation, we remember infrequently encountering a seriously divided board. Of course, historically there have been occasional circumstances where that occurred for one reason or another. Some of them involved family issues. Some involved other issues. Over the last couple of months, however, we have had multiple situations with a divided community bank board. The boards were divided on different issues. In some cases, half the board wants to sell the bank, half doesn't. In some cases, half the board wants some changes in the board, half doesn't. In some cases, half the board wants change in the CEO, half doesn't.

The interesting thing about community bank divided boards is that (unlike Congress) they appear to remain, for the most part, civil discussions. Opinions are respected (although they are different), and resolutions are reasonable and adopted by all. As we recently told one divided board that had reached a resolution of their situation, the sign of a good negotiated settlement is that "everyone is unhappy." That was certainly the case in that circumstance.

The key for a divided board, whether the divide relates to family issues or otherwise, is simply to sit down in a civil manner and work through the issues until there is some resolution that everybody can live with, although each individual may not be happy with it. Those values are the foundation of community banking.

DEAL FATIGUE

We are currently working on several M&A transactions where some of the parties are beginning to show signs of deal fatigue. This type of fatigue is not uncommon in community bank acquisitions. We sometimes see deal fatigue occurring near the end of the deal, where both of the parties have been working a long time to get a deal done but it is not quite over the finish line yet.

Deal fatigue typically evidences itself by individuals in the transaction getting worked up over immaterial issues. What do we typically recommend when deal fatigue sets in? Our typical recommendation is that you take a step back and focus on the big picture. We generally indicate that it is important not to become distracted and worry about immaterial or trivial matters. Instead, we believe the parties are best served by keeping their eyes on the ultimate prize, which is the completion of the deal. In other words, if deal fatigue begins to set in, we recommend our clients refocus on the material items related to the transaction and let go of the immaterial or trivial matters in order to get the deal done.

CHANGE-IN-CONTROL

With the current Administration's tax proposals floating around, a number of our clients around the country are trying to make stock transfers that may take advantage of the existing estate and gift tax exemption currently at $11.7 million, which under the Biden proposals would reduce to $3.5 million or somewhere in that neighborhood.

Anytime there is a transfer of shares in a community bank holding company (or bank for that matter if you have no holding company) it is critical that change-in-control issues be considered. A change-in-control of a bank or holding company requires prior notice and approval (or non-objection) from the regulators to the recipient of the shares and approval by the Federal Reserve before acquisition of control occurs. Of course, if the recipient of the shares is not aware of the change-in-control rules, then typically an after-the-fact notice is filed. Also in connection with transfer of shares, particularly if a trust is involved, it is critical not only to review the change-in-control issues, but to make sure the trust itself does not become a bank holding company. The Federal Reserve has specific rules in this regard.

The bottom line and the issue with all this is that it is now the middle of October. The Federal Reserve is a large federal agency. Although they provide good service most of the time, we really do not believe they work nights and weekends. They are currently backed up with not only merger applications but change-in-control applications as well. If you want to do something that involves transfer of stock that may be a change-in-control, the first step is to determine whether it is a change-in-control and requires a filing with the Federal Reserve and prior notice. The second step is to determine whether any involved trusts could possibly be a bank holding company. The third step is to determine whether a prior notice which is required by the statute will be filed or whether the stock has already been transferred and a post-transfer notice to the Federal Reserve will have to be filed.

Unfortunately, community bank change-in-control issues involving the Federal Reserve at the holding company level or the FDIC or OCC at the bank level are complicated. Get some assistance if you have a potential change-in-control issue.

A POLITE DISAGREEMENT WITH THE REGULATORS

We recently had what is best described as a polite disagreement with a particular state bank regulatory agency. Similar to virtually every other state, this particular state has a provision in its state statutes that prohibits any person or company from obtaining control of a state-chartered bank without prior regulatory approval. This is essentially the state equivalent of the federal Change in

Bank Control Act. What is a little bit unique is that this state has a specific provision in their state statutes that says prior approval is not required if the transaction is subject to approval by the Federal Reserve pursuant to the federal Bank Holding Company Act. Based on the language in the state statute, we transmitted to the state regulatory agency notice of the transaction and our interpretation of the statute.

The state regulatory agency came back to us and said they had a little different view of the statute. They said that it only applied when there was also an application to merge the two banks together. We politely pointed out that this is not stated anywhere in the state banking act. Interestingly enough, the individual with whom we were discussing the issue said they agreed with our interpretation of the statute. However, they said the department as a whole would not allow this type of precedent to be set, so they were going to require regulatory approval before the transaction could be consummated. It is always a little frustrating when the state banking department imposes a set of rules other than what the statute specifically provides.

We are not totally surprised by the agency's response. The moral of the story here is that when considering any strategic transaction that may involve regulatory approval, particularly by a federal agency, it is incumbent upon the bank or its professionals to touch base with the state agency. This is because the state statute and regulations may not be interpreted based on what they provide on their face. There may be "desk drawer" interpretations that mandate other action. Be careful.

TALENT DEVELOPMENT

We have facilitated a number of strategic planning sessions over the last couple months. In each one of these sessions, we have had some discussion about talent development, typically in conjunction with discussions regarding management succession. What is interesting is that many of these sessions involve some type of comment that talent development in the banking industry is harder than it used to be because many regional and national banks have done away with their management training programs. The general belief is that those programs trained a number of individuals that left their larger banks and came to community banks.

Our view as it relates to this particular component of management development is (politely): Who cares? The reality is that talent development is a non-negotiable. Not having talent development is not an appropriate strategic option for any community bank. For those banks that have no talent development program in place, we see the development and implementation of this type of program as being of critical importance.

CYBERSECURITY CULTURE

Cybersecurity is certainly top of mind for community banks. Fortunately, we have not had any "empty the vault" scenarios (yet), but we have had multiple scenarios involved with apparent wire transfers and other money losses that have resulted from cyber attacks of some sort, either on the bank or its customers (or in some cases, both). We were recently with one bank discussing various strategic issues when during the technology discussion the bank indicated that they maintained a "culture of cybersecurity." This is similar to the "culture of compliance" addressed in previous *Musings*. It is basically a top-of-mind awareness by all bank personnel of cybersecurity issues. Good idea.

CONCLUSION

We are at the end of October already. Thanksgiving, Christmas, and other major holidays will be here soon. Halloween is this weekend. Stay safe, enjoy, and look out for the little trick-or-treaters.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Presentations:

- November 2, 2021 – ICBA Webinar – "Liquidity Strategies for Illiquid Community Bank Stocks" (Greyson E. Tuck) Registration: Liquidity Strategies for Illiquid Community Bank Stocks
- November 5, 2021 – Oregon Bankers Association Virtual Northwest Bank Directors Series – "Dusting Off the Crystal Ball - Community Banking Past, Present and Future" (Greyson E. Tuck) Registration: Dusting Off the Crystal Ball
- November 10, 2021 – Graduate School of Banking-Wisconsin Webinar – "Maintaining Community Bank Independence in a Consolidating Environment" (Greyson E. Tuck) Registration: Maintaining Independence
- November 17, 2021 – Financial Education & Development Webinar – "Seven Keys to Effective Succession Planning" (Greyson E. Tuck) Registration: Seven Keys to Effective Succession Planning

