GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from South Dakota, North Dakota, Minnesota, Wisconsin, Alabama, Georgia, Texas, and Oklahoma!

CHAIRMAN'S WISDOM

We have had numerous engagements in 2021 that involved reviewing the bank's organizational structure and other issues with respect to improving efficiency and making sure that the bank provides a path forward for the next generation of management succession, and a path outward for those directors and officers who may be departing.

One of those engagements that sticks in our minds in a very favorable way was for a well-run, high-performing, fairly closely-held community bank. At the beginning of the engagement, as part of our process, we had one-on-one discussions with the Chairman of the Board. When we asked the Chairman how he viewed his role in the bank, his comment was, "To make the uncomfortable comfortable and to make the comfortable uncomfortable." We thought the Chairman's concept was a good one - being a comfort to those who need it in the bank, particularly those younger officers on their way up, and disrupting those who need disruption because they have become complacent.

REGULATORY OUTLOOK FOR 2022

We thought it might be helpful if we provide our community banks with the regulatory outlook for 2022. In a nutshell, we view it as "not too good." As we mentioned previously in *Musings*, we are seeing significant regulatory activity at the examiner level in particular with respect to compliance, primarily fair lending and equal credit issues. Clearly, the current administration has a significantly higher priority level with respect to these consumer-related issues. We believe that will continue and grow stronger in the new year. We believe we will see both more formal and informal enforcement actions. Those informal enforcement actions are generally in the nature of a Memorandum of Understanding or some type of letter agreement with your friendly federal or state regulator. The formal enforcement actions, of course, involve Consent Orders, Cease and Desist Orders, removal actions, civil money penalties, and the like. Over the last 30 years of working with community banks across the nation, we can attest to the fact that enforcement actions have been "cyclical." We believe over the next couple of years - 2022 and 2023 - enforcement actions will increase and so will the pressure on community banks.

Please keep in mind, if your community bank is faced with an enforcement action, the Board, as surprising as it seems, is "in control." Fortunately, we still live in the United States of America where not even the friendly federal regulators can force a Board to do something without their consent or without due process (i.e., an administrative hearing). Although our firm has "mixed it up" with the regulators more than any other firm in the country (at least we believe so), we generally advocate pushing back on an enforcement action where it makes sense, utilizing leverage to cut the best deal, or, if the bank is simply in the wrong, acknowledging it, agreeing to a corrective program, and moving on. Our point is this: it is not simply a foregone conclusion that the board must execute a document in the form provided, or even at all, just because the regulators request the board to do so. If anyone needs any additional information on enforcement actions by your friendly federal regulators, let us know. We have years of experience.

MERGER AND ACQUISITION APPROVALS

As most *Musings* readers know, community bank mergers and acquisitions have been very strong this year, both in number and size. We believe that will continue on into 2022 and likely 2023. There has been a lot of "noise" on Capitol Hill and in the trade press about merger and acquisition approvals. Congress and certain Senators in particular are concerned that the Federal

Reserve from a holding company approval standpoint is simply being too easy on bank merger transactions. One Senator in particular is taking this position, among other reasons, because it appears the Fed simply approves every acquisition as it is presented to it. In other words, their concern is that there are very few acquisition transactions that are disapproved by the Fed. What we believe what the Senator does not understand or does not want to understand is that the reason the Fed approves every transaction is because those transactions that are not going to get approved or are dead on arrival with the Fed are withdrawn after the application is filed. In other words, neither party to a merger wants to have a public Federal Reserve Order denying their merger application. As a result, the unwritten rules in the community bank merger and acquisition business include that if you go to the Fed and they give you "a wink and a nod" that this transaction is not going to be approved, then you simply withdraw the application and move on. As a result, nearly 100% of the applications presented to the Fed are approved.

Most of the pressure on merger and applications has involved the larger institutions, not the community banks, as such. As we all know, however, what impacts the larger institutions typically trickles down to the community banks as well. We will keep an eye on this for you and give you our thoughts through *Musings* in 2022.

FINTECHS ON THE MOVE

We have noted late in the year that fintechs are certainly on the move. By "on the move," we mean on the move to try and obtain a community bank charter for whatever their purpose, either to provide services to community banks, often through the use of the "payment rails," or to simply provide a funding source for the lending they are originating through the fintech. Whatever the reason, it is still providing a "small bank premium" for banks under $75 million in total assets. We have witnessed this many times through 2021. We believe that will continue through 2022. While a strong cash offer from a fintech is often attractive, the real question is whether the transaction can get consummated. In other words, can the fintech get regulatory approval, and does it have the cash? Any community bank facing this issue needs to make sure that their advisors explore both those concerns. There is no sense signing up for a transaction that has a very good price to the community bank's shareholders but will not be able to get completed.

SUBCHAPTER S

As most *Musings* readers know, Subchapter S has been available for community banks since 1998. Many of the community banks who converted to Subchapter S early on did so simply because they could reach agreement and sign all the documents "sitting around the dining room table with the family." Over the last 10 years, most of the conversions to Subchapter S have been late to the game and have involved freeze-out mergers and more difficult political situations with respect to the elimination of shareholders.

Our firm still believes that Subchapter S is, in virtually every case, the best way to enhance the value for the shareholders and keep your bank independent over the long term. We did significant analysis of the benefit of Subchapter S following the prior administration's tax cuts. We concluded it was still significantly advantageous for most community banks to retain or convert to Subchapter S status. We continue to believe that today.

We are in the process of converting a number of community banks to Subchapter S and have a number on the agenda for 2022. If your bank is still a C Corp and would like to discuss this or have us run the financial analysis through our proprietary models to see what it would look like for your bank, please let us know. We think the earlier the community bank board begins to consider this change in tax structure in 2022, the easier it will be to accomplish by year-end 2022.

SHAREHOLDER AGREEMENT REVIEW

We recently assisted a board in the review of their Subchapter S Shareholder Agreement. This is the first time the board had reviewed the agreement in a number of years. However, part of the review was an acknowledgement that the agreement needed to be reviewed on at least an annual basis. The board basically decided that they were going to add the Shareholder Agreement to the list of policies that are reviewed at least yearly. We thought that to be a very good policy for the board. If you have a Shareholder Agreement and have not taken a close look at the agreement in a while, we recommend doing so. It certainly will not hurt.

NON-QUALIFIED DEFERRED COMPENSATION

We have recently been assisting a client in developing the terms of a non-qualified deferred compensation plan. If you are not familiar, a non-qualified plan is distinct from a qualified deferred compensation plan. The difference lies in the taxation of the benefits provided by the plan. In short, qualified plans have to meet certain criteria established in the Internal Revenue Code and have an overall more beneficial tax treatment than do non-qualified plans.

Since a non-qualified plan does not have to meet certain criteria established by the Internal Revenue Code, the terms and conditions of a non-qualified plan are pretty much limitless. A non-qualified plan can incorporate whatever terms and conditions the plan sponsor believes to be appropriate. This particular plan was akin to a 401(k), where bank employees were given the opportunity to defer a portion of their salary, and the bank matched up to 50% of the deferral on a dollar-for-dollar basis. The entire amount would then be provided a preferential rate of return.

One item of consideration related to this type of plan is the treatment of the benefit if a bank employee leaves employment prior to normal retirement age. Some plans provide for what is best described as cliff vesting, which is basically an all or nothing proposition where the participant would only get the return of his or her deferred compensation if they were to leave prior to normal retirement age. In that instance, the individual would not get any of the bank match or interest credited on that amount. Other plans are a little more participant friendly, providing for partial vesting in the event an employee stays at the bank for a number of years, reaches a certain age that is not full retirement age, and the like.

The most pertinent benefit of a deferred compensation plan is employee retention. The whole idea behind the plan is to put something in place that incentivizes the employee to remain with the bank long-term.

THE POTENTIAL CHIEF BRANDING OFFICER

We recently facilitated a strategic planning session for a nearly one billion dollar in total assets community bank. The session included what we would consider to be the typical discussion, including opportunities to enhance shareholder value, considerations for potential acquisitions, employee stock ownership plans, and similar strategic considerations. One of the interesting items of discussion was that of the bank's advertising, marketing, and branding. The interesting discussion was whether the bank was of a size that it needed a Chief Branding Officer.

This particular bank has traditionally overseen and coordinated all of these marketing/branding activities through a marketing committee. However, it was recognized that these activities were "disjointed" and in need of improvement. The group discussion resulted in the acknowledgement that the bank was now of the size where they needed one individual whose full-time job is to oversee and coordinate all of the bank's efforts in this area. The comment was that the committee worked when the bank was half its size with half the number of locations. However, given the bank's size and scale, the group believed they were now at a point where they needed a professional to come in and take over responsibility for these activities on a full-time basis.

RELATED-PARTY TRANSACTIONS

Several times over the past couple months we have assisted clients in evaluating potential acquisitions of companies that engage in activities that are "closely related to banking." These are permissible activities for a bank holding company. The usual suspects include trust companies, wealth management firms, insurance agencies, and similar companies. In each of these transactions, one of the banker's initial questions is typically what regulations may be applicable to this type of related-party transaction.

About ten years ago, the Dodd-Frank Act made certain revisions to Regulation O. The changes essentially apply the requirement for market terms to any transaction with an insider. In other words, the regulators will review this type of transaction to ensure that it is on commercially reasonable terms and conditions.

In our experience, the regulators will really take a look at the process in reviewing the transaction. They typically take a keen interest in whether appraisals were obtained, terms related to financing, and the like.

If you are thinking about purchasing a business from an insider or engaging in a similar related-party transaction, keep these issues in mind. The regulators are going to review the process you have followed to determine whether the transaction incorporates market terms.

YEAR-END PESSIMISM: GRAY SWAN EVENTS

We continue to be optimistic that the new year will be a good one for community banks. Not everyone is so optimistic, however. We recently read an article about potential 2022 gray swan events. As most of you know, a gray swan event is one that can both be foreseen and disruptive, unlike a black swan event, which comes out of nowhere and was not anticipated. This article listed multiple gray swan events to be worried about, including the following: war involving Russia or China, worsening of the global supply chain problems, Federal Reserve policy mistakes because they are wrong about inflation, and a major cyber attack. If that is not enough, there are probably others. We tend to be more optimistic than pessimistic, but we thought we would share these year-end worries so we provide balanced information to *Musings* readers.

GERRISH SMITH TUCK ANNOUNCEMENTS

We want to take time to give a heartfelt thanks to our clients and friends for helping make Gerrish Smith Tuck successful since its creation in 1988, and particularly successful in 2021. We are pleased to provide services to community banks across the nation, as well as support the families of Gerrish Smith Tuck who are instrumental in providing the high quality work product and service that our firm has become known for.

Also, we would like to announce the recent addition of Hayden Cherry to our firm as an Associate. Hayden has significant expertise in a variety of areas, including mergers and acquisitions, capital raising, and the like. Hayden will be involved in both the financial advisory, consulting, and legal services provided by the firm, particularly in the area of management studies and community bank mergers and acquisitions.

CONCLUSION

We are pleased to produce *Musings* on New Year's Eve and note that "*Musings* never sleeps." (We actually believe sleep is highly overrated.)

We hope all of you have a wonderful and safe New Year's. Please keep "dodging" the virus as we have tried to do. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming:

- January 13-14, 2022 – Community Banking Board Chair Forum (Jeff Gerrish, Philip Smith, and Greyson Tuck) Registration: Board Chair Forum
- January 20, 2022 – Financial Education & Development Webinar (Philip Smith, presenter) Registration: Understanding the Current M&A Market for Community Banks