GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Texas, New Mexico, South Dakota, Georgia, Minnesota, Wisconsin, Indiana, and Ohio!

NEW SHERIFF IN TOWN

Most community banks (not all by any means) are regulated by the FDIC. FDIC insures deposits, provides regulatory supervision, and sets policy impacting the majority of community banks. FDIC Chair Jelena McWilliams, a champion for community banks, stepped down from her position last week after a dispute with the Board. New FDIC Chairman, Martin Gruenberg, has been with the agency since 2005 and has been Chairman or Acting Chairman three times. He is a strong consumer advocate. Immediately upon his appointment as Acting Chairman, the FDIC issued a press release which indicated FDIC priorities this year are as follows: Community Reinvestment Act, Climate Change, the Bank Merger Act, Crypto-Assets, and the BASEL III Capital Rules. Clearly, a Biden Administration bent, as would be expected. Not specifically enumerated, but we feel very confident a strong consumer protection approach will also be an FDIC priority. We will keep you posted as the development of these priorities occurs.

REGULATORY ENFORCEMENT ACTIONS

Under the current administration it appears that regulatory enforcement actions will continue to increase, particularly in the consumer protection area. Regulatory enforcement actions can run the gamut from a Board Resolution or Memorandum of Understanding (both totally unenforceable and not subject to civil money penalties for violation) to an agreement with the regulator under Section 8 of the Federal Deposit Insurance Act (called a Formal Agreement with the OCC, a Consent Order with the FDIC, and a Written Agreement with the Federal Reserve). Each of those latter enforcement actions are subject to enforcement in court and civil money penalties for a violation.

One issue that most boards of directors do not understand when they are requested to consent to an enforcement action is that the board is "in control." It may not seem like it when the regulators are pounding the table and breathing down your neck, but the reality is this: if the board elects not to consent to whatever is being proposed by the regulators, then the regulators are required to go through a lengthy process (also known as "due process") before they can force an enforcement action on a bank. As a practical matter, the process generally involves discovery, an administrative hearing, and a final determination by the board of the agency, or the Comptroller of the Currency in the case of a national bank, as to whether an enforcement action will be issued.

In connection with the FDIC's recent release of their enforcement actions (they do a press release the last Friday of every month for enforcement actions entered the prior month), there was a very interesting situation involving a cease and desist order issued by the FDIC to a smaller community bank. This small bank, at least from the content of the order which recited the facts, simply stonewalled the FDIC. The board refused to sign the order, which was proposed originally as a consent order. Because the board refused to consent, the FDIC was required to go through its "process." The bank apparently did nothing other than send a few letters to contest it (i.e., no formal answer, no administrative hearing held, nothing). Nevertheless, it still took more than a year from the time the FDIC proposed the consent order, which the bank refused, to the time it was actually entered. Again, this is without any defense provided by the bank. As we have always indicated, if nothing else, the board's refusal to consent to an enforcement action can certainly buy the institution time. Time is typically an ally in this case because it gives the bank the opportunity to correct the problems that are the subject of the friendly federal regulator's proposed enforcement action.

The moral of the story is the board is in control. If the board elects not to move forward, then the federal regulatory agency has a long road ahead, even without a defense by the bank, before it eventually gets what it wants.

STRATEGIC BOARDS

We have recently been with a number of larger community banks in the $2-$5 billion range. One of the common discussions with the board of a community bank that size is the possibility of establishing a holding company board that is more of a strategic board and a bank board that is more of a local, business development, customer character-type board. Many of these multi-billion dollar banks started out as small banks where the boards of the bank and the holding company were always the same (because that is the way we always did it), unless there was a concentration of ownership, in which case the holding company board may be an ownership board and the bank board may be the operational, local board. When the bank has grown up to be a large size community bank, however, it is probably time to begin to think about evolving the holding company board into a strategic board. This could certainly easily be done over a period of years as board members retire off both the bank and the holding company boards and the new board members only become members of the bank board. We believe that the holding company board should be a strategic board. It reports directly to the shareholders. It is not that it can't develop strategies with the bank board - it does and should - but it also has different responsibilities, such as allocation of capital, incurrence of debt, sale of equity, and those issues that surround the holding company board that are not present necessarily at the bank board. As you think to the future about evolution of your board, think about evolving toward a more strategic and likely smaller holding company board.

BANK ACQUISITIONS

We have had the opportunity over the last 30 plus years to assist multiple community banks in acquiring other banks. We enjoy the buy-side financial advisory and legal work. It is always interesting and gives us a feeling we are significantly helping our community bank clients.

When a client comes to us on the buy side, indicates it may want to buy a bank, and asks if we would help evaluate it, we of course do. One of our questions is often, "What makes you think that bank is an attractive addition to your franchise?" Although it is a challenge and a bit provocative, we really believe part of the buy side advisory services we provide is to challenge the assumptions that are made. Often, bias can creep into acquisitions where either the board or management is pushing for an acquisition, for whatever reason, and it is often beneficial to have a cold look from the outside as to whether the proposed acquisition not only makes financial sense but also makes cultural, geographic, and franchise sense. Buy side advisory and legal work is much more than just running the numbers and preparing the documents. There has to be an understanding of the industry, the market, and why a particular acquisition may or may not make sense.

TRANSACTION APPLICATION PROCESSING

Over the past couple months, there have been a number of different times where the regulatory review process for bank mergers and acquisitions has been called into question. The general concern seems to be that the bank regulators are not closely scrutinizing regulatory applications. Some are painting the picture that the bank regulatory agencies simply rubber stamp an approval for any merger application that may be submitted. As we have previously discussed in *Musings*, that is not a correct assessment, in part because the regulatory agencies never turn down applications but instead request they be withdrawn.

If you have the belief that the bank regulatory agencies simply rubber stamp any application that comes their way, please let us set the record straight. Over the past six or so months, we have seen a marked increase in the amount of regulatory scrutiny given to merger applications. We have recently had a number of different circumstances where the regulators have asked for additional and detailed information on items that, frankly, in the past have been check-the-box type items. We believe what is really happening is that we are now seeing the change in administration and change in tone at the top work its way into the actual application process.

Do not let our comments alarm you too much. It is not that your holding company cannot get regulatory approval for a transaction today. That is not the case at all. However, the approvals from the friendly federal regulators do not seem to come as easy as they used to. It seems that in today's environment we are getting more scrutiny over items that in the past did not receive the same level of scrutiny.

MANAGEMENT SUCCESSION PLANNING

We have had the opportunity over the past couple weeks to spend some time on-site at a very profitable and well-functioning community bank. Our time at the bank was, in part, due to a requirement in the bank's recent report of examination that the bank engage a qualified third party to conduct a management and organizational study. We were engaged to complete the study, part of which is completing on-site interviews with the bank's directors and executive officers.

Prior to our on-site meetings, we were skeptical of the regulatory wisdom in requiring this study. As noted, the bank is a very well-run and profitable community bank. As we spent time during the on-site interviews, it became clear to us that really the organization did not need a management and organizational study. Instead, they needed a management succession plan.

This particular community bank has two officers that have been with the bank for a very long time. As you might suspect, these two individuals are nearing retirement age. By no means do they have a foot in the grave. Still, they are within five or so years of looking towards a management transition. As we worked through the process, it became apparent to us that a specific and well-defined plan for the bank was needed past the retirement of these two individuals. We basically worked with them to craft a plan to ensure the bank continued to achieve success without having the benefit of the day-to-day involvement of these two individuals.

The story here is not uncommon. As we have said many times, management succession planning is one of the most critical and difficult parts of ensuring long-term success for a community bank. Although in this instance the regulators may have not formally named the management and organization study a management succession plan, that is really what they were looking for. We think that there was some validity to their thought, as the process has revealed the opportunity to improve the bank in this specific area.

MANDATORY RETIREMENT

We have often weighed in in *Musings* about our thoughts on mandatory retirement. In the perfect world (where none of us live), we believe mandatory retirement should not be necessary. The problem, of course, with mandatory retirement is the bank may be getting rid of an older group of directors who function well, are active in their trade or business, and have great historical knowledge and wisdom in the bank while at the same time "locking into place" some of the younger directors who may not be worth keeping. Yes, we understand that most boards will either nominate for three year terms or nominate for one year terms, which provides some kind of an evaluation process. But does it really? For the most part, once you are on a community bank board, you are on for life, until mandatory retirement hits, or until the Chairperson or some other senior person tells you it is time to get off.

We really believe that the best approach is not mandatory retirement but having a strong Chairperson or Lead Director who can evaluate the performance of directors, communicate directly with them, remediate any problems, and, if there is a big problem, remove it. We have often seen in our community banks that older directors moving off the board due to mandatory retirement seem to be bunched up in groups so that the bank may lose three or four at a time, which is probably not healthy either. The other issue we also see often is that when somebody who the board really wants to keep on approaches mandatory retirement, they simply make an exception. If you are going to do all that, why don't you just do it the right way? Have a strong Chairperson or Lead Director deal with board retirement issues. Just food for thought for the future.

BANKING IN THE METAVERSE

If you are not familiar, the metaverse is an alternate reality world created by Meta (f/k/a Facebook). According to Meta founder Mark Zuckerberg, the metaverse is the future of life as we know it, where all activities will happen in a virtual reality world. In the metaverse, individuals have unique avatars and the ability to move around the metaverse and interact with other avatars at various different points of virtual reality. For example, one of the first metaverse events was a rave at a virtual nightclub.

To many community bankers, the idea of banking in the metaverse seems closer to laughable than it does reality. However, we are not quite so certain that is the case. If you have been paying attention, you will know that over the past couple weeks luxury brand Louis Vuitton bought "space" in the metaverse to establish a Louis Vuitton store. The idea is apparently that the avatars will be able to enter into Louis Vuitton's physical space, which will essentially take them into a virtual reality store, and then buy Louis Vuitton's products and services. What is yet to be seen is whether Louis Vuitton will actually ship physical products and services to these customers or whether they are simply buying virtual versions, such that an avatar might be able to have a Louis Vuitton purse or coat. We expect Louis Vuitton will probably do both.

Louis Vuitton's recent move has us thinking about community banking. We have yet to see a community bank that has "purchase digital space in the metaverse for the establishment of a digital branch" as a strategic action item in their strategic action plan. While that may seem too "out there" today, we anticipate we are probably headed there at some point in the future. We do think it likely that in the not too distant future financial services providers will look to establish digital branches within the metaverse, or other alternate reality worlds, and use those as an opportunity to try and further their customer interactions.

While all this may seem heady, keep in mind that only ten or so years ago the idea of pulling a phone out of your pocket and taking a picture of a check to deposit it seemed almost inconceivable.

CONCLUSION

We hope all of you remembered Valentine's Day yesterday. If not, you are probably in deep trouble today. We look forward to seeing many of you in the coming weeks at the various state and national conventions.

Stay safe. Have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Meetings and Webinars:

- February 27-March 3, 2022 – 2022 ICBA LIVE Annual Convention Registration: https://www.icba.org/
    - Bank Director Current Issues Seminar
        - "Gerrish's Musings: What Community Bank Directors Need to Know" (Jeff Gerrish)
        - "The Board's Role in the Current M&A Environment" (Philip Smith)
    - "For Sale? Strategies on Staying Independent" (Philip Smith)
    - "Liquidity Strategies for Illiquid Community Bank Stocks" (Greyson Tuck)

