GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Florida, South Dakota, Texas, Mississippi, Indiana, Wisconsin, and North Dakota!

HOT BUTTONS

There are a number of hot buttons in banking, many of which are relevant in community banking as well. A couple of these fit in the category of diversity, equity, and inclusion (DEI) and environmental, social, and governance (ESG) issues. The large banks are paying serious attention to both of these issues. We often get asked by community bank boards of directors, particularly as part of a planning session, whether community banks need to address these issues as well. Our general recommendation to the board of directors is that the community bank board not ignore these issues, yet the board must understand that of all their constituents, their primary constituent remains the shareholders. If the bank's shareholders are not happy and there is no bank charter, then there is no mechanism to move forward on DEI or ESG issues. As such, the primary goal of every community bank has to be to enhance shareholder value and thereby keep the bank independent so that it can deal with DEI, ESG, and other issues, including being a good corporate citizen, the employer of choice, and the economic engine in the community. Don't forget your shareholders. If they are not happy, you may not have a community bank with which to do those other things.

ORGANIZATIONAL STUDIES

Over the last several months, we have conducted multiple organizational/management studies for community banks in various parts of the country. The studies have been prompted by various factors, including significant organizational growth, crossing certain relevant thresholds ($500 million, $1 billion, $3 billion), and other issues. The interesting thing about these organizational structure/management structure studies is that although there is some commonality, each organization is unique, primarily based on skillsets and personalities of the senior management and board of directors group. We were assisting one community banking organization with an organizational/management study and took specific note of one manager. Although she was forward-thinking, she couldn't get her ideas adopted by the rest of the management team or board of directors. This was primarily due to her style, which was an aggressive, take-no-prisoners approach. She finally acknowledged as part of the interview process that although she had very good ideas, the fact she couldn't get any of them adopted was not a productive end result. She recognized she needed to change her style to be one much more of a collaborative nature - much more patient, more of a nudge than a push. We did not disagree with her assessment and believe that that change in her leadership style will bode well for both her and the organization.

Think about whether an organizational/management study might be helpful for your organization. This can include the Board of Directors as part of the study/interview process or not. Think about whether you need to do it before the regulators push you toward it.

CORPORATE DOCUMENTS

We have had numerous contacts in the last couple of months from various community banks and their holding companies curious as to whether they can take certain actions such as removal of directors, officers, and the like. The general answer at the bank level is that since the holding company owns 100% of the bank stock, the holding company can take pretty much any action it needs to at the bank level. It can also take that action fairly quickly. Action at the holding company level is likely different. The holding company is governed by state law of its state of incorporation, its Articles of Incorporation, and its Bylaws. The authority to do anything with respect to the holding company and its directors or officers is subject to those three sources. As we have mentioned in *Musings* previously, it makes sense for the holding company board to have its corporate documents reviewed prior to the time they need to do anything "drastic." In other words, review it before you need it.

REGULATION, REGULATION, REGULATION

As we have noted previously in *Musings*, particularly with many "new Sheriffs in town" at a number of the federal agencies, that the regulators are flexing their muscles. This is evidencing itself in not only some of the consumer compliance issues, particularly involving purported discrimination such as equal credit, fair lending, and the like, but also in Regulation O. We had not seen the regulators pay much attention to Regulation O until the last few months. Those of you directors who are not familiar with Reg. O, should be. This is the Bert Lance regulation (late 1970's) providing restrictions on loans from the bank to bank insiders. The regulation itself is pretty complicated and detailed. Of course, one issue is whether the director or officer is considered an executive officer under Regulation O. Another consideration is does the extension of credit constitute an "extension of credit" under Regulation O.

The problem with Regulation O is that a violation can be the basis for civil money penalties against the individual and the bank, and in this environment, likely will. Keep in mind with respect to Reg. O, just like any other statute and regulation, strict adherence needs to be provided. That means, among other things, that the director who is the subject of the Reg. O loan actually leaves the room, not just "wink, wink" leaves the room. Be careful; it is getting tougher out there.

AUDIT COMMITTEE INDEPENDENCE

As most community banks understand, the purpose of the Audit Committee is to have a committee consisting of a majority of independent outside directors review financial matters for the bank. When the community bank is under $500 million in total assets, an Audit Committee consisting of a majority of independent outside directors is a "best practice." When the community bank exceeds $500 million in total assets, it becomes a mandated practice pursuant to regulations of our friendly federal regulators. The regulations basically provide that a majority of the Audit Committee must consist of independent outside directors.

We have recently had a number of clients bring situations to us asking us to determine whether the outside director to be placed on the Audit Committee would be considered independent. Some of them have involved an issue where the outside director has been a former employee of the bank. Some involve a situation where the director has served as an Executive Chairman but not an employee (but otherwise pretty active in the bank). Each of these needs to be determined on a case-by-case basis. Unfortunately, there is not a lot of clarity coming out of the regulators on this. It is generally one of those situations where the bank makes its decision and the regulators come in and either accept it or criticize it. If you have any questions on this independence issue, please let us know. It appears to be another emerging regulatory hot button.

SUBORDINATED DEBENTURES

As most *Musings* readers know, there have been many community bank holding companies that have either recently issued subordinated debentures or are giving consideration to this potential strategic transaction. If you are not familiar, subordinated debentures are today's version of trust preferred securities. They are essentially unsecured 10-year interest-only notes. The interest rate is fixed for the first five years and then floats for the second five years. They require a bullet payment at maturity.

Why is it that the issuance of subordinated debt is so prevalent in today's environment? There are two primary drivers. The first driver is the need for additional capital. Many boards are thinking that additional capital is appropriate, for a myriad of different reasons. For some, this is to increase capital levels after expected asset growth. For others, it is to repurchase stock or engage in a strategic transaction. For others, it is merely viewed as an insurance policy for the unknown future (which Putin's actions last week are not helping!). The second driver for subordinated debt is that it is a cheap form of capital. Most of these subordinated debentures are being issued with interest rates between 3.75% and 4.5%. For 10-year interest-only money, that is a pretty good rate.

We have recently assisted a number of community bank holding companies in "running the numbers" (as well as doing the legal work) on various strategic transactions that include the issuance of subordinated debentures. If you are thinking about a strategic transaction or are just looking for additional capital, this may be a great opportunity. Please let us know if you would like our assistance in "running the numbers" and evaluating the opportunity. We would be happy to help.

ANTI-COMPETITIVE CONCERNS

We received a call earlier this week from a client that had been approached by an investment banker wanting to discuss a "strategic merger of equals." This investment banker contacted the president of the bank and wanted to discuss a potential combination of two banks that are direct competitors in the same market. As our client put it to us, the two banks are literally in each other's backyards.

The investment banker apparently pitched the opportunity as a strategic merger of equals that would allow the banks to enjoy significant cost savings and synergies. What the investment banker forgot to consider are the anti-competitive issues.

When our client called us and described to us what was going on, our immediate concern was whether this transaction would be deemed to be anti-competitive. If you are not familiar, the Department of Justice looks at every bank merger transaction and makes a determination as to whether the transaction may be deemed anti-competitive. This is done utilizing what is referred to as an HHI analysis. It is a mathematical equation where the market share for all of the market participants is squared and added together on both a pre-merger and post-merger basis. The golden rule of the HHI analysis is known as the "1,800/200 rule." If a market has a concentration of more than 1,800 and an increase in HHI of more than 200 as a result of a transaction, it is deemed to be anti-competitive. If a transaction is deemed to be anti-competitive, it is possible to make arguments such as redefining the market area, including non-bank competitors, and the like, such that the transaction should not be deemed anti-competitive. As mentioned in last *Musings*, the regulatory scrutiny over bank mergers has increased as of late, so we see this as particularly tough in today's environment.

We ran an HHI analysis on this transaction and had to break the news to our client that we thought they were going to have an uphill battle from the start. As we told our client, we never look to kill a deal in its infancy. However, our responsibility is to understand the issues and provide practical advice. In this situation, the post-merger HHI was well in excess of the "1,800/200 rule." We told our client that they could move forward with the transaction, but that they would have a significant hurdle to cross in terms of the anti-competitive issues.

If you are thinking about a merger or acquisition opportunity, make sure to keep the anti-competitive issues in mind early in the consideration of the transaction. The HHI analysis is important, particularly in today's regulatory environment. Given the rhetoric, we do not anticipate the Department of Justice will be liberal in granting exceptions to transactions that the HHI analysis deemed to be anti-competitive.

PROXY STATEMENTS

We are currently representing several different community bank holding companies that are acquiring another community bank holding company. In each, we have completed the Agreement and Plan of Merger and have submitted the various regulatory applications. The target holding company is in the process of drafting the materials for the special meeting of shareholders where the target shareholders will vote to approve the transaction. As is our typical practice when we represent a buyer, the target's counsel provided those documents to us in order to allow us to review and comment on the materials.

In this circumstance, one of the questions we are often asked by our clients is what exactly is required to be disclosed in a proxy statement. What is interesting is that there is no specific list of items we can point to that lists all the items that must be disclosed. Instead, the requirement is that the target shareholders be provided all relevant information to make a fully informed investment decision as to the transaction. This typically includes a myriad of different disclosures related to the transaction, consideration, background and history, related party interests, and the like.

We have been through some transactions where counsel for the acquiror does not view it as important to review the target bank's proxy materials. That is not the position we take. We think it is important because there is risk associated with the disclosures. Once the target bank is merged with and into the acquiror, the acquiror takes the target bank "warts and all." If there was ever an issue related to the target's disclosures, the acquiror would have responsibility for those issues after closing. Due to inheriting this liability, we see it as very important that we, as the acquiror's counsel, have the opportunity to review and comment upon the target's proxy materials.

NET INTEREST MARGIN

We read with interest a recent article in the *American Banker* regarding the anticipated net interest margin for banks over the next couple years. The general wisdom is that the Federal Reserve is going to hike interest rates in order to try and curb inflation. Typically, when interest rates go up, loan rates and deposit rates both move up, although loan rates typically move up a little quicker than do deposit rates. This article, citing the fact that most banks are "awash in deposits," indicates the expectation that deposit rates will not likely follow loan rates. Instead, deposit rates will likely remain where they are, or may slightly increase, but will not increase in the manner consistent with loan rates.

Why is it that some believe the treatment of loan and deposit interest rates over the next couple of years will break from the industry traditions? It is simply an issue of supply and demand. For the past two years, banks have had a tremendous amount of excess liquidity. Deposit growth has far outpaced loan growth for the vast majority of institutions. The reality is that deposits are akin to a product in the retail industry. A retailer's product only provides a profit if it can be sold. A bank's deposits only provide net income if they can be lent or invested at a rate that materially exceeds their cost.

Most community banks would never say this, but most community banks would be happy for a number of their deposits to walk out the door. This would reduce the excess liquidity and even further improve a bank's net interest margin. Due to this excess liquidity, when loan rates rise, this *American Banker* article reflected a belief that deposit rates will not follow. We generally agree with this view. We think that many banks are going to see an increase in their net interest margin because they are going to keep deposit rates low. There simply is no current incentive to fight and try and keep deposits.

CONCLUSION

The end of February is here. We are now heading toward the end of the first quarter of 2022. For many of you, this issue of *Musings* will hit your inbox while you are attending the ICBA Convention. Please come and visit with us personally if you are able. We would very much enjoy it.

Stay safe and have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Presentations

- February 28, 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) (8:10-9:10 a.m.)
        - “The Board’s Role in the Current M&A Environment” (Philip Smith) (1:35-2:25 p.m.)
    - Learning Labs
        - March 1, 2022 – “Liquidity Strategies for Illiquid Community Bank Stocks” (Greyson Tuck) (7:00-7:50 a.m.)
        - March 1, 2022 - “For Sale? Strategies on Staying Independent” (Philip Smith) (8:00-8:50 a.m.)
- March 1-2, 2022 – Mississippi Department of Banking and Consumer Finance, 2022 Bank CEO Summit (Greyson Tuck, presenter) Registration: Summary - 2022 DBCF Bank CEO Summit (cvent.com)
- March 16, 2022 – Graduate School of Banking-Wisconsin Webinar; “Independence and Community Bank M&A: What You Need to Know” (Philip K. Smith, Presenter) Registration: Independence and Community Bank M&A: What You Need To Know