GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Georgia, South Carolina, Wisconsin, Minnesota, Utah, Nevada, and Texas!

LOANS, LOANS, LOANS

With the increase in balance sheet liquidity resulting from a variety of sources during the pandemic, most community banks are looking to grow the loan portfolio. When the pandemic began, we generally referenced this balance sheet inflation as "artificial." We put that term in the dust bin along with "transitory inflation" (as used by the Fed) and some others. Virtually all the community banks we have worked with over the last couple of years are looking for ways to deploy the cash generated by the deposits into earning assets. Most community banks have put about as much as they feel comfortable in the investment portfolio and are now pursuing a strategy of reallocating assets from cash and securities into loans. At least that is the hope.

Boards of directors of community banks need to understand that loan portfolio growth may mean a couple of different things. The big benefit of a reallocation of assets strategy is that the community bank is not growing its balance sheet, so no additional capital is required. It is simply shifting assets from cash and securities into loans (typically). When establishing a strategy of growing the loan portfolio, however, the board needs to decide whether its goal is to grow the loan portfolio through the normal mechanisms utilized by community banks (i.e., relationship banking) or simply to add loans to the portfolio. Adding loans to the portfolio would generally mean depending on another source to generate the loans, not establishing a relationship with a borrower, and simply booking the credits on the bank's books. The long-term, traditional way of doing this is through purchasing participations from other banks. There, typically, at least for community banks, the bank would have a "relationship" with the originating banks such that it trusts it and believes in its underwriting (even though it is purportedly doing its own underwriting). In the current day and time, however, growing the loan portfolio can simply involve having an independent third party generate assets for the bank. This could be a fintech or something that looks like one. This is much more akin to "purchasing assets" (loans, in this case) than it is relationship banking. It is one hundred percent transactional. So, if the bank partners with a fintech or something that looks like a fintech that generates a bunch of loans, the fintech puts them to the bank, which actually extends the credit and either keeps the loans on its books or bundles them up and sells them off in packages. This constitutes growing a loan portfolio, but is it really growing the franchise value of the bank?

We are not at all against purchasing assets. In fact, we have been with a number of banks lately who have discussed purchasing assets. Some of the loan assets they would purchase would be at a much lower rate but also at a significantly lower risk factor than loans they would organically generate and keep on their own books. There are a lot of places to purchase assets and a lot of partners to contemplate when considering purchasing assets as a way to grow the loan portfolio.

Our only suggestion to community banks around the country is to really think about what it is you are trying to do. If you are trying to grow your franchise through establishing relationships with borrowers no matter the geography, then simply purchasing assets with no relationship with the underlining borrower will not do that. If you are simply interested in deploying some of that excess liquidity on what may be a shorter term basis, then that is certainly a viable strategy if that is what the board determines is appropriate. We just want to make sure the board understands the difference.

FUTURE OF MORTGAGE GROWTH

With the Federal Reserve set to raise interest rates (at any moment), the general consensus of our community bank clients around the country, most of whom are heavily involved in the residential mortgage business, is that that business will begin to taper off. Obviously, refinances will likely go away as the rates rise, yet it is anticipated that new home originations will remain strong. Mortgage is one of the more cyclical parts of a community bank's business. The question generally, from a strategic standpoint, is when the rates go up and the business turns down, do you dismantle the mortgage department or do you figure some way to keep it going so that when the rates go back down or mortgage picks up you will have the infrastructure present? We have been with community banks that handle that in different ways. For the community banks whose fixed overhead in the mortgage area is relatively low (i.e., all their originators are on some type of commission-based structure), then continuing to maintain that low fixed overhead and hoping they can keep their people makes sense. For those who have a high fixed overhead, then adjustments will likely need to be made. The time to be thinking about that is now in order to plan ahead with respect to the downturn in the mortgage business, no matter how temporary or long-term it may be.

BANK ACQUISITIONS

It seems like every time we have a planning session one of the topics for discussion is geographic expansion and whether the community bank should be proactive with respect to identifying a bank to acquire. We have been with a number of banks lately who have decided they do want to be proactive and have identified three or four potential community banks. We recall several situations where those community banks were in rural, dying communities. Our question to those community banks who established the proactive strategy is why would the bank want to acquire another location in that community? How would this look for you and your franchise 10 or 20 years from now? Does it add franchise value, or are we just doing an acquisition to do an acquisition? Several of the community bank boards with a proactive strategy decided to move forward even after considering those questions. Several pulled back and decided to develop their existing franchise and existing locations. The interesting thing is, notwithstanding that the location may not be attractive for their bank, it may, for whatever reason, be attractive to somebody else. Each bank and board of directors has its own internal thought processes. This is not dissimilar to a large bank selling off branches in some of these smaller towns. Those branches are no longer attractive to those large banks for whatever reason, but they may be significantly attractive in enhancing value for some of the smaller community banks. Each bank has a different approach and will come up likely with a different result.

POTENTIAL BRANCH CLOSURES

We recently facilitated a strategic planning session for a community bank that has a number of different branch locations. In our preparation for the planning session, we developed the opinion that it was likely the bank was "branch heavy." In other words, we thought it likely they had too many branches given the size of the bank and that some or all of the branches were likely not profitable.

During the planning session, we got to the point of discussing the bank's geographic footprint. We addressed the issue from both a potential expansion and potential contraction point of view. When discussing contraction, it became readily apparent that the bank is losing a pretty good amount of money each year by operating a number of the bank's branches. This was particularly notable considering much of the planning session was dedicated to ways to improve overall bank profitability.

During the planning session, our encouragement to the board was to identify the actual dollar figure that these branches were collectively losing on an annual basis. We see that as important for two reasons. First, it moves the decision of potential branch closures more from a concept to an actual decision. Second, it causes the board to address head-on the losses associated with the operation of these branches and makes real the decision of whether the benefits of keeping the branches open justifies the related expense.

In our experience, this is not an unusual situation for many community banks. We have seen a number of different times where bank boards decide to continue to maintain branches notwithstanding the fact that the branch is causing a net drain on earnings. We do not generally take exception to this strategy, provided the board hits the issues head-on and determines that the net drain on earnings is justified based on the benefits of maintaining the branches.

CORPORATE DOCUMENTS

We seem to be getting a lot of emails and calls lately from community bankers who have finally realized that their corporate documents are likely out-of-date. As we always say, you don't need to pay attention to those corporate documents until you need to. At the point you need to, it is probably too late. Particularly with proxy season coming upon us and disgruntled shareholders apparently rearing their unattractive heads, it is imperative that the corporate documents be appropriately structured. As noted in prior *Musings*, bank corporate documents are generally easy to change. They need to be reviewed and revised, but the revision is easy to do because, for most community banks, the holding company holds 100% of the bank stock. Revision to the bank corporate documents can therefore be done without any kind of formal meeting, typically by unanimous consent of the holding company as shareholder. The holding company documents are the real governing documents for the organization and the ones that are more difficult to address. If you have not reviewed your holding company documents in some period of time, please do so with the idea that eventually the board may need to utilize them for something out of the ordinary, such as removal of a director, the acquisition of another bank, the issuance of a large amount of stock, or something else. You need to make sure those documents are appropriate ahead of time to handle those unusual situations.

DISGRUNTLED SHAREHOLDERS

As we have often noted, proxy season is upon us. Proxy season seems to bring disgruntled shareholders out of the woodwork. They generally start their quest for stirring the pot by simply requesting a copy of the shareholders list. We have had a number of those in the last few weeks. The general rule is that the Articles and Bylaws of the holding company and state law govern the shareholders' right to corporate documents. Typically, the request starts with a request for the names and addresses, as well as ownership percentages, of the existing shareholders. For the most part, that is going to be governed by state law. In our experience, most state laws follow the Delaware corporate code, which generally provides that a shareholder can inspect a copy of the shareholders list as long as they jump through a few hoops, such as requesting the information in writing, providing the holding company a certain number of days' notice, and having a "proper purpose" for their request, which they explain in connection with the request.

The usual discussion with a disgruntled shareholder is whether they have a "proper purpose" for their request for the information. If the holding company decides to contest a shareholder's request for the shareholders list, then it generally takes the position the shareholder's request does not reflect a proper purpose. There is a fair amount of litigation over this, most of which has been resolved in favor of the shareholder, but not all. It is, however, at least a short-term delaying tactic while the board determines what to do.

Keep in mind that many requests by shareholders for a list of other shareholders are "fairly benign," but you simply never know.

LIBOR "TOUGH LEGACY" CONTRACTS

President Biden recently signed into law a $1.5 trillion dollar government funding omnibus. As you might imagine, the law's provisions are expansive. However, there is one provision we believe is particularly notable for many community bankers. This is a provision that deals with "tough legacy" contracts that have interest rates based on LIBOR.

If you are not familiar, LIBOR refers to the London Interbank Offered Rate. A number of years ago, this rate was found to have been the subject of certain criminal activity and is now being phased out. "Tough legacy" contracts are contracts that have LIBOR as a referenced interest rate but no fallback language for another interest rate should LIBOR be terminated.

Many community bank holding companies have previously issued trust preferred securities. The interest rate on trust preferred securities is generally LIBOR plus some stated interest spread. While the provisions for "tough legacy" contracts certainly help, there still is not a whole lot of clarity on what is going to happen as it relates to the interest rate for trust preferred securities.

Most trust preferred securities have a provision that tied interest rate to LIBOR. Most also had language that pointed to the creation of an alternative referenced rate in the event LIBOR was terminated. Most also had a second clawback provision that essentially said that if there is no alternative rate, the last LIBOR used will control for the life of the contract going forward. This would essentially turn trust preferreds from a floating rate into a fixed rate instrument.

We don't know exactly how all of this will shake out. However, it is coming to a head pretty quickly. We think the provision in the omnibus act as it relates to "tough legacy" contracts will help. The real uncertainty at this point is whether a bank holding company's trust preferred securities constitute a tough legacy contract.

THE POTENTIAL PRIVATE PLACEMENT

We recently received a call from a client that is considering a capital raising transaction. This particular board is thinking about raising $3-$4 million. In discussing the issue, what is notable is that the bank's capital isn't necessarily stretched thin. The bank's capital ratios are not as high as they used to be, primarily due to COVID-related asset growth. However, they are not to a point we think the bank is in danger of regulatory criticism.

In talking through the issues, it became clear that the holding company was not thinking about raising additional capital solely for the purpose of supplementing bank capital ratios. Instead, the primary concern was more about protecting against recent increases in concentration of ownership. There had been several transactions that had occurred over the past couple of years that had resulted in higher concentrations of ownership. Because of these transactions, the board was considering selling additional shares to level out those concentrations.

Our advice to the board was that this strategy was okay, as long as it did not unnecessarily harm the existing shareholders. In other words, we do not have an issue with the board selling additional shares provided they have a strategy to utilize the capital to the benefit of the shareholders. We suggested to the board that satisfying its fiduciary duty involved not moving forward with the transaction to increase capital without a corresponding capital allocation strategy which would result in an increase in net income.

KSOP EMERGING LIABILITY

We have worked with a number of community banks over the last several months that are dealing with the emerging liability from the KSOP or ESOP. If you are not familiar with the emerging liability issues, it simply involves the ESOP or KSOP, which holds stock of the holding company for the benefit of the employees, being required to redeem that stock when the employee retires. When the employee retires, in most cases, they can put that stock back to the ESOP (or holding company) to have it repurchased so they can get cash for their retirement or cash to roll into another qualified plan which they will then withdraw during retirement. Each mature KSOP should have an emerging liability study. We have done a number of these studies. Some of them are eye-opening as to the actual emerging liability of that KSOP, with the main question of how it is going to be funded - either through the KSOP itself or through the holding company redeeming shares. There are various alternative funding mechanisms that can be utilized with a KSOP emerging liability that involves something other than simply selling the bank to the highest bidder and paying out the KSOP participants in that fashion. If you would like any further information on the emerging liability issues for KSOPs, please let us know.

CONCLUSION

Notwithstanding the fact it is mid-March, we are continuing to see some "crazy" weather as we travel around the country. We are seeing some general warming trends, particularly in the southern part of the country, but we are also seeing some weather aberrations in other areas that make travel interesting, to say the least. We look forward to seeing many of you in the coming weeks.

Stay safe. Have a good two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Presentations

- 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

- March 29-April 1, 2022 –ICBA Credit Analyst Institute (Virtual); March 30th: "Legal Issues and Regulatory and Compliance Matters" (Cliston V. "Doc" Bodine, III, Presenter) Registration: Credit Analyst Institute

