GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from North Dakota, Minnesota, California, Washington, Arizona, Nevada, Colorado, Wisconsin, and Illinois!

THE TOUGH DECISION

We were recently with a smaller, family-owned community bank. This bank had been in existence (and in the family) for a long period of time. Several of the family members worked in the bank. The strategic question we were brought in to discuss with the family and the board was whether or not now was the time to sell the bank. We began the discussion indicating our viewpoint in favor of independent community banks and our belief that there is a good future for community banks. We also indicated that particularly with many family-owned organizations that are in their second and third generations, perspectives change and it may be time to sell the family business—in this case, the bank. The principal owner of this community bank holding company was a gentleman in his late sixties who indicated he probably wanted to work another five to 10 years. For that reason, he was against trying to find a buyer for the bank. We told him if that was his only concern, that as part of the negotiation of the transaction, we could attempt to negotiate with the potential buyer some type of a long-term or evergreen employment contract. We did inform him that those are not allowed in every state, but based on our brief research, we believed that in this particular state they would be allowed. While that did not necessarily turn his head, it did give him a possibility to consider. A sale would at least allow all the family members to receive their money, pay their capital gains tax, and move on. He would keep his employment, stay occupied, and continue to run the bank. This would be even more true if the holding company and bank were acquired by a group that was only looking for a charter. This is typically a fintech type operation, mortgage company, or some other entity that wants to keep the community bank in place and simply expand it, usually to a different geography with additional technology.

WILLINGNESS TO CHANGE

We often find ourselves consulting with and advising boards on strategic matters. We facilitate dozens upon dozens of planning sessions every year for community banks. We were recently in a session for a bank that had several legacy senior employees. That is a nice way to say that several of them had been there for a long, long time—possibly too long.

Every strategic issue that came up was met with either "we do it this way because that is the way we have always done it", or "we are not going to change the strategy because what we have done historically has been successful". Although it is difficult to argue with historical success, at some point, especially when the environment is changing dramatically, as it is today, there is an argument to make that change is necessary. This is the first time in many young bankers' lives that they have ever been in a rising rate environment. Also, most of them have never seen asset quality problems or an economic downturn of any magnitude. Add onto that the fintech incursion/partnership options and the high degree of technology adoption occurring as a result of the pandemic, and the environment certainly has changed fairly dramatically. For any bank to take the position that strategically we are not going to make any changes because "that is the way we have always done it, and it has been successful" is fairly short-sighted in our opinion. Keep an open mind to change. Sometimes suggested changes will work out great for your organization. Sometimes suggested changes are simply misguided. It is the board and senior management's job to sort that out.

ATTRACTING AND RETAINING KEY EMPLOYEES

As we travel the country dealing with boards and senior management on strategic and legal issues, we acknowledge that one of the most significant issues currently facing community banks is the ability to retain existing and attract new personnel, particularly in the lending area. As all community bankers are aware, there is a limited pool of qualified lenders. That, coupled with a high demand for qualified lenders, makes for high compensation and benefits. We generally recommend on the attracting and retaining piece that the bank pay fair cash compensation, a bonus structure that is not totally discretionary, and equity in the company, or at least something that looks like equity. Couple all that with some vesting schedules and possibly a deferred compensation plan supported by bank-owned life insurance that provides appropriate forfeitures if the employee leaves prior to retirement, and your community bank will have some fairly significant tools to attract and retain key personnel. If any *Musings* readers would like any additional information on some of these possible tools, please let us know.

YOUNGER EMPLOYEE RECRUITMENT

Attracting and retaining younger employees is one of the major issues that many community banks are facing today. Over the past year or so, we have had a number of different discussions with board and management teams about the difficulties in attracting and retaining young talent. During these conversations, the community bank management typically groans about the wants and perceived entitlements of younger employees. The general characterization is that they do not want to come to work in a physical office, do not want to follow a set schedule, do not want to stay with the company long term, and similar complaints. When talking through this issue, we often ask the community bankers whether they are fighting the tide on these issues or are looking to change their employment practices to fit what it is these younger employees may want. The answer is almost universally that community banks are fighting the tide in this regard. Most community banks are not interested in making significant changes to structure a workplace that promotes remote working, flexible schedules, and the other things younger employees are purported to want.

Our typical comment in seeing this situation is that community banks do not necessarily have to completely change their employment practices at this point. With that said, we do see it important that community banks at least recognize the dichotomy of the situation. The perceived wants and needs of younger workers and the willingness of community banks to adopt their practices to match those wants and needs do not line up. Our recommendation is that community banks begin contemplating how to close the gap between those two.

REVENUE DIVERSIFICATION

As noted above, our firm facilitates numerous strategic planning sessions each year. One of the major topics of discussion in the strategic planning sessions is revenue generation. Of course, the whole idea is to increase revenues to increase net income. In discussing this issue, one of the topics that always comes up is that of revenue diversification. In other words, the discussion always involves opportunities to engage in alternative lines of business to increase non-interest income. The options for alternative lines of business are extensive, but the usual suspects include securities brokerage, trust, wealth management, and insurance. The regulations essentially allow a bank or bank holding company to engage in any activity that is "closely related to banking."

Materially increasing non-interest income through these alternative lines of business is possible, but it is not easy. One alternative is to engage in the business de novo. That is building the line of business from the ground up. The other alternative is to purchase an existing business. The de novo route requires less capital outlay at the beginning but extends the time in which it takes to see any material level of return. The acquisition route typically requires a larger initial outlay but typically provides more accelerated returns. We do not see one as completely preferable over the other. It really is a matter of circumstances, primarily the existence of any excess capital and the availability of acquisition targets.

If you are thinking about engaging in an alternative line of business, keep these issues in mind. There are a couple different ways that you can get into the business. It is really just about evaluating the alternatives and determining which one makes sense.

INTEREST IN ACQUISITIONS

Over the past couple weeks, we have begun a confidential marketing process for a community bank that has decided to pursue a potential sale. We are utilizing an appropriate marketing process, which involves calling a number of potential acquirers and asking them whether they have interest in evaluating a potential acquisition opportunity. The list of potential acquirers is based on a number of factors, such as size, profitability, geographic location, and the like. If an acquirer indicates they do have an interest in looking at the transaction and agrees to execute a required Confidentiality Agreement, they are provided a Confidential Information Memorandum that fully discloses the specifics related to the opportunity.

Based on what we have seen over the last couple weeks, we can say that there continues to be a strong interest by community banks in evaluating acquisition opportunities. In our particular circumstances, the vast majority of potential acquirers we have contacted have signed the Confidentiality Agreement and received the Confidential Information Memorandum. Of course, only one of these potential acquirers will ultimately be the buyer in the transaction. Nonetheless, this process has confirmed that there are still a number of community banks that have a strong interest in acquisitions.

MANAGEMENT TRANSITIONS

Transitioning from a long-time president and CEO to a new president and CEO is a corporate event that many community banks have either recently experienced or are preparing to experience over the next couple years. One of the issues that always comes up in these corporate transitions is the role the retiring president and CEO should play in the organization after retirement. In some circumstances, the individual completely leaves the organization. In others, he or she continue in some capacity, such as the chairman or director. In some circumstances, we have even seen where the retiring CEO retains some title at the bank and has some sort of ongoing employment, such as a business development officer.

It is not uncommon that we get asked what is the appropriate way to handle this transition. In our view, the answer is that there is no right answer. It depends on the facts, circumstances, and personalities involved. In some circumstances, it is best for the retired president and CEO to completely leave the organization. In others, the individual remaining on the board and continuing to play a role works great. We do believe the most important aspect of this transition is communication and appropriately setting expectations. Above all, we see it necessary to ensure the bank employees have no misgivings about who it is that is in charge. We believe a best practice in this area is to make clear to the employee base that the retired individual is retired and is no longer in charge of the day-to-day operations of the organization. It needs to be made clear there is a new sheriff in town and that the new president and CEO is at the top of the corporate leadership hierarchy.

RISING RATE ENVIRONMENT

A recent article regarding rising interest rates in the daily *American Banker* this week involves a full page of stating the obvious—as rates rise, the value of bond portfolios fall. For community banks who are holding bonds to maturity, it really does not make any significant difference since they will eventually collect the full amount of the bonds. Those holding those bonds as "available for sale" will, of course, take some hits to equity, but this will not impact tier 1 capital under the current regulations. For a community bank that wants to stay independent, while the impairment of the bond portfolio will not look pretty, we do not think it will be a significant adverse event.

CORPORATE DOCUMENTS

As we have spent a lot of electronic ink on in *Musings*, spring, with the annual holding company meetings and/or bank meetings, seems to bring out what in the bigger banks would be called the "corporate gadflies." These are shareholders who are either disgruntled or think they should be more involved in the process. It has also caused a lot of banks and holding companies to again revisit their holding company's Articles of Incorporation and their bank's Charter and Bylaws. We are currently undertaking several assignments to review and update those documents. The goal is to not only bring them current as it relates to indemnification, holding virtual annual meetings and things like that, but also to eliminate either redundant provisions or provisions that no longer make sense in the current environment or based on current ownership or strategies. Also, although a lot of the big banks are getting rid of anti-takeover defenses, we are still strong proponents of anti-takeover defenses for the community bank. Although anti-takeover defenses do not stop the bank from being sold, they do put the board in control of the process, as opposed to the potential buyer having any success going directly to the shareholders. If you have not looked at your Articles of Incorporation and Bylaws of your holding company and bank in a long time, it is probably time to do so. Let us know how we can assist.

CONCLUSION

This issue of *Musings*, the way the calendar fell, is being delivered on Good Friday and the first night of Passover. We wish all of you a great holiday weekend. We hope you can all spend quality time with friends and family.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Presentations

- April 24, 2022 – Western Bankers Association 2022 Annual Conference; "Independence? You Must Stay Relevant!" (Philip K. Smith, Presenter) Registration: Western Bankers Association Annual Conference
- May 5, 2022 – Graduate School of Banking-Wisconsin Webinar; "Strategies to Remain Independent in a Consolidating Environment" (Greyson E. Tuck, Presenter) Registration: Strategies to Remain Independent in a Consolidating Environment
- May 12, 2022 – Graduate School of Banking-Wisconsin Webinar; "Financial Analysis of Bank M&A Transactions" (Greyson E. Tuck, Presenter) Registration: Financial Analysis of Bank M&A Transactions
- May 18-20, 2022 – Louisiana Bankers Association 122nd Annual Convention and Exposition; May 18th - "Practical Advice for Community Bank Directors" (Greyson E. Tuck, Presenter) Registration: Louisiana Bankers Association Annual Convention
- May 23-26, 2022 – Abrigo ThinkBIG Conference; May 25th - "Dusting Off the Crystal Ball: Banking in 2042" (Greyson E. Tuck, Presenter) Registration: THINKBIG