GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Missouri, Mississippi, Texas, Illinois, Wisconsin, Minnesota, and Ohio!

THE EXAMINER FROM HELL

Although we would like to say regulatory issues are getting better (i.e., more cooperative, collaborative and the like), that is simply not the case. We thought it might be time to revisit the Examiner from Hell from the last recession to remind *Musings* readers that there are some friendly federal regulators out there that are not actually friendly when it comes to the regulatory process. The Examiner from Hell from the last recession examined a community bank client of ours. The examination did not go well due to asset quality issues (basically due to the economy and the crash in the real estate market) and the examiner proposed to the Regional Office that the bank be given the opportunity to consent to a cease and desist Order. We represented the bank in this regard and negotiated the Order, to which the board ultimately voluntarily consented. Upon the first visitation after the Consent Order was entered and was finalized, the examiner was reviewing the progress with the Consent Order. One of the items in the Consent Order indicated that "Within 10 days after the effective date of this Order the Bank shall do 'X.'" The examiner wrote the bank up for not being in compliance with the Order because the bank did not complete "X" within 10 days after the effective date of the Order. The bank, in fact, had completed "X" 30 days before the Order became effective. In other words, bank management was proactive to get "X" completed before there was any Order. They got written up for a violation of the Order by the Examiner from

Hell. Fortunately, that examiner has probably retired by now and will not be around for the next asset quality softening. This is just a friendly reminder to be careful out there. It's not gotten a whole lot easier.

THE CURRENT M&A ENVIRONMENT

We recently read with interest an article from a daily banking publication regarding the current bank M&A environment. The article reflected a slowdown in the bank M&A environment, as evidenced by a reduction in the number of deal announcements in the month of April (about 10) when compared to the number of deal announcements in April of 2021 (more than 20). The point of the article was that the slowdown is basically attributed to sellers being very bullish on the value of their bank and holding out for higher prices. The article basically said that bank sellers are expecting net interest margins to increase in the rising rate environment, and are not willing to sell because buyers are not willing to pay an increased price for these increased earnings.

Based on what we are seeing around the country, we respectfully disagree that an increase in sellers' pricing expectations is the reason for the slowdown. In our view, we see the reduction in the number of deals as more attributable to the buyer's concern (the buy-side of the transaction) than the seller's unreasonable expectations.

Our experience leads us to believe that community bankers are generally a conservative bunch from a financial perspective. It is no secret that there are a number of different reasons to be conservative in today's environment. While we do recognize that an increase in interest rates generally results in a higher net interest margin, we see a healthy dose of skepticism with respect to other issues that is giving bankers cause for concern. We think those concerns are having a stronger impact on the current number of deal announcements (or lack thereof) than sellers holding out for a higher price.

We do not see that the M&A environment has come to a screeching and complete halt. But, we are seeing a slowdown, and we think the slowdown is attributable to bankers that have a healthy respect for the unknown risk that may be present as a general matter in the economy or specifically in a target bank.

MANDATORY RETIREMENT

We were recently working with a bank that had a mandatory retirement policy which was creating somewhat of a problem for the board. The board instituted mandatory retirement to be effective at a certain age, with the exception that the individual director who was subject to mandatory retirement could remain on the board if a certain percentage of the board of directors approved it. The problem, of course, was that every time a director came up for mandatory retirement, every director would vote to have he or she stay on the board.

The board had a good discussion on this and came up with a good solution – to advance the mandatory retirement age and set it in stone with no exceptions. We believe that is probably the best result in the circumstances.

BOARD FEES FOR INSIDE DIRECTORS

We recently had an interesting discussion with a community banker that is an inside director. If you are not familiar with the lingo, the term inside director is used to identify an individual that is both a member of the board of directors and a bank employee. This is typically an executive officer, such as the President, CEO or CFO.

The discussion related to board fees. The question was essentially whether inside directors are paid board fees. We somewhat laughed at the fact that each of "yes" and "no" are correct answers to the question.

The reality is that community banks are split as it relates to this particular matter. Some community banks pay their inside directors the same as outside directors. Other community banks do not pay inside directors, instead believing that being a director is simply part of employment, and the compensation for employment covers the services as director. We do not see either of these as technically correct or incorrect. It is just a split and is really a matter of individual preference among boards.

DIVERSITY IN THE BOARDROOM

Diversity in the boardroom is becoming a discussion point (at least) for community banks. Some are discussing it only so they do not appear "tone deaf." Others are discussing it because they really want to add diversity to their boardroom. We were recently with a mid-size community bank that had a typical bank board, particularly for a bank that had been in existence for a long time. It fit in the category of "pale, male, stale, and frail" with the emphasis on "male." The board, to its credit, recognized the problem and sought to add diversity to the board, even if it meant expanding it beyond their original comfort level with respect to number of directors. We will see what comes of it.

HOPING FOR A "GREATER FOOL"

We were recently discussing a troubled credit with one of our long-time bank clients. In this particular situation, the banker we were talking with had inherited what is appropriately described as a troubled loan. This loan has been in workout mode for some time. The workout has been going well enough. But the banker commented that the bank is hoping for a "greater fool" to come take the loan off the bank's hands.

While the comment was made in jest, the thinking and hope behind the comment is real. We went on to discuss with this banker that the rising interest rate environment will not help the bank as it relates to this particular credit. The borrower is already weak as it relates to cash flows. Every increase in interest rates just makes it that much harder for the borrower to perform.

Our bet is that almost every community banker in the country has been in this spot at one time or another. Troubled loan workouts are not easy. Over the past ten years or so, there have been a number of headwinds, but increasing interest rates has not been one of them. That is all changing and it is happening pretty quickly. We anticipate the rising rate environment will increase the number of lenders that are hoping for a "greater fool" to help resolve problem credits.

DEPOSIT COMPETITION

We recently facilitated a strategic planning session for a small community bank. Like many community banks, this particular bank has seen a significant increase in assets over the past couple years. The bank has been awash in deposits, and loan demand has not kept pace. In order to try and obtain yield, the bank invested in bonds and grew its bond portfolio in a pretty meaningful way. Over the last several years, most community banks in this situation would be engaged in a strategy involving a reallocation of assets from cash and securities into loans. The benefit of this strategy is it doesn't require any additional capital but it does boost income.

It is no secret that the increase in rates has not been kind to bond prices. This bank now has a pretty healthy unrealized loss in the bond portfolio. There are numerous other community banks in this situation.

What was interesting in this case is that during the planning session, we talked a lot about deposit generation. Although the bank has a low loan-to-deposit ratio, the general feeling was that the bonds are so far under water the bank cannot afford to pursue a "reallocation of assets strategy" to sell the bonds and recognize what is currently an unrealized loss. The general feeling was that the bonds are essentially trapped until maturity, and that the bank might be well-served by going out and getting additional deposits to increase cash, because if there is a changing of the tide and some of this cash begins to go out of the bank, it could be very painful to have to sell securities over the next couple of years.

We do not know if this is a one-off or might be an emerging trend, but we did see it as an interesting discussion.

CONCLUSION

On June 27th and 28th we will be presenting at an ICBA sponsored in-person Merger & Acquisition Workshop in Music City, Nashville, Tennessee. We look forward to seeing many of you there.

Also, it's a good thing we aren't superstitious by nature (particularly a good thing with *Musings* coming out on Friday, May 13th). We hope everyone stays safe and enjoys the milder weather (without the tornadoes and heavy storms).

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Presentations

- 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

- June 2, 2022 - Independent Community Bankers of America (ICBA) Director Forum – "Director Duties, M&A and Strategic Planning: What All Directors Need to Know" (Philip K. Smith, Presenter) Registration: Director Duties, M&A and Strategic Planning: What All Directors Need to Know
- June 8, 2022 – Financial Education & Development/Community Bankers Webinar Network (Webinar) – "Building a Better Board" (Philip K. Smith, Presenter) Registration: https://financialedinc.com/building-a-better-board
- June 27-28, 2022 – Independent Community Bankers of America Community Bank Mergers & Acquisitions Workshop (In Person) (Philip K. Smith and Greyson E. Tuck, Presenters) Registration: ICBA M&A Workshop

