GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Michigan, Texas, South Carolina, Oklahoma, Kansas, Washington, and Oregon!

THE KANGAROO COURT RETURNS

We have previously made general comments in *Musings* on the regulatory appeals procedure. We have commented specifically on the appeals procedure established by the friendly federal regulator who regulates most of the community banks, the FDIC. During the Great Recession, we handled numerous appeals for community banks across the nation who contested certain supervisory determinations by their friendly federal regulator. Each time back then, in the 2008 through 2012 timeframe, we felt as though our appeals were in front of a kangaroo court because those who were making the final determinations as to whether the bank was correct or the examiner was correct were basically the examiners' supervisors. Recently, under former FDIC Chairwoman, Jelena McWilliams, the FDIC established an independent Office of Supervisory Appeals. We viewed that as a significantly positive move so that banks would actually have some opportunity to get before an independent body (other than an administrative law judge) to appeal a Material Supervisory Determination.

A Material Supervisory Determination, by the way, can be any examination decision related to a number of issues, including CAMELS rating, component rating, appropriateness of loan loss reserve, alleged statutory violation, Matters Requiring Board Attention, decisions to initiate informal enforcement actions (such as a Memorandum of Understanding), IT ratings, Trust ratings, CRA ratings, Consumer compliance ratings, Truth in Lending Act (Reg Z) restitution, and even asset classifications where the amount individually or in the aggregate exceeds 10% of the Bank's total capital.

Since the "coup" at the FDIC a few months back and Chairman McWilliams' resignation, Acting Chairman Martin Gruenberg has been in charge of the Agency. Last week the FDIC under Acting Chairman Gruenberg eliminated the Office of Supervisory Appeals and restored the Supervisory Appeals Review Committee. The kangaroo court has been restored. The Supervisory Appeals Review Committee basically consists of a bunch of insiders at the FDIC. Not a good day for community banking.

BENEFIT CORPORATIONS

We recently had an inquiry from a community banker as to whether *Musings* has addressed whether it made sense for banks to consider becoming "B" Corporations or Public Benefit Corporations. For purposes of definition, a Certified "B" Corporation is a business that has been evaluated and certified by the nonprofit B Lab on five categories: corporate governance, treatment of workers, impact on community, impact on environment, and treatment of customers. Examples of companies that are certified B Corporations include Danone North America, Patagonia, and Ben & Jerry's. The certification process for a B Corp. is fairly extensive through B Labs and not inexpensive.

Public Benefit Corporations (PBCs) are different. Unlike a B Corporation, which is a professional certification with limited legal standing, a PBC is a legal framework similar to a C Corp or an LLC that is available in 34 states. PBCs follow a business strategy of considering the impact of its decisions on all stakeholders, including the public, not just shareholders.

Does this make sense for your community bank? It depends. For years we have been "pounding the table" that the real key to success for community banks is for the directors and senior management to focus on enhancing shareholder value. Enhancing shareholder value is how you keep your bank independent so you can do all the good things, such as being a good corporate citizen, the employer of choice, the economic engine in the community, and the like. If you do not have a bank, you cannot do those things. If you are 100% owned by one group or family and you want to take much more of an environmental, social, and governance stance, then a Certified B Corporation or a Public Benefit Corporation may make sense. If anyone wants any further information on this, please let us know.

CONSENT ORDERS

On the last Friday of every month, the FDIC, which provides supervision over most of the current community banks, issues its list of enforcement actions for the prior month. The Friday before Memorial Day was no exception. The first bank on the list was a bank that agreed to a Consent Order. As we have noted in *Musings* before, it is called a Consent Order because the bank voluntarily agrees to it. This consent order is fairly typical and requires, among other things, increased board oversight, a management study and a management plan for the future, effective strategic planning, management training in a variety of areas, (including credit risk and interest rate risk management), the creation of a profit plan, the creation of a capital plan, restrictions on both dividends and growth in total assets (5% in a six month period), improvements in the bank's lending policy, and many other affirmative actions that the bank is required to complete within various timeframes. Our review of this Order was primarily to determine whether anything was "new." Most of the provisions of the Order are similar to those we saw during the Great Recession for banks undergoing asset quality issues.

We suppose that's the good news. We also know that more Orders will be forthcoming. If you are having regulatory issues or need help with compliance with an Order, a Memorandum of Understanding, or a Written Agreement, let us know.

ACQUISITION OPPORTUNITIES

Several of our recent *Musings* have expressed a sentiment towards a slowdown in community bank M&A activity. We have previously indicated we see this primarily as a result of potential buyers having some sense of caution about the target bank's operations, particularly as it relates to loans and securities. However, just because the number of deals announced has slowed down, that does not mean we are actually seeing a major drawback in interest or opportunities to take a look.

Over the past couple weeks, we have helped numerous different clients evaluate potential acquisition opportunities. These have all come in the form of the potential acquirer's receipt of a Confidential Information Memorandum provided by various investment bankers around the country. So we think it is proper to say the current M&A environment is one where there is still a respectable number of interested buyers and potential sellers. That said, we do believe we will see deal timelines continue to extend out, as the due diligence review will become only that much more important given the various economic uncertainties.

ASSET LIABILITY MANAGEMENT

We recently had an interesting discussion with the education directors of a community bank education program. The question asked of us was what do we see as appropriate educational program offerings in today's environment. Of course there are many, but one of the ones that jumped out at us is asset liability management.

The past 15 years or so have been a relatively stable rate environment. While there have been a couple bounces in rates, none of them have been too severe. The last 60 to 90 days has changed that, and we are now seeing increases in interest rates with an expectation of additional raises. The jump in interest rates is one of the largest over the past 40 or so years.

Putting all of this together, we see asset liability management as extremely important over the next 12 to 24 months. Our expectation is there may be a number of bank presidents and chief executive officers that have never been through a period of this level of volatility. Likewise, there are probably a number of banks around the country that do not have a significant amount of "institutional knowledge" to navigate these issues.

If your bank does not have a strong base of institutional knowledge in terms of asset liability management in a volatile rate environment, we recommend you look outside the bank for external resources to get better educated on this particular function of bank management. The net interest margin is the most significant driver of profitability in the bank, so managing the net interest margin through these interest rate changes will be of critical importance over the next couple years.

COMMON STOCK VALUATION CONCERNS

Many community banks obtain an annual valuation of their holding company common stock for a number of different reasons. Some of these are ESOP valuations, and others are valuations that are completed for what we call informational purposes. The most common approach is to have the stock valued as of December 31st each year. Most community banks then use that valuation throughout the year.

Many community banks that historically have used a December 31 valuation for the upcoming year are now rethinking this issue. This is particularly true if the community bank holding company is thinking about a repurchase of its own shares. The central question most banks are dealing with is whether the value of the shares has materially decreased due to changes in the market and the underlying book value of the bank.

An explanation of the approach on valuation theory is beyond the scope of *Musings*. However, we do see it as appropriate that community banks at least ask themselves the valuation question prior to engaging in a material transaction. We are not saying a change in valuation is an absolute requirement, but we see critically looking at the situation and making a determination on how to proceed to be appropriate given the changes in a number of factors since December 31st.

BOARD FEES

Over the past couple months, we have been in a couple different situations where we have been involved in a special meeting of the holding company or bank board of directors. These have all come in the acquisition context. As the name implies, a special meeting is a meeting that is separate and apart from the normally scheduled, routine board meetings. In each of these meetings, the issue of whether the directors should be separately compensated for their attendance at the meeting came up. In both of the meetings, the directors indicated they were not being separately compensated for attendance at the special meeting. Instead, the prevailing view was that uncompensated attendance at the special meeting was just "part of the deal" of being a director and receiving normal director compensation.

There is no right or wrong answer as it relates to compensation for directors at special board meetings. Some boards separately compensate directors for attendance at a special meeting. Other boards do not. We do not have a strong position one way or the other as it relates to whether payment should be made. Instead, we think the board should discuss it and make a collective, appropriate determination as to any level of payment.

THE NEXT GENERATION OF BANKERS

Several members of our firm, including the three of us, are involved in various ways in the Graduate Schools of Banking around the country. This involvement ranges from teaching, to advising, to being a member of the board of directors and executive committee of the School. We recently had the opportunity to have further involvement with some of the students from one of the graduate schools. We wanted to report through *Musings* that the next generation of bankers appears to be smart, enthusiastic, and ready to take over (immediately). We were pleased to see the level of enthusiasm and the interest with respect to what is going on in the industry. Always a good sign.

MUSIC CITY MERGERS AND ACQUISITIONS

We look forward to seeing many of you at the ICBA sponsored Merger & Acquisition Workshop coming up at the end of the month (June 27-28) in Music City, Nashville, Tennessee. This is a hands-on workshop, ideal for any level - from Chairman of the Board, outside directors, CEO, to CFO. For more information, click on the link: ICBA M&A Workshop

CONCLUSION

We hope each of you had a wonderful Memorial Day weekend and had the opportunity to spend time with friends and family. As we push toward the end of the second quarter of 2022, we look forward to seeing many of you in our travels around the country.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Presentations

- 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