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# GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Ohio, Indiana, California, Washington, Oregon, Texas, New Mexico, and South Carolina!

## FURTHER COMMERCIAL REAL ESTATE GUIDANCE

Last week the friendly federal regulators jointly produced a proposed “Interagency Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts.” This Statement is to provide further guidance to FDIC insured financial institutions. It is also the “canary in the coal mine.” The regulators are strongly clanging the warning bell with respect to asset quality as it relates to commercial real estate. The policy statement provides, among other things: “Challenges that arose during the pandemic remain, including inflation, supply chain imbalances, labor challenges, and vulnerability to rising interest rates. These additional risks could adversely affect the financial condition and repayment capacity of borrowers in a variety of industries.” The policy statement indicates there is stress across basically all commercial real estate types, including hospitality, office, retail, and entertainment.

The policy statement reaffirms the principles from the friendly federal regulators’ 2009 (Great Recession) policy statement that “(1) financial institutions that implement prudent CRE loan workout arrangements after performing a comprehensive review of a borrower’s financial condition will not be subject to criticism for engaging in these efforts, even if these arrangements result in modified loans that have weaknesses that result in adverse credit classification; and (2)

modified loans to borrowers who have the ability to repay their debts according to reasonably established terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the loan balance.”

Although it looks like the friendly federal regulators’ hearts are in the right place, based on history, we have a hard time believing them. If any *Musings* readers would like a copy of the policy statement, please let us know.

### HEIGHTENED REGULATORY SCRUTINY

As we have noted previously in *Musings*, when the friendly federal regulators find asset quality to be good, they move to compliance and other things to pick on. We have been contacted by several community banks recently with respect to the regulators’ focus on compensation issues. The friendly federal regulators do maintain compensation guidelines, which basically indicate that banks cannot pay compensation that either “shocks the conscience” or results in an unsafe or unsound practice (it doesn’t get much more subjective than that). The apparent current focus of the friendly federal regulators involves banks where the matriarch or patriarch may have gone from an extraordinarily active status to a less active status yet continues to receive the same compensation.

Our general argument to the regulators is that the “offending senior” was likely undercompensated during his or her time at the bank, and the continuing compensation is either to make up for that or should be viewed simply as a retirement benefit. Sometimes that carries the day, and sometimes it doesn’t. If the bank is doing extraordinarily well from a financial standpoint, it makes it a little more difficult for the friendly federal regulators to argue about compensation paid. If the bank has issues in other areas, it makes it easier for them. We have generally been successful in either preserving the compensation of the seniors or agreeing to some modest reduction plan over a period of years. The one we had the most difficulty defending was where the matriarch of the bank had been made the “Chaplain” of the holding company and was heavily compensated for that duty. In any event, don’t be surprised if your friendly federal regulators, particularly when asset quality is good and there are no compliance issues to find, look for something else, which may end up being executive compensation.

## SMALL BANK PREMIUM

As we have noted previously in *Musings*, M&A in the community bank arena is still very active. It is extremely active in the small bank area due to the small bank premium. The small bank premium is simply the ability of a buyer (often a non-traditional buyer) to pay a higher price than a traditional buyer (another bank) might pay due to the fact that it is so much easier to get into the insured deposit business through an existing bank than it is through a de novo charter.

Our firms maintain a long list of potential purchasers of community banks. A segment of those potential purchasers involves non-traditional purchasers (i.e., mortgage companies, fintechs, and the like) who are very interested in getting a bank charter so they can have direct access to the payment systems and federal deposit insurance to lower their cost of funds. The alternative for many of these non-traditional buyers is to charter a new bank. Last year there were relatively few new banks chartered. This year will likely be the same. In addition to the approximately one year it takes to charter a new bank and the \$20 million in capital or more, depending on where it will be located, as well as the regulatory scrutiny of the business plan and the principals, chartering a new bank is a daunting task. Acquiring an existing small bank is a lot quicker, easier, and less costly. This results in what we refer to as the “small bank premium.” For purposes of the small bank premium, a small bank is generally considered a bank with less than \$100 million in total assets. We have assisted a number of small banks in selling to non-traditional buyers. Often, these buyers will pay something north of twice book value, where a traditional buyer would be more in the 140% to 150% range. An interesting phenomenon.

## COMMUNITY BANK CEO FOCUS

We read an interesting article the other day in one of the trade publications that indicated some “shock” that community bank CEOs were focused on growing loans. This conclusion was the result of a survey of 100 community bank CEOs of banks as large as \$10 billion. We’re not sure why this was “survey-worthy” since, as most *Musings* readers know, the economic engine to drive profitability for virtually any community bank is the loan portfolio. Growth of the loan portfolio is top of mind and the number one strategic priority for every community bank that we have worked with across the nation over the last year or so. While community banks have a number of options to enhance the value for their shareholders – (i.e., profitability, creating share liquidity, good cash flow, and a decent return on equity through both interest income and non-

interest income) - the bulk of community banks still are focused primarily on quality, profitable growth of the loan portfolio. No surprise there.

### STOCK REPURCHASE TRANSACTIONS

If you are even a casual *Musings* reader, you will know that we are big fans of stock repurchase transactions. Frankly, we believe it is one of the best ways to enhance shareholder value for community bank shareholders. It provides a selling shareholder cash, and it provides those shareholders who do not sell an increased ownership percentage, increased return on equity, increased earnings per share and increased dividends per share (assuming the dividend remains constant and is paid over a fewer number of shares outstanding).

Unfortunately, over the past couple weeks each of the Senate and House have passed major legislation aimed at reducing inflation and addressing climate change that has provisions that will impact stock repurchase transactions. The bill has not yet been signed into law by President Biden, but we expect a ceremonial signing soon.

Simply put, the new bill imposes a 1% tax on certain stock repurchase transactions. There is nuance in the bill, but the general rule is that there is a 1% tax imposed on stock repurchase transactions that in the aggregate exceed \$1 million in a taxable year where the issuer's securities are traded on an "established trading market." The definition of an established trading market is broad and includes the usual suspects, such as the NASDAQ and New York Stock Exchange. It also includes any market where there is a dealer quotation system. This includes the OTCQX and Pink Sheets.

If your community bank holding company stock is not traded or quoted on any established trading market, the new tax will not apply to you. However, if your shares are traded or quoted on any established trading market, as broad as that may be defined, keep the new tax in mind. If your community bank holding company is traded or quoted on an established trading market and repurchases more than \$1 million of your shares in a given tax year, it is very likely you will end up having to pay an additional 1% tax on the dollar amount of shares repurchased.

We have prepared a Memorandum to Clients & Friends on this issue. The bill is not fully signed into law, so there may be some changes. Still, we believe it is a good overview at this point. Please let us know if you would like a copy.

## SHAREHOLDER EDUCATION

We recently had the opportunity to spend a couple hours with the shareholders of what we classify as a very well-run and profitable community bank. This particular bank is a family-owned bank and is not unlike many of the other family-owned banks we have seen around the country. The shares are now predominantly owned by about the third generation removed from the original family member that bought the bank.

There is no member of the family that is in the bank on a day-to-day basis. With this in mind, the President and CEO asked that we assist in presenting what was essentially a shareholder education session. We were brought in as the “outside experts” to talk to the family shareholder group about the bank and how it is performing as a community bank when compared to peer. The meeting lasted a couple hours and will act as a springboard for further discussions among the shareholder group regarding ownership and related strategies.

Overall, we thought the meeting was a great success. The shareholder base was very engaged during the meeting, asking a number of questions about the bank, its performance, management succession, how to keep it going, and the like. The shareholders also remarked that it was helpful to get an outside perspective from our firm. As one of the shareholders put it, it really helped them “appreciate the value of the asset they own.”

Keep this strategy in mind if you find yourself in a similar situation. We really do believe shareholder education is a key to ensuring shareholders want to continue to own the stock, particularly when it has a strong investment value.

## CHANGE IN CONTROL CONCERNS

Our most recent polite disagreement with the Federal Reserve is over the Change in Bank Control Act. We recently filed a Notice of Change in Control for a group acting in concert, which was a group of family members doing some estate planning that added some “new shareholders” to a family group that had previously been approved as control shareholders.

When we filed the application, there was no single member of the family group owning more than 25% of the holding company common stock. However, the group, when acting in concert, controls more than that amount. We filed the appropriate applications, and the Federal Reserve came back with an approval that approved the control group in full. The approval

provided no information about any further approval requirements or limitations on the amount of stock the group or any individual member of the group could own.

Not long after we received the approval, we received an email from the Federal Reserve that, in our view, is not a correct interpretation of the Change in Bank Control Act. The Federal Reserve essentially said that although the family group acting as a concert had been approved in full, if any individual within the control group sought to go above 25% ownership on an individual basis, that would require a prior Notice of Change in Control. We disagree with the Federal Reserve on this stance because we do not see this as a proper interpretation of the actual language of the Change in Bank Control Act. To us, the Federal Reserve is picking and choosing between individual shareholders and groups acting in concert. We raised the issue with the Federal Reserve, and the friendly federal regulator's lawyer indicated that what they had stated was the Federal Reserve's interpretation of the Change in Bank Control Act and that we needed to abide by it.

Keep this issue in mind if you have a control shareholder within your organization that owns less than 25% of the holding company but plans to go above 25% ownership. According to our discussions with the Federal Reserve, the expectation is to file a second Notice of Change in Control notwithstanding the prior approval.

### [SPEAKING OF CHANGE IN CONTROL FILINGS...](#)

Many community bank holding companies appreciate the requirements to file a Notice of Change in Control with the Federal Reserve when a shareholder or group of shareholders acting in concert exceeds 25% ownership of common stock. However, many holding companies may not be aware that most states require a state filing in this instance as well. The banking statutes for most states provide that state approval is required if a shareholder or group of shareholders acting in concert is going to obtain control of a state-chartered bank or a holding company that controls the bank. Unlike the federal Change in Bank Control Act, which presumes control if you are a greater than 10% shareholder and are the largest shareholder, and absolutely finds control at 25% ownership, the state statutes typically only have the 25% threshold. This means in most states a shareholder becomes a control shareholder if they own more than 25% of the shares.

Keep these state issues in mind if you are going through a Change in Control proceeding. You do not want to find yourself in a circumstance where you file the correct application with the

Federal Reserve and later find out you were also supposed to file a simultaneous application with the state.

## CONCLUSION

As we have traveled around the country, particularly in the southern states, we noticed more school buses, indicating school is in session. We anticipate the northern states will follow in a couple of weeks. Be careful. Please watch for the kids and stay safe.

See you in two weeks.

*Jeff Gerrish*

*Philip Smith*

*Greyson Tuck*

## Upcoming Webinars and In -Person Presentations

- August 25-28, 2022 – Southwestern Graduate School of Banking 154<sup>th</sup> Assembly for Bank Directors at The Lodge at Spruce Peak, Stowe, Vermont. Session: “Strategic Planning in a Changed Environment” (Philip K. Smith, Presenter) Registration: [SWGSB Assembly for Bank Directors](#)
- August 31, 2022 – Independent Community Bankers of America Webinar: “Maintaining Organizational Relevancy: Implementing Appropriate Compensation Practices for Community Banks” (Cliston V. “Doc” Bodine, Presenter) Registration: [Compensation Practices](#)
- September 12-13, 2022 – Independent Community Bankers of America 2022 LEAD FWD Summit in Fort Worth, Texas. Session: A Look to the Future: “Community Banking in 2042” (Greyson E. Tuck, Presenter) Registration: [ICBA Lead Fwd](#)
- September 14-16, 2022 - Community Bankers of Washington 2022 Membership Convention & Trade Show at Tulalip Resort in Marysville, Washington. Session: “Building a Better Board” and “Community Banking: A Bright New Outlook for an Old Industry” (Philip K. Smith, Presenter) Registration: [CBW Convention](#)
- September 22-24, 2022 – Pennsylvania Association of Community Bankers 2022 Convention at Disney’s Grand Floridian Resort & Spa in Lake Buena Vista, Florida. Session: “Practical Advice for Community Bank Directors and Trustees” (Greyson E. Tuck, Presenter) Registration: [PACB Convention](#)
- September 29-October 1, 2022 – Community Bankers Association of Illinois 48<sup>th</sup> Annual Convention and Exposition at the Marriott St. Louis Grand in St. Louis, Missouri. Session: “Want to Remain Independent? You Must Be Relevant!” (Philip K. Smith, Presenter) Registration: [CBAI Convention](#)

- October 18, 2022 – Independent Community Bankers of America Webinar: “Maintaining Organizational Relevancy: Key Insurance Issues for Community Banks” (Cliston V. “Doc” Bodine, Presenter) Registration: [Key Insurance Issues](#)
- October 25, 2022 – North Carolina Bankers Association 2022 Young Bankers Conference at The Beaufort Hotel in Beaufort, North Carolina. Session: “A Look to the Future: The Financial Services Industry in 2042” (Greyson E. Tuck, Presenter) Registration: [NCBA Young Bankers Conference](#)