GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Arizona, Utah, Washington, California, Texas, Pennsylvania, Ohio, and Florida!

CRYPTO COMPANIES AND FDIC INSURED BANKS

As many of you know, the federal regulators (all of them – not just the bank regulators) are currently debating which entity should regulate what part of cryptocurrencies and crypto companies. Today the FDIC came out with a publication that includes a fact sheet on FDIC insurance and crypto companies and an advisory to financial institutions regarding deposit insurance and dealing with crypto companies. These are hot off the presses today (July 29th). If any *Musings* readers would like a copy, please let us know.

M&A IS NOT DEAD

Over the past four months or so, we have talked about the slowdown in community bank mergers and acquisitions activity. We have read a number of articles in our daily reading that reflect the same. While we are seeing a decrease in activity, do not confuse a decrease with death. We can report that the community bank M&A environment is not completely dead. It is just different.

We have had a number of different clients reach out to us over the past couple weeks to discuss and request our assistance in pursuing potential M&A transactions. We have also signed up a couple new deals. This activity reflects and supports our argument that M&A is not dead. The environment is simply different. We are not seeing as many public bidding processes that result in multiple Indications of Interest. Instead, the deals today seem to reflect smaller marketing processes or one-off negotiations that are taking a little bit longer to bring together.

M&A: IMPACT OF UNREALIZED LOSS IN THE BOND PORTFOLIO

As a result of the previous *Musings* where we addressed the issue of the current environment for most community banks (which involves a significant unrealized loss in their bond portfolio), we received a number of emails from *Musings* readers regarding the impact of this current environment on mergers and acquisitions. The general question was will community bank mergers and acquisitions cease due to the unrealized loss in the bond portfolio?

As noted above, we believe M&A will continue for community banks, both buyers and sellers, notwithstanding the required accounting treatment that all assets and liabilities of the target must be recorded on the books of the buyer at fair value as of the date of acquisition (including the bond portfolio, of course). Mergers and acquisitions will continue because the buyers and sellers will determine where the risk ultimately falls. Does the buyer take the complete risk of the current unrealized loss in the bond portfolio because of the knowledge that it will eventually get paid out on the bonds if held to maturity? Alternatively, does the buyer take the risk because its capital account is so enormous that the loss in the target's bond portfolio is immaterial? Does the unrealized loss in the bond portfolio fall on the seller as a ding on the purchase price? Is there some combined loss/risk sharing between the parties that gets the deal done? As with most things, risk allocation is negotiable. We don't believe unrealized losses in the bond portfolio will bring M&A to a screeching halt, it just creates an additional risk factor that must be assessed and negotiated.

THE TRICKLE DOWN EFFECT

We have regularly complained over the last 20 years in *Musings* about the fact that regulatory enforcement actions by your friendly federal regulators are reserved primarily for community banks, or certainly not the largest banks. Since the last recession, the friendly federal regulators have become not as friendly toward the largest banks. Many of those banks (Wells Fargo is a good example) have been operating under cease and desist orders and receiving civil money penalties, and have generally been targeted with a variety of other enforcement actions. We are not sure whether it was banker pressure, trade association pressure, or the competition between the friendly federal banking regulators and the Consumer Financial Protection Bureau that has begun the move to hold accountable some of the largest offenders.

As we know, what happens to the largest banks typically trickles down to the community banks. This trickledown effect occurs whether it is ESG concerns, climate change concerns, or even enforcement action concerns. As we have noted in *Musings* previously, we believe we will see many more enforcement actions at the community bank level, particularly in the compliance area. These will continue until safety and soundness softens (if it does), at which point these enforcement actions will move over to complaints about earnings, capital, management, and the other CAMELS components. We suggest that boards take a wait-and-see attitude but also fully understand their rights in connection with a proposed enforcement action from the regulators, whether it be a Board Resolution, Memorandum of Understanding, Formal Agreement, or the opportunity to consent to a Cease and Desist Order.

REGULATORY ENFORCEMENT ACTIONS PART II

Over the past year or so we have mused several different times (including the article above) about an anticipated increase in regulatory enforcement actions. We have previously seen various signs and warnings that have led us to believe that more formal and informal regulatory enforcement actions were on the way. We think we are now at a point where we are ready to say that we are at "the beginning" of a new period of increased formal and informal regulatory enforcement actions. We say this because over the past month or so we have assisted a number of different clients in reviewing and considering informal or formal regulatory enforcement actions.

We anticipate this new wave of regulatory enforcement actions will be just a little bit different than the last wave, which really began around 2008 and lasted for three to five years. In that last wave, asset quality was a major issue as a result of the Great Recession. The new wave of regulatory enforcement actions is a bit different. While there is certainly an essence of asset quality in a number of the documents we are seeing, the new wave of regulatory enforcement actions seems to be more compliance centric. There are elements of BSA/AML and fair lending, as well as IT and cybersecurity items.

Keep these issues in mind as you prepare for your next examination. We hope you are able to avoid any type of these regulatory enforcement actions. If that does not turn out to be the case, be sure you understand the regulatory process as it relates to the action and your rights. This remains the United States of America where due process is required, so the regulators cannot force your bank to do anything without your board's consent or an opportunity for a hearing.

TERMINATION OF REGULATORY ENFORCEMENT ACTIONS

The FDIC (which regulates most of the community banks) recently amended its rules and updated its guidance related to the termination of regulatory enforcement actions, including the conditions under which the FDIC would terminate formal regulatory enforcement actions. In summary, these orders can be terminated when any of the following conditions are met:

- The Insured Depository Institution (IDI) is in full compliance with all of the provisions of the order and has fully corrected the violations of laws and regulations, unsafe and unsound practices, or conditions that led to the issuance of the order;
- Any provisions deemed "not in compliance" have become outdated or irrelevant to the IDI's current circumstances, including situations in which the IDI closed; or
- Deterioration of any provisions deemed "not in compliance" leads to issuance of a new or revised formal action.

In addition, there is an exception where one regulatory enforcement action can be replaced with a less severe or less comprehensive action instead of termination. The guidance indicates that this exception is expected to be used very rarely.

In order to terminate a regulatory enforcement action, the FDIC requires the Regional Office to document the justification for terminating the order. Frankly, these rules are not all that different than the old rules, but they comprise the FDIC's updated guidance on the issue. If any *Musings* readers would like a copy of this document, please let us know and we will forward it on.

STRATEGIC PLANNING

As most *Musings* readers know, members of our consulting and law firms facilitate dozens and dozens of strategic planning sessions each year for community banks. We are always delighted to assist a bank in determining "what it wants to do with its life" for the future. We have always considered our strategic planning sessions "action planning" because we stay away from the traditional format (i.e., "box") that most strategic planners use. Our goal has always been to identify the issues, address the issues at a high level, and have the board or ownership, depending on the bank, set the direction for the organization. Management then provides the operational and tactical plans. In other words, the board determines where the organization should go, and management determines how best to get there, subject to board oversight.

We often get asked who should attend the strategic planning session. In a very closely-held bank, especially one that is family-controlled, a session needs to be had with the family to determine issues that only family can determine, such as independence, sale of shares, redemption of shares, appetite for debt at the holding company, and the like. At the bank level, certainly the board of directors should be involved, as well as senior management. We often get questions about how "deep" in the senior management ranks should the community bank draw for attendees at the strategic planning session. Our general, succinct, and clear-cut answer is "it depends." It depends somewhat on the politics of the organization, and it depends somewhat on how deep you want the original "buy-in" to the strategic plan to be. If middle management, for example, is allowed to participate in the planning and feels like they have a voice in creating the plan, then the buy-in, theoretically, should be better because of that. How deep you go in the organizational chart varies with each bank, but it is a consideration on the front end with respect to planning.

ESG AND DEI

Environmental, Social, and Governance (ESG) and Diversity, Equity, and Inclusion (DEI) are certainly relatively hot topics these days, even in the community bank space. The larger banks are wrestling with these issues as well, due primarily to their activist or institutional shareholders who are holding them accountable for their activities in this area. What is a community bank to do with respect to ESG and DEI? The answer is "the best you can." Those of you who have been *Musings* readers for a long time know that our firm has consistently taken the position that the community bank's primary purpose is to enhance the value for its shareholders so the community bank can serve its community and other constituents, including employees and customers. If the community bank does not enhance shareholder value such that the shareholders want to continue to hold its stock, then there may not be a community bank to engage in ESG and DEI issues.

Thus far, there have been no regulatory mandates, at least as it relates to community banks, on ESG and DEI. We anticipate politics will drive whether or not ESG and DEI become more or less important from a regulatory standpoint. We will keep an eye on it. Right now, our advice is for community bank boards to at least be aware of the issues but not feel the pressure to immediately change their strategies and approach in either of these areas.

MANAGEMENT SUCCESSION

In our view, appropriately planning for management succession is one of the most difficult tasks for a community bank Board of Directors. We see succession planning as difficult because there are so many different variables and unknowns that have to be addressed. We have recently been working with a community bank that has been struggling with management succession for a number of years. This is a smaller community bank in a rural location where attracting new talent to come into the community is near impossible. Of course, the regulators have been harping on this bank for multiple years that they need to make a hire to bring into the bank an individual to replace a retiring President and CEO. The answer to the regulators that we have wanted to give a number of times, but which we have not actually given, is that it is "easier said than done."

The bank recently was successful in hiring an individual that is intended to take over as President and CEO in the next three or so years. They did so by utilizing an appropriate mix of existing relationships, talent attraction and retention techniques, and a little bit of luck. This is often the formula for finding bank succession in these types of situations.

Management succession is hard. That is particularly true for those smaller community banks located in rural areas that have difficulty attracting new talent to move into a region. If you find yourself in that situation, maintain perseverance on the hunt. Most of the time it eventually pays off.

THE COMMUNITY BANKING BOARD CHAIR FORUM – IT'S NOT TOO EARLY

As many of you know, Gerrish Smith Tuck facilitates and the Barret School of Banking sponsors the Community Banking Board Chair Forum. This is an in-person forum designed for community bank Board Chairpersons, Vice Chairs, Directors, and Chief Executive Officers. This meeting is a "forum," not a lecture or seminar type event. It is primarily discussion facilitated by the three of us. The Forum will be held January 9-10, 2023 in person at the Ritz-Carlton in Naples, Florida. If you would like to register for the Forum, please follow the link: Community Banking Board Chair Forum 2023. It's never too early to register.

CONCLUSION

It's hard to believe we are already opening the door to August 2022. We are proud that our community bank client base continues to meet the challenges they face in their individual markets. The kids will be going back to school soon. Enjoy the rest of the summer.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Presentations

- 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